Shares for the employees? What are the obstacles?

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Despite its vigorous development, the Bulgarian capital market endures certain specific weaknesses, including the slow carrying out of the process of dissociation of public companies' shareholding from their management. As a result, a small number of companies in Bulgaria have independent and professional management. In Bulgaria we rarely see the otherwise wide spread practice in western companies to stimulate the achievement of better results by making free or preferential shares, options or warrants available to the management. This is a way for the company's officers to become further involved in the company, as they have personal interest in managing it in such a way so that at the end of the period when they are entitled to receive or buy the shares they are able to draw the optimal economic gain from the share price.

The 2006 amendments to the Law on the public offering of securities introduced the possibility for public companies to offer free shares to their employees as a form of remuneration and stimulation, without the companies being obliged to issue a prospect. Under Regulation 809/2004 of the European Commission, issuers are required to publicly announce the information for potential opportunities and arrangements made with their employees as to their participation in the company capital through issued options, warrants and other derivatives. Article 79, paragraph 3, section 6 of the Law on the public offering of securities provides that the general obligation of public companies to publish a prospect when securities are being publicly offered does not apply when they "are offered, distributed or ought to be distributed among present and former members of the managing body and/or among employees by their employer who already disposes of securities, admitted to being traded on a regulated market".

Therefore, this form of stimulating the high management of a public company is acceptable in Bulgaria. A question arises as to whether this practice is so uncommon here because of the lingering business processes or it is the legislation that stops public companies from following the substantial western model.

After careful examination of the legislation in force, two legally acceptable means for stimulating key employees of a public company through shares or derivates of shares stand out, both of them appearing to be vague or difficult to apply for the majority of the public companies. One of them consists in share redemption (limited by the Law on the public offering of securities to not more than 3% of the capital) under article 111, paragraphs 5 and 6 of the Law on the public offering of securities, which according to experienced companies, despite the incentive permitting for a prospect not to be issued, is a clumsy procedure, that passes through a decision of the General assembly of

shareholders of the public company and notification to the Financial supervision commission. Limitations to the number of shares that a public company is authorized to redeem in a one-year period are to be taken into account as well.

The second possibility involves issuing warrants to the employees of a public company and subsequent increase of the capital under article 195 of the Commercial act, following the provision of article 113, paragraph 2, section 2 of the Law on the public offering of securities. Under art.1, s.4 of the additional provisions of the Law on the public offering of securities, a warrant is a type of security, materializing the right to subscribe a certain number of securities under pre-determined or determinable issuing value within a defined period of time. In this way key employees of the company are given the right to subscribe certain number of shares from the company's capital at a preferential rate. Thus, on one hand the mentioned employees would have a direct interest in the good performance of the company on the market and the high price of its shares, and on the other hand, the company guarantees to a greater extent their loyalty, at least throughout the period of exercise of their rights on the issued warrants. Under the western model this type of warrants are to be issued to employees with a certain length of service within the company and the rights thereunder normally mature after at least five years.

It is likely that public companies are faced with ambiguities here as well, since the Law on the public offering of securities allows a public company to execute an increase in its capital pursuant to article 195 of the Commercial act (i.e., under the condition that newly issued shares are acquired by certain individuals at certain rates, i.e. the holders of the issued warrants). This however appears to violate a basic principle governing the very notion of public company – the protection of shareholders, and particularly of the minority shareholders, reflected in the right of each shareholder to subscribe for a proportional number of shares from every new emission, corresponding to the number of shares held by him before the increase. Yet article 113, paragraph 2, section 2 states that the prohibition for a public company to increase its capital under article 195 of the Commercial act is not to be applied when this increase is necessary for ensuring the rights of the holders of warrants. The legislator has estimated that in certain explicitly indicated cases the principle could be violated without this leading to invalidity of the performed act.

From technical perspective though, the legislator has not made it clear whether a prospect is to be published in case of capital increase under article 195 of the Commercial act in relation to article 113, paragraph 2, section 2. If the holders of warrants are employees of the public company and the warrants are issued so that these employees subscribe shares from the new emission at preferential rates, we fall under the hypothesis of article 79, paragraph 3 and 4, and a prospect is not to be published. However, warrants are securities and as such could be transferred freely. Consequently, if the capital is being increased under

article 195 without publication of prospect on the grounds of article 79, paragraph 3 and 4, then should warrants be issued under the condition not to be transferred to third parties, and if the answer is no, then should prospect be published if certain employees have transferred their warrants in the period following the decision on increase the capital or warrants have been issued to individuals not employed by the company,?

Both options for stimulating the employees generate a side issue with material importance – perhaps an oversight of the legislator or an issue deliberately unresolved. This is the tax issue, linked to the acquisition of these shares on a market that is not regulated and not at market prices.

According to the Income taxes on natural persons act, revenues from deals with public companies' shares, tradable rights in shares and shares and of collective investment arrangements, executed on a regulated market, are not taxable. When sold, free shares, or shares acquired by employees at preferential rates, generate revenue that does not fall under the previously cited hypothesis and therefore are taxable which, depending on the particular case, could drastically decrease the amount of the bonus and even deprive it of any sense. The legislator should reflect on this issue, since stimulating the high management of public companies is inextricably bound up with the development of the capital market in Bulgaria – a reason that led to the introduction of the tax incentive making revenues from deals with securities on a regulated market nontaxable.