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4 February 2022

Market Conduct Division

Treasury

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Submission on employee share scheme reforms

We enclose EY's response to the *Treasury Laws Amendment (Measures for Consultation) Bill 2022: Employee Share Schemes* (**2022 ESS Reform Bill**), released for consultation on 20 December 2021.

Our response follows from our submission to Treasury on 25 August 2021 with respect to the *Treasury Laws Amendment (Measures for a later sitting) Bill 2021* (**2021 Bill**) (**2021 Submission**). A copy of our 2021 Submission is enclosed at Schedule 1, for reference.

It is our view that the 2022 ESS Reform Bill should not proceed in its current form. Overall, EY considers that the 2022 ESS Reform Bill does not appropriately progress the legislative agenda for employee share schemes (**ESS**). The draft bill, if implemented, would significantly increase the regulatory hurdles for companies seeking to operate ESS and introduce unnecessary complexity and risk. Compared to the regulatory environment for ESS operated by some of our major trading partners (and relative to the existing regime in Australia under ASIC Class Orders 14/1000 (**CO 14/1000**) and 14/1001 (**CO 14/1001**)), the 2022 ESS Reform Bill represents a major step backwards in the goal of simplifying the regulatory system for ESS. Our view is that CO 14/1000 and CO14/1001 should remain in force, unless the 2022 ESS Reform Bill is to be substantially amended.

In particular, we are concerned about:

- Additional complexity in offer documentation and other requirements when compared to CO 14/1000;
- The inconsistency with existing provisions under the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**) and the ASX Listing Rules; and
- The imposition of penalty provisions that we consider will discourage companies from operating employee share schemes due to the risk.

We also note that a number of key areas of concern in our 2021 Submission are still to be addressed. These include: the distinction between ESS interests that are offered for monetary consideration and those which are not, the imposition of an issue cap, the imposition of a monetary cap and the burdensome valuation requirements for unlisted companies, the definition of "stapled securities" and offence related to failure to provide a notice of intent.

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We would be pleased to discuss our submission.

Yours sincerely

Chris Galway
Partner
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People Advisory Services

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EY submission on the 2022 ESS Reform Bill

Our comments on the 2022 ESS Reform Bill are summarised in the table below. Further detail on each point is set out in the “Detailed submission” section that follows.

Executive Summary

Provision	Summary comments
1. Offers for consideration – both listed and unlisted companies	
Required disclosures *s 1100T(2)(e)*	► The requirement for an offer document to explain “how the ESS participant may, from time to time, calculate the value of the ESS interests” will be difficult to satisfy where the ESS interest is an incentive right or an option. For unlisted companies, this requirement is also problematic for all types of ESS interests, because entities are unlikely to have an up-to-date share valuation available. ► Guidance as to what information would satisfy this requirement, particularly for private companies, would be welcomed.
Essential terms of the offer *ss 1100Q(1)(h); 1100V*	New offer document ► The requirement to provide each participant with a new offer document within 60 days of the company becoming aware of an offer document is out of date, or otherwise incorrect in any material respect, presents a significant administrative burden on the company for the duration of an award of ESS interests (which could be for a period of up to 15 years). Guidance on which information would need to be updated when it becomes out of date would be helpful. We would also suggest this requirement ends when ESS interests are granted to each participant, to reduce compliance obligations for companies. Misleading or deceptive statements ► Whilst we agree that an offer document should not contain any statements, or omit any information, which would result in the offer document being misleading or deceptive, we question the policy rationale of this change. There is no such provision in CO 14/1000 or the prior CO 03/184, and we are not aware of any information produced during this consultation process to indicate that misleading or deceptive statements in ESS offer documents is a particular issue that requires addressing. ► There are many situations where the persons listed in the table may not be directly involved in a particular offer under a share scheme. We are

<table>
<tr><th>Provision</th><th>Summary comments</th></tr>
<tr><td></td><td>concerned that this provision will inhibit companies from offering ESS (particularly to the broader employee population), because the risk is seen as significantly outweighing the potential benefit of offering ESS interests.</td></tr>
<tr><td colspan="2">2. Offers for consideration – additional requirements for unlisted companies</td></tr>
<tr><td>Additional essential terms
s 1100W</td><td><u>Conditions on vesting / exercise</u>
► The requirement that certain financial information and a valuation be provided to a participant at least 14 days prior to the vesting / exercise of ESS interests will present a significant administrative burden to unlisted companies and reduce the flexibility of participants to exercise ESS interests. This may result in either the company being required to maintain financial and valuation information on an ongoing basis, or force the company to design a plan where exercise can only occur at specified / limited times.
► We suggest that financial information is provided on vesting/exercise.
<u>Information request for financial and/or valuation information</u>
► Similarly, the requirement to provide an up-to-date valuation within 30 days of a participant's request will significantly increase administration costs, particularly where there are large numbers of participants and bearing in mind that exercise periods can extend for as long as 15 years from the date of grant. We suggest that this be amended to refer to up-to-date financial information.</td></tr>
<tr><td>Monetary cap
s 1100X</td><td>► The monetary cap of $30,000 for unlisted companies remains too low, and the calculations are complicated and will significantly increase administration for unlisted companies. We are not aware of any information produced during this consultation process which explains the monetary cap being set at $30,000, nor the rationale for a monetary cap.
► It will be very difficult for unlisted companies to safely utilise the additional 70% of dividends and 70% of cash bonus amounts, without the risk of miscalculating these amounts. Both dividends and cash bonuses are discretionary and there is no guarantee that either will be paid in respect of any 12-month period. As only the unused monetary cap of $30,000 is able to be carried-forward, these additional amounts (once the actual dividend and cash bonus amounts are known and can be accurately calculated) do not provide any added flexibility to the monetary cap. Additionally it is impractical in the start-up context where a typical employee's remuneration</td></tr>
</table>

Provision	Summary comments
	consists of salary and an employee equity grant (no bonus) and the company is not generating profits to pay dividends. The proposal runs counter to the work undertaken by the Government in 2015 when introducing the start-up equity plan reforms. ► Further clarity would be welcome with respect to ESS interests for which any amounts payable are only payable following an initial public offering (**IPO**) or a sale of the company. ESS interests that vest on a "liquidity event" such as an IPO or a sale of the company typically vest immediately prior to the liquidity event so that the participant can participate in the liquidity event on the same terms as other shareholders. If the monetary cap is retained, we suggest revising the requirement so amounts payable in respect of ESS interests that vest immediately prior to the liquidity event are also exempt from the monetary cap. ► We suggest removing the monetary cap in the interests of simplicity and reducing the administrative burden.
3. Trust requirements	
Trust requirements *ss 1100P(1)(c); 1100P(2); 1100Q(d)*	► The requirement that a trust is operated such that "the trustee acquires *the* ESS interest in connection with *the* employee share scheme" is not reflective of the operation of employee share trusts in practice. ► We suggest revising this requirement to allow the trustee to acquire ESS interests in connection with more than one employee share scheme operated by a company. Alternatively, we would suggest that the trust requirements are aligned with the definition of an 'employee share trust' under s 130-85(4) of the *Income Tax Assessment Act 1997* (Cth). ► The inability for a Trustee to charge fees to the body corporate is not appropriate where the body corporate has contracted with a third party trustee company to administer the employee share trust.
4. Directors' liability	
Directors' liability *s 1100V*	► Allowing a participant to recover loss or damage from each director of the body corporate making the offer, and any other person named in the offer document, as a result of a breach of the essential terms outlined in s 1100V, unreasonably imposes personal liability on individuals. It will inhibit companies from offering employee share schemes in Australia.

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Provision	Summary comments
	► The 'no liability' terms in s 1100V(3) may limit personal liability in the event of loss or damage suffered by an ESS participant. However, we are of the opinion that requiring individuals to make reasonable inquiries or to rely on information provided by external parties still imposes a heavy burden that directors are unlikely to be willing to take on. ► There is no such existing provision in CO 14/1000 and we are not aware of any information provided during this consultation process that would justify the imposition of personal liability. We suggest this requirement be removed.
5. Ongoing concerns from our 2021 Submission	
Distinction between ESS interests that are acquired for monetary consideration, and those which are not *Refer to page 6 of Schedule 1*	► We do not believe additional requirements should be imposed on ESS interests that are acquired for monetary consideration. These provisions are not consistent with ESS measures already supported by tax legislation, such as "start-up" options and plans that involve pre-tax salary sacrifice by employees.
Notice of intent *Refer to page 7 of Schedule 1*	► 5 years' imprisonment for failure to provide a notice of intent is unnecessarily severe, remains disproportionate to the nature of the offence and is completely out of line with late or missed filing penalties in other major jurisdictions.
Issue cap *Refer to page 8 of Schedule 1*	► The 5% issue cap for listed companies and 20% issue cap for unlisted companies remains arbitrary and inconsistent with encouraging the operation of ESS in Australia. Issue caps are a matter for the Board and shareholders of companies to determine. ► In addition, the proposed caps duplicate the issue limits in CO 14/1000 and CO 14/1001, but do not provide the ability for shareholders to approve a higher limit.
ESS interest	► The definition of "stapled securities" does not include a stapled security that consists of one share in a company and one unit in a trust. Many of Australia's large, listed property companies issue stapled securities. The

Provision	Summary comments
Refer to page 10 of Schedule 1	current definition prevents many stapled groups from obtaining regulatory relief under the 2022 ESS Reform Bill.

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Detailed submission

EY sets out the following matters for The Treasury's consideration.

1. Offers for consideration – both listed and unlisted companies

Required disclosures

Under s 1100T, the offer document is required to explain how an ESS participant may, from time to time, calculate the value of the ESS interests. This is likely to present difficulties for companies, particularly where the ESS interest is an incentive right or an option for which the market value is typically calculated using a complex financial model. In addition, private companies will not typically have an up-to-date share valuation available.

Further clarification on the information needed to satisfy this provision would be welcome.

Essential terms of the offer

s 1100V sets out a number of terms which are essential to an offer for consideration. We believe the following requirements will increase the administrative burden and risk for companies and may have an adverse impact on the operation of ESS in Australia:

- **s 1100V(1)(b):** The requirement to provide a participant with a new offer document within 60 days of the company becoming aware of an offer document becoming out of date, or otherwise incorrect in any material respect
- **s 1100V(1)(c):** The requirement that the offer document must not include misleading or deceptive statements or omit information that would result in the offer being misleading or deceptive.

s 1100V(1)(b) imposes an ongoing compliance obligation on the company and each director of the company, by virtue of s 1100V(2), for the duration of the particular award, which may be as long as 15 years (being the maximum period of time for tax deferral under Division 83A of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**)). This is impractical in its application and is unnecessary for listed companies that are subject to continuous disclosure obligations. It would be preferable for this requirement to end at the point the ESS Interests are granted with respect to the relevant offer.

In respect of s 1100V(1)(c), we do not consider that the policy rationale for the imposition of thresholds for misleading or deceptive statements or omissions has been explained. We are not aware of any information being presented that suggests deceptive statements or omissions is a particular issue in this context. We are concerned that this provision will discourage companies from operating ESS, or increase external advisor costs to review all documentation. In fact, this requirement will provide executives of a company with an avenue to pursue compensation where their ESS awards have not vested, on the basis of any ambiguity in the drafting.

In addition to the administration and costs imposed by these requirements, the imposition of personal liability on directors in the event of contravention per s 1100V(2) may act as a deterrent to the operation of ESS in Australia. See '4. Directors' liability' below.

2. Offers for consideration – additional requirements for unlisted companies

Additional essential terms

In addition to ss 1100Q and 1100V, unlisted companies are required to comply with the essential terms under s 1100W when making offers for consideration. We suggest revisiting the following terms to minimise administrative burden on unlisted companies:

- **s 1100W(3)(a):** An option cannot be exercised, and an incentive right cannot vest, unless valuation and certain financial information is provided to the participant 14 days prior.
- **s 1100W(3)(b):** A participant may request the valuation and financial information required in s 1100W(3)(a) at any time prior to the expiry date for incentive rights or options and the company must provide the information within 30 days of the request.

The only way to fully comply with s 1100W(3)(a) would be for a company to restrict when the exercise of options can take place during an exercise period. Currently, companies normally allow participants to exercise their options at any time during an exercise period, to provide them with maximum flexibility.

To maintain flexibility during an exercise period, a company would need to maintain current valuation and financial information during an exercise period, which would be unnecessarily burdensome and potentially very costly.

Similarly, the ability for a participant to request the same valuation and financial information at any time prior to expiry of an award also imposes an ongoing administrative burden and cost, particularly where the expiry date of an award may run to 15 years from date of grant, and where there are a large number of participants (as is typical of ESS operated by unlisted companies).

To reduce administration and maintain the flexibility for participants to exercise at an appropriate time for them and the company, we suggest that financial information is provided on vesting/exercise.

Monetary cap

The new monetary cap requirement under s 1100X operates to limit the amount payable by a participant in respect of all ESS offers within a 12-month period as follows:

- The monetary cap is set at $30,000 in respect of a particular 12-month period (commencing on the date that the ESS offer is made) and may be increased by an amount equal to:

  70% of all dividends received by the participant in that 12-month period (from interests held in the company issuing the ESS interests)

  plus

  70% of the participant's cash remuneration that is condition on the achievement of objectives for that 12-month period

- Any part of the $30,000 monetary cap that is not used in a 12-month period (excluding any increase from dividends / cash remuneration) may be carried forward to the next 12-month period, up to a maximum of five years (i.e., the maximum monetary cap is $150,000).

As noted in our 2021 Submission, a monetary cap of $30,000 is very low and will likely impact the ability for unlisted companies to attract and retain talent by offering ESS interests as part of a competitive remuneration package. This proposal runs counter to the 'start-up share scheme' reforms introduced by the Government in 2015 which established a tax qualified scheme for start-up companies.

The calculation methodology is complex and will significantly increase administration for companies to calculate the monetary cap each year (including any carried-forward amounts). It will be difficult for unlisted companies to calculate the additional 70% of dividends and 70% of cash bonus amounts received in advance, without the risk of over-estimating these amounts. Further, payment of dividends and cash bonuses is less prevalent in unlisted companies and as these amounts cannot be carried-forward, it is unlikely that many companies will be able to utilise this additional amount to increase the monetary cap. Many employees in start up companies do not receive cash bonuses, and these companies do not typically pay dividends.

The cap calculation does not include any amounts that only become payable at a time when the ESS interests are able to be traded on a financial market or where the amounts will become payable in connection with a sale of the company. . However, further clarity would be welcome on whether payments made in respect of awards that vest immediately prior to a liquidity event would also be excluded from the monetary cap. In our experience, awards typically vest immediately prior to a liquidity event, so that participants can participate in the liquidity event on the same terms as other shareholders.

To ensure unlisted companies can continue to offer ESS interests to attract and retain talent, we suggest removing the monetary cap.

3. Trust requirements

Employee share trusts are commonly used by companies to administer ESS in Australia. A trust structure:

- provides a vehicle for acquiring and holding ESS interests;
- enables a company to manage costs relating to the satisfaction of ESS awards, especially those made for no monetary consideration - for example to manage costs relating to share price growth, the company may contribute to the trust to acquire shares in the market prior to awards vesting;
- allows ESS interests in respect of lapsed awards to be 'recycled' to satisfy other grants of awards under any of a company's ESS; and
- allows the company to use the services of a specialist external (third party) trustee company for good-governance purposes.

The requirement that the trustee acquires "*the* ESS interest in connection with *the* employee share scheme" under s 1100P(1)(c) and s 1100Q(1)(d) implies that the ESS interest must have been acquired for the purposes of a specific employee share scheme – this would seem to require a trust for each plan that operates. In practice, companies will typically operate one trust for all ESS in place and shares / ESS interests may be used for the purpose of settling an award under more than one ESS, depending on which awards vest/are exercised first (and forfeited shares into the trust are 'recycled' and used to settle awards in other plans).. The current drafting limits this flexibility and is not reflective of the operation of employee share trusts in practice.

Additionally, s 1100P(3) limits the activities of the trust to "managing the employee share scheme" – again, on a strict interpretation this could require companies to operate one trust per employee share scheme, which would be administratively burdensome and extremely costly. This is also inconsistent with the definition of an "employee share trust" under s 130-85(4) of the *Income Tax Assessment Act 1997* (**ITAA 1997**), which we note does not limit the operation of the trust to one ESS.

Section 1100P(3)(c) prevents a trustee of the trust charging any fees for administering the trust to the body corporate. This is impractical where a company has specifically contracted the services of an external trustee company to administer the trust on their behalf. The eternal trustee will charge fees to the Company for this service. It would be preferable to state that a Trustee can charge fees to the body corporate, but that such fees must be paid for by the body corporate and not from trust funds (or from participants).

For simplicity and consistency with existing legislation, Treasury may consider requiring that the trust meet the definition of an "employee share trust" per s 130-85(4) of the ITAA.

4. Directors' liability

The ESS Reform Bill imposes liability on *each director* of a company or responsible entity, for loss or damage caused by the failure to comply with section 1100Q(1)(h) and section 1100V. While the 'no liability' terms in s 1100V(3) may limited personal liability in the event of loss or damage suffered by an ESS interest, the requirement still imposes a heavy burden on individual directors to make reasonable inquiries or to rely on information provided by an external party.

We do not consider that the policy rationale for the imposition of personal liability has been made out. Directors are unlikely to be willing to assume this liability and may choose to limit the operation of ESS if they are to be personally liable. We suggest removing this requirement.

5. Ongoing concerns from our 2021 Submission

We are concerned that some of the issues that we identified in our 2021 Submission have not been addressed. These cover:

- the distinction between ESS interests that are offered for monetary consideration and those which are not
- offence related to failure to provide a notice of intent

- the imposition of an issue cap
- the definition of “stapled securities”

Please refer to Schedule 1 for our detailed commentary on these issues.

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Directors

Market Conduct Division and Individual and Indirect Taxation Division

The Treasury

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25 August 2021

Submission on employee share scheme reforms

We enclose EY's response to the *Treasury Laws Amendment (Measures for a later sitting) Bill 2021: Employee Share Schemes* (**ESS Reform Bill**), released for consultation on 29 July 2021.

EY considers that, overall, the ESS reforms should simplify the regulatory framework for companies seeking to operate employee share schemes (**ESS**) in Australia.

In particular, EY supports:

- the exemption from the *Corporations Act 2001 (Cth)* requirements for ESS offers made to employees for no monetary consideration;
- the streamlining of the ASIC filing requirements; and
- the removal of cessation of employment as a taxing point for ESS interests.

Based on our experience assisting companies establish and operate ESS in Australia, however, we are of the view that the ESS Reform Bill requires further consideration and amendment, if it is to achieve its objective of making it easier for businesses to offer ESS in Australia and to provide a regulatory environment which is competitive on the global stage.

The policy objective of reducing "red tape" for businesses is unlikely to be met for many ESS structures, and in some instances, the ESS Reform Bill imposes further administrative burden than under the current regime. For example, the synchronisation of the start date for the removal of the cessation of employment taxing point will be key in ensuring that Australian businesses are not burdened with operating under two sets of tax rules, for years to come.

In addition, and of most concern to us, are the new penalty provisions relating to disclosure requirements and other formalities which are so draconian - involving terms of imprisonment - as to totally dissuade employers from offering such plans to employees; thereby resulting in a total nullification of the other very good work that has been done to encourage the take up of share plans in Australia.

The penalties are clearly disproportionate to the nature of the offences involved and also excessive compared to what other countries adopt for similar offences overseas. We strongly urge you to reconsider the need for imprisonment and other harsh penalties for such offences.

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We would be pleased to discuss our submission.

We note the House of Representatives Standing Committee on Tax and Revenue tabled its report on the Tax Treatment of Employee Share Schemes on 23 August 2021. We have not yet had an opportunity to review the report in detail and as such make no comment on the report in this submission.

Yours sincerely

Chris Galway
Partner
People Advisory Services

Hillel Nagel
Associate Partner (Legal Practitioner)
People Advisory Services

EY submission on ESS Reforms

EY supports the changes proposed in the ESS Reform Bill and the policy intent that there is no disclosure where an employer provides ESS interests (as defined in the ESS Reform Bill) for no monetary consideration. EY also supports the removal of the taxing point for ESS interests where an employee ceases employment. Our submission focuses on areas where changes and clarity are required to support the operation of ESS in Australia.

Our comments are summarised below in terms of those matters where we believe additional clarity and/or amendment is required. Further detail on each point is set out in the “Detailed submission” section that follows.

Executive Summary

Provision	Summary comments
1. Distinction between ESS interests that are acquired for monetary consideration, and those which are not	
Meaning of ESS interest	► We do not believe additional requirements should be imposed on ESS interests that are acquired for monetary consideration. ► ESS offers that require payment from employees are typically structured on an advantageous basis for employees, and may not require payment until the underlying securities can be sold at a gain (e.g. share options). ► These provisions do not support certain ESS measures already supported by tax legislation, such as “start-up” options and plans that involve pre-tax salary sacrifice by employees.
2. Offences	
General	► The offences are draconian and disproportionate. ► They do not align with practice in UK, Europe, the US, Canada and New Zealand. ► The severity of the offences is likely to negatively impact the operation of ESS by Australian companies and the opportunity for Australian employees to participate in ESS offered by global companies.

Provision	Summary comments
Notice of intent	► 5 years' imprisonment is unnecessarily severe. ► We suggest that the penalty provisions align with those relating to, for example, the pecuniary penalty provisions for failure to provide the relevant disclosures.
Civil penalty provisions	► The provisions are not proportionate. ► Treasury should consider how many companies have fallen foul of the current regime, and the level of risk that it is seeking to address.
Director liability and section 1100X	► Directors are unlikely to be willing to take on personal liability for errors in disclosure, given that the operation of ESS is not for fundraising purposes, but to benefit and incentivise employees. This will affect the number of ESS that continue to be implemented. ► Separately, the drafting in section 1100X(b) needs revisiting.
3. Issue cap	
ASX listed companies	► The 5% limit is arbitrary and is an issue for each company's board and shareholders to consider – not for regulators to legislate. ► The 5% issue cap also does not interact with the 15% limit under the ASX Listing Rules.
Unlisted companies	► The 20% issue cap is arbitrary and problematic for companies who are employee-owned, and is inconsistent with encouraging employee share ownership and the operation of ESS in Australia. ► As noted above for listed companies, any cap on ESS issuances is an issue for the board and shareholders of each company to determine and not for regulators.
4. Monetary cap	
$30,000 monetary cap for private companies	► The $30,000 limit is materially too low, and many companies will not be able to utilise it, especially in relation to grants made to senior management.

Provision	Summary comments
	▶ We suggest not imposing a cap or, if a cap is used, having a significantly higher one.
5. Definitions	
ESS Contribution Plan	▶ This definition should exclude ESS where the contributions are not held for any significant period of time, but are generally applied after a relatively short period towards the purchase of ESS interests (and typically , the employee can immediately realise a gain by selling the underlying shares).
ESS interest	▶ The definition of "stapled security" should be amended to reflect typical Australian market practice – a share in a company stapled to one (or more) share in another company and / or one (or more) unit in a trust. Further, section 83A.335 of the *Income Tax Assessment Act 1997* (**ITAA 1997**) has an existing definition under the ESS income tax provisions which refers to a stapled security as a security where "at least one of the ownership interests that are stapled together to form the stapled security is a share in the company". ▶ Rights and options granted under ESS are not generally tradeable. ▶ ESS interests acquired for no monetary consideration should be excluded from the provisions altogether to align with the policy intent.
6. Valuation	
Valuation to be provided within 14 days of the exercise date	▶ This requirement is practically difficult to meet, when it is not known at which time during an exercise period (which could be as long as 15 years) an employee will exercise their option.
7. Tax	
Removal of cessation of employment as a taxing point	▶ To assist with the practicalities of managing the tax treatment for ESS, we suggest that these new rules apply for all grants of ESS interests from the effective date – not just to new grants.

Detailed submission

EY sets out the following matters for The Treasury's consideration.

1. Distinction between ESS interests that are acquired for monetary consideration and those which are not

Whilst we welcome the simplification of ESS offers relating to ESS interests (as defined under the ESS Reform Bill) which are not acquired for monetary consideration, we do not support the heavy requirements imposed for offers relating to ESS interests that are acquired for monetary consideration.

ESS are operated by Australian employers as a benefit to employees, and to provide employees with an opportunity to participate in the growth in value of their employer group. Employees are normally offered participation in an ESS on an advantageous basis, as compared to offers made to ordinary investors. ESS that require monetary consideration will normally have at least one of the following features:

- the ESS interests will be acquired at a discount to market value; and/or
- the employer will provide free/matching ESS interests in addition to the ESS interests acquired by employees; and/or
- where the ESS interests are options, the requirement to pay for the underlying shares is generally deferred and at the later time the employee will have the ability to choose whether to exercise the option, taking the prevailing market value of the company's shares into account at the time the option may be exercised.

The additional requirements imposed on ESS interests that are acquired for monetary consideration are not aligned with the intention of the ESS reforms and are out of step with the regulatory regimes in many overseas jurisdictions.

The additional requirements imposed on ESS interests that are acquired for monetary consideration also do not support the operation of "start-up" ESS, introduced in 2015 to provide specific tax concessions to employees participating in ESS operated by early stage businesses. "Start-up" options, for example, are required to have an exercise price equal to at least the market value of the shares on the date that the start-up options are granted. These options typically allow the cost of acquiring the underlying shares to be deferred until the options are "in the money" and employees can realise a gain by exercising the options and selling the underlying shares.

The requirements also do not support the operation of salary sacrifice plans which provide beneficial tax treatment to employees by allowing pre-tax contributions to acquire shares.

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2. Offences

General observations

The various offences under the ESS Reform Bill are excessive, draconian and problematic. Whilst we understand Treasury's view that employers who offer ESS interests be required to provide both employees and ASIC with certain information, the offences for failing to carry out the requirements of the ESS Reform Bill are grossly disproportionate to the offence committed.

Further, the offences are much greater than those imposed under other jurisdictions, such as the UK, the European Union, the US, Canada and New Zealand. This puts the operation of ESS in Australia completely out of step with the global regulatory environment.

The severity of the offences under the ESS Reform Bill is likely to affect:

- the take-up of ESS by Australian headquartered companies, who will not want to take on such a significant risk; and
- the ability for Australian employees to participate in, and benefit from, ESS offered by international companies, who will not have the risk appetite to consider it worthwhile to extend participation to employees in Australia. This could result in Australians who are employed by a global company missing out on ESS participation.

Notice of intent

Under section 1100G(3) of the ESS Reform Bill, it is an offence, punishable by up to 5 years' imprisonment, to fail to submit a "notice of intent" with ASIC.

We note that under other jurisdictions, such as the UK and the European Union, there is a general exemption from securities law requirements for offers made under ESS (including where employees pay monetary consideration), and no filings at all are required. This is in stark contrast to the proposed requirements under the ESS Reform Bill, putting Australia out of step with the global stage.

We understand that Treasury is of the view that the penalties should align with those imposed in other parts of the *Corporations Act 2001 (Cth)* (the **Act**) relating to product disclosure statements. We consider that a more relevant reference would be those sections that grant exemptions from the requirement to issue a product disclosure statement, or that provide less disclosure.

Civil penalty provisions

The civil penalty provisions for:

- failing to provide an ESS disclosure document;
- failing to provide certain information to ESS participants;
- failing to comply with the valuation requirements; and

- providing misleading or deceptive statements in ESS disclosure documents

are overly excessive and much higher than under the current regime. The maximum civil penalty under the ESS Reform Bill is 15 years' imprisonment.

We strongly recommend that Treasury reconsider these measures, and keeps the current penalty regime. Treasury may wish to consider how many (if any) companies have fallen foul of the current ESS regime, and whether the new measures are proportional.

Director liability and section 1100X

Section 1100Y of the ESS Reform Bill imposes liability on *each director* of a company or responsible entity, for loss or damage caused by the failure to comply with section 1100X(1), "*Misleading statements in ESS disclosure documents etc*".

Directors are unlikely to be willing to approve the implementation of an ESS that will result in them becoming personally liable, especially as the purpose of operating an ESS is not for fundraising, but rather, to recruit, retain and incentivise employees. The implementation and operation of ESS is normally a cost to the employer, due to the expenses incurred in establishing the ESS, and the fact that the ESS interests are generally acquired on advantageous terms. The proposed directors' liability provisions will diminish the implementation of ESS in Australia.

Further, we note that section 1100X(b) is drafted such that the provision will be contravened where a "new circumstance" arises during an application period in respect of an ESS offer, which would have been required to have been included in the ESS disclosure document. This provision does not provide the opportunity to amend the ESS disclosure document or make any subsequent notifications with respect to the new circumstance. We would not expect for a person to be found to contravene this section without being given the opportunity to correct the ESS disclosure document, as soon as they become aware that a new circumstance has arisen.

3. Issue cap

ASX listed companies

Under section 1100J(3) of the ESS Reform Bill, in order for an offer to be considered an "ESS offer", the total number of newly issued shares that may be used in connection with the ESS offer within a three year period, must not exceed 5%. This cap is arbitrary and low and the draft provisions do not allow for the limit to be increased by, for example, obtaining shareholder approval.

This does not interact with the ASX Listing Rules, which allow companies to issue new shares equal to up to 15% of share capital without shareholder approval each year. Companies are able to issue new shares in excess of this 15% cap where prior shareholder approval is obtained.

Imposing the 5% issue cap with respect to ESS offers will affect many listed companies who are currently relying on the 15% cap under the ASX Listing Rules, or who have sought separate, specific shareholder approval to issue new shares. The issue cap is not a decision for regulators to impose – it is a decision to be made by the board and shareholders of each company.

It is not clear what objective the cap is intended to meet from an ESS reform perspective. We suggest that, as a minimum, the issue cap is amended to align with the ASX Listing Rules, and that a provision is inserted to allow shareholders to approve a higher cap.

Unlisted companies

Under section 1100J(3) of the ESS Reform Bill, in order for an offer to be considered an "ESS offer", the total number of newly issued shares that may be used in connection with the ESS offer within a three year period, must not exceed 20%.

The arbitrary limit is problematic for smaller companies who may require a greater proportion of equity to be available for employees. Such a cap would be unworkable for the many unlisted companies which are predominantly employee-owned. For example, as recently reported in the Financial Review, Barrenjoey (an Australian investment bank) is 50.1% owned by its employees.

The 20% cap is inconsistent with encouraging employee share ownership and the operation of ESS in Australia. It is also not aligned to current practice in Australia and overseas, and is not a matter to be addressed in the ESS Reform Bill – this matter lies with the board and the shareholders of each company. We suggest that the cap be removed altogether or, if a cap is to be included, there is the ability for a company to approve a higher limit.

4. Monetary cap

A monetary cap of $30,000 per ESS offer is very low, and very few unlisted companies will be able to use this exception for all offers made under their plans. We suggest that the monetary cap be removed, or at least significantly increased. The ESS Reform Bill imposes greater disclosure requirements, and as such, we would expect that the monetary cap would be increased, to reflect the information provided.

Employers of private companies often require key management (including, for example, the CEO) to acquire shares in the company for monetary consideration, as a way of aligning their interests to the company and those of shareholders. In many cases, the acquisition is on beneficial terms (e.g., by way of an interest-free limited recourse loan provided to the employee). For these types of ESS arrangements a cap of $30,000 is materially too low and does not take into account any funding arrangement or discount that may be offered to employees.

Further, ESS interests are often offered by private companies as a way to "top-up" the value of remuneration packages offered to key employees, when the company's cash flow/ funds are insufficient to allow them to offer a competitive salary. In these instances, the value of the ESS interests will, in most cases, exceed $30,000.

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5. Definitions

"ESS contribution plan"

We suggest that the definition of an ESS contribution plan under section 9(b) of the ESS Reform Bill is amended, to apply only where the deductions or contributions made under the ESS are held for a period of more than one month (and not directly applied to acquire ESS interests).

"*ESS interest"*

The majority of stapled securities in Australia are offered by property companies, and consist of one equity security (for example, one ordinary share), stapled to one unit in a unit trust (and/or a share in another company). The definition of "ESS interest" under section 1100F(e) of the ESS Reform Bill should be amended to include a stapled security that includes a "unit", in order to reflect market practice in Australia.

Section 83A.335 of the ITAA 1997 refers to a stapled security as a security where "at least one of the ownership interests that are stapled together to form the stapled security is a share in the company". We suggest that the ESS Reform Bill definition aligns with the ITAA 1997.

Rights and options granted under ESS are not generally tradeable in any financial market. They are private contracts between the company and the relevant employee, and will normally lapse if the employee attempts to transfer or trade them in any way. We would therefore suggest that sections 1100F(b) and 1100F(f)(i) are amended, to remove references to rights and options being traded.

In respect of sections 1100F(c), (d) and (f)(ii), we do not agree that the definition of ESS interest should incorporate whether the ESS interest involves the payment of monetary consideration. To align to the policy intent, ESS interests that do not involve monetary consideration at the time of issue should be able to be offered without being subject to subdivision C.

Particularly with regards to section 1100F(f)(ii), many companies grant options with an exercise price as a way to allow employees to participate in any increase in share value. Many early stage companies offer share options to employees which can access the tax concessions under the "start-up" ESS provisions.

When such options vest and become exercisable:

- if share price has increased, the employee may exercise the options to acquire shares at the exercise price. Typically, exercise of the options occurs at a time when the employee can sell the shares (e.g., for an unlisted company, exercise may occur at the same time as a liquidity event for shareholders such as where the company is being acquired under a takeover); or
- if share price has decreased, the employee can choose not to exercise the options – and no monetary consideration is paid by the employee.

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For this reason, options that allow for deferred payment of any monetary consideration should not be included in the definition of “ESS interest”.

6. Valuation

Section 1100V(2) of the ESS Reform Bill requires that company valuation be provided at least 14 days before the exercise or vesting of an ESS interest. It is typical for options to have an exercise period, within which the employee can choose to exercise their option. The *ITAA 1997* allows the exercise period to be as long as 15 years. Therefore, it is unworkable for an employer to be required to provide a valuation within 14 days of the exercise date, when the exercise date is open ended or unknown.

We propose that the requirement be for the valuation to be provided within 14 days **of the end of the exercise period.**

7. Tax

We welcome Treasury’s decision to remove cessation of employment as a taxing point for ESS interests. However, this new provision should apply to **all** grants from the effective date, and not just to new grants.

If the new provision only applies to new grants, employers will be required to refer to two separate sets of ESS tax rules where an employee ceases employment, for many years, due to the vesting periods, restricted periods and, in the case of options, exercise periods, relating to ESS interests which have already been granted. This will increase the administrative burdens for employers operating ESS, rather than reducing them.

Removing the cessation of employment taxing point for all ESS interests from the effective date will significantly reduce the administrative burden on companies operating ESS, as well as reducing complexity for new plans being implemented by companies.

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