Equity Compensation
Looking Beyond Legality

ESOPs can emerge as vital compensation tool to attract and retain talent if design of the program is aligned to company's need and the plan is communicated well to employees

BY **HARSHU GHATE**

Equity based compensation, popularly known in India as ESOPs, gets talked about quite often – in the Board meetings, management huddles and also sometimes in HR conferences. Most of the times, these discussions hover around the legal aspects, the tax impact and off late also the accounting charge. Invariably, all the interactions that one hears on this subject include everything but the 'compensation' angle of ESOPs. This instrument is still perceived as a legal and financial instrument, which is very complicated to understand given its own jargon and terminology. Unfortunately, many HR professionals also have the same view. This instrument needs to be looked at as a potent compensation tool to attract and retain talent.

QUICK VIEW

- Discussions on ESOPs needs to go from taxation and legal aspects to the power of attraction and retention of talent
- The success of an ESOP plan is largely dependent on how well the plan is communicated and administrated
- ESOPs should be as part of the total rewards strategy and HR should play an instrumental role in design, communication and administration of the plan

For ESOPs to be "sold" to employees as a part of compensation, it is critical that the entire Plan is designed, communicated and administered like any other component of compensation. It is very common to see the HR function getting involved in ESOPs only till the Plan is designed and rolled out to employees. The baton then is usually handed over to either Finance or Legal team. There is very little effort invested in communication and administration of the Plan. Interestingly, the success or otherwise of an ESOP plan is largely dependent on how well the Plan is understood by the employees (communication) and whether the process for them to encash their value is streamlined and hassle free (administration). If at the time of granting of Options, employees are only told about the enormous value of what they are getting but later they encounter difficulties in realizing their gains, the entire HR exercise of implementing ESOPs would actually boomerang, as it does in many cases.

Customized design

Even while designing a Plan, the tendency is to follow a publicized success story, without factoring in the specific needs of a sector or the company. Some companies follow the industry leader often ignoring that it is much larger and well established as compared to you. It would greatly benefit if you were to design an option which is specific to your needs and profile of the employees you plan to cover. Many are not aware that it is possible (and perfectly legal) to design different option structures for employees of different levels. For instance, one

ESOPs are still perceived as a legal and financial instrument, which is very complicated to understand given its own jargon and terminology. **ESOPs need to be looked at as a potent compensation tool to attract and retain talent**

can have options for senior management at the market price with performance based vesting, whereas for the middle and junior management they could be at discount with time based vesting. ESOPs structured with performance based vesting are essentially another form of variable pay whereas with time based vesting they are essentially deferred pay.

Effective communication

The companies usually go overboard while communicating the attractiveness of ESOPs. While ESOPs do provide a significant upside potential, there are situations and periods when ESOPs may not look that attractive. Even though usually such periods (falling stock markets for instance or a bad business year) are a passing phase, it is important for the employees to know about them. The tendency of the employees to perceive ESOPs as a pendulum (swinging with the stock markets) needs to be rectified by emphasizing the long term nature of the instrument. Many of us would have experienced that the same options which were underwater not more than a year and half ago are now worth a fortune. Given a normal option life of five to six years, this was a small period of aberration. The heartburn that the employees felt during those days could have been avoided if the long term element of this compensation was adequately communicated.

Communication is an on-going exercise. As a part of the HR function, one would have enough opportunities and occasions to interact with employees. It could be Town halls, one on ones, open house forums, et al. ESOPs, their valuations, information on business performance, recent changes in regulations and their impact, et al, should form part of the agenda at such events. Such communication is all the more critical when the going is not good and option values are sliding down. Unlisted companies have a different challenge of communicating the value and appreciation when there are no market quotes. Involvement of HR is extremely critical during the entire Plan period.

While talking about communication, an important side issue that is worth a discussion is whether ESOPs are only about compensation. Do we grant ESOPs just to reward employees? One of the top three stated objectives of ESOPs is to encourage employee ownership. Does this objective go beyond compensation? When we say 'employee ownership', we are talking about employees as owners. It means that employees have to think like owners would in a given business or economic situation. They have to take similar risks like an owner would and take a bad year or a failed business decision in a stride and move on with optimism and positive frame of mind. This is easier said than done. A well thought of and structured communication program is essential to bring about this change in the employees' mindset and cultivate their behavior.

Last mile process hiccups

Coming back, if ESOPs are to be accepted as a potent compensation tool by the employees, it is crucial to streamline the process for them to encash their value. At the end of the day, it is the cash in hand that the employees will be checking. If the process to get the cash is fraught with delays and market uncertainties, it will drive the employees away. The challenges here


Harshu Ghate

The tendency of the employees to perceive ESOPs as a pendulum needs to be rectified by emphasizing the long term nature of the instrument

are different for listed and unlisted companies. In case of listed companies, the challenge is not about the visibility of the value but about its realization. Most of us believe that if the company's shares are quoted, the realization of the gains is not a big issue. However, that's not true thanks to some of the regulations and procedures. Let us take the following example:

Options granted – 10000	Rs	Options exercised – 10000	Rs
Exercise price	100	Exercise price payable	10,00,000
Market price on date of exercise (1st December)	150	Perquisite tax payable (30% of the appreciation (150-100) for 10000 options	1,50,000
Market price on the date of allotment (15th December)	140	Total funds required by the employee to exercise	11,50,000
Market price on listing of shares (23rd December)	130	Perceived gross realization (based on market price on date of exercise)	15,00,000
Market price on the date of sale of shares (26th December)	110	Possible gross realization (best case – market price on date of listing of shares)	13,00,000
Date of receipt of cash (29th December)		Actual gross realization (based on market price on date of sale of shares)	11,00,000

Every listed company is required to list the ESOP shares separately as and when they are allotted. The shares so allotted to employees can be traded in the market only after listing. The employee needs to be communicated about the date of listing so that he can trade. So we are talking about four relevant dates – date of exercise, date of allotment, date of listing and finally the date on which he/she can trade (after listing is communicated to him/her). In the example given above, the time lag between the date of exercise and date of receipt of cash is close to one month. One irritant here is the shere time lag but the other and more important one is the market risk, which the employee takes during this period. Given the price movements in this example, the employee hoped to pocket Rs. 3,50,000 post tax when he chose to exercise. In reality though, he is out of pocket by Rs. 50,000 by the time he could sell the shares. After all the hard work that one does in communicating and educating the employee and generating the enthusiasm, it would be very frustrating if the employee were to shell out cash instead of earning a bounty. Very often, HR teams express helplessness citing the legal process and time lags. Usually the buck is passed to the Finance or Legal teams who handle the allotment and listing process.

Both the bottlenecks, time lag and market uncertainty, can be addressed completely if the company were to follow the practices followed globally, namely cashless exercise and same day sale. Use of technology to facilitate on-line exercises and payments, email alerts and pop ups will help in reducing time lags. It is also important to allot ESOP shares more frequently than the usual monthly or quarterly schedules.

Trust route can be very effectively used to ensure availability of listed shares on the day when employees exercise. It is possible to bring down this time lag to less than three days. This will lead to minimal market risk.

In case of unlisted companies, the challenge is visibility of the share price. But the bigger challenge is how to provide liquidity to the employees. It is important to spell out the alternative options the company would explore to ensure liquidity of the shares. Some of the common choices used are buying by the investors or promoters. Rarely, buy back commitment from the company is provided. In case of broad based coverage of employees, a regulated internal market place should also be explored.

As the process owner, HR is the key stakeholder in making ESOPs successful. If ESOPs are to be accepted enthusiastically by the employees as the sought-after compensation, it will have to be ensured that the entire experience of owning an ESOP is as enjoyable and rewarding as the cash it generates. HR managers should ensure that ESOPs are not looked as a legal instrument with complexities but a user-friendly and attractive component of compensation. pm

Harshu Ghate is Co-Founder & Managing Director, ESOP Direct