



Directors
Market Conduct Division and
Individual and Indirect Taxation Division
The Treasury
Langton Crescent
PARKES
ACT 2600
ESSreforms@Treasury.gov.au

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By Email

Dear Treasury

Submission – Treasury consultation: Employee share schemes

1 Introduction

This submission is made by Herbert Smith Freehills (**HSF**) in response to Treasury consultation on exposure draft legislation and explanatory materials announced in the 2021-2022 Federal Budget and published in July 2021 in respect of regulatory arrangements for employee share schemes (**ESSs**).

HSF is an international law firm with 27 offices located around the globe and which specialises in, amongst other things, financial services and financial services regulation. We regularly advise domestic and foreign, listed and unlisted entities who wish to make ESS offers to employees of their Australian subsidiaries.

In this submission we have provided our high level comments in respect of Treasury's exposure draft legislation and explanatory materials. We would be happy to discuss our comments with Treasury and provide any supporting explanation if that would assist.

2 Eligibility

2.1 Definition of ESS participant

The following individuals are eligible to participate in an ESS under the proposed reforms:

- (a) employees and directors of a company;
- (b) employees and directors of its associated entities (or responsible entities in the case of a listed schemes);
- (c) independent contractors predominantly providing services to the company or its associated entities; and
- (d) persons that are about to be in categories (a) and (b) above.

Prospective independent contractors

We are unaware of a policy reason why ESS participants should include prospective employees but exclude prospective independent contractors. For start-up businesses which use independent contractors and not solely employees, not being able to offer incentives as part of the services offer to contractors will:

- (a) make it harder for them to compete for talent and attract employees;
- (b) put them at a competitive disadvantage to start-up businesses which solely or mainly have employees; and

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- (c) because they are generally cash poor, put them at a competitive disadvantage to larger and more established businesses which are able to offer competitive sign on packages.

'Predominately' providing services

Additionally, for an independent contractor to qualify as an ESS participant, they must also be 'predominately' providing services to the company or its associated entities.

- (a) 'Predominately' is not defined and this creates uncertainty for a small business seeking to understand if an independent contractor qualifies as an ESS participant or not.
 - (1) If a contractor works 55% of the hours of a comparable full time position do they qualify?
 - (2) Do they have to work 90% of the hours of a comparable full time position to qualify?
- (b) By contrast under the current ESS exemptions, there is a clear and objective test for contractors: whether they would work the number of hours that are the pro-rata equivalent of 40% or more of a comparable full-time position.
- (c) We would invite Treasury to consider introducing a more certain and objective test for qualifying as an independent contractor, to give more certainty to small businesses in particular and assist employers and employees to work together to secure a strong and sustained post COVID economic recovery.

2.2 Value cap

Where payment is not required or where ESS interests are granted or offered to independent contractors the value cap for offers made by unlisted companies has been increased from \$5,000 to \$30,000 per employee per year.

We welcome this increase but we would invite Treasury to consider increasing it further, to say \$50,000 per employee per year, so that small and start-up businesses which are growing rapidly are able to attract the best talent and invest in their businesses, particularly where their share options in the start-up phase may be more valuable, reflecting the rapid growth of, and the potential value of, the start-up business.

3 Content of offer documentation

3.1 Valuation

Under the proposed legislation, the valuation of ESS interests to be provided by an unlisted body corporate with its short form offer documentation must:

- (a) be less than 1 month old;
- (b) explain the method used to conduct the valuation; and
- (c) be conducted on a reasonable basis.

Where an unlisted entity has an annual turnover of greater than \$50 million, the valuation must be an independent expert valuation.

For organisations seeking to compete for talent and wishing to provide incentives at the point of on boarding their new staff (which could occur weekly or more frequently for businesses in a growth phase), the requirement to obtain a new valuation with an external service provider every month significantly increases its administrative burden and the costs of operating the ESS arrangements (which costs would be wasted costs if the valuation varies very little month to month) and seems to be inconsistent with the policy intention to reduce red tape for businesses.



We would invite Treasury to consider permitting valuation reports for unlisted entities with an annual turnover of more than \$50 million to be “less than 6 months old” (instead of “less than 1 month old”).

4 Liability

4.1 Notice of intent – s 1100G

Confirming the prescribed form

Under the proposed section 1100G and Schedule 3 of the Corporations Act, a failure to lodge a ‘notice of intent’ with ASIC in the ‘prescribed form’ before any ESS offers are made in connection with the ESS is an offence with a maximum penalty of five years’ imprisonment.

We understand the ‘prescribed form’ for a notice of intent to be the *CF08 Notice of reliance on Class Order [CO 14/1000] Employee incentive schemes: Listed bodies; and Class Order [CO 14/1001] Employee incentive schemes: Unlisted bodies (CF08)*.

We would invite Treasury to consider prescribing either in a note in the draft legislation or in the explanatory materials that the ‘prescribed form’ is the CF08 to provide clarity on this, particularly given the proposed consequences of a failure to provide the prescribed form.

Liability for failing to lodge the prescribed form

We note that a form CF08 is not a disclosure document (like a prospectus) containing prescribed content intended to assist employees to make an investment decision but is rather an administration form, providing contact details and a notice of use to ASIC, similar to a form FS88, which is used to notify ASIC that a product disclosure statement is in use.

Given the content of the CF08, it follows that the penalty for failing to lodge an administration form (i.e. for failing to manage red tape) should be commensurate with the penalty for failing to lodge a form FS88, which is a maximum penalty of two years’ imprisonment, rather than the penalty for a provide a prospectus under section 727 of the Corporations Act, which is a maximum penalty of five years’ imprisonment.

We would like to invite Treasury to consider reducing the penalty for a failure to provide the prescribed notice to ASIC to a maximum penalty of two years’ imprisonment,, consistent with the Government’s commitment to reducing red tape for business.

4.2 ESS offer document – s 1100P(1)

Under the proposed section 1100P(1) and Schedule 3 of the Corporations Act, a failure to provide an ‘ESS disclosure document’ to each ‘ESS participant’ is a civil penalty and an offence with a maximum penalty of fifteen years’ imprisonment.

We note that in the *Exposure Draft Explanatory Materials* that Treasury is seeking to align the penalties in section 1100P(1) with those in Part 6D.3 Division 1 for failing to provide disclosure documents.

- (a) However, the penalty that this new penalty appears to be being aligned to is the maximum penalty of 15 years imprisonment for a breach of section 727(1), which relates to a failure to *lodge* a disclosure document with ASIC before making an offer of securities.
- (b) We invite Treasury to revisit the appropriateness of this penalty because by contrast, an ESS disclosure document does not need to be *lodged* with ASIC.
- (c) Instead we invite Treasury to consider aligning the penalty for a failure to *provide* an ESS disclosure document with the penalty for a failure to *provide* a prospectus or similar offer document under Chapter 6D of the Corporations Act



which carries a maximum penalty of 5 years imprisonment for a breach of section 727(2).

5 Other Issues

5.1 Potential typographical error

In section 1100J(6)(a) (and the pre-amble to that section) there is a reference to 'listed registered schemes'.

As section 1100J(6)(a) cross-refers to the 'offer value cap' in section 1100J(4), which only applies to unlisted bodies corporate, we wanted to check whether this reference to 'listed registered schemes' is intended and appropriate.

5.2 Extension of the regime to unlisted managed investment schemes

The scope of the ESS relief in the exposure draft legislation continues to be limited to listed and unlisted body corporates and to listed registered schemes and to not apply to unlisted managed investment schemes.

While we appreciate that this approach has been the case for some time, we note that this limitation means that small businesses which operate as unlisted managed investment schemes, (such as unincorporated joint ventures, limited partnerships and unit trusts) are not able to utilise the ESS relief and so are not able to offer incentives to employees and contractors, which makes it harder for them to compete for talent and attract employees and puts them at a competitive disadvantage to small businesses structured as corporates and larger, more cash rich businesses.

Take, for example, a newly formed incorporated limited partnership that is conditionally registered as an Early Stage Venture Capital Limited Partnership or Venture Capital Limited Partnership that may be better able to attract directors and employees such as fund managers if it were able to offer incentives to them. These partnerships are businesses that are usually start-up in nature, and if they can attract the right talent, would be capable of making a significant impact on emerging technology and other innovative Australian businesses requiring seed capital and early funding.

We invite Treasury to revisit expanding the concept of 'eligible ESS interests' to interests in unlisted managed investment schemes, to support start-up businesses that prefer to pursue a different business form to a traditional body corporate vehicle.

Yours sincerely

Sent electronically without signature

Fiona Smedley
Partner
Herbert Smith Freehills
+61 2 9225 5828
fiona.smedley@hsf.com

Matt Dulaney
Solicitor
Herbert Smith Freehills
+61 2 9322 4563
matt.dulaney@hsf.com

Tori Pearson
Solicitor
Herbert Smith Freehills
+61 2 9225 5663
tori.pearson@hsf.com

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