Law Council
OF AUSTRALIA

Business Law Section

25 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 Directors,

Employee Share Schemes – Exposure Draft Legislation

The Corporations Committee & Taxation Law Committee of the Business Law Section of the Law Council of Australia (the **Committees**) welcome the opportunity to provide this submission to the Commonwealth Treasury (**Treasury**) in response to the exposure draft legislation implementing the reforms to Employee Shares Schemes in 2019, and the changes to regulatory and tax arrangements for Employee Share Schemes (**ESS**) that the Government announced in the 2021-22 Budget. (**Exposure Draft Legislation**).

The Commonwealth Government has announced proposals to improve the ability of businesses to offer an ESS to help them attract, retain and motivate employees and grow the businesses. The Committees are supportive of legislative amendments in the area of ESS and consider that the possibility of allowing businesses to make offers of ESS interests without the need to make disclosure, or be capped in the size or value of those grants, is precisely what is needed to help simplify an unnecessarily complex area for businesses operating in Australia and to promote innovation and employment growth. The Committees also consider that the proposed removal of the deferred taxing point at the cessation of employment is an important step in allowing Australian businesses to attract and retain talent on a global stage.

However, the Committees consider that the current proposals outlined in the Exposure Draft Legislation (and which are addressed in further detail in this submission) have some shortcomings that will prevent the changes from encouraging innovation in Australia and supporting business (in particular, those that are unlisted or smaller listed businesses). We provide an outline of these limitations in section 1 below as well as suggestions as to how to overcome them. In section 2, we provide an outline of some more technical drafting improvements we recommend be made, which will better achieve what we understand to be the objective of putting the previous Australian Securities and Investments Commission (ASIC) Class Order relief into primary legislation. In section 3, we provide our recommendations regarding the proposed commencement date of the removal of the deferred taxing point on the cessation of employment.

The Committees note all references to the 'Act' in paragraphs 1 and 2 are references to the *Corporations Act 2001* (Cth) and references to specific sections are to sections of the Act.

Telephone +61 2 6246 3737 • ***Fax*** +61 2 6248 0639 • ***Email*** jessica.morrow@lawcouncil.asn.au
GPO Box 1989, Canberra ACT 2601, DX 5719 Canberra • 19 Torrens St Braddon ACT 2612
Law Council of Australia Limited ABN 85 005 260 622
www.lawcouncil.asn.au

1 Primary areas of concern in the Exposure Draft Legislation

1.1 Treatment of monetary consideration

The Exposure Draft Legislation draws a key distinction between offers made under ESS which require payment to participate and those which do not. Where "ESS interests" are offered for issue in return for monetary consideration, the offeror must provide an ESS offer document (which carries with it prospectus-level liability for issuers, their directors and anyone who consents to the inclusion of a statement in the offer document) and also comply with certain other restrictions on the size and value of grants.

Although it is helpful that the Exposure Draft Legislation clarifies that non-monetary consideration (for example, the provision of labour) is not treated as consideration for these purposes, the Committees have significant concern that, as drafted, the legislation would treat options (or similar types of ESS interests) which have an exercise price that is greater than $0 as an offer made for monetary consideration (since at the future time of exercise, monetary consideration would need to be provided).

The Committees strongly recommend the drafting be amended to explain that the exchange of monetary consideration for an ESS interest only applies where cash is paid upfront for that relevant interest or is otherwise a pre-condition of receiving the grant of ESS interest itself. An option (or other convertible instrument), by contrast, may be granted to a participant, if it is without any upfront payment, and the holder then has complete discretion to elect later to pay any exercise (or conversion) price where they consider that it is in their economic interests to do so.

The Committees believe this is an important clarification as forcing issuers of ESS interests such as options that have this feature to comply with the enhanced regulatory requirements will have adverse effects. Further, options are favoured by "startup" companies to attract and retain talented staff since they are commonly used throughout the world, are well understood and provide an in-built performance condition through the exercise price (we do not in our experience tend to see nil exercise price options used frequently but the current drafting would create a bias towards that). Those entities would be discouraged from using this relief because: (a) they are capped on the value of grants that they can make (although higher than the existing $5,000 limit for unlisted companies, $30,000 is not high enough to make a meaningful difference to the ability of unlisted entities to use equity based pay as a means to attract people, particularly not at mid-management levels); and (b) we anticipate the compliance costs associated with managing liability risk on ESS offer documents (as outlined in more detail in section 1.2 below) would be inhibitive.

Put simply, the Committees believe that because the new beneficial treatment only applies to ESS which do not require any out-of-pocket expenditure by the participant, the objectives of the new legislation will not be met in practice as this will continue to unduly limit entities in using options and similar types of incentives due to the cost and restrictions imposed.

1.2 Imposition of strict liability regime

Whilst the Committees can appreciate the desire to impose strong incentives to comply with the obligations to provide an ESS offer document and ensure it meets the content requirements, the Committees consider that extending strict liability for deficiencies in ESS offer documents to issuers, their directors and certain other

persons may not be helpful or practical. Furthermore, the Committees note this is a departure from the position under the ASIC Class orders [CO 14/1001] or [CO 14/1000] (**Class Orders**), which did not impose strict liability on corporations or individuals for ESS offer documents.

It is unclear why such a harsh approach was considered to be necessary since if an issuer were not to comply with the requirement to provide an ESS offer document when required to do so, they would ultimately not be complying with the conditions of Division 1A of Part 7.12 of the Act, thus issuing securities or financial products in breach of Chapter 6D or Part 7.9 attracting the severe existing sanctions in those parts of the Act as they apply automatically.

Similarly, any ESS offer document would attract the liability provisions contained in Part 7.10 of the Act, which would protect participants from misleading and deceptive conduct or from deliberate or dishonest misstatements.

This imposition of this new liability regime cuts across the desire for simplicity and lower cost for making ESS offers as this will require the involvement of legal advisers to advise on these requirements and to design (and run) due diligence processes to get the benefit of the due diligence defences to that strict liability regime. Given the need for unlisted entities to include valuation information, there will be an impetus to get third party independent valuation reports for the benefit of "due diligence Committee" established for this purpose. This overall process will be cost inhibitive for most issuers, especially unlisted ones (and the Committees note entities imposed with this burden may as well be proceeding with an IPO process). The costs associated with obtaining legal advice and independent valuation reports would likely run into the many tens of thousands of dollars (and likely more). ASIC has previously been critical of low-cost due diligence processes, of which advisers and issuers will be mindful, given the proposed regime mirrors the existing liability and defence provisions[1]. It is not practicable to expect that unlisted (or, indeed, many smaller listed) entities would consider that expenditure worthwhile. This would defeat the legislative purpose of making it simpler and cheaper for businesses to utilise equity-based incentives.

For the above reasons, **the Committees strongly recommend that the legislation be amended to:**

(a) remove the provisions imposing liability for failure to provide an ESS offer document (rather, a provision explaining that failure to do so would mean that it is not a valid ESS offer); and

(b) remove the provisions which impose liability in connection with ESS offer documents (Subdivision E).

In addition, the Committees seek clarity on the interaction between the Exposure Draft Legislation and existing liability regimes through the following questions:

(a) The Exposure Draft Legislation notes that lodgement of an ESS disclosure document will not be required but lodgement is contemplated in certain circumstances (see section 1274(2)(a)(iva) of the Act). If lodgement is made, how does the new liability regime intended to interact with liability under section 1308 of the Act?

[1] ASIC REP484

(b) Has any thought been given to obtaining a carve-out from state Fair Trading legislation (as there is for other disclosure defects under section 1041K of the Act)?

1.3 ASIC modification power

The Committees note that as currently constructed, the Exposure Draft Legislation does not grant power to ASIC to modify or vary the proposed new Division 1A of Part 7.12 under the Act.

As a general principle and as noted in the Committees' submission in 2019[2], the Committees believe that it would be best to eliminate inconsistencies between the Corporations Act and the Class Orders. The Committees also understand (and agree with) the Government's desire to ensure that the law is contained in legislation rather than in regulatory instruments.

However, in the experience of the Committees' members, the application of laws to ESS is highly complex (in fact, ASIC has told us that relief applications they receive in this area are some of the most complex that they deal with). With such a complex area there is a risk that circumstances will arise which do not quite "work" and there would be benefit in ASIC having the power to modify or relieve the issuer from strict compliance with the law where the policy objectives of the legislation would not otherwise be frustrated. There is also the potential for there to be unexpected implications from the application of the Exposure Draft Legislation once it is in place.

In addition, at present the drafting creates scope for confusion as to whether the absence of any modification power for ASIC is intended to send a message to ASIC that it should not use its modification powers over Chapter 6D and Part 7.9 for any matter that might relate to an ESS.

For all of the above reasons, **the Committees strongly recommend granting ASIC modification and variation powers with respect to the proposed new Division 1A of Part 7.12 under the Act**. Furthermore, given that the cost of obtaining ASIC relief (even where it is standard in nature) for an ESS can be upwards of $10,000 or more (due to the number of heads of modification power that may come into play), this modification power should not be limited to granting relief on an individual basis. ASIC should have the ability to correct, on a class wide basis, any deficiencies in the Exposure Draft Legislation that are later revealed. This would be far more preferable than forcing market participants to apply for uncontroversial relief at high cost whilst time is taken to enact future legislative reform.

1.4 Additional recommendations for improvement

The Committees make the additional recommendations below, which we consider would further help the legislation achieve its stated objectives of making it simpler for businesses to create and effectively utilise ESS.

(a) (**Unlisted registered schemes**) **The Committees strongly recommend unlisted registered managed investment schemes be included expressly and allowed to benefit from the Exposure Draft Legislation and regulatory relief.** The Committees note there should be no reason in principle why they should not also get the benefit of the relief by being treated in the same way as unlisted bodies corporate. The

[2] Submission from Business Law Section of the Law Council of Australia 16 May 2019: *Employee Share Schemes Consultation Paper April 2019*: (https://lawcouncil.asn.au/publicassets/c5f28aec-1e43-ea11-9403-005056be13b5/3623%20-%20Employee%20Share%20Schemes%20Consultation%20Paper.pdf)

Committees do not see why any concerns about potential complexity of ESS offers that might be made could not appropriately be dealt with through the definition of 'ESS interests' that applies to such entities (which could be modelled on that which applies to unlisted bodies corporate, but instead limiting it to units of unit trusts).

(b) (**Independent contractors**) The Exposure Draft Legislation treats all offers to independent contractors in the same way that offers made for monetary consideration are treated. There is no explanation for this, and this is also at odds with the operation of the existing ASIC class orders, which allow contractors to an entity who work an equivalent of 40% or more of a full-time position with the entity as eligible to receive offers that benefit from the relief. **The Committees strongly recommend that the differential treatment of independent contractors be removed provided that at least 40% of the contractor's time is with the issuer.**

(c) (**Participation by family trusts**) **The Committees strongly recommend the modification of section 1100E(3) of the Act to include all trusts where the beneficiaries are immediate family members**. The current sub-section (3) only applies if the trust is a self-managed superannuation fund (SMSF) which will not always be the case. There is no policy reason to limit family trusts from being nominated as a recipient of a grant.

2 Drafting issues which need to be addressed

2.1 Definition of ESS interests for listed companies (s 1100F(1))

(a) The Committees note that paragraph (f) of the definition requires that "units in, incentive rights granted in relation to or an option to acquire an interest mentioned in any of paragraphs (a) to (e)" must either be listed or be capable of being exercised without payment of monetary consideration (i.e. it needs to be a nil strike price option or a nil cost unit or right). The Committees suggest that these conditions are not logical since ESS interests are rarely (if ever) listed on a financial market (like ASX). Requiring an option to have a nil strike price would also significantly reduce the ability of listed companies to rely on these provisions. The Committees suggest that this is an error and the intention was for the underlying security (i.e. the "interest mentioned in any of paragraphs (a) to (e)") to be listed on a financial market (such as ASX) rather than the ESS interest itself. If that change were made, this issue would be resolved, since it would not be necessary to have nil strike price options provided the option was over the ordinary securities of the entity listed on ASX.

(b) The Committees note that limb (e) of the definition is intended to be flexible enough to pick up securities that form part of a staple. The Committees note the inclusion is helpful but a stapled security is very likely to also include units in a listed managed investment scheme which are stapled to the entity and could even include other types of security, such as a warrant. As such, the definition needs to incorporate that flexibility for it to be useful (that is, the Exposure Draft Legislation should not only apply to stapled groups comprised of companies, it also needs to apply to stapled groups comprising companies, registered managed investment schemes or other trusts). This type of ESS interest also needs to be included in the definition of an ESS interest of a listed registered scheme (s 1100F(3)).

(c) The Committees suggest it is currently unclear as to what sorts of securities are contemplated by limbs (c) and (d) of the definition. Upon review the Committees contemplate that perhaps paragraph (c) of s1100F(1) of the Act is intended to refer to paragraph (a)? Further clarification from Treasury may be required on this point.

(d) In limb (b) of the definition, the Committees suggest that it would be helpful if the explanatory materials accompanying the bill made it clear that this limb is intended to capture CHESS Depositary Interests traded on ASX (which we presume is the intention, as we are not otherwise familiar with beneficial interests in ordinary securities being quoted on ASX).

2.2 Definition of incentive right

The Committees note that the definition of "incentive right" appears to be missing the words "value of" before the words "right is contingent on any of the following" (that is, the definition should be defining the factors that influence how much cash is payable on vesting of the incentive right not the conditions on which an incentive right may vest). If this change is not made, then the types of vesting conditions imposed on an incentive right would be limited to those types listed out in (a) to (d) which surely is not the intention.

2.3 On-sale

The Committees note that section 1100L of the Act is intended to dis-apply the on-sale provisions (e.g. section 707(3) of the Act) from ESS interests. The Committees note this needs to be broadened to apply to any underlying securities issued on exercise/vesting of an ESS interest (since the definition of "ESS interest" does not include the underlying security itself). So to give an example, if a listed entity issues options and issues new ordinary shares on exercise of those options, the legislation needs to make it clear that there are no on-sale restrictions on the ordinary shares (as well as on the options themselves).

2.4 Controller selldowns

Section 1100L(2) of the Act aims to limit the on-sale relief so that it does not apply to a sale by a controller. The Committees note that this was not something that was a feature under the previous Class Orders. It is unclear what purpose would be served by a controller selldown being made under an ESS offer document (which is what the provision requires). Further, the Committees note the requirement for a controller to issue a cleansing notice would still remain under Chapter 6D (whether the shares held by the controller are acquired through an ESS or otherwise) so there is no need to impose this additional (and unnecessary) disclosure obligation through section 1100L(2).

3 Taxation recommendations

3.1 Commencement date

The Exposure Draft Legislation provides that the deferred taxing point on the cessation of employment will be removed for ESS interests that are issued on or after the first 1 July after the commencement date of the regime. The commencement date is not until the first 1 January, 1 April, 1 July or 1 October to occur the day after the enabling legislation receives Royal Assent. Therefore, the amendment will only apply to ESS interests issued after 1 July 2022 at the earliest.

The Committees are very supportive of the removal of the deferred taxing point on the cessation of employment. However, the Committees do not believe that there is a need to delay the introduction of the amendment until 1 July 2022. Nor do the

Committees believe that there is a benefit to having the amendment apply only to new ESS interests issued after 1 July 2022.

The Committees strongly recommend that the amendment be brought forward so that it applies to both existing and new ESS interests from the date of the Treasurer's announcement in the 2021-22 Budget. This approach would bring the commencement regime of the amendment into line with the usual approach for tax amendments. Tax amendments normally apply to events that occur after the relevant Minister has announced the amendment, even if this is before the relevant enabling legislation is passed. The Committees recommend that this approach be adopted for the tax amendments contained in the Exposure Draft Legislation. Therefore, a deferred taxing point should not arise where ESS holders cease employment from the date that the Budget was announced (i.e. 11 May 2021).

The Committees do not believe that its proposed commencement regime will have adverse administrative impacts for ESSs. It is unlikely that plan terms will need to be amended in order for holders of existing ESS interests to benefit from the removal of the deferred taxing point on the cessation of employment. This is because tax deferred ESSs generally have certain restrictions in place at the time of the cessation of employment. These vesting, settlement and disposal restrictions will ensure that tax continues to be deferred beyond the cessation of employment without an amendment of plan terms being required.

There may be a small amount of existing ESSs which will be required to have their plan terms amended in order to benefit from the Exposure Draft Legislation. These types of plans are those which provide options or rights that are exercisable at the cessation of employment. Issuers may decide to impose further restrictions on these ESS interests beyond the cessation of employment so that ESS interest holders can benefit from the Exposure Draft Legislation. However, as the Exposure Draft Legislation only seeks to bring in a concessional amendment, issuers will not be obliged to amend their plan terms to impose these further restrictions. As no obligations are imposed on ESS issuers by the Exposure Draft Legislation, the Committees do not consider application to existing ESS interests will impose an undue administrative burden on ESS issuers.

In light of the above, it is the Committees' strong preference that the commencement date of the taxation amendments in the Exposure Draft Legislation be brought forward so that they apply to existing and new ESS interests from the date of the Treasurer's announcement. While this is the Committees' strong preference, there are alternative commencement dates which the Committees consider may be acceptable. These are (in order of preference):

(i) application to new and existing ESS interests from the date the Exposure Draft Legislation receives Royal Assent;

(ii) application to new ESS interests issued from the date of the Treasurer's announcement; and

(iii) application to new ESS interests issued from the date the Exposure Draft Legislation receives Royal Assent.

The Committees would be pleased to discuss this submission if that would be helpful. The Committees would also be happy to prepare marked up changes to the Exposure Draft Legislation and share those with you should that assist in considering these submissions.

Please contact Robert Sultan, Chair of the Corporations Committee at robert.sultan@nortonrosefulbright.com, Shannon Finch at shannonfinch@jonesday.com or (02) 8272 0751, Tony Sparks at Tony.Sparks@AllenOvery.com or (02) 9373 7879 or Adam D'Andreti at adandreti@gtlaw.com.au or (02) 9263 4375 and, in relation to the taxation components of this submission, Andrew Clements at andrew.clements@au.kwm.com or (03) 9643 4089 if you require further information or clarification.

Yours faithfully,

Greg Rodgers
Chair, Business Law Section