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Dear Nathania

Response to The Treasury's Employee Share Schemes Consultation Paper – April 2019

We thank the Treasury for the opportunity to submit feedback on its Employee Share Schemes Consultation Paper – April 2019 (**Consultation Paper**) in which it outlined the proposed revisions to the regulatory framework for employee share schemes in Australia (**ESS**).

PwC Australia has a specialist multi-disciplinary ESS practice, drawing on legal, tax, accounting, valuation and remuneration consulting professionals in Australia and from around the world to prepare holistic and market leading solutions and advice to companies and ESS participants. We are regularly called upon to advise domestic and global offerors (listed and unlisted) to design, document and implement ESSs and advise on the application of Australian securities laws and ASX listing rules, tax laws, valuation and accounting considerations and other associated matters that require consideration when offering an ESS.

We have been actively involved in the ESS policy development process in recent years given our participation in industry bodies, regular ongoing engagement with the Australian Taxation Office and having previously made submissions to the Australian Securities & Investment Commission (**ASIC**) in relation to ESS (notably in relation to ASIC's consultation paper 218 '*ASIC Consultation Paper 218: Employee Incentive Schemes*' and having reviewed and commented on drafts of ASIC Class Order [CO 14/1000] (**Class Order 14/1000**) and ASIC Class Order [CO 14/1001] (**Class Order 14/1001**) prior to their release).

In the Consultation Paper, the Treasury has concisely summarised the current regulatory framework and, we agree, the regime is both complex and fragmented. With that said, in our view,

ASIC's efforts to facilitate the offers of ESSs by listed companies (initially through ASIC Class Order 03/184 and more recently through ASIC Class Order 14/1000) have had a significant and positive impact on the implementation of ESS by domestic and foreign listed companies. From an adviser perspective, following the introduction of ASIC Class Order 14/1000 in particular, we have generally and consistently been able to design and implement ESSs that meet the commercial objectives of the relevant listed companies and yet fall within the conditions of ASIC Class Order 14/1000.

However, the impact of ASIC Class Order 14/1001 in facilitating the implementation of ESSs by unlisted companies has been disappointing. Offerors have generally felt the incentive effect for participants in an ESS that meets the conditions of ASIC Class Order 14/1001 are not commensurate with the cost and time required to develop and implement such a plan. In particular, the $5,000 offer cap has caused frustration for offerors (the view being that an award valued at that amount or less simply does not have a significant enough incentive and/or retention effect) and accordingly the take up amongst our clients has been low.

Given the above and on the basis that the Australian Government has reaffirmed its general policy to support the use of ESSs, we believe meaningful reform particularly to facilitate the growth of unlisted company ESSs is critical.

We would welcome the opportunity to further discuss or expand on our views and consider any other specific issues on which Treasury might like our view in respect of the proposed revisions to the regulatory framework for ESSs.

Responses to Treasury's proposals and queries

Our responses to Treasury's proposals and queries in the Consultation Paper are set out below. Please note that we have not responded to all of Treasury's proposals and queries.

1. Consolidating and simplifying existing exemptions and ASIC relief

A new ESS specific disclosure exemption in Chapter 6D of the Corporations Act

In our experience, the most consistent impediment to unlisted companies implementing their preferred ESS design is the inability to meet a disclosure exemption in Chapter 6D or Chapter 7 of the Corporations Act in relation to each of their desired offerees. In particular, where an offeror wishes to roll out a broad based of securities, the relative inflexibility of the most commonly used Chapter 6D disclosure exemptions (being the small scale offering exemption, the senior manager exemption and the sophisticated investor exemption) and ASIC Class Order 14/1001 provides considerable frustration.

We therefore submit that a new Corporations Act exemption with specific application to ESS should be introduced. This exemption could take a similar form to the small scale offering exemption however with revised thresholds and application only to members of the unlisted company's workforce. We note that workforces of today increasingly include contractors and consultants participating and contributing in key functions and so limiting such an exemption to offers to employees and executive directors may be too restrictive. Instead the approach taken in ASIC Class Order 14/1000 to the concept of 'eligible participant' could be adopted.

A suggested formulation would be that personal offers of securities that result in no more than 50 issues in any 12 month period to 'eligible participants' and that lead to less than $2 million being raised in any 12 month period are exempt from the disclosure requirements. When counting the number of issues of securities and determining the value of securities issued over a 12 month period, the following offers would not count toward the limits under the new ESS exemption:

(a) offers of securities that fall within another exemption to Chapter 6D of the Act (except the small scale offering exemption in s.708(1) of the Act);

(b) offers of securities under the small scale offering exemption in s.708(1) of the Act to parties that are not eligible to fall within the new ESS exemption;

(c) offers of securities or financial products that are made in reliance on ASIC Class Order 14/1001;

(d) offers of securities or financial products not received in Australia; and

(e) offers of securities or financial products made under a disclosure document.

In addition, to ensure the positive impact of the new ESS disclosure exemption is not hindered by other technical requirements within the Act, we support Treasury's proposal that the definition of "eligible employee share scheme" be extended – in our proposal, the concept would be extended to include offers under the new ESS exemption with the benefit of exempting such offers from the on-sale and hawking restrictions and licensing requirements in the Act.

The proposal that ASIC would have a power to determine that a company is not permitted to rely on a statutory ESS exemption would not in our view promote regulatory certainty and therefore we do not consider any benefits of such power would outweigh the downsides.

No monetary consideration

It is regularly a surprise to our clients that ongoing service of an ESS participant to the offeror or other members of its corporate group is considered by ASIC to be consideration for the purposes of section 708(15) and (16) of the Corporations Act, notwithstanding that no monetary consideration is sought from the ESS participant in connection with grant, vesting and (where relevant) exercise of the relevant security.

We submit that if no monetary consideration is sought by the offeror from the ESS participant in connection with the grant, vesting and (where relevant) exercise of the relevant securities, then section 708(15) and (16) of the Corporations Act should be able to be applied by the relevant offerors when offering those securities.

While we do not dispute the logic of ASIC's interpretation of 'consideration', in our view, the interpretation has had the effect of stifling the use by unlisted companies of ESSs involving options and/or rights with no grant or exercise price and therefore is inconsistent with the Australian Government's stated policy objective of supporting the use of ESSs.

2. *ASIC Class Order 14/1001 (unlisted companies)*

Even if a new ESS disclosure exemption were introduced into Chapter 6D of the Corporations Act (as is proposed above), we consider there remains a place for a revised ASIC Class Order 14/1001, notably in relation to offers of financial products which we understand are considered a more complex product than securities and therefore worthy of more comprehensive regulation.

Increasing offer cap per employee

We strongly support an increase to the offer cap presently enshrined in ASIC Class Order 14/1001. In our view, an increase in the offer cap per employee from $5,000 to $10,000 per year will not make the ASIC Class Order meaningfully more relevant to unlisted companies in Australia.

However if this cap was substantially increased (perhaps to $30,000 or $40,000), we would expect a considerably higher take up amongst unlisted companies notwithstanding the disclosure and other conditions set out in ASIC Class Order 14/1001 would still need to be met. At that level, it is our view that offerors would consider the incentive and/or retention effect would justify the cost and effort of designing, preparing and implementing an ESS.

Senior managers

We support Treasury's proposal to exclude senior managers from the offer cap under Class

Order 14/1001 on the basis that such persons have various methods of informing themselves about the value of the offeror and therefore do not require the offer cap as a method of investor protection.

Level of disclosure

We suggest that the level of disclosure currently required by ASIC Class Order 14/1001 is sufficient to address any risk associated with an increased offer cap.

Of relevance to ESS participants that receive grants of financial products under ASIC Class Order 14/1001 that involve the payment of an exercise price, we submit that those persons do not require a 'valuation document' prior to paying that exercise price and exercising their financial products provided that they are a senior manager at the time of exercise.

Guidance on value

We are aware of differing views on how eligible products are to be valued for the purposes of the offer cap and accordingly we submit that further ASIC guidance in this area would be valued by unlisted companies looking to rely on ASIC Class Order 14/1001.

Contribution plans

Given the prevalence of limited recourse loan funded share plans for unlisted companies in Australia, we submit that contribution plans should be permitted under ASIC Class Order 14/1001.

To the extent a contribution plan involves a loan funded contribution by the ESS participant, the terms of that loan could be consistent with the terms permitted by ASIC Class Order 14/1000 (i.e. in relation to shares only, limited recourse in nature etc).

We note that it is common for offerors to require an ESS participant to apply the after-tax value of dividends and capital distributions received from the offeror to pay down any loan received from the offeror or an affiliate of the offeror. It would be valuable for ASIC to confirm in guidance that it does not consider such application of funds to be inconsistent with the loan recourse requirements in ASIC Class Order 14/1000 and, were our proposals to be accepted, in ASIC Class Order 14/1001.

ASIC Class Order 14/1000 (listed companies)

We would like to flag with Treasury the following issues that regularly arise when listed companies seek to make offers under ASIC Class Order 14/1000:

(a) Prohibition on options or rights to acquire options or rights

Class Order 14/1000 currently prohibits the offer of options over options and incentive rights over incentive rights[1]. We understand the reason for this is that ASIC consider the valuation of such financial products is considered unduly difficult for the ESS participants.

However, as a result of regulator and investor pressure, many of our listed clients (initially in the financial sector but more and more broadly) are moving to implement short term incentives where those incentives are substantially delivered in the form of equity (typically subject to ongoing service conditions) rather than cash. Due to preferential tax treatment and simplicity on forfeiture, such 'deferred' short term incentives are commonly structured as performance rights.

It can be challenging to meet the requirements of ASIC Class Order 14/1000 in relation to such plans because at the outset of a performance period the outcome of the short term incentive performance is not known and therefore the number of performance rights that may be required cannot be calculated. It would be simpler if an offeror could offer at the outset of a short term incentive performance period a right to receive performance rights when the short term incentive outcome had been determined. Importantly, typically, no monetary consideration is required to be paid upon the grant, vesting or (where relevant) exercise of the performance rights.

Furthermore, some domestic and many foreign listed offerors wish to offer equity instruments to their Australian workforce that ratchet up or down in the event of outperformance or underperformance against a threshold. In some cases, the ratchet up on outperformance takes the form of the grant of further rights or options (noting that original and further issued options and rights may be settled in shares and/or cash upon vesting and/or exercise in due course). Again, it would be simpler if an offeror could offer at the commencement of the relevant performance period a right to receive performance or incentive rights. Importantly, typically, no monetary consideration is required to be paid upon the grant, vesting or (where relevant) exercise of such performance or incentive rights.

We submit that the retention effect of such awards can be significant and that offerors would value regulatory change in this area through the inclusion of such instruments as eligible products in ASIC Class Order 14/1000.

(b) <u>IPOs and the 3 month listing requirement</u>

Upon or immediately following a listing on the ASX (**IPO**), it is common for companies to make grants of (a) options with an exercise price equal to the IPO price, (b) grants of

[1] Regulatory Guide 49 – Employee incentive schemes, paragraphs RG49.65 and RG49.69

performance rights with no exercise price, or (c) grants of shares on a tax exempt basis to the substantial majority of their employee base.

These offers cannot presently be made in reliance on Class Order 14/1000 as the relevant offeror will not have been listed for at least 3 months at the time of the grant. We note that ASIC commonly grants specific relief to the 3 month requirement to entities listing on the ASX and therefore we submit that the 3 month requirement need not apply if the offer does not involve monetary consideration for the grant or exercise of the options, performance rights or shares or, if consideration is required (e.g. on an exercise of an option), that consideration is not payable prior to 3 months after the IPO.

(c) Prohibition on interest being payable on loans

In our submission to ASIC in response to its Consultation Paper 218: Employee incentive schemes, we raised our concerns regarding the terms of loans prohibiting interest being payable. We submitted that there may be instances where companies do want to charge interest on loans.

Where a loan is not interest bearing, fringe benefit tax (**FBT**) will not be payable to the extent the "otherwise deductible" rule applies. This rule applies where, if interest had been charged, it would have been deductible to the participant. For interest to be deductible to the participant, there must be a reasonable expectation of assessable dividends from the underlying shares acquired with the loan.

In instances where there is no reasonable expectation of assessable dividends (e.g. the shares are non-dividend paying shares, or the business will not generate income for a long time), the otherwise deductible rule would not apply. To overcome this issue, some ESS loan plans are designed such that interest is payable on the loan at the FBT benchmark rate and FBT is therefore not payable on the loan fringe benefit.

Provided the interest charged does not exceed the FBT benchmark rate and the limited recourse principles still apply to both principal and interest on the loan, we submit that such an approach should be permitted.

(d) Timing for lodgement of CF08 – Notice of Reliance on Class Order

In our experience, the condition that a notice of reliance be lodged with ASIC no later than 1 month after the body first relies on the Class Order has on occasion caused an offeror that otherwise met all requirements of the Class Order to be disqualified from relying on that Class Order.

We submit that ASIC should accept late lodgement of the notice of reliance in exchange for a late lodgement penalty. Such an approach is consistent with many other ASIC filings (e.g. form 484s).

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If you have any queries, please contact Nick Brown by phone on +61 3 8603 0291 or by email at nick.brown@pwc.com

Yours sincerely

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