Directors
Market Conduct Division and
Individual and Indirect Taxation Division
The Treasury
Langton Crescent
PARKES ACT 2600

25 August 2021

Dear Directors

SUBMISSION ON PROPOSED EMPLOYEE SHARE SCHEMES DRAFT LEGISLATION

I am submitting these comments in a personal capacity, as Professor of Employee Ownership and Reward at the University of New South Wales (see final page for biographical information).

1. Introduction

The proposals in the exposure draft legislation relating to tax rules and disclosure requirements are to be welcomed. Specifically, the abolition of cessation of employment as a taxing point for shares and rights made available under the deferred taxation arrangements, and the removal of disclosure requirements for shares issued at no consideration ('free shares') are desirable changes. The proposals attempt and generally achieve a balance between promoting ESS by reducing regulatory requirements, maintaining compliance, and protection of employees from 'excessive risk'. Nevertheless, there are some issues relating to the timing of the cessation of employment changes, the conditions for relief from prospectus requirements, and the severity of the sanctions for non-compliance.

2. Cessation of employment and tax deferral

The removal of cessation of employment as one of the tax deferral points is welcome. In the time I have been familiar with ESS in Australia, the cessation of employment rule has been seen by issuers, advisers, and plan administrators as the most important employee-level 'friction' in operating ESS.

The only disappointing element of the proposal is the timescale. As set out in the Budget Papers, this change will apply only to new ESS interests offered from July 2022: existing ESS interests will be unaffected. There is no obvious technical reason why the new requirements should not apply to existing as well as future ESS interests from Royal Assent. Indeed, there is likely to be some unwelcome confusion amongst continuing ESS participants as to whether particular interests are subject to taxation at cessation or not. This may work against the policy objective of promoting ESS.

Clearly, bringing the effective date of implementation forward will bring some loss of taxation receipts forward to 2021-22 from 2023-24 but this is essentially an issue of phasing rather than long-term loss, and would be transitory in nature. Although the Budget Papers do not present it as such, the removal of the tax liability at cessation will in principle increase future tax receipts following the decline experienced during the transition period (relative to the pre-Budget position).

3. Regulatory reforms

The key conceptual underpinning of the reforms to the Corporations Act is that ESS is provided for the purpose of attraction and retention of staff, not fundraising. Accordingly, ESS which offer shares at no consideration ('free shares') are exempt from the prospectus requirements of the Act. This is entirely reasonable and is a welcome part of the proposals.

A fundamental conceptual problem arising in relation to contributory plans is that they inevitably have a fund-raising dimension, even though that is probably not the primary purpose of most ESS[1]. But where can the line be drawn between employee-focused and fund-raising objectives? The proposed reforms deal with this issue by differentiating fund-raising vs employee-focused by magnitude. Thus, a set of issue and value caps is used to distinguish whether an offer document or a prospectus is required. In the absence of a clearer conceptual basis, such caps can inevitably seem arbitrary:

- The 5% over 3 years issue cap for listed entities may be low for some companies that are particularly committed to ESS, though most will fall beneath this cap.
- Conversely, the $30,000 value cap per employee in unlisted entities looks generous, and might be seen to expose employees to undue financial risk.

[1] In some jurisdictions ESS are seen as a source of 'patient', 'friendly' capital

It is worth noting that the European Prospectus Regulation approach provides a prospectus exemption for all employee share schemes (in listed and unlisted companies) that offer below an overall offer limit per company set by each Member State (typically Euro 5-8 million).

An alternative approach in the Australian context might be to extend the automatic exemption proposed for no consideration schemes to all-employee schemes whose rules offer shares to employees in accordance with the tax concessions set out in the tax legislation. Other schemes might be subject to the exemption regime proposed in the draft legislation. Whilst the limits for tax concessions are widely seen as low, this would nevertheless have the benefit of further harmonising tax and corporate rules whilst providing means to secure compliance and to protect employees from excessive risk.

One aspect of the proposed reforms which is welcome but which nevertheless may give rise to issues in practice, is the proposal to remove the requirement that an entity's shares be traded for three months prior to an ESS to be eligible for relief (Sec 1.39 in the Explanatory Notes). This is presumably to facilitate the offer of an employee share subscription during an IPO. Since this may be seen to be conjoined to the public offer, for which a prospectus will typically be required, there may be some doubt as to the relief treatment of the ESS. Might this be clarified by requiring a cross-reference in the ESS offer documents when an ESS is made alongside a public offer aimed at fund-raising?

4. Penalties

The penalties for non-compliance are severe. Given that breaches in relation to ESS are far more likely to result from technical breaches or oversights than deliberate malfeasance, the scale of the potential punishments may be viewed as excessive. It is arguable that a 'rogue' employer intent on fleecing its workforce will seek easier ways to extract money than an employee share scheme, and that nearly all employers will usually have a sense of responsibility to their workforces that is considerably greater than that of hawkers of questionable financial products to their potential customers. The policy danger here is that the scale of punishments for non-compliance may deter some companies and their directors from offering ESS.

5. Final remarks

It is of course generally desirable that adequate information is provided to potential investors when a corporate entity seeks to raise funds, and thus a full and comprehensive prospectus is valuable and necessary. Fund-raising prospectuses are of course costly to produce, and exemptions for ESS are desirable to reduce a barrier to the use of ESS by companies. The use of an offer document in place of a full prospectus can also be seen in a more positive light. Our research (conducted in

collaboration with Computershare) has shown that many employees make the decision whether to join an ESS very quickly, without consulting others, and on the basis of a partial reading of the available documentation (see https://www.computershare.com/News/UnderstandingTheParticipationDecision_digital.pdf)

In the light of this behavior, it is imperative that ESS offer information be as concise, informative, and accessible as possible, and thus a short document is far preferable to a more substantial one.

I hope these comments are useful.

Yours sincerely

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Biographical note

Andrew Pendleton is Professor of Employee Ownership and Reward, and Head of the School of Management and Governance in UNSW Business School. Prior to moving to Australia in 2019, he held academic appointments at the universities of York and Durham in the UK. He has researched and published on ESS and employee ownership for more than twenty years. He was a member of the UK Inland Revenue Advisory Group that designed the Share Incentive Plan and Enterprise Management Incentives. He is a Faculty Fellow and Mentor in the Institute for the Study of Employee Ownership and Profit Sharing at Rutgers University, USA. His most recent publication on ESS can be found here: https://doi.org/10.1016/j.jbef.2021.100539