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CLIENT UPDATE

Employee Stock Options - Recent legal developments in Pakistan.

As a result of recent amendments in the company law, startup companies are also allowed to offer stock options to their employees. It is expected that after the procedure and the conditions for the issuance of employee stock options are prescribed, an increasing number of startup companies will offer stock options to their employees.

Introduction

Employee Stock Options (“ESO”) are a type of equity compensation that a company can grant to its employees. Rather than directly allotting the shares to the employees, the company gives them a right or an option (but not an obligation) to acquire a specific number of shares of the company at a specified price and during a specific period.

ESOs are a popular method used by companies to attract and retain top talent. An ESO plan helps motivate employees and increases productivity. By making them equity owners of the company, an ESO aligns the employees’ incentives with the long-term goals of the company.

ESOs can be very effective for startup companies. An ESO allows a startup company to hire talent without putting too much pressure on its tight operating budget and limited cashflows, and scarce resources during its early days. Typically, an ESO vests over several years



and pays off only in a liquidity event or exit. It creates a strong incentive for the employees to stay longer with the company and pushes them to contribute to the long-term success of the company. Hence, while investing in a startup company, a sophisticated investor would almost always require an ESO to be offered to the employees.

ESOs can be structured in several ways depending on the strategic considerations of the company and the goal it desires to achieve through it. Typically, the terms and conditions of an ESO are stated in an ESO plan or scheme document approved by the shareholders and the directors of the company. An ESO must comply with the constitutional documents of the company and the applicable regulations.

Regulation of ESOs in Pakistan

In Pakistan, the issuance of ESOs is regulated under the company law, the Companies Act, 2017 (“**CA 2017**”).

Until recently, only public companies were allowed under the CA 2017 to offer ESOs to their employees. In this regard, the proviso to section 83 of the CA 2017 stated that “... *a public company may reserve a certain percentage of further issue for its employees under ‘Employees Stock Option Scheme’ to be approved by the [Securities and Exchange Commission of Pakistan] in accordance with the*

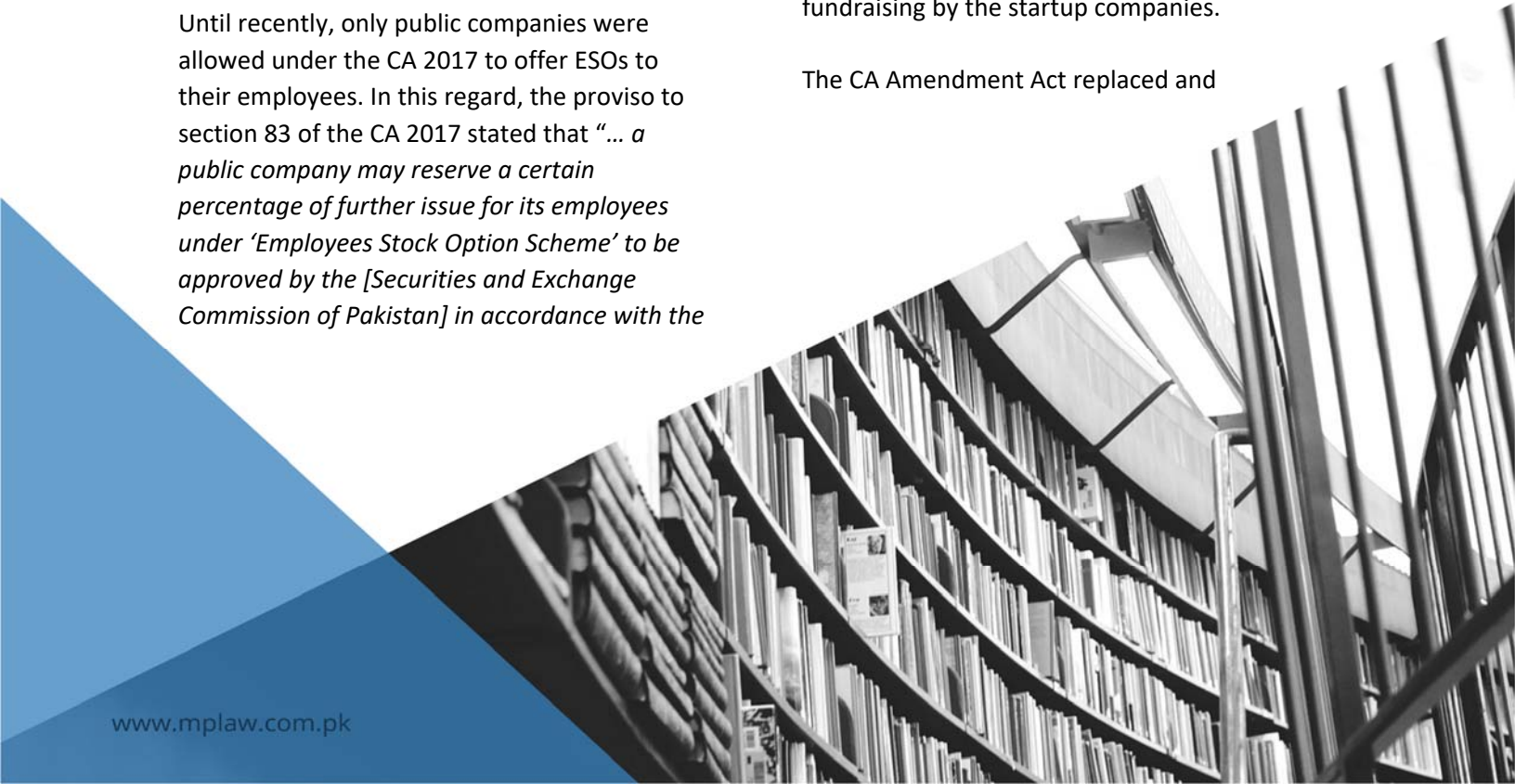
procedure and on such conditions as may be specified”.

The procedure and the conditions for ESOs were laid down in chapter IV of the Companies (Further Issue of Shares) Regulations, 2020 (“**CFIS Regulations**”), issued by the Securities and Exchange Commission of Pakistan (“**SECP**”).

Previously, the CA 2017 did not allow private companies (including startup companies) to issue ESOs to their employees. A private company could offer its shares (not an option) to its employees, but only after offering such shares first to its existing shareholders by way of a rights issue and their refusal to subscribe for the same. However, this structure does not offer the benefits of an ESO plan.

In December last year, the Parliament enacted the Companies (Amendment) Act, 2021 (“**CA Amendment Act**”), and introduced several amendments in the CA 2017, inter alia, to facilitate the startup ecosystem in Pakistan and to create an enabling environment for fundraising by the startup companies.

The CA Amendment Act replaced and



substituted the proviso to section 83 of the CA 2017 (discussed above) with a brand-new provision, i.e., section 83A of the CA 2017, that allows all companies (including the private companies) to offer ESOs to their employees following the procedure and conditions to be specified by the SECP. The new provision reads as under:

“83A. Employees’ stock options. — Notwithstanding anything contained in section 83 or any other provision of this Act, a company may, under the authority of special resolution, issue shares in accordance with its articles under employees’ stock option in accordance with such procedure and subject to such conditions as may be specified.”

Unlike the proviso to section 83, the newly added section 83A of the CA 2017 does not require the company to obtain the SECP’s approval before offering an ESO to the employees. Section 83A only requires the company to comply with the procedures and conditions to be specified by the SECP.

Procedure for offering ESOs by public companies

As stated above, the procedure for issuance of an ESO by a public company is laid down in chapter IV of the CFIS Regulations. Following are some important conditions for the issuance of an ESO by a public company:

- The company must be expressly authorized under its Articles of Association to offer an ESO.
- The board’s decision to offer an ESO must contain all relevant information including the quantum of the shares to be issued under the ESO and the issue price.
- The ESO plan must be approved by the shareholders of the company.
- The shares shall not be issued at discount to the face value without the required approvals.
- The ESO scheme or plan shall be administered and supervised by the compensation committee.
- The vesting period under the ESO must be at least one year.
- The lock-in period of the shares issued under the ESO shall be as determined by the company.
- A lapsed option can be offered to other eligible employees within a specified period.
- An option under the ESO shall not be pledged, hypothecated, or alienated by the employee.
- The company shall not amend or modify an ESO plan or scheme to prejudice the option holders.



As highlighted above, the newly added section 83A of the CA 2017 has taken away the requirement of the SECP's approval for a company to offer an ESO to the employees. However, the CFIS Regulations still require the company to state that the ESO is subject to the SECP's approval. It is expected that the SECP will remove this anomaly in due course.

Procedure for offering ESOs by private companies

Section 83A of CA 2017 now allows a private company to offer an ESO to its employees. However, an ESO must be offered *"in accordance with such procedure and subject to such conditions as may be specified [by the SECP]."*

The procedure and the conditions for offering ESOs prescribed by the SECP in the CFIS Regulations apply to public companies. So far, the SECP has not prescribed the procedure and the conditions for offering ESOs by private companies. Therefore, at present, private companies may not make recourse to section 83A of the CA 2017 for offering ESOs to their employees.

In July 2022, the SECP issued the draft Companies Regulations, 2022 ("Proposed CR 2022"), for public consultation. Regulation 113 in Chapter VIII of the Proposed CR 2022 prescribes the procedure and the conditions for

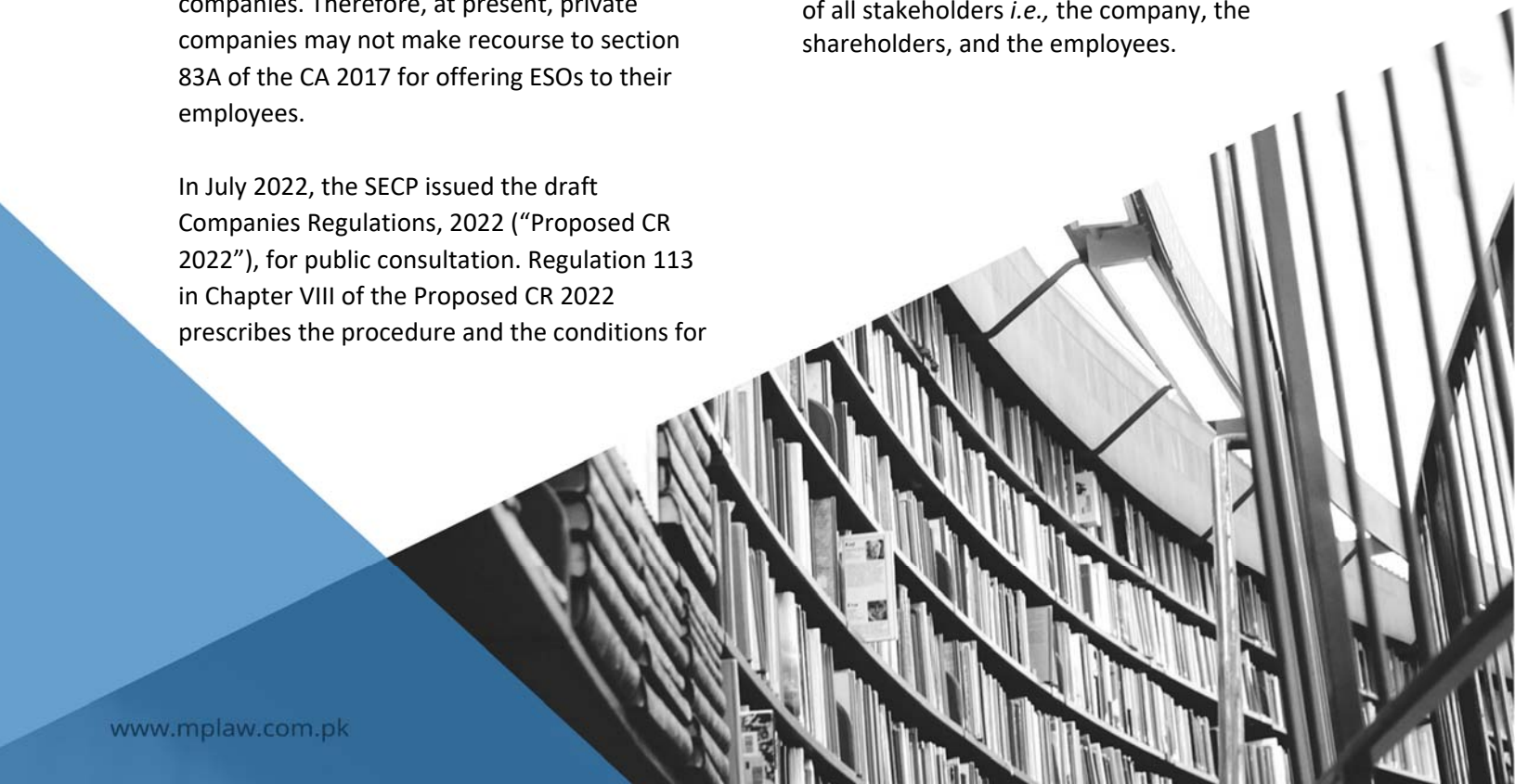
offering ESOs by companies, both public and private. These conditions are almost the same as those laid down in the CFIS Regulations for public companies.

Therefore, it can be expected that private companies will soon be allowed to offer ESOs to their employees subject to similar conditions as laid down in the CFIS Regulations for offering ESOs by public companies to their employees.

Concluding remarks

The recent legal developments are welcoming which will streamline the process of offering ESOs by private companies. It is expected that after the implementation of the Proposed CR 2022, an increasing number of startup companies will offer ESOs to their employees.

ESOs are powerful incentives that, when structured properly, can maximize shareholder value. However, an ESO plan or scheme should be properly structured to reconcile the interests of all stakeholders *i.e.*, the company, the shareholders, and the employees.



An ESIO should be capable to align the interests of employees with those of shareholders. An ESO should be fair in that it should recognize the relative contributions of the employees to the company's success. At the same time, an ESO should not create undue dilution of the company's equity and should encourage the reasonable long-term holding of the shares by the employees.

certain tax consequences after an employee exercises the option and is issued shares pursuant thereto as well as when he disposes of such shares. There are other legal, tax, and accounting considerations concerning ESOs by the companies. Therefore, it is strongly recommended to seek expert assistance and advice while designing and structuring an ESO and throughout its duration.

The value of a right or option granted to an employee to acquire shares under an ESO is not chargeable to income tax. However, there are

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