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31 August 2021

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

By email
ESSreforms@Treasury.gov.au

Dear Sir/Madam

Submission on Exposure Draft Legislation - Employee Share Schemes

We welcome the opportunity to provide comments on:

- *Exposure Draft Treasury Laws Amendment (Measures for a later sitting) Bill 2021: Employee Shares Schemes - Removing cessation of employment as a taxing point;* (**Tax Exposure Draft**) *and*
- *Exposure Draft Treasury Laws Amendment (Measures for a later sitting) Bill 2021: Employee Shares Schemes* (**ESS Exposure Draft**).

Introduction

Baker McKenzie, a global law firm with over 6,000 lawyers in 76 offices in 46 countries, advises a large number of multinational corporations with regard to their global equity plans, most of whom make grants to Australian employees. In this regard, we maintain a current global database of the tax and securities law treatment of share plans in 50 countries. We also advise on a regular basis with regard to the taxation of internationally mobile employees and have direct ongoing experience with regard to the administrative issues relating to the grant and taxation of equity interests received by employees. Thus, we feel uniquely qualified to comment on both of the Exposure Drafts.

The Tax Exposure Draft

We are very supportive of the proposed change to remove cessation of employment as a taxing point and look forward to the improvements for employers and employees once they are enacted.

Having cessation of employment as a taxing point is out of step with the situation in most countries with which Australia competes for talent. While some companies have introduced complicated features into their share plans to navigate around the impact of this rule, many companies that operate globally have been unable to do so.

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The ESS Exposure Draft

As with the Tax Exposure Draft, we think that the ESS Exposure Draft represents a significant step in the right direction. In broad terms, the proposed changes to the existing securities law exemptions will likely make it easier for businesses, especially ones that are not listed, to offer equity-based awards to their employees.

However, we also believe there are serious shortcomings in the current ESS Exposure Draft, and we would urge the Government to reconsider both the scope and drafting of these reforms before seeking to give them effect.

Our comments in relation to the two Exposure Drafts are set out below.

1. The Tax Exposure Draft - Our submissions

1.1 The change should be implemented with effect for all outstanding ESS interests at the time the legislation comes into effect rather than for awards granted after that date:

- the ESS rules should be as simple as possible and easy for employers and employees to understand and implement
- it creates administrative confusion to have some awards subject to cessation of employment as a taxing point and others not - this will create unnecessary tracking and monitoring of awards to determine which rules will apply and ESS reporting will be more complicated
- communication to employees will be more complicated and confusing if the change only applies to new ESS interests granted after the change comes into effect
- the cessation of employment rule has had extremely unfair results for some employees (particularly in the case of redundancy) and it is equitable to rectify the situation as soon as possible
- having different rules for different outstanding awards encourages convoluted tax structuring and may encourage cancellation of existing awards
- if the share price increases between cessation of employment and the next relevant ESS deferred taxing point, the impact on Government revenue of implementing the change for all outstanding awards will be positive as the amount of tax payable by the employee will be greater

1.2 The start date for the change should not be deferred until 1 July following Royal Assent, but should have immediate operation

1.3 The impact on ESS reporting should be considered:

- consideration should be given to the ESS reporting requirements and how they can be satisfied several years after an employee has ceased employment - exceptions to the requirement to provide an ESS statement should be available

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where a provider no longer has employee details - lodging an ESS Annual Report should be sufficient in this situation

We would welcome the proposed change being introduced into Parliament as soon as possible with effect for all outstanding equity awards from the earliest time possible.

2. The ESS Exposure Draft - Our submissions

2.1 As noted above, whilst there are some welcome features in the reforms, they also reveal a number of serious shortcomings. Some of our concerns relate to substantive provisions. Others reflect what appear to be drafting errors or inconsistencies. Below we have described some of our key concerns with the ESS Exposure Draft. However, it should be noted that the issues we describe here do not represent a comprehensive list of all of the issues we have identified.

2.2 Given the substantive points we raise, as well as the number of drafting errors we have found in the proposed reforms, we would urge the Government to spend further time developing its proposed legislation before seeking to pass it into law.

2.3 With that said, our key comments are as follows:

(a) **Architecture**

The purpose of the ESS Exposure Draft, as we understand it, is to provide a set of exemptions to Australian securities and licensing laws for certain employee equity incentive plans.

We think the best way to capture this intent would be to draft those exemptions in a way that states clearly when they apply, and what conditions need to be satisfied in order for them to apply.

Unfortunately, the ESS Exposure Draft does not do this. Instead, it begins with a series of lengthy definitions (e.g., of "ESS participant", "ESS interest" and "ESS offer"), after which it sets out the substantive exemptions (in sections 1100K and 1100L), after which it sets out prohibitions on making certain ESS offers without accompanying "ESS disclosure documents", after which it sets out further lengthy definitions and provisions which need to be satisfied in order to avoid falling foul of the prohibitions. Whilst it's possible to navigate through this structure, the process of doing so is far more challenging than it ought to be. Items which are in reality substantive conditions on the exemptions applying are embedded in definitions, whilst ESS disclosure - which is intended to be a key condition on the exemptions applying in certain cases - is couched instead as a prohibition, whose ambit can only be gleaned by looking to the further definitions of "ESS offer document", "ESS supporting information" and so on.

It seems to us that the drafting style in the ESS Exposure Draft replicates something of the approach that ASIC adopts in drafting its Legislative Instruments (and previously, its Class Orders). In our experience, ASIC's drafting style has rarely made its Instruments and Class Orders easier to

understand, and more frequently has been a source of confusion and a barrier to understanding.

We would urge the Government to reconsider the overall architecture of the ESS Exposure Draft. In our view, the proposed reforms would be much easier to understand and apply were they structured in a way that follows the logic that the new rules are actually trying to achieve.

Given more time, we would of course be happy to provide a suggested redraft of the rules.

(b) **Options and RSUs issued by listed entities**

Because of the way "ESS interest" is defined, listed entities cannot grant options or restricted stock units (**RSU**s) unless the options or RSUs are publicly traded (which almost certainly will not be the case) or they have both a zero grant price **and** a zero exercise price. In the case of options, this is a significant - and anomalous - limitation. In effect it means that listed entities can only grant options with a zero exercise price. There is no equivalent limitation in Class Order 14/1000, nor are unlisted entities subject to an equivalent limitation (indeed, section 1100V of the ESS Exposure Draft specifically contemplates that unlisted companies may grant options and RSUs with a more-than-zero exercise or vesting price).

(c) **ESS disclosure documents**

The ESS Exposure Draft makes a fundamental distinction between:

- offers to employees that require no monetary payment (**Free Offers**); and
- offers that require monetary payment, or that are extended to independent contractors (**Other Offers**).

In the former case, no specific form of disclosure is required. In the latter case:

- a "notice of intent" will need to be filed with ASIC (section 1100G);
- issuing companies will need to provide employees with certain "ESS disclosure documents" (Subdivision C); and
- unlisted companies must also comply with a "value cap" of AUD 30,000 (see the definition of "ESS offer" in section 1100J).

As noted above, the architecture of these provisions - especially in relation to disclosure - is unfortunate. For example, there is no positive requirement to give employees ESS disclosure documents,

but instead only a prohibition on not giving them ESS disclosure documents.

Leaving that issue aside, the drafting of these provisions creates significant doubt as to when the disclosure and other additional requirements apply. For example:

- Is the offer of an option or RSU with a more-than-zero exercise price an ESS interest that is "offered for issue in return for monetary consideration" or is it not?
- If a company offers some equity awards for free and others for payment of money at the same time and under one and the same plan, do all of those awards trigger the additional disclosure and other requirements (meaning for example, that they all need to be accompanied by ESS disclosure documents), or only the ones that require payment of money?
- If a company offers some free awards to employees and some to independent contractors at the same time and under one and the same plan, do all of the offers trigger the disclosure and other requirements, or only those to the independent contractors?
- If a company offers free awards without lodging a notice of intent, does it automatically fall foul of section 1100G if it subsequently "intends" to offer awards for payment of money? (Note that, read literally, the notice of intent must be lodged before the company offers **any** awards under the relevant plan, and not merely before it offers awards that require payment of money).

Given the significance of the distinction between Free Offers and Other Offers, as well as the potentially very significant penalties that can arise for companies that fail to comply with the applicable requirements, it is crucially important that the provisions be drafted in a way that is clear and easy to understand.

(d) **ESS offer documents**

Where an ESS offer document is required, it must (among other things):

> *"explain how the ESS participant may, from time to time, calculate the value of the ESS interests" (section 1100Q(1)(e))*

However, it is not at all clear what is meant here by the "value" of the relevant ESS interests, or how that value is to be calculated. This requirement seems especially incongruous - and potentially onerous - for listed entities. Under Class Order 14/1000, listed entities are required to explain to employees how they can find the market (i.e.,

quoted) price of the shares that make up or underlie their awards. In contrast, the proposed new provisions appear to require something more than this. If a listed company offers shares to its employees, does it have to provide them with a valuation over and above the price of those shares (as quoted on the relevant stock exchange)? If so, to what end? If a listed company offers options or RSUs to its employees, does it have to provide a valuation of those options or RSUs over and above the quoted price of the underlying shares?

(e) **ESS supporting information - financial statements**

A company that has to provide employees with an ESS offer document must also provide them with "ESS supporting information", which in the case of unlisted companies includes a copy of their most recent accounts. Such accounts must be the accounts that the company that is otherwise required to file with ASIC or (if it does not file accounts with ASIC) a balance sheet and profit and loss statement prepared in compliance with Australian accounting standards (section 1100S).

This requirement may present particular difficulties for foreign companies that are not required to file accounts in Australia, since:

- they may regard their accounts as commercially sensitive and be unwilling to disclose them to employees; and
- the requirement to prepare accounts under Australian accounting standards may prove onerous.

We raised the first issue in our response to Treasury's Employee Share Scheme Consultation Paper, dated April 2019. Under Class Order 14/1001, 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, 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 Class Order 14/1001 because they could not comply with the requirement to disclose this sensitive financial data to their employees.

The ESS Exposure Draft, rather than addressing this issue, compounds it by imposing the additional requirement that accounts be prepared in accordance with Australian accounting standards.

(f) **ESS supporting information - valuation**

If an unlisted company has to provide "ESS disclosure documents" and its business has an annual turnover of more than AUD 50 million, it must also give employees an independent valuation of the awards at the time of grant and (if the awards have an exercise price) of the underlying shares at the time of exercise (sections 1100T(1) and 1100V(2)). Significantly, the valuation must be conducted within the 1-month period before the offer or exercise (as the case may be).

Whilst we appreciate the logic of this requirement, the timing of the valuation, and the lack of any qualification regarding confidentiality, may be significant impediments for some companies.

For example, unlisted US companies often prepare independent valuations as a matter of course. However, such valuations are typically prepared (at most) on a quarterly basis, and so such companies may encounter difficulty in timing their equity grants to employees (and the exercise of options or vesting of RSUs) so as to coincide with their valuations. In the case of options, timing issues may be particularly intractable since there may be no set "exercise date". For example, options may instead have an "exercise window" which spans months (or even years), and which leaves it up to the employee when to exercise their options within the window. In those circumstances, as drafted the valuation requirement imposes an obligation on companies:

- to anticipate when employees will exercise their options; and
- to provide entirely new valuations to different employees whose option exercise dates are more than a month apart.

In addition, whilst in our experience unlisted US companies are typically willing to provide valuations to employees, it is often the case that such valuations need to be an appropriately redacted and/or summarised so as to preserve the company's commercially sensitive information (see also paragraph (e) above).

Again, this is an issue we raised in our response to Treasury's 2019 Employee Share Scheme Consultation Paper.

(g) **Issuing versus transferring awards**

Whilst Class Orders 14/1000 and 14/1001 clearly cover both offers to issue awards and offers to transfer awards, it is not clear that the ESS Exposure Draft does this.

For example, an ESS offer is defined to mean an "offer for the issue of ESS interests", and whilst the rules generally cover offers made though trusts, this is only the case where the relevant company

"issues" ESS interests to a trustee of a trust for the purposes of that trustee "issuing" ESS interests to ESS participants (section 1100E(5)).

The wording of these provisions would not appear to cover plans where:

- the trustee acquires the relevant plan shares on-market; or
- having acquired the plan shares, the trustee transfers them to the employees.

Given that the above two elements are common features of employee share plans that make use of trusts, this seems to us to be a significant oversight.

(h) **ESS liability**

The new rules also include a liability regime under which:

- ASIC can issue stop orders in relation to defective ESS disclosure documents (section 1100W); and
- a person who issues a misleading or deceptive ESS disclosure document can face both civil and criminal liability (section 1100X).

Whilst this liability regime is intended to mirror the prospectus liability regime that already exists under the Corporations Act, in our view it is at best inappropriate, and at worst highly problematic, in the context of ESS offers. In particular:

- Section 1100X(1)(b) prohibits a company from making an ESS offer if a circumstance arises after the offer is made that (had it arisen before offer) would have required disclosure in an ESS disclosure document. In effect, this section imposes a requirement that companies look into the future in order to determine whether they can make an offer in the present. Presumably, this section is intended to replicate section 728(1)(c) (dealing with prospectus liability), but section 1100X falls wide of its mark because it misunderstands how section 728 operates. Under section 728, companies are prohibited from making offers under a prospectus if a new circumstance has arisen since the prospectus was lodged with ASIC that would have been required to be included in the prospectus. In other words, unlike section 1100X, section 728 does not require companies to be capable of seeing into the future.
- The liability provisions in the ESS Exposure Draft also:
    - potentially make directors liable for any contravention by their company; and

- impose potentially very significant penalties both for substantive breaches (such as where an ESS offer is misleading) and more technical breaches (such as a failure to file a "notice of intent").

We submit that this approach to liability in the context of ESS offers is inappropriate. In particular, we are concerned that by seeking to make directors personally liable, and by imposing very serious penalties for what appear to be minor and technical contraventions, these provisions will have a chilling effect on employee equity plans, especially in the case of multinationals, who may well decide that the risks associated with rolling out employee incentive plans in Australia under the new rules outweigh the benefits.

(i) **Drafting anomalies and inconsistencies**

In addition to the concerns we have already described, there appear to us to be some other drafting anomalies and inconsistencies within the ESS Exposure Draft.

To give just two examples:

- In section 9 "incentive right" is defined to mean a right that is "contingent" on the price or value of the relevant securities or financial products. This makes no sense, because the right to receive (for example) shares or cash upon vesting of an RSU is never "contingent" on the value of the shares or cash being received, but rather on the vesting conditions attaching to the RSU. In this respect, the definition of an incentive right contained in the two Class Orders is much clearer.

- The ESS Exposure Draft does not define "listed" companies or schemes. Since the definition in the Corporations Act only covers entities listed on one of five prescribed Australian securities exchanges, as currently drafted any entity listed on an overseas stock exchange would be treated as "not listed" for the purposes of the new rules.

Needless to say, if these drafting issues are not addressed there is a risk that these reforms, if passed into law, will be an unwieldly piece of legislation that raises as many questions as it answers.

(j) **General comments**

Finally, we would take this opportunity to make some general comments about ESS offers in the broader context of the regulation of financial products.

The present regulatory framework distinguishes between securities on the one hand, and other financial products on the other. 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:

- the action that may trigger the disclosure requirement; and
- the available exemptions.

In our response to Treasury's 2019 Employee Share Scheme Consultation Paper, we discussed this problem in detail, providing examples and concluding that the current regulatory landscape 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 for which there would seem to be no clear policy rationale.

Whilst we applaud the idea of an exemption that applies to all ESS offers, we believe that the ESS Exposure Draft represents a missed opportunity to bring some much needed consistency and clarity to this area of law.

Please let us know if you have any queries or would like to discuss.

Yours faithfully

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