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Ms Nathania Nero
Senior Policy Adviser
Consumer and Corporations Division
The Treasury
Langton Crescent
Parkes ACT 2600

By email
ESSreforms@treasury.gov.au

Dear Ms Nero

Employee Share Scheme Consultation Paper

We refer to Treasury's Employee Share Scheme Consultation Paper dated April 2019 (**Consultation Paper**).

Baker McKenzie is pleased to provide the enclosed responses to the questions raised in the Consultation Paper. The document also provides additional observations that we believe may be useful to Treasury in formulating its approach to this area of the law.

If you would like to discuss our responses or comments, please feel free to contact me.

Yours sincerely

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Encl

Baker McKenzie.

A. BACKGROUND

We are pleased to be invited to comment on Treasury's Consultation Paper.

The Consultation Paper sets out a number of proposals which aim to simply the legislative and regulatory framework which applies in the context of employee share schemes (**ESS**). In particular, the Government proposes to:

- consolidate and simplify the statutory exemptions and ASIC Class Order relief from disclosure, licensing, hawking, advertising and on-sale obligations in the *Corporations Act 2001* (Cth) (**Corporations Act**);
- increase the value limit of financial products that an unlisted company can offer in a 12 month period from $5,000 per employee to $10,000 per employee;
- expand relief for unlisted companies offering an ESS to cover contribution plans, where an employee can make a monetary contribution to acquire financial products; and
- allow small companies that cannot come within these exemptions to offer an ESS under a disclosure document lodged with the Australian Securities and Investments Commission (**ASIC**), without publicly disclosing commercially sensitive financial information, unless they are otherwise obligated to do so.

According to the Consultation Paper, there are three key limitations in the current regulatory framework surrounding ESS, namely:

- the current regulatory framework is unduly complex and fragmented - exemptions to regulated disclosure vary in their scope and conditions, and are located across both the Corporations Act and various ASIC Class Orders;
- the conditions in the ASIC Class Order are too restrictive and may constrain companies (particularly unlisted companies) from adopting an ESS; and
- the current regulatory framework does not sufficiently protect commercially sensitive information.

The stated aim of the proposals set out in the Consultation Paper is to make the regulatory framework less complex, and to reduce the time and cost burden for small businesses offering an ESS, whilst preserving the rationale underpinning the existing ASIC Class Order relief.

We set out our responses to each of the questions raised on these proposals in Section B of this submission.

B. COMMENTS ON TREASURY'S QUESTIONS

Consolidating and simplifying existing exemptions and ASIC relief

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

We agree that the current exemptions are unduly complex. Whilst consolidating all of those exemptions into the Corporations Act is one option, the more important exercise will be to ensure that the range of disclosure exemptions are harmonised and expanded so that they reflect a consistent underlying policy and are of practical benefit to businesses.

In the case of an ESS, at a minimum that regime must deliver clear and consistent exemptions for an ESS that are readily understandable and, most importantly, that do not impose undue burdens or limitations on businesses seeking to rely on them. We have suggested the beginnings of a broader and simpler approach to ESS exemptions in our response to question 6.2.

Even if all current exemptions were to be consolidated into the Corporations Act, it would still be important for ASIC to have the power to grant not just individual relief but also Class Order relief. This would allow the regulatory regime to continue to evolve, without the need to introduce new legislation each time changing circumstances called for an adjustment to the rules.

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

Yes. However, in our experience (and particularly in the ESS space) the difficulties that businesses experience have to do not merely with the complexity of the framework (e.g. the fact that it is distributed across the Corporations Act and ASIC Class Orders) but also with the limited scope of the available exemptions.

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

Yes, there would be benefits in consolidating and simplifying the current regulatory regime, provided that such consolidation and simplification is conducted in tandem with substantive reforms. Merely consolidating the current ASIC Class Order into the Corporations Act will not, by itself, reduce complexity or benefit business.

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

Whilst consolidating all relevant provisions into the Corporations Act may help, it would be of limited value if not accompanied by substantive reforms. In terms of the consolidation approach, we consider it would be most helpful if there was a stand alone part of the Corporations Act which governed ESS (similar to the crowd-sourced funding regime under Part 6D.3A of the Corporations Act).

1.5	Are there significant advantages or disadvantages in using ASIC Class Orders as opposed to primary legislation to regulate ESSs?

As noted above, one advantage to using ASIC Class Orders is that this practice allows the applicable exemptions to evolve, in response to changing circumstances, without having to enact new legislation.

1.6	Are there any requirements or conditions of the ASIC Class Order that should be removed or amended as part of the consolidation?

Yes. In our experience, there are two conditions which frequently mean that ASIC Class Order 14/1001 is unusable:

- **The $5000 limit** - in many instances, the existing Class Order is of limited or no value to unlisted businesses because their remuneration packages are designed around equity awards that are greater (sometimes much greater) in value than $5,000 per individual per year. This is a particular issue for start-ups, since these businesses often rely on their ability to attract key personnel based on the anticipated uplift in the value of shares in the start-up company. Further, start-ups are often cash constrained, so that equity is typically a significant component of a total remuneration package.
- **Disclosure of annual report** - under the current Class Order, unlisted companies are required to provide employees with copies of their most recent financial statements. Whilst in Australia the general rule is that companies have to file accounts with ASIC (which then become publicly accessible) this is not the case in other jurisdictions. In the United States (**US**), for example, unlisted companies are generally not required to make their financial statements public, and such information is widely regarded as being commercially sensitive and confidential. We have had a number of US clients that have been unable to rely on ASIC Class Order 14/1001 because they could not comply with the requirement to disclose this sensitive financial data to their employees. In contrast, unlisted US companies often prepare independent valuations as a matter of course, and in our experience are typically willing to provide an appropriately redacted and/or summarised version of such valuations to employees.

As noted in our response to question 6.2, instead of making piecemeal adjustments to existing exemptions, an alternative approach would be to formulate a much simpler and broader-based exemption that could apply to all ESS offers.

1.7 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?

In our view, no. Class Orders 14/1000 and 14/1001 already give ASIC the power to exclude companies from relying on them, and we see no need for any extension in this power. In particular, we submit that if ASIC has a similar power to exclude a company from relying on a statutory exemption, this would only add to the existing regulatory complexity and uncertainty.

Increasing the offer cap per employee

2.1 Do you support increasing the offer cap per employee?

Yes. However, we do not consider that the Government's proposal (i.e. to increase the cap from $5,000 to $10,000) goes far enough. Please see our response to question 2.3 below.

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

The main benefit is that more businesses (including start-ups) will be able to make use of the exemption. This in turn will be of potential benefit to Australian employees, since it will mean that they can participate in equity incentive plans that they might otherwise be excluded from.

The main risk is that employees who take a significant component of their remuneration in the form of an equity-based award may not realise the value of that award - for example, if the share price goes down. However, in our view this risk will be adequately ameliorated if employees are given an appropriate level of disclosure about their awards.

In our view, this disclosure could be effected by providing employees with (at the option of the company relying on the exemption) either financial statements or an appropriately redacted and/or summarised independent valuation.

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

In our view, the minimum limit ought to be $20,000. In our experience, ASIC has routinely granted relief from the existing $5,000 limit by raising it to $20,000, and so we consider any monetary limit should be no lower than this. We have had clients for whom even a $20,000 limit was of no or only limited value, and so we urge the Government to consider whether an even higher limit (say, $40,000) may be warranted.

In determining an appropriate cap, we urge the Government to have regard not only to the existing protections that would mitigate any risk borne by employees (see previous question) but also to the practical challenges that businesses face (especially relatively new businesses) in designing remuneration packages that will be competitive in the market and that will attract high-calibre personnel.

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

Yes, in our view senior managers should be excluded. Under the Corporations Act a general exemption from the prospectus requirement is available for offers of securities to senior managers. That exemption permits offers of securities to senior managers regardless of the value of the offer. Moreover, in our experience ASIC has routinely granted specific relief from the $5,000 limit on the basis that awards of any value can be granted to senior managers.

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?

In our view, yes - the existing level of disclosure is sufficient. However, for the reasons stated in relation to questions 1.6 and 2.2, we consider that the requirement to provide an annual report in conjunction with an offer document should be replaced with a requirement to provide employees with (at the option of the company relying on the exemption) either financial statements or an appropriately redacted and/or summarised independent valuation.

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

Yes - there would be advantages for businesses and employees. Businesses would be advantaged because they would be able to roll out equity incentive schemes without the need (and attendant costs) of preparing a prospectus and/or obtaining an Australian financial services licence (**AFSL**).

In our experience, the costs (including legal and accounting costs) of preparing an Australian prospectus purely for an employee share scheme would be in the order of $50,000 to $100,000. The costs of applying for an AFSL would be at least $50,000 as such a licence requires compliance systems, insurance arrangements, and personnel with specific regulatory experience and qualifications, plus ongoing costs of at least $30,000 per year for these matters.

In reality, a company that cannot rely on an exemption will simply refrain from offering equity-based incentives to Australian employees, rather than assume the above costs. Thus, an increased cap would advantage Australian employees, as it would afford them the opportunity to participate in equity incentive plans that they might otherwise be excluded from.

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.

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

The key benefit is that unlisted companies would be able to offer, and their employees would be able to enjoy, a wider range of equity-based awards than are currently available under Class Order 14/1001.

The main risk with such contribution plans is that, because employees are actually required to pay money to receive their awards, they are exposed to an economic risk that would not otherwise apply.

That being said, Class Order 14/1001 already covers incentive rights and options which have a nil grant price (i.e. where no monetary consideration is payable on grant of the award) but which require a monetary payment upon vesting and/or exercise of the award. As currently drafted, Class Order 14/1001 requires in such circumstances that the underlying shares have been listed for at least three months at the time of vesting or exercise, or that employees are provided with a 'valuation document'.

In our view, these existing protections in the Class Order would be sufficient to mitigate any risks associated with offers of contribution plans.

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.

We comment on this question in two parts.

(a) Are any additional protections necessary for employees participating in contribution plans?

No. As noted in our response to question 3.2, in our view the protections that already apply to exercise or vesting of options and incentive rights would be sufficient. Those existing protections are specifically intended to address the situation in which employees pay money to receive the underlying shares. We see no difference in principle between the financial exposure assumed by employees in such circumstances and the financial exposure assumed by employees who participate in a contribution plan.

(b) 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.

We do not quite understand this question.

As presently drafted, the $5,000 cap applies to all and any equity awards that are offered in reliance on Class Order 14/1001. We agree that it makes sense to have a monetary cap that is consistent across all types of equity awards covered by the Class Order. However, the present question appears to suggest that offers over the cap might be permitted in certain circumstances.

If it is proposed that senior managers receive a higher level of disclosure than other employees in circumstances where they are offered awards in excess of the monetary cap - we do not agree. We consider all employees granted equity awards in reliance on the Class Order should receive the same information.

If what is being proposed is that there could be two caps - the standard $10,000 cap, plus a higher cap involving enhanced disclosure - again we do not agree. Whilst there might be a certain logic to such an approach, it would add undue complexity and would not address the key issue, which is to settle upon a realistic monetary cap that works.

As noted in our responses to previous questions, we consider that:

- a much higher cap is needed in order for Class Order 14/1001 to be of real use (see question 2.3);
- a significantly elevated cap is justified in light of the disclosure protections that already exist in the Class Order (see question 2.5);
- those existing disclosure protections should be revised to give companies the option of providing employees either with financial statements or a summary of an independent valuation (see questions 1.6 and 2.2); and
- certain additional protections - which are already contained in Class Order 14/1001 - may well be appropriate where employees pay money for equity awards (see questions 3.2 and 3.3(a)).

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

Yes - there would be advantages for business and also for employees. These would be essentially the same as those described in our response to question 2.6.

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. However, we suspect that the narrower definition of ESS offers under income tax law is not the reason why this particular exemption has been underutilised, for two main reasons.

First, in our experience the main expense that companies (both unlisted and listed) seek to avoid when designing an ESS is the expense of preparing an Australian prospectus. In many instances, where no exemption from this requirement is available companies will simply decide not to offer any ESS at all, and will instead choose remuneration structures that are not regulated by Australian securities laws (such as fixed cash bonuses). Consequently, for many companies the most important stumbling block is not that their disclosure document (including financial information) would be made public once lodged with ASIC, but the fact that a disclosure document needs to be prepared at all.

Second, as a general rule, and under section 292 of the Corporations Act, any Australian company that is either (a) a public company, or (b) a proprietary company that is either large or small and foreign-controlled, has to lodge financial statements with ASIC. Such statements are not covered by an exemption in section 1274 of the Corporations Act and are therefore publicly accessible.

The Consultation Paper proposes that the expanded exemption under section 1274 would continue to apply only to companies with an annual turnover of no more than $50 million. According to the Consultation Paper, this is to ensure that:

"*The expanded exemption would only apply to small companies, as large companies generally already have financial reporting obligations under the Corporations Act requiring them to lodge audited financial reports with ASIC, which are made available to the public.*"

However, companies that have an annual turnover of no more than $50 million may still be either public or "large" for the purposes of section 292, and therefore caught by that financial reporting requirement. Likewise, small proprietary companies that are foreign-controlled are caught by section 292 if they are not consolidated into accounts lodged with ASIC by a parent company.

In such cases, the exemption under section 1274, even if available, does not offer any real benefit, since these companies are in any event required to disclose their financial statements under section 292.

It is also worth noting that foreign companies that are registered to carry on business under the Corporations Act are generally required to lodge accounts with ASIC under section 601CK - a requirement that again may apply even where the foreign company has an annual turnover of no more than $50 million.

Finally, and as noted in our response to question 1.6, in our experience companies that are sensitive about disclosing their financial information are often overseas (and particularly US) unlisted companies that are not subject to comparable financial reporting obligations in their home jurisdictions. In such cases, companies are typically very resistant to disclosing sensitive financial data to their employees, let alone to the public at large via ASIC's website.

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

Given that the disclosure document would be provided to ESS offerees, we do not see any particular risk associated with expanding this exemption in the way envisaged. However, and as noted in our response to question 4.1, the exemption under section 1274 of the Corporations Act would be more meaningful if it were to be combined with a parallel exemption from public disclosure for any financial reports lodged under section 292 (and if relevant under 601CK) of the Corporations Act.

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

Yes. As noted in our response to question 4.2, the exemption under section 1274 of the Corporations Act would be more meaningful if it were to be combined with a parallel exemption from public disclosure for any financial reports lodged under section 292 or 601CK of the Corporations Act.

Listed companies

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

Yes, subject to our comments in relation to question 1.1.

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

Please see our responses to questions 1.3 to 1.5.

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.

In our experience, Class Order 14/1000 works well. The only condition that businesses sometimes find difficult to comply with is the condition that employee contributions under contribution plans be kept, pending their use to purchase shares, in a separate account with an Australian authorised deposit-taking institution. In our experience, companies will often express a strong preference for administering employee contributions through their normal payroll accounts and processes. This can be a particular issue for foreign businesses and multinationals, since they may need to open a new account with a new bank just in order to be able to offer their contribution plans in Australia.

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

Please see our response above.

Other reforms

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

The present regulatory framework distinguishes between securities, and other financial products. Whereas securities are subject to disclosure regulation under Chapter 6D of the Corporations Act, other financial products are subject to disclosure regulation under Part 7.9. The regimes under Chapter 6D and Part 7.9 are materially different, in terms of (a) the action that may trigger the disclosure requirement; and (b) the available exemptions.

We note that Part 7.9 of the Corporations Act only applies in relation to financial products which are issued, or will be issued, "in the course of a business issuing of financial products". There is confusion in the market about whether a company that is issuing awards to employees under an employee incentive scheme may be taken to be in the business of issuing financial products so as to trigger the operation of Part 7.9 of the Corporations Act. In our view, there is a strong argument that equity-based incentives that are granted to employees in the context of employee incentive plans do not amount to a "business" of issuing financial products, but rather form part of the internal functioning of the employer company. We recommend that the legislation is amended to clarify this position.

Securities and other financial products are both covered by the licensing requirement in Part 7.6 of the Corporations Act, but again the exemptions available in each case are not the same.

An ESS offer may also be subject to:

- Chapter 5C of the Corporations Act, which regulates managed investment schemes (ASIC takes the view that the operation of a contribution plan "may involve the incidental operation of a managed investment scheme" - see Regulatory Guide 49 Employee incentive schemes, at para 49.180).
- the advertising restrictions in sections 734, 1018A and 1018B of the Corporations Act; and
- the "hawking" restrictions in sections 736, 992A and 992AA of the Corporations Act.

The result of all this is a confusing palimpsest of rules which appears to draw arbitrary distinctions between classes of financial products that ought to be regulated in the same way, and which imposes restrictions which may not be appropriate in the context of an ESS.

For example:

- An ESS offer may be subject to different disclosure obligations (and exemptions) depending on whether it is an offer of:
  - shares, units in shares, or options over unissued shares (all of which are "securities"); or
  - restricted stock units, options over existing shares, or "phantom" shares (i.e. cash awards that are benchmarked against the value of shares) (all of which are likely to be financial products but not "securities").
- Whereas a grant of shares that is not accompanied by an offer (e.g. a stock dividend) will not require a prospectus under Chapter 6D of the Corporations Act, a grant of restricted stock units may require a product disclosure statement under Part 7.9 of the Corporations Act even if there is no accompanying offer.
- Whereas an offer of options over unissued shares will be exempt if made to senior managers or if it qualifies as a "small scale" offering, the senior managers and "small scale" offering exemptions will typically not be available for an offer of options over issued shares even though issued and unissued shares are economically identical from a recipient's perspective.
- Conversely, as a general rule Part 7.9 will not apply to options over issued shares that are not being granted in the course of a business of issuing financial products. No equivalent exemption is available under Chapter 6D for securities.
- A company making ESS offers may have to rely on different exemptions for different offers, with different conditions attaching to each. It may, for example, need to rely on the "small scale offerings" exemption in some cases (meaning that the relevant offers will not need to be accompanied by any particular form of disclosure),

whilst for other cases it may need to rely on ASIC Class Order 14/1001 (meaning that those offers will need to be accompanied by an offer document, financial statements, etc).

- Finally, even where an ESS offer is exempt from the core disclosure and licensing requirements, it may still fall foul of the prohibitions on advertising and hawking, and/or the requirements to be registered as a managed investment scheme. There would seem to be no clear policy rationale for this.

In our view, much of this complexity and inconsistency could be removed through the implementation of a simple exemption that applies to all ESS offers. We outline a possible approach in our response to question 6.2.

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?

Yes. As an alternative to making piecemeal adjustments to existing exemptions, we would suggest a simpler and broader exemption that applies to all ESS offers.

The details of such an exemption - including any appropriate protections for employees - would need to be considered carefully, but a starting point could be the exemption that already exists in Parts 7.6 and 7.9 of the Corporations Act. Under those Parts, the licensing and (in most cases) the disclosure obligation only apply to financial products that are offered or issued in the course of a business of issuing financial products.

As mentioned above, there is a strong argument that equity-based incentives that are granted to employees in the context of employee incentive plans do not amount to a "business" of issuing financial products, but rather form part of the internal functioning of the employer company. On this basis, a broad-based licensing and disclosure exemption is already available for ESS offers where the equity-based awards being offered are not "securities".

We submit that this existing exemption could inform a broader approach to ESS offers, supplying the basis for a general exemption from all relevant regulations, including the requirement for a disclosure document, the requirement to hold an AFSL, the requirement to register as a managed investment scheme, and the restrictions on advertising and "hawking".

We consider that a broader exemption to regulated disclosure for offers made under an ESS would be in line with the approach taken in other comparable jurisdictions. For example, under the prospectus regime that applies in European Union member states, the offer of non-transferable equity-based awards will not be subject to the prospectus requirements where no consideration is paid for the award or the shares (as is the case for offers or awards of free shares which are commonly granted by multinational companies to employees). For offers that do fall under the prospectus regime (i.e. because consideration is paid), there is an exemption for offers to employees that requires only a simple disclosure document that is not prohibitive for companies to produce, from either a cost or time perspective, and generally does not require a filing with any securities regulator. Similarly broad disclosure exemptions for equity offers to employees apply under the legislative regimes in Singapore, Hong Kong and New Zealand.

Our experience is that Australian employees who are employed by a global company (based in a jurisdiction where there is greater flexibility to make equity-based incentive awards to their employees) are often denied the opportunity to participate in that company's employee incentive scheme. Rather than assume the costs of producing a disclosure document and other filings, the global company is often more likely to exclude Australian employees from participating in the company's incentive scheme. The complicated and restrictive nature of Australia's legislative and regulatory regime in the context of ESS therefore has the potential to disadvantage Australian employees compared with employees in other countries.