Law Council
OF AUSTRALIA

Business Law Section

4 February 2022

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 – Revised Exposure Draft Legislation

The Corporations Committee of the Business Law Section of the Law Council of Australia (the **Committee**) welcomes the opportunity to provide this submission to the Commonwealth Treasury (**Treasury**) on the revised exposure draft legislation released on 23 December 2021 that seeks to remove regulatory barriers in offering Employee Shares Schemes (**ESS**), which build on the previously consulted ESS reforms in August 2021 (**Revised Exposure Draft Legislation**).

The Committee would like to acknowledge and express gratitude to Treasury for taking on board the majority of the recommendations in relation to the Revised Exposure Draft Legislation proposed in the Committee's submissions dated 25 August 2021.

The Committee continues to believe that the best way to achieve the important objective of improving the ability of businesses to offer an ESS to help them attract, retain and motivate employees and grow their businesses is to limit the more onerous compliance requirements to offers of ESS interests where cash is paid upfront for that relevant interest or is otherwise a pre-condition to receiving the grant of an ESS interest itself. This will allow listed and unlisted companies to issue options with a non-nominal exercise price without the need to comply with the more onerous requirements, which impose real costs (for example, of obtaining valuations and to meet financial and other disclosure requirements).

However, the Committee also appreciates that there is a policy concern to ensure that participants in ESS have available to them sufficient information to enable them to make an assessment about whether it is economically in their interest to exercise their options (or to otherwise fund monetary consideration that becomes payable). The exceptions that have been proposed which allow for options (or similar) to be granted without a need to comply with these requirements where they may only be exercised in the event of an IPO or other liquidity event will go some way to address our concerns. This submission sets out some technical amendments to these exceptions which we think will assist them to work better in practice (particularly as it relates to unlisted entities). This is addressed in section 1 below as well as recommendations to overcome some of the potential practical limitations of some of the other revised legislative drafting. In section 2, we provide a response to the Treasury's questions from the most recent consultation paper with regard to the "issue cap."

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

All references to the 'Act' in sections 1 and 2 are references to the *Corporations Act 2001* (Cth) and references to specific sections are to sections of the Act.

1 Areas for clarification in the Revised Exposure Draft Legislation

1.1 IPO (liquidity event) exemption to the monetary cap

The Committee agrees with Treasury that there is limited financial risk for ESS offers that involve liquidity events (such as an IPO or share sale) and, as such, the "monetary cap" under the Revised Exposure Draft Legislation should not apply. However, with respect to the IPO exemption, the Committee notes the drafting in the Revised Exposure Draft Legislation could be broadened to provide more flexibility to entities, particularly as they relate to the exercise of options around the time of listing. Currently, the Revised Exposure Draft Legislation states that the IPO exemption will only apply "once the ESS interests are in a class of interests that is able to be traded on the official list of a financial market". In practice an entity may need to facilitate the exercise of options *prior to* the date the underlying securities commence trading on a financial market (for example, if there is time delay between the date an entity is admitted for quotation and the date the entity's securities begin trading) and, in this scenario, an unlisted entity would not be able to seek the benefit of the IPO exemption from the "monetary cap." It would also be best if the drafting made it clear it also applies if the underlying ESS interest is admitted to quotation (which is the far more likely scenario).

The Committee recommends the drafting of the IPO exemption carveout to the monetary cap in section 1100X of the Revised Exposure Draft Legislation be amended to state it comes into "effect upon the ESS interest (or underlying ESS interest) being admitted to quotation or approved for quotation on the official list of a financial market."

1.2 Removal of civil liability to discourage grants for "no consideration"

Whilst the Committee appreciates Treasury amending the Revised Exposure Draft Legislation to remove the criminal liability provisions relating to ESS offers in Division 1A of Part 7.12 of the Act, the Committee notes that, as currently drafted, any deficiency of disclosure within an ESS offer document would still result in breach of Chapter 6D or Part 7.9 of the Act, attracting the severe existing sanctions in those parts of the Act as they will apply (as the regulatory relief falls away). In particular, personal liability for directors and others involved in the preparation of offer documentation is a major concern. Given the Revised Exposure Draft Legislation requires unlisted entities to include financial information as well as valuation information within an ESS offer document, the existence of a regime of strict civil liability (coupled with due diligence defences) will still give rise to the concerns we raised about this creating a cost burden, particularly for unlisted entities. For example, would it be necessary to have the financial disclosure subject to an independent accountant's review to be comfortable that due enquiry has been made about the accuracy of that information? Likewise a valuation – this would likely require the use of a third party independent valuer to give the individuals involved in the preparation of the offer materials sufficient comfort.

Although this would undoubtedly improve the quality of disclosures it is more likely to create a disincentive to create an offer document in the first place for unlisted entities. This in turn could distort the market and create a scenario where most grants of ESS interests utilising this regulatory relief are made for no consideration, which may not always be the best commercial decision for an entity (including what is most fair for

existing shareholders and in the best interests of the market or be most tax effective for participants themselves).

Given that the misleading and deceptive conduct provisions in Part 7.10 of the Act would otherwise apply to an offer document (in particular, sections 1041E to 1041F and 1041H) (and persons knowingly involved in a breach by the issuer would have accessorial liability), it is not necessary to impose prospectus-level civil liability to an offer document (particularly where the objective is to liberalise this process).

The Committee recommends that the Revised Exposure Draft Legislation be amended to remove the provisions imposing liability under the Act for disclosure deficiencies within an ESS offer document (rather, the Committee recommends a provision explaining that a deficiency of disclosure would mean that it is not a valid ESS offer, similarly to the way the current ASIC class orders operate).

1.3 Obligation to provide financial accounts and valuation information to option holders

The Committee understands the desirability of keeping an ESS participant fully informed by providing all reasonable information to make an informed investment decision. However, the Committee sees the newly inserted obligation (under section 1100W(3) of the Revised Exposure Draft Legislation) for an unlisted entity to provide updated financial accounts and valuation (a) 14 days prior to exercise of an option, and (b) anytime upon request by an option holder, as overly burdensome.

The 14 day requirement should be abbreviated to 7 days. If an unlisted company was going through an IPO process and wanted to rely on its IPO prospectus (which contains the relevant financial accounts and valuation information) to satisfy disclosure requirements, needing to provide this 14 days prior to option exercise could have an impact on IPO timetables (since usually the exercise of options occurs at or before listing). Some IPOs have short timetables which have listing occuring within 14 days of prospectus lodgement. These requirements should not influence IPO timetable decisions. We recommend that a period of 7 days be used instead (which also aligns with the ASIC exposure period for an IPO prospectus and so is presumably enough time to consider the information).

In addition, the Committee notes that allowing an option holder to request this type of financial information at any time until an option is exercised could significantly increase compliance costs of an unlisted entity and create a burden on management (since there would be a need to create revised financial and valuation information each time such a request was made).

For the above reasons, the Committee recommends that the Revised Exposure Draft Legislation be amended so that:

a) the 14 day requirement (under section 1100W(3)(a)) is shortened to 7 days in line with what is required for ASIC's exposure period review under the Act for an IPO prospectus; and

b) the obligation for an entity to provide financial accounts and valuation information at the request of an option holder (under section 1100W(3)b)) only apply to holders of options that have vested and are capable of being exercised, where requested 7 days prior to exercise of the option.

1.4 "Issue cap" and disclosure document exemptions

One of the requirements that an offer of ESS interests for monetary consideration needs to meet is to come within the "issue cap" (see sections 1100Q(1)(c) and 1100Q(2)).

The way the issue cap is currently defined in section 1100Q(2), offers of ESS interests that have been (or will be) be made either without monetary consideration (i.e. offers referred to in section 1100P) or offers that may be made without needing to comply with a prospectus/PDS requirement (i.e. offers referred to in section 1100S) would need to be counted in calculating the 5% or 20% threshold (for listed and unlisted entities, respectively).

The Committee recommends that the Revised Exposure Draft Legislation be amended to clearly state it is only grants (or anticipated grants) of ESS interests referred to in section 1100Q that should be included under the "issue cap" for the purposes of section 1100Q(2) of the Revised Exposure Draft Legislation.

This is because the chief policy concern which underpins the issue cap is in the use of ESS as a capital raising mechanism from retail investors. That concern is not present where the ESS grants are made for no monetary consideration and is less significant where the participant is otherwise exempted from prospectus/PDS disclosure (since they are a senior manager or director or are sophisticated and professional investors).

At present, the issue cap contained in the ASIC class orders only applies to issues and grants that are made in reliance on the ASIC class orders (i.e., not taking up this recommendation would result in the issue cap being more restrictive than it currently is) (see ASIC Regulatory Guide 49 at pages 9 and 35 for confirmation that this is how the issue cap presently works).

Finally, the Committee does not consider that the issue cap is needed in order to protect shareholders from dilution. See the discussion in section 2 below on our reasons for holding this view.

2 Treasury questions on the "issue cap"

The Committee refers to Treasury's consultation paper questions on the "issue cap" as currently included in section 1100Q of the Revised Exposure Draft Legislation. The Committee does not have an immediate problem with the "issue cap" *per se*. However, the Committee notes that the 5% limit for listed companies can be challenging for small technology companies (who commonly have employee options on issue in the order of 20% at the time of listing) (whereas for larger listed companies, a 5% cap is very easy to provide sufficient headroom for ESS grants). .

With respect to Treasury's policy concerns, the Committee does not see why the "issue cap" is needed to manage the risk of employees being used as a capital raising source (since that is what the Committee believes the "monetary cap" seeks to do).

In addition, the Committee does not view the risk of dilution of other shareholders (if the "issue cap" were to be removed) as a risk at all. It is a "risk" existing shareholders always face in relation to any issue of securities whether under an ESS or a placement or rights issue. For a listed company, there are protections from dilution in the relevant listing rules. For unlisted companies (and also listed companies), this is a commercial issue which is typically managed by market forces (for example, if an entity were to give employees too much ownership this could affect the entity's ability to attract future capital from other

shareholders (or new investors would impose restrictions – as they often do – on the entity's ability to dilute through ESS issues beyond an agreed threshold).

In light of this, the Committee does not view the "issue cap" as a required regulatory tool to enforce the stated policy objects of the Revised Exposure Draft Legislation and does not see any reason to retain the "issue cap" as a condition to the relief. However, should the "issue cap" be retained, the Committee believes that the Committee's recommendation as outlined in section 1.4 could improve the practical application of the "issue cap" as a regulatory tool.

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

Please contact Robert Sultan, Chair of the Corporations Committee at robert.sultan@nortonrosefulbright.com, or BLS Executive Member Shannon Finch at shannonfinch@jonesday.com or (02) 8272 0751, or Committee members Tony Sparks at Tony.Sparks@AllenOvery.com or (02) 9373 7879 or Adam D'Andreti at adandreti@gtlaw.com.au or (02) 9263 4375 if you require further information or clarification.

Yours faithfully,

Philip Argy
Chairman
Business Law Section