KPMG

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KPMG submission in response to Treasury Consultation Paper *Employee Share Schemes* released April 2019

Dear Ms Nero

KPMG welcomes the opportunity to comment on the consultation paper *Employee Share Schemes* published by Treasury in April 2019 (the **Consultation Paper**).

We support in principle the proposals to consolidate and simplify the current regulatory framework applying to employee share schemes (**ESSs**) and broaden the relief available under the current framework as set out in the Consultation Paper.

For a number of the proposals, we have suggested an alternative approach, which we consider to be consistent with the objective of simplifying the existing complex and fragmented regulatory framework and incentivising the increased uptake of ESSs in Australia, whilst still providing appropriate protections for employees.

We elaborate on these issues in our responses to the discussion questions set out in the Consultation Paper in our submission below.

We look forward to seeing the detail of the changes proposed to the current regulatory regime in due course, and having an opportunity to review and provide feedback on the proposed changes through further consultation.

In the meantime, please do not hesitate to contact us if have any questions or would like to discuss this submission.

Yours sincerely

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KPMG submission in response to Treasury Consultation Paper

Executive Summary

KPMG appreciates the opportunity to comment on Treasury's proposals to consolidate and simplify the current regulatory framework applying to ESSs and broaden the relief available under the current framework as set out in the Consultation Paper.

The long-term mutual benefits of ESSs as a form of remuneration are well recognised. While ESSs provide employees with an opportunity for financial benefit through ownership interests in a company and potential tax advantages, employers are equally afforded cash savings and an effective means to attract and retain talent and drive company growth and performance.

We agree that the existing regulatory framework is complex, fragmented and technical in nature, and some of the relief available under the existing framework is too restrictive. As a result compliance can be burdensome, time consuming and costly, and companies (particularly small companies) may be discouraged from implementing ESSs.

In particular, we support the proposals to:

- consolidate and simply 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**). However, as an alternative approach, we would recommend consolidating the exemptions and relief available from the obligations applying to ESSs into ASIC class orders or legislative instruments, which can be more readily updated to reflect developments in market practice and regulatory policy, than if they are 'hardwired' into the Corporations Act; and
- increase the value limit of financial products that can be offered by an unlisted company per employee under ASIC class order relief. We would, however, encourage a more meaningful increase to the limit than that currently proposed, which we consider would make offering ESSs more attractive especially for small businesses, while still imposing some constraint on the value of the financial products that may be offered under the ASIC class order to address risks associated with offering financial products without a disclosure document.

In addition, we recommend other reforms to the existing regulatory framework as outlined in this submission, including:

- enabling the use of loan arrangements as well as contribution plans to fund the acquisition of financial products under ESSs offered by unlisted companies under ASIC class order relief;
- extending the relief available under [CO 14/1001] to also cover the offer of non-voting ordinary shares, which are commonly offered by unlisted companies under an ESS;
- amending the 'small scale offering' exemptions under Chapter 6D and Chapter 7 of the Corporations Act to increase the limits placed on the number of employees and the amount that may be raised as a result of offers made under these exemptions; and
- expanding the ASIC class order relief for listed companies currently available under [CO 14/1000] to cover offers under an ESS made around the time of an initial public offering.

Importantly, as part of this reform process, we would encourage the opportunity for stakeholder consultation to consider the detail of the proposed changes before they are finalised and to provide feedback on any draft form of the changes proposed.

KPMG responses to Consultation Paper proposals and discussion questions

1. Consolidating and simplifying existing exemptions and ASIC relief

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

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

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

1.1. KPMG supports in principle the proposal to consolidate and simplify the current statutory exemptions available under the Corporations Act and ASIC class order relief under [CO 14/1001] as well as [CO 14/1000].

1.2. We agree that a difficulty with the current regulatory framework is that the range of exemptions and relief from disclosure, licensing and other legal requirements are complex and fragmented across different parts of the Corporations Act, Corporations Regulations and ASIC class orders, making it complex, time consuming and costly for companies to navigate and comply with the regulatory framework, which may deter some companies (particularly smaller companies) from implementing an ESS.

1.3. The existing regulatory regime is made further complex by the lack of alignment and inconsistencies between statutory definitions and exemptions in the Corporations Act and the scope of ASIC class order relief. The Consultation Paper acknowledges the misalignment between the definition of ESS offers under the Corporations Act and the broader scope of ESSs covered by the ASIC class orders, but inconsistencies and misalignment within the regulatory regime extend beyond this to:

a. limitations in the scope of equivalent statutory exemptions under Chapter 6D and Chapter 7 of the Corporations Act which mean that offers of certain financial products offered under ESSs may fall outside the scope of statutory exemptions under both Chapter 6D and Chapter 7[1]; and

b. limitations in the scope of statutory exemptions from financial assistance, self-acquisition and buy-back provisions under the Corporations Act available for ESSs which apply the statutory definition of an 'employee share scheme' under section 9 of the Corporations Act which is not as broad as the scope of ESSs covered by the ASIC class

[1] Although 'small scale offering' and 'senior manager' exemptions are available under both Chapter 6D (see s708(1) and s 708(12)) and Chapter 7 (see s1012E and s1012D(9A)) of the Corporations Act, the exemptions under Chapter 7 only apply to 'managed investment products' and not financial products which may be subject to the Chapter 7 disclosure regime more broadly. Conditional rights to underlying shares are a type of financial product commonly offered under ESSs which, depending on their characteristics, may not meet the definition of a 'security' for the purposes of Chapter 6D of the Corporations Act. Such rights can include share rights, performance rights, share appreciation rights, restricted stock units and phantom share schemes. These rights are typically 'derivatives' and subject to the disclosure regime in Chapter 7 of the Corporations Act, but will fall outside the 'small scale offering' and 'senior manager' exemptions under Chapter 7 unless they are 'managed investment products' (i.e. interests in a 'registered scheme).

orders[2]. Therefore, the inconsistencies have implications beyond the disclosure and licensing regimes applicable to ESSs.

1.4. In practice, it is therefore often unclear to companies how the statutory exemptions and ASIC class orders operate, how they differ in scope and conditionality and that there are gaps in the statutory exemptions and ASIC relief available from the regulatory requirements which may preclude the offer of certain financial products and ESS structures.

1.5. Accordingly, we support Treasury's proposal to consolidate and simplify the existing statutory exemptions and ASIC class order relief to make the regulatory regime less complex and fragmented and more user friendly, which would make it more cost-effective and efficient for companies to implement an ESS. We also consider that this would provide an opportunity for inconsistencies and misalignment between statutory definitions and exemptions and the scope of ASIC class order relief under the existing regime to be harmonised.

1.6. While we support the proposal to simplify and consolidate the current regulatory regime in principle, we would want to consider the detail of the proposed changes before they are finalised and caution against amendments that narrow the breadth of the existing exemptions and relief, or which would result in the regulatory framework becoming overly restrictive or conditional. A simplified regulatory framework that provides the flexibility for financial products offered under ESSs, ESS structures and exemptions from legal obligations applying to ESSs to adapt in response to market trends and policy changes over time would be preferable.

1.7. Importantly, as part of this process of reform, we would encourage the opportunity for stakeholder consultation and to provide feedback on any draft form of the changes proposed.

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

Question 1.5: Are there significant advantages or disadvantages in using ASIC class orders as opposed to primary legislation to regulate ESSs?

1.8. Whilst we recognise that having all obligations applying to ESSs and available exemptions contained in the Corporations Act would mean that the regulatory framework is less fragmented and the relevant obligations and exemptions are easier to locate and navigate, we have concerns that amendments to the regulatory regime and exemptions would be made more difficult if this approach was taken and all relevant obligations and exemptions were consolidated and 'hardwired' into the Corporations Act.

1.9. In this regard, we note the issues under the existing regulatory framework caused by the lack of alignment between certain statutory definitions and the scope of ASIC class order relief outlined in paragraph 1.3. In our view, the inconsistencies and lack of alignment between statutory concepts and ASIC class order relief are, at least in part, a consequence of the statutory regime falling out of step with the ASIC class order relief which has been

[2] The differences in the scope of these statutory exemptions and ASIC class order relief mean that offers under ESSs to non-executive directors and contractors will fall outside the scope of the statutory exemptions from financial assistance, self-acquisition and buy-back provisions for ESSs, notwithstanding that ASIC class order relief has been expanded to cover ESS offers to non-executive directors and contractors.

more readily able to be updated and extended to reflect developments in market practice and regulatory policy.

1.10. As an alternative approach, we would recommend using ASIC class orders or legislative instruments rather than primary legislation to regulate ESSs, and particularly the exemptions and relief available from the obligations applying to ESSs. In our view, consolidating the exemptions and relief into one or more class orders or legislative instruments rather than the Corporations Act would enable future amendments to such exemptions and relief to be made more easily.

1.11. We believe this is an important consideration in the context that we are continuously seeing developments in the financial products offered, and ESS structures used, in the market both in Australia and globally, and recognise that market practices and regulatory policy will continue to evolve over time. For the regulatory framework, and in particular the scope of exemptions, to remain effective and appropriate and support the use of ESSs, it is important for the framework to be able to be updated to reflect developments in market practice and changes to regulatory policy.

1.12. However, we note that outside of legal practitioners, the availability of ASIC class order relief is not always widely known. Accordingly, if this alternative approach was to be taken, we would suggest that greater prominence be given to the availability of the class order relief in relevant sections of the Corporations Act and ASIC regulatory documents.

Question 1.6: Are there any requirements or conditions of the ASIC class order that should be removed or amended as part of the consolidation?

1.13. We consider that some of the requirements and conditions of the ASIC class orders, particularly those applicable to unlisted companies under [CO 14/1001], are overly restrictive and can preclude companies from being able to make offers under an ESS, or otherwise from using structures that would make economic sense for both employers and employees, in reliance of ASIC class order relief.

1.14. We would support the removal or amendment of certain requirements and conditions of the ASIC class orders as outlined in sections 2, 3 and 5 of this submission to enhance the effectiveness and accessibility of ASIC class order relief and increase the use of ESSs, particularly by unlisted companies.

1.15. In addition, we note that the type of financial products that may be offered by unlisted companies seeking to rely on [CO 14/1001] are limited to fully paid voting ordinary shares, or units, options to acquire or incentive rights granted in relation to such shares. However, this requirement precludes unlisted companies from offering a number of possible ESS structures in reliance on [CO 14/1001], and unlisted companies that intend to offer other classes of shares must rely on statutory exemptions in order to do so. In particular, in our experience, it is not uncommon for unlisted companies to offer non-voting ordinary shares under an ESS.

1.16. We understand the policy rationale for imposing this restriction, as outlined in ASIC Regulatory Guide 49 on *Employee incentive schemes* (**RG 49**), is to protect employees from the risks associated with the difficulties in understanding and valuing classes of financial products which are not voting ordinary shares. However, in our view, this is less of a concern in the context of non-voting ordinary shares which are more readily understood and less difficult to value than other classes of shares (such as preference shares).

1.17. Further, we consider the risk profile of a minority shareholding in an unlisted company to be similar regardless of whether of whether the share is a voting or non-voting ordinary share. Accordingly, we would recommend extending the relief available under [CO 14/1001] to cover the offer of non-voting ordinary shares, and units, options and inventive rights over such shares, but not other class of shares.

1.18. In addition, we consider that consolidation of the current regulatory regime also provides an opportunity to amend the 'small scale offering' exemptions under Chapter 6D and Chapter 7 of the Corporations Act. The thresholds under these exemptions (currently restricting companies from offering financial products, over the last 12 months, to no more than 20 persons and raising no more than $2 million without having to issue a disclosure document) have remained unchanged since first introduced into the Corporations Act.

1.19. To incentivise the continued uptake of ESSs in Australia, particularly by unlisted companies, we would recommend an increase to the restrictions on:

a. the number of employees to 50; and

b. the amount that may be raised as a result of offers made under these exemptions to $5 million.

2. Increasing the offer cap per employee

Question 2.1: Do you support increasing the offer cap per employee?

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

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

Question 2.5: Is the level of disclosure currently required by the ASIC class order for unlisted companies sufficient to address any risks associated with an increased employee cap?

Question 2.6: Are there any significant advantages or cost savings for business as a result of an increased cap per employee?

2.1. KPMG supports increasing the $5,000 offer limit per employee for unlisted companies seeking to make ESS offers without a disclosure document, in reliance on ASIC class order relief. The low monetary value of the existing $5,000 offer limit provides a barrier for unlisted companies seeking to rely on [CO 14/1001]. As a result, in our experience, unlisted companies are less readily able to rely on ASIC class order relief than listed companies, and may only have the statutory exemptions available to them when looking to make offers under an ESS. This, in turn, limits how unlisted companies are able to implement and structure ESSs, and the extent to which they are able to offer participation in ESSs.

2.2. While we support an increase in the current offer limit, in our view, an increase in the limit to $10,000 proposed in the Consultation Paper will not go far enough to result in a meaningful increase in the reliance by unlisted companies on ASIC class order relief. For the reasons discussed below, we would recommend a greater increase to the offer limit than the $10,000 limit currently proposed.

2.3. For unlisted companies, particularly in a start-up context, having adequate cash available to pay market competitive salaries to attract and retain talent in Australia is a fundamental challenge (particularly when viewed in comparison to the compensation packages that are offered to the same category of highly-skilled employees globally).

2.4. However, the ability to offer equity-based remuneration can make up for any shortfall created by early stage capital restraints and make overall remuneration packages more competitive. Offering meaningful equity-based remuneration is also key to retaining and incentivising employees who are key to company growth and performance. In our experience, the value of offers under an ESS that unlisted companies seek to make to such employees typically exceeds $10,000 (and certainly $5,000).

2.5. While we understand the policy rationale for imposing an offer limit, as outlined in RG 49, is to reduce the risks associated with offering financial products to employees without a disclosure document, particularly where there is no reliable market price available for the financial products, in our view, these risks can be offset or mitigated where:

a. an appropriate level of disclosure is provided to employees being offered participation in an ESS – in this regard, we consider the existing disclosure requirements under [CO 14/1001] (which require a directors' valuation and financial reports to be provided and details of the terms of the ESS and offer and general information about the risks of acquiring financial products to be disclosed) to be adequate; and

b. a limit on the value of financial products that may be offered per employee is still applied, although we support increasing the current offer limit.

2.6. Accordingly, we would recommend increasing the offer cap per employee to a more realistic monetary value of at least $50,000 which we believe would increase reliance by unlisted companies on ASIC class order relief and, as a result, the use of and scope of ESSs offered by unlisted companies, while still imposing some constraint on the value of the financial products that may be offered under the ASIC class order to address risks associated with offering financial products without a disclosure document.

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

2.7. KPMG supports the exclusion of 'senior managers' from the offer cap. Such persons generally have oversight of the operations and financials of the company and possess the necessary knowledge to make significant business decisions on behalf of a company, such that they are in a position to make their own informed investment decisions regarding participation in an ESS offered by the company, and the risks associated with such participation. Senior managers therefore do not require the same level of protection that the offer cap is intended to afford.

3. Facilitating the use of contribution plans

Question 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?

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

Question 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.

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

3.1. KPMG considers it is both appropriate and practical for unlisted companies to use contributions plans to fund the acquisition of financial products under an ESS, and would support expanding the scope of [CO 14/1001] to permit the use of contribution plans.

3.2. The most common form of contribution plan would be a salary sacrifice arrangement under which employees are able to forego future salary in order to receive financial products under an ESS. Currently, salary sacrifice arrangements are broadly available and supported by the tax regime governing employee share schemes, however, they are not supported by [CO 14/1001].

3.3. The benefit of allowing unlisted companies to offer contribution plans as part of an ESS is that it provides greater flexibility in the kinds of plans companies can offer. For example, salary sacrifice arrangements have benefits for both employees and employers, whereby:

a. employees are provided with a choice in the form their remuneration may take, which encourages employee engagement; whereas

b. for the employer, the ability to offer additional equity under an ESS in lieu of a cash salary provides a cash saving that can then be invested in the business.

3.4. We recognise the policy rationale for not allowing monetary contributions to be made to acquire financial products under an ESS where there is no reliable market price in an unlisted company context, as outlined in RG 49. However, in our view, the financial risks faced by employees in participating in a contribution plan (and potentially losing out on contributions made under a salary sacrifice arrangement), are similar financial risks associated with participating in an ordinary ESS arrangement as part of an employee's overall remuneration package – i.e. having a portion of the employee's remuneration package devalued where the share price reduces.

3.5. Accordingly, in enabling the use of contribution plans under [CO 14/1001], we would support extending similar protections to employees as those that are currently afforded to employees where contribution plans are utilised by listed companies under [CO 14/1000].

3.6. We would also support contribution plans being made subject to a general cap that aligns with the offer cap per employee under [CO 14/1001] (which, as outlined in section 0 of this submission, we recommend be increased to a minimum of $50,000). However, we are not supportive of including an additional requirement for an independent valuation, as this would increase the administrative burden and costs for a company, when a directors' valuation is already required and would be adequate for this purpose.

3.7. In addition, we consider that relief under [CO 14/1001] should be expanded to permit loan arrangements to fund the acquisition of shares under ESSs offered by unlisted companies. Loan arrangements consist of the employer (or group company) providing employees with a loan to acquire shares, generally at market value.

3.8. While it is common practice for unlisted companies to implement ESS structures under which loans are offered to assist employees to fund the acquisition of shares in the company and allow for employees to share in the future growth of the company, these structures are not permitted under [CO 14/1001] and unlisted companies that wish to implement such arrangements are currently confined to relying on the limited statutory exemptions available under the Corporations Act.

3.9. The policy rationale for not permitting loans under ESSs offered by unlisted companies is the same as for not permitting contributions plans to be utilised – i.e. both structures require the employee to make monetary contributions to acquire financial products in the absence of a reliable market price. However, in our view, this risk can be mitigated if the same conditions that apply to listed companies under [CO 14/1000] that provide loans under an ESS, namely that:

a. the loan is not used to acquire options or incentive rights;

b. no fees or interest are payable under the terms of the loan; and

c. either the lender has no recourse against the employee in relation to the repayment of the loan, or the recourse of the lender against the employee in relation to the repayment of the loan is limited to forfeiture of the shares in the company.

3.10. In our view, such conditions would provide sufficient protection to mitigate the potential for any downside risk or additional liability as a result of participating in an ESS loan arrangement.

4. Expanding the exemption from public access to disclosure documents

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

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

4.1. KPMG supports expanding the existing exemption for certain 'start-ups' from the requirement for disclosure documents lodged with ASIC to be made publicly available so that it applies to a broader range of unlisted companies and a broader range of ESS offers.

4.2. We recognise the policy rationale for public disclosure obligations to apply to publicly listed companies given that their securities are publicly traded and to ensure that the market is informed of information that may have a material effect on the price or value of their securities. However, those same public interest considerations and the need for investor safeguards do not apply in an unlisted company context, and we consider that the content requirements applying to disclosure documents and the requirement to lodge offer documents with ASIC provides the appropriate protections for participants in an ESS offered by an unlisted company.

4.3. However, whilst we are supportive of expanding the types of ESSs eligible for the exemption from public access to disclosure documents, in our view, given both the time and resources required, as well as the costs involved, to produce a disclosure document, it would be preferable for disclosure exemptions and relief to be broadened in line with the recommendations outlined in this submission so that the circumstances in which unlisted companies are required to prepare a disclosure document are limited in the first place.

5. Listed companies

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

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

5.1. KPMG supports simplifying and consolidating the relief for listed companies available under [CO 14/1000] and the Corporations Act as part of the simplification and consolidation of statutory exemptions and ASIC class order relief more broadly outlined in section 1 of this submission.

5.2. Whilst the relief available to listed companies under [CO 14/1000] is less restrictive and better utilised than the relief available to unlisted companies under [CO 14/1001], the same inconsistences and issues with the misalignment of certain statutory definitions between and exemptions and the scope of ASIC class order relief discussed in paragraph 1.3 of this submission apply to the exemptions and relief available to listed companies.

5.3. In addition, although we consider that the complexity and fragmentation of the existing regulatory regime provides more of a barrier to unlisted companies seeking to implement ESSs than listed companies, in our view, all companies would benefit from the reduction in the complexity of the current regulatory regime, and the time and cost burden in complying with the regime, that would result from simplifying and consolidating the existing regime.

Question 5.3: Are there any requirements or conditions of the ASIC class order that should be removed or expanded as part of the consolidation?

5.4. KPMG recommends expanding the relief available under [CO 14/1000] to cover offers under an ESS made on or around completion of an initial public offering (**IPO**) and listing of shares in a company as part of the reforms proposed to the existing regulatory regime.

5.5. For relief to be available under [CO 14/1000], the company's shares must have been traded on ASX or an approved foreign market at all times in the 3 months before the date that the offer is made, and not suspended for more than a total of 5 days in the 12 months before the offer is made. This requirement will not be met where a company proposes to make offers under an ESS around the time of an IPO.

5.6. However, individual relief from the quotation requirement is standard relief regularly sought by companies in connection with an IPO that is generally granted by ASIC where the other requirements and conditions of [CO 14/1000] are met and the offer is otherwise within the policy of the class order relief.

5.7. Given the standard nature of this individual relief, and the well-established basis for providing such relief, we consider that expanding the relief available under [CO 14/1000] to cover offers under an ESS made on or around completion of an IPO would be appropriate and would remove this administrative burden and the legal costs associated with companies looking to list having to make an application for relief from the quotation requirement.