Law Council
OF AUSTRALIA

Business Law Section

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Ms Nathania Nero
Senior Policy Adviser
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The Treasury
Langton Crescent
PARKES ACT 2600

By email: ESSreforms@treasury.gov.au

Dear Ms Nero,

Employee Share Schemes Consultation Paper April 2019

The Corporations Committee of the Business Law Section of the Law Council of Australia (the **Committee**) welcomes the opportunity to provide this submission to the Commonwealth Treasury (**Treasury**) in response to the public consultation paper *Employee Share Schemes Consultation Paper, April 2019* (**Consultation Paper**).

Summary

The Commonwealth Government has announced proposals to improve the ability of small businesses to offer employee share schemes to help them attract, retain and motivate employees and grow their businesses. While the Committee is supportive of legislative amendments in the area of employee share schemes, it considers that the current proposals outlined in the Consultation Paper (and which are addressed in further detail in this submission) could be expanded to provide additional relief.

The current regulatory regime in the *Corporations Act 2001* (Cth) (**Corporations Act**) and Australian Securities and Investments Commission (**ASIC**) Class orders [CO 14/1001] and [CO 14/1000] (**Class Orders**) is understandably focussed on investor protection, but in the view of the Committee, this regime does not now appropriately take into account other policy objectives; namely, the need to encourage innovation in Australia and to support all businesses (and in particular those that are unlisted or smaller listed businesses) in attracting and retaining the people that they need to develop leading products and services. Equity is a valuable tool for incentivising employees - especially for cash poor companies, and greater flexibility in granting equity to employees will positively contribute to investment in Australia and employment growth. Foreign companies that would like to incentivise their Australian employees are also dissuaded from utilising equity due to the complexity as the policy rationale applies equally to those companies, and therefore may discourage investment in Australian businesses, particularly when compared to more favourable equivalent frameworks in other jurisdictions.

The Committee's submissions are underpinned by their view that there are greater benefits for Australian employees in the long term in the form of greater employment and other economic opportunities in reducing the complexity and restrictions that are endemic in the regulation of Employee Incentive and Share Schemes (**ESS**) in Australia. The Committee considers that the current regulatory regime does not pay sufficient regard to the fact that employees of a large number of unlisted entities would regard equity investments as inherently speculative and so would not necessarily equate the independent valuation of what they receive with a cash salary (as ASIC's policy statement in relation to ESS appears to suggest). Even more importantly, the Committee does not believe it is correct to assume that grants of equity are in lieu of cash or other forms of (liquid) remuneration – in many cases the offeror is cash-poor and relies heavily on the ability to offer the potential for future equity upside to attract and retain highly skilled mobile workers.[1]

Unless expressly defined in this letter, capitalised terms have the meaning given to them in the Consultation Paper.

We set out below the Committee's responses to questions posed by Treasury in the Consultation Paper on an exception's basis.

Questions and specific responses

Consolidating and simplifying existing exemptions and ASIC relief

Do you support consolidating and simplifying the statutory exemptions and ASIC Class Order [CO 14/1001] in the Corporations Act?

Yes, the Committee supports consolidating and simplifying the statutory exemptions and both of the Class Orders in the Corporations Act to reduce overlap that currently exists between the Corporations Act and the Class Orders.

However, the Committee agrees with the Consultation Paper that ASIC should continue to have an ability to grant modifications or exemptions from the applicable legislative provisions in order to preserve future flexibility.

Does the complexity of the current regulatory framework for ESSs create significant difficulties for businesses looking to offer an ESS?

Yes.

In the Committee's experience, there is limited reliance on CO [14/1001] by start-up and early stage businesses as the restrictions on issuing incentive schemes, including the low annual monetary cap of $5,000 and the requirements for preparation of offer documents render the use of the class order unworkable and the burden of compliance too heavy.

This results in companies who may not be able to comply with [CO 14/1001] relying upon other disclosure exemptions such as the small scale offerings exception[2] and

[1] ASIC Regulatory Guide 49.111 states that *"…We consider that offers under an employee incentive scheme are not generally for 'no consideration' because the participant is providing continued services and, in some cases, may consider that the products offered under the scheme are part of their remuneration or are a reason for remaining with the same employer.*"

[2] Section 708(1) of the Corporations Act

the senior manager exemption[3] and choosing to "run the risk" of breaching the licensing, advertising and hawking provisions of the Corporations Act to the extent that those provisions apply to the plan. As a general observation, businesses struggle to understand the complexity of the Class Order and the limitations and restrictions imposed without seeking legal advice which can be time consuming and costly.

Would there be significant benefits or risks for business in consolidating and simplifying the current regulatory regime?

The Committee considers that there would be significant benefits in consolidating and simplifying the current regulatory regime. This would reduce compliance costs as there would be greater clarity in what the law is and how it applies in a particular case.

However, the full benefits to the economy could not be realised unless the overall regulatory regime was reformed to make it less restrictive than it currently is – see section 1.6 for the Committee's suggestions as to how that could be done.

The Committee does not consider that consolidation and simplification would result in any significant risks provided that ASIC retained the flexibility to modify the law in this area to cope with any future developments in market practice and needs.

Would compliance be significantly easier if the obligations applying to ESSs were all contained in the Corporations Act?

Yes.

Additionally, the current statutory provisions concerning employee equity participation are overlapping and at times inconsistent.

It would be helpful to harmonise the law as there is no apparent utility in having statutory exemptions for "eligible ESS" in the Corporations Act which sit alongside the Class Orders. To the contrary, this leads to confusion which is ultimately inimical to the broader policy objectives of making these exemptions available in the first place.

As a general principle, the Committee believes that it would be best to eliminate inconsistencies between the Corporations Act and the Class Orders, but to preserve ASIC's ability to modify ESS so that the regulation of ESS can continue to develop as market circumstances change in the future via use of the Class Orders.

Are there significant advantages or disadvantages in using ASIC class orders as opposed to primary legislation to regulate ESSs?

The use of class orders, now named 'Legislative instruments' provide relief to a class of persons in particular circumstances under powers delegated to ASIC and which are made at the initiative of ASIC.

[3] Section 708(12) of the Corporations Act

The advantage of ASIC legislative instruments is that they are a more flexible means of regulating ESS than legislation and it is for that reason that the Committee recommends that ASIC should retain the power to regulate ESS following any legislative consolidation of the laws in this area.

However, the major disadvantage of relying solely on ASIC legislative instruments is that legislation is better able to take into account the full range of policy objectives relevant to the regulation of ESS. ASIC is constrained by its own legislative objectives and regulatory priorities, the most relevant one of which in the ESS context is consumer and investor protection.

There is naturally a trade off between achieving consumer and investor protection and other policy objectives which the Committee considers to be of equal importance – such as the stimulation of innovation and investment in employment in Australia by all commercial enterprises.

Another benefit of utilising legislative change is that the current regime in the Corporations Act is overlapping and at times inconsistent and it is more appropriate that this be remedied by wholesale legislative amendment rather than a patchwork of ASIC legislative instruments, which are more difficult to apply, particularly by smaller commercial enterprises who do not have the financial resources to afford the specialised legal advice required to understand the rules.

For these reasons the Committee considers that there are significant advantages in utilising legislative change, rather than ASIC legislative instruments, to regulate ESS provided that flexibility is preserved by retaining a power for ASIC to modify or exempt persons or classes of persons' obligations under those laws.

Are there any requirements or conditions of the ASIC class order that should be removed or amended as part of the consolidation?

The Committee's view is that the Class Orders should no longer be required on the basis that the Corporations Act will be amended to include the exceptions and conditions.

However, in transferring those into the legislation, the Committee considers that there are several amendments that could be made to better achieve the policy objectives of ESS:

Increase in monetary cap

See response to question 2.2 below.

Extend the exceptions to a broader range of financial products for unlisted entities

The current approach to determining which financial products receive the benefit of [CO 14/1001] is informed by a view that because unlisted entities do not have listed securities with a readily identifiable price, a more limited group of financial products should be entitled to the relief.

This approach does not pay heed to the commercial reality that unlisted companies more often than not have more, not less, types of financial products on issue than listed entities where ASX Listing Rules and market practice tend to have the effect of streamlining the nature of equity securities on issue by listed entities. This is particularly the case for start-ups and unlisted companies with private equity/VC investors, where it is common to have other classes of shares (e.g. preference shares) and convertible securities (e.g. warrants over ordinary shares).

Any statutory exemptions for unlisted companies will continue to be left largely unused unless they are broadened to include:

- varying classes of ordinary shares
- preference shares
- options and warrants over ordinary shares and preference shares; and
- interests in managed investment schemes.

To the extent that there are policy concerns about product complexity, the Committee submits that these can be addressed via disclosure about the terms of the financial product (including around the nature and risks of any future financial returns) and the provision of an independent valuation.

Expanding the list of financial products would reflect the position in the United States, Singapore and New Zealand, where regimes are not restricted to voting ordinary shares only.

Extend the exceptions to a broader range of financial products for listed entities

There should not, in theory, need to be any difference between the list of eligible financial products for listed and unlisted entities (with the exception of Depositary Interests, which are only relevant to listed entities) and the Committee suggests that this be reflected in any amendment to the legislation. This would also make the legislation simpler and reflect the position in the United States, Singapore and New Zealand.

As with the case for unlisted entities, to the extent that there are policy concerns about product complexity, the Committee submits that these can be addressed via disclosure about the terms of the financial product (including around the nature and risks of any future financial returns) and the provision of an independent valuation.

For clarity, the Committee considers that listed entities (and also unlisted entities) should be entitled to the benefit of the exceptions where they make grants of options over, incentive rights over and units in financial products which are unlisted where more than nominal consideration is payable for those financial products but only on the basis that independent valuations are obtained for those grants.

Loans

On the same basis, the Committee suggests that the exemptions for unlisted entities should be broadened to enable unlisted entities to offer limited recourse loans to fund the acquisition of financial products under a qualifying employee incentive plan (on the basis that any interest on such loans is also limited recourse). The lack of any out of pocket cost for participants is a substantial mitigating factor. This would bring the regime into line with the United States, and in Singapore (where the Singapore Companies Act includes a specific exemption for the provision of financial assistance in relation to an employee share scheme).

Remove the requirement for independent valuations in certain circumstances

Based on the feedback of our unlisted entity clients, it is clear that the requirement for independent valuations imposes an additional cost burden which has the effect of reducing the prevalence of equity-based consideration that is offered to staff or, perhaps worse, a practice of avoiding the requirement altogether (although imperfectly) by relying instead on the small offers exception or the senior managers exception and making the grants anyway.

For that reason, the Committee proposes the removal of the requirement that an independent valuation be obtained by the Company for grants of employee incentives made for nominal consideration or nil consideration.

In these circumstances, the participant will not suffer any out of pocket cost by participating in the plan and for the reasons given in the introduction to this letter, the Committee does not agree with ASIC that grants of equity are in lieu of other forms of remuneration[4].

The Committee believes that it should be a condition of the relief that the offer document to employees explain the nature and terms of the financial product being offered, the circumstances in which financial returns may be realised (including after taking into account the terms of issue of any other financial products issued by the entity) and risks in relation to the same so that an informed decision can be made by an employee about whether to participate.

Remove the 3 month quotation requirement for companies that are going to IPO

[CO 14/1000] requires the underlying financial products the subject of the grant to have been quoted on a financial market for at least 3 months and without suspension for more than five trading days.

Commonly, relief is sought (and routinely granted) from ASIC for this condition where an employee incentive scheme is established by an entity at the time of its IPO on the basis that at the time of grant the ordinary securities (or units) of that entity will not have been trading on ASX for at least 3 months. This is granted on condition that vesting of the grant may not happen for at least 3 months.

This would be a comparable position to the United Kingdom and Singapore, where there are no equivalent provisions requiring 3 month trading.

[4] ASIC Regulatory Guide 49.111 and 49.154.

In the interests of efficiency, this condition to the exception could be amended to exempt this requirement in circumstances where grants are made under a plan being established upon listing of an entity on ASX, or any other approved financial market.

Allow loans made by listed companies to be full recourse and to bear interest

The Committee considers that listed issuers should be entitled to offer full recourse loans and interest bearing loans to participants where the underlying financial product is listed on an eligible financial market. This is because the value of listed financial products are readily ascertainable and participants should be capable of obtaining financial advice appropriate to their personal circumstances on whether to make such an investment decision. At the very least, these grants should be able to be made to Senior Managers. Permitting such loans would reflect the position in the United States (although for completeness it is noted that listed companies are restricted from entering into personal loan transactions with executive officers and directors).

Should ASIC be given an additional power to determine that a company should not be permitted to rely on a statutory exemption for an ESS?

The Committee is not opposed to ASIC having an additional power to determine a company should not be permitted to rely upon a statutory exemption on the basis that merely reflects the status quo (and is consistent with the 'low doc' regime under the Corporations Act where ASIC has the power to deprive an entity of reliance on that regime in certain circumstances).

Increasing the offer cap per employee

2.1 Do you support increasing the offer cap per employee?

Yes, please see below for further comments from the Committee.

2.2 What are the benefits or risks of increasing the employee offer cap?

The benefit of increasing the cap would be that it would make access to the exemptions possible for unlisted entities. The present cap of $5,000 is extremely low and in the Committee's experience of dealing with unlisted clients, a barrier to reliance on the [CO 14/1001]. The Committee has previously noted that a low cap per employee per year results in a regime which fails to significantly assist start-ups in attracting and retaining talented employees while at the same time preserving capital.[5] The present cap of $5,000 is much lower than for certain applicable plans in the United States (USD25,000 under a Company Employee Stock Purchase Plan), certain applicable plans in the United Kingdom (GBP30,000 cap on aggregate unexercised options under a Company Share Option Plan or GBP250,000 cap on aggregated unexercised options under an Enterprise Management Incentive plan), in Singapore (uncapped) and in New Zealand (uncapped).

The Committee considers that the risks of raising the cap are negligible. As previously outlined, employees of unlisted entities are either not receiving any equity-based remuneration at all due to the cap or, if they are, it is in reliance on

[5] See page 8 of the Committee's response to ASIC Consultation Paper 218: 'Employee Incentive Schemes' dated 31 January 2014

another disclosure exception without regard to the other legal requirements (for e.g., financial services licensing requirements). Those participants are not instead receiving cash in lieu of equity. Accordingly the Committee does not think that raising the cap would reduce investor protection either.

2.3 Is a $10,000 limit per employee per year appropriate or is a greater increase appropriate?

The Committee believes that a $10,000 annual limit on offers that may be made to employees is too low, as it is not materially higher than the current cap of $5,000.

The feedback that Committee members have received from their unlisted clients is that a more appropriate approach would be to define the limit by reference to the percentage of the total annual remuneration of that employee (on an annualised basis) – that is, provide that no more than 30%-50% of total annual remuneration may be in the form of equity without provision of a prospectus/PDS and complying with any other applicable requirements. The Consultation Paper notes that "for every dollar spent on wages and salaries, small companies using an ESS paid approximately 25 to 53 cents to employees in the form of share based payments".[6] Accordingly, a cap of 30-50% would be consistent with current remuneration practices.

Additionally, we suggest that companies that qualify for the start-up tax concessions should have a separate ESS regime with an even more generous cap (or, ideally, no cap at all) to drive growth and innovation given that the policy objective of both corporations and tax laws is to encourage the use of equity to incentivise employees and to achieve greater alignment between employees and employers which may not otherwise be available to them as start-up companies.

2.4 Should senior managers (within the meaning of s9 of the Corporations Act) be excluded from this cap?

The Committee considers that senior managers should be excluded from any monetary (or percentage based) cap imposed on unlisted entities.

However, the Committee also submits that the current definition of a 'Senior Manager' under the Corporations Act is imprecise and difficult to apply in practice. Under section 9 of the Corporations Act, a 'Senior Manager' is a person (other than a director or secretary) who makes or participates in making decisions that affect the whole or a substantial part of a corporation or has the capacity to significantly affect the corporation's financial standing. It may be difficult to use the current definition under the Corporations Act where it is often difficult to distinguish between senior managers and other employees. The level of sophistication will vary from business to business and it appears difficult to draw that distinction (other than in an arbitrary way) given that businesses will differ in size and organisational structure.

The Committee proposes that the definition of 'Senior Manager' should be amended to refer to "Senior Employees" and be defined as persons (other than a director or secretary of the Corporation) who:

[6] See page 3 of the Consultation Paper, 'Benefits of an ESS' which refers to the 2017 report *The performance and characteristics of Australian firms with Employee Share Schemes* released by the Department of Industry, Innovation and Science in 2017.

(a) ~~Makes, or participates~~ have responsibility for ~~in~~ making decisions ~~that affect the whole, or a substantial part~~ about the financial and operating policies ~~of the business~~ of the corporation; or

(b) [in the reasonable opinion of the corporation,] otherwise have such responsibilities granted by the corporation ~~has the capacity to affect significantly the corporation's~~ as to give them an understanding of the corporation and its financial ~~standing~~ position, performance and prospects.

The Committee suggests that these changes will have the benefit that entities will have greater flexibility in determining which of their employees is sufficiently senior enough to receive grants beyond the size of the cap.

The Committee further submits that it would be appropriate for this definition to apply for the purposes of s 708(12) of the Corporations Act so that it may make the application of that exception clearer in other contexts.

2.5 Is the level of disclosure currently required by the ASIC class order for unlisted companies sufficient to address any risk associated with an increased employee cap? Is any additional disclosure or protection necessary or desirable?

The Committee does not consider that the level of disclosure required by the Class Orders requires amendment in light of any increase to any monetary cap. The current level of disclosure provides sufficient detail to employees regarding the financial products offered by employers.

Annual financial reporting remains an appropriate obligation for companies offering employee incentive arrangements.

2.6 Are there any significant advantages or cost savings for business as a result of an increased cap per employee? Please provide details.

Increasing the cap in the manner recommended above would be a significant advantage to business as it would actually allow unlisted entities to get the benefit of the statutory exceptions to laws applying to ESS.

It would also reduce the need for business to incur legal fees in receiving advice to help structure ESS which can otherwise be made without the need to rely on the applicable statutory exception. These costs may be material.

Facilitating the use of contribution plans

3.1 Do you support contribution plans being able to be used to fund the acquisition of financial products for an ESS of unlisted companies?

Yes, the Committee supports the use of contribution plans by unlisted companies (which can be an attractive alternative for employee participants from a tax perspective where the start-up rules cannot apply, the participants do not want to pay a significant hurdle rate under a premium price option plan and do not want to pay income tax either upfront or at the deferred taxing point).

The use of contribution plans is currently permitted for listed companies, however, only for products that are able to be traded on an eligible financial market. If contribution plans were to be permitted for unlisted companies as part an ESS, the Committee suggests that an independent valuation should be provided, consistent with the policy principle that the value must be able to be readily determined by employees.

3.2 What are the benefits or risks of allowing unlisted companies to offer contribution plans as part of their ESS?

The benefit of allowing unlisted companies to offer contribution plans as part of their ESS would be that it would make access to the exemptions possible for unlisted entities.

The Committee considers that the risk of allowing unlisted companies to offer contribution plans as part of their ESS are negligible in circumstances where an employee is able to make an informed decision based on an independent valuation provided at the time of the offer.

3.3 Are any additional protections necessary for employees participating in contribution plans? For example, capping monetary contributions at $10,000 per employee per year or requiring an independent valuation where a contribution plan is offered or the $10,000 cap is exceeded. Please provide details.

Yes, see our response to question 3.1.

3.4 Are there any significant advantages or cost savings for business as a result of allowing contribution plans?

Permitting contribution plans for unlisted companies in the manner recommended above would be a significant advantage to business as it would actually allow unlisted entities to get the benefit of the statutory exceptions to laws applying to ESS.

It would also reduce the need for business to incur legal fees in receiving advice to help structure ESS which can otherwise be made without the need to rely on the applicable statutory exception. These costs may be material.

Expanding the exemption from public access to disclosure documents

4.1 Do you support expanding the types of ESS eligible for the exemption from public access to disclosure documents?

Yes, the Committee supports the exemption being expanded to public access to disclosure documents particularly in circumstances where a company is not otherwise required under law to disclose financial and other commercially sensitive information.

4.2 What are the benefits or risks of expanding the types of ESS eligible for this exemption?

The Committee does not have any comments in response to this question other than to say that they do not foresee any significant risks.

4.3 Are there any other changes to the scope or availability of this exemption that are necessary or desirable? Please provide details.

The Committee does not have any comments in response to this question.

Listed companies

5.1 Do you support simplifying and consolidating the relief for listed companies in the Corporations Act?

Yes, the Committee supports simplifying and consolidating the relief for listed companies in the Corporations Act. Further, the Committee believes that there are additional amendments that can be made to the Corporations Act to facilitate further use of employee incentive arrangements as outlined above in response to question 1.6.

5.2 What are the potential benefits or risks of consolidating the relief for listed companies in the Corporations Act?

See the Committee's responses in the introduction and question 1.3 above.

5.3 Are there any requirements or conditions of the ASIC class order that should be removed or expanded as part of the consolidation? If so, please explain why.

See the Committee's response to question 1.6 above.

5.4 Are there any other barriers or costs for listed companies offering ESSs?

The Committee does not have any comments in response to this question.

Other reforms

6.1 Are there any other regulatory barriers to small businesses offering ESSs?

The Committee does not have any comments in response to this question beyond what has been recorded above.

6.2 Are there any other reforms to the regulatory framework for ESSs that would further facilitate or reduce costs for small businesses offering an ESS?

Under Australian tax law, employers are permitted to offer $1,000 worth of shares tax-free to employees in certain circumstances. If the reforms are passed which would increase the $5,000 cap under [CO 14/1001] to $10,000 it would not align with the taxation regime and while there is no technical reason for alignment, the policy objective of both corporations and tax laws is to encourage the use of equity to incentivise employees and to achieve greater alignment between employees and employers. It would therefore be beneficial for the harmonisation of tax thresholds to align with any corresponding changes made under the Corporations Act in the event that Treasury is only minded to increase the cap to $10,000 as opposed to adopting the Committee's proposal to make the cap much higher and based on a percentage of remuneration.

Please contact Shannon Finch, Chair of the Corporations Committee at shannonfinch@jonesday.com or [(02) 8272 0751, Adam D'Andreti at adandreti@gtlaw.com.au or (02) 92634375 or Tony Sparks at Tony.Sparks@AllenOvery.com or (02) 9373 7879, if you require further information or clarification.

Yours sincerely,

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