



## ERGO

*Analysing developments impacting business*

### SEBI'S NEW EQUITY-BASED BENEFIT AND SWEAT EQUITY REGIME: AN OVERVIEW

23 August 2021 Through its notification published in the Official Gazette on 13 August 2021, the Securities and Exchange Board of India (SEBI) has brought into effect (immediately from 13 August 2021) the SEBI (Share Based Employee Benefits and Sweat Equity) Regulations, 2021 (2021 Regulations). The 2021 Regulations have replaced the SEBI (Issue of Sweat Equity) Regulations, 2002 (Sweat Equity Regulations) and the SEBI (Share Based Employee Benefits) Regulations, 2014 (SBEB Regulations), and the new regime will assume relevance even for existing share-based benefit schemes. In this ERGO, we navigate through the key changes brought about by the 2021 Regulations.

#### Share-based benefits

1. Share-based benefit schemes for employees engaged exclusively: The SBEB Regulations applied to all permanent employees of a company (or of holding company / subsidiary of such company) working in or outside India. This led to the inference that even employees in dual employment could partake in the share-based benefit scheme(s) of either of their employers. However, the 2021 Regulations provide that the schemes would apply to employees who are *exclusively* working for a company (or *exclusively* working for a group company of such company).
2. Definition of "employee": There are two significant changes to the definition of "employee". *First*, unlike the SBEB Regulations which provided that the permanent employees of a holding company or a subsidiary company could participate in the equity-based scheme(s) of a listed company, the 2021 Regulations have expanded the scope to provide that the employees (permanent or non-permanent) exclusively working with a *group company* or an *associate company* of a listed company would also be eligible to participate in such scheme(s). The omission of the term "permanent" also makes it clearer that a fixed-term employee may be eligible to participate in the schemes of a listed company.  
  
*Second*, while the 2021 Regulations reiterate that independent directors will not be eligible to participate under the equity-based benefit schemes, they also clarify that non-executive directors would be eligible to participate in such schemes.
3. Switching between modes of administration: In its report dated 18 June 2021 (SEBI Report), SEBI had noted that there may be practical issues in the implementation / administration of a scheme through a trust and, therefore, companies should have the flexibility to switch to a different mode of administration of a scheme. Consistent with this view, the 2021 Regulations provide that if the prevailing circumstances so warrant, the company may switch to a different mode of administration of the scheme from the current arrangement provided (a) a fresh approval of the shareholders by way of a

special resolution is obtained, and (b) the change in the mode of administration is not to the detriment of employees' interests.

4. Off-market share transfer by fund to facilitate payment of exercise price: Under the SBEB Regulations, a trust set up for administration of a scheme was permitted to undertake an off-market transfer of shares in its pool for limited purposes, including facilitating a 'cashless exercise of options' by an employee. The words 'cashless exercise' did cause some confusion in the absence of a definition, which was taken note of by SEBI in the SEBI Report. Accordingly, these words have been substituted under 2021 Regulations. It has been clarified that a trust would be permitted to undertake an off-market transfer of shares to enable an employee to make payment towards (a) the exercise price, (b) his / her tax obligations pursuant to exercise of options, and / or (c) any related expenses.
5. Treatment of options in case of transfer of employees pursuant to a scheme of arrangement / amalgamation / merger / demerger: The SBEB Regulations were silent on the aspect of treatment of options in case of transfer of an employee pursuant to a scheme of arrangement / amalgamation / merger / demerger. This would often lead of uncertainty around how a certain plan of action agreed upon between the entities involved in the relevant transaction as regards outstanding options would be looked at by SEBI. The 2021 Regulations provide that, in such cases, the treatment of options shall be specified in the scheme of arrangement, amalgamation, merger or demerger, though such treatment cannot be to the detriment to concerned employees' interests.
6. Minimum vesting in case of death of an employee or permanent incapacity: Through a circular dated 15 June 2021, SEBI had announced "relief" to the families of the deceased employees (who were employed with listed companies) under the SBEB Regulations, providing that the provision under the SBEB Regulations pertaining to the minimum vesting period of one year will not be applicable in case of death of an employee (for any reason). Accordingly, the employee stock options or the stock appreciation rights granted to such employees will vest on the date of their death irrespective of the options or the rights meeting the minimum vesting criterion or timeframe. This "relief", made available to the employees whose death occurred on or after 1 April 2020, caused confusion among listed companies who had always proceeded with the understanding that the SBEB Regulations already provided for such facility to the deceased employee by virtue of the expression 'all the options, SAR or any other benefit granted to him under a scheme till such date shall vest in the legal heirs or nominees of the deceased employee'.

The 2021 Regulations attempt to resolve this ambiguity by expressly clarifying that in the event of death or permanent incapacity of an employee, the minimum vesting period of one year shall not be applicable and, therefore, the options granted to the concerned employee would vest on the date of such death or permanent incapacity.

7. Treatment of excess monies or shares in case of winding up of a scheme: The SBEB Regulations allow for use of excess monies or shares available with the trust in the event of winding up of a scheme for two purposes viz. repayment of loan, and distribution among employees. The 2021 Regulations have provided another option and allowed the use of excess monies or shares for the purpose of another scheme framed under the said regulations, subject to the approval of the shareholders through an ordinary resolution.
8. Timeline for appropriation of inventory: Another welcome change that has been brought about by SEBI under the 2021 Regulations is increase in the time limit for appropriating inventory. Under the SBEB Regulations, if a company implemented an employee stock option scheme or a stock appreciation rights scheme which involved purchasing shares from the market via trust, the purchase had to be backed by grants before the expiry of the financial year subsequent to the year of purchase. This limit has now been increased from 1 financial year to 2 financial years. This gives sufficient

time to the company to identify employees to whom grant can be made while making purchase of the shares of the company (via the trust) at an opportune time.

## Sweat equity shares

1. Definition of "employee": Similar to the change brought about in respect of equity-based benefit schemes (as discussed above), the 2021 Regulations omit the term "permanent" from the definition of "employee" as used in the chapter relating to sweat equity shares.
2. Limit on issue of sweat equity shares: In the SEBI Report, SEBI noted that the Sweat Equity Regulations did not prescribe the maximum limit of sweat equity shares that may be issued by a company. Accordingly, basis the recommendations in the SEBI Report, the 2021 Regulations provide that a company shall not issue sweat equity shares for more than 15% of the existing paid-up equity share capital in a year and more than 25% at any time. These limits are largely in line with the caps that exist in case of unlisted companies under the Companies (Share Capital and Debentures) Rules, 2014.
3. Alignment with other SEBI regulations as regards pricing and lock-in: The Sweat Equity Regulations provide that the price of sweat equity shares shall be at least the higher of (a) average of the weekly high and low of the closing prices of the related equity shares during the last six months, and (b) the said average when taken for the two weeks preceding the relevant date. Further, the erstwhile regulations prescribe the lock-in period of sweat equity shares as three years from the date of allotment. The new regime links the pricing and the lock-in period of sweat equity shares with the pricing requirements (applicable to persons other than qualified institutional buyers) and the lock-in period provided in case of preferential issue of shares under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018, as amended from time to time.

## Comment

While the 2021 Regulations do not substantially alter the legal regime that has prevailed thus far, the clarifications brought about by SEBI therein in relation to the eligibility of a non-executive director for coverage under an equity-based benefit scheme, the treatment of options upon transfer of employees in the event of certain corporate transactions, or the minimum vesting period in case of death of an employee are certainly helpful. However, the expression "employee as designated by the company" in the definition of "employee" may cause confusion, more so when one refers to the SEBI Report. In the said report, SEBI had highlighted that "a listed company should be given the flexibility to determine the persons that are to be categorized as 'employees'". Perhaps, SEBI could have clarified that any person who is employed for salary or wages in connection with the work of an establishment and on whose work the listed company has supervision and control would be considered as "employee". The labour laws have their share of jurisprudence determining the tenets of employer-employee relationship which, when supplemented by a clearer view of SEBI, could have helped determine the status of such individuals who shall qualify as employees to receive the benefits under an equity-based benefit scheme.

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