AUSTRALIAN INVESTMENT COUNCIL

30 April 2019

Nathania Nero
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Consumer and Corporations Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: ESSreforms@treasury.gov.au

Re: Employee Share Schemes Consultation Paper

Dear Ms Nero,

The Australian Investment Council welcomes the opportunity to contribute our feedback in response to Treasury's Consultation Paper on Employee Share Schemes (the consultation paper) released in April 2019.

The Australian Investment Council is the voice of private capital in Australia. Private capital investment has played a central role in the growth and expansion of thousands of businesses, which when combined represents a multi-billion dollar contribution to the Australian economy. Our members are the standard-bearers of professional investment and include: private equity, venture capital and private credit funds, alongside institutional investors such as superannuation and sovereign wealth funds, as well as leading financial, legal and operational advisers.

The Australian Investment Council and its members recognise the important role that Employee Share Schemes (ESSs) play in the remuneration and incentivisation of staff in startups, scale-ups and other high growth companies, particularly those that are constrained by limited resources but have the potential to grow into large and sustainable businesses. While reforms in this area over recent years have significantly improved the ESS regime, we believe that there are still opportunities to further enhance how these schemes operate and how companies are able to remunerate their staff.

We support the proposals to improve the current ESS regulatory framework as set out in the consultation paper. In particular, consolidating and amending the statutory exemptions regarding disclosure, licensing and other provisions as well as increasing the value limit of financial products that can be offered by unlisted companies would increase the take-up and effectiveness of these schemes.

However, we believe that further reforms are necessary to make them even more widespread and increase their effectiveness in incentivising employees to share in the common goals of business growth and success. We have provided a series of recommendations that detail further improvement and refinement of ESSs.

This ESS consultation process presents a compelling opportunity to make meaningful reforms to not only provide startups, scale-ups and other high growth companies with valuable remuneration and recruiting tools in the form of ESSs, but also to help boost Australia's startup and innovation eco-system over the long term. Individuals that are able to share in the success of the startups that they work for often reinvest back into the startup ecosystem, creating a virtuous cycle of investment and growth for the next crop of successful businesses.

We look forward to participating in any future discussions about the issues we have set out in this submission. If you would like to discuss these further, please do not hesitate to contact either me or Kosta Sinelnikov, the Australian Investment Council's Head of Policy & Research, on 02 8243 7000.

Yours sincerely,

Yasser El-Ansary
Chief Executive

Responses to consultation paper proposals and other reforms

1. Consolidating and simplifying existing exemptions and ASIC relief

The Australian Investment Council supports the proposal to consolidate and simplify the range of existing exemptions that are offered under the Corporations Act and ASIC class orders. The complexity created by the current framework, which often requires small companies to engage costly legal advice if looking to set up a workable ESS, can be addressed through a number of ways. It is our view that consolidating the statutory exemptions and the relevant class orders into the Corporations Act would be the most straight-forward approach and create a single source of reference for companies, employees and advisers.

We believe that changes also need to be made to the Corporations Act disclosure regime with respect to the 'small scale offer' exemption. In our view, current rules whereby companies are only able to offer financial products, over the last 12 months, to no more than 20 employees/investors and raise no more than $2 million without having to issue a prospectus are too restrictive.

Some of the most productive and fastest-growing companies, both in terms of sales and number of employees, are 'scale-ups' – companies that have proceeded from the initial startup phase with a proven product and market opportunity which now need further capital and expertise to hire more staff, drive sales growth and invest more deeply in research and development. These companies are 'scaling up' to become mature and large profitable companies.

These companies typically have hundreds of employees and require $10 million or more to fund their next stage of growth. Therefore, relying on the small scale offer exemption from disclosure requirements (i.e. providing a disclosure document) would be inappropriate for most scale-ups. We recommend that, within the scope of the ESS regulatory framework, the restriction regarding the number of employees is lifted and the limit to the amount raised is doubled to $4 million. This would enable more companies to access the exemptions and help them and their employees become more productive and align business interests with a greater number of employees.

In other jurisdictions, similar schemes have much higher limits, or no restrictions whatsoever. For example in the US, there are almost 7,000 employee share ownership plans (ESOPs) with an estimated 28 million employees participating. There is no requirement under US law that a company must disclose detailed, or even summary, financial information to those employees that are under an ESOP, and there are no limits to the amount of capital within the ESOP or the number of employees that it can be offered to.

In the UK, the Enterprise Management Incentive (EMI) is a tax-advantaged share option scheme designed for smaller companies. A qualifying company has discretion to decide which employees should have options, up to a maximum share value of £250,000 (approximately A$460,000) per employee or £3 million (approximately A$5.5 million) for the whole company. There is no limit on the number of employees that the EMI is offered to.

Providing mechanisms such as the suggested disclosure exemptions for the alignment of interests between high growth companies and their employees would help to ensure that Australia retains and nurtures its promising entrepreneurs and businesses, and is able to compete globally for talent on an equal footing.

2. Increasing the offer cap per employee

We support the proposed increase to the $5,000 annual cap per employee for ESS offers made without a disclosure document. Many startups, whether at the early or later stage as scale-up businesses, look to

attract highly skilled employees that have the talent and experience to help these startups get to their next phase of growth. Attracting and retaining those employees requires offering competitive incentives that can match those being offered globally because many of these prospective employees will be fielding offers from other centres of startup activity such as Silicon Valley or London.

We believe that a $5,000 cap is far too low to be effective in creating competitive incentives to attract and retain these types of employees. While setting a new cap of $10,000 is a step in the right direction, we recommend that the cap is increased even further to $20,000 to make this a more attractive feature of ESSs in Australia, further align interests between employees and companies, and reduce the associated per employee administrative costs. While $20,000 would be a significant amount for an individual employee to receive in compensation, it would still only make up a very small part of the shareholding of a startup due to the fact that many companies, although still in their early startup phase, can be valued in the tens of millions of dollars.

Furthermore, many startup employees often take lower salaries than they might attract in a more mature company and the ESS is a key way to reward them in order to balance a lower salary and taking on the additional risk of taking on employment in an early stage but growing business.

We also believe that exclusions to the cap, for example for 'senior managers' (as defined in s9 of the Corporations Act) as suggested in the consultation paper, would also be appropriate. Such employees generally make significant decisions affecting the business and should thus have the necessary level of knowledge about and experience within the business for disclosure requirements to be redundant.

3. Other reforms – ESS startup tax concessions

Treasury should consider a range of other reforms in order to further improve and refine the ESS regulatory framework. Under the National Innovation and Science Agenda, changes were introduced to the tax treatment of shares and options offered through an ESS by eligible startup companies. These changes (in effect tax concessions) were particularly important for startups given the role such offers often play in remunerating staff at a time when company cash-flow is limited and every spare dollar is being invested back into the business.

Provided below are a set of recommendations that aim to further improve the eligibility rules for companies to gain access to ESS startup tax concessions:

a. The 10-year incorporation requirement

Under current rules, a company and its subsidiaries must have been incorporated less than 10 years before the end of the most recent income year before the ESS interest is acquired to be eligible. Our members have seen a number of companies failing this requirement because a founder has re-used a corporate entity from an earlier venture and subsequently started up a new business through that entity (a common occurrence often known as 'pivoting') which has then grown successfully. But at this point the entity is now more than 10 years old and its ESS is ineligible for the startup concessions, which has resulted in unfairly penalising the employees that would have otherwise had access to them. We therefore believe that the 10-year incorporation requirement should be removed to better accommodate for the evolution of many startups as businesses that had limited success in earlier ventures but have nonetheless grown and succeeded later on.

b. The no more than 10% requirement

Another eligibility provision is that the employee must not hold a beneficial interest or voting power of more than 10% in the entity immediately after acquiring the ESS interest. We believe that there needs to be a mechanism to grant founders (who typically hold large stakes in startups) or other senior executives additional equity without creating an immediate tax liability. This need can arise in a number of

circumstances, such as when founders take on different roles within a startup as it grows or where one co-founder leaves and the remaining founder(s) have to perform additional duties for which cash compensation may not be available. Similarly, where a company goes through multiple funding rounds, the founders' equity can be diluted and investors often want to re-incentivise founders during these stages with 'at risk' equity. However, these cannot be solved if issuing options will lead to an immediate tax impost. Removing the no more than 10% requirement would address these issues and incentivise founders of startups to continue to use their skills, knowledge and experience to help build and grow the businesses that they had established.

c. The 3-year sale restriction

An employee is currently not permitted to dispose of the ESS interest for a period of 3 years starting from when the ESS interest was acquired (subject to very limited exceptions). We believe that this requirement is unnecessary. One of the primary benefits for an employee to gain access to the startup concessions is that they are taxed on capital account and can access the capital gains tax discount. They can only access the benefit if they were granted their options at least 12 months prior to any disposal.

However, a company cannot secure a sales process more than 12 months in advance and the restriction therefore provides no practical benefit. The 3-year sale restriction may also become an issue if the company is a target for acquisition by other investors or corporations in that time. It may also serve to discourage investors (both local and overseas) such as venture capital funds from providing capital to a startup as these investors generally want to ensure that there is a clean path, especially from a tax and regulatory perspective, to enter or exit their investment if required. We thus recommend that the 3-year sale restriction is removed.