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Dear Mr Lee

Employee incentive schemes - Consultation Paper 218

I refer to ASIC's Consultation Paper 218 relating to employee incentive schemes and ASIC's invitation to comment on the proposals in the paper. We regularly assist clients (and in particular, unlisted companies) in structuring and implementing employee share and option plans and management equity incentive arrangements, and are very familiar with the issues and complications that arise in this context.

Accordingly, we welcome ASIC's proposal to make the current ASIC Class Order 03/184 more flexible, although (as noted below) I believe that ASIC should go further in expanding the scope of the Class Order (particularly in the context of unlisted companies). In addition, there are several respects in which the exemptions from disclosure in the Corporations Act, the ASIC Class Order and the provisions relating to offer information statements do not work well together. While changes in the Corporations Act itself may be outside the scope of the current enquiry, ASIC should consider whether those changes also should be made, in order to further facilitate the implementation of employee incentive schemes.

1 Interaction between section 708 of the Corporations Act, ASIC Class Order 03/184 and offer information statements

When making an offer of equity interests to its employees, the three main avenues for a company to follow in complying with the securities law provisions of the Corporations Act are the exemptions under section 708, offer information statements pursuant to Chapter 6D and ASIC Class Order 03/184. Ideally, a company should be able to use any or all of these avenues at any time, but because of the slightly different technical requirements and exclusions under each of them, it can be tricky to use these avenues either sequentially or in combination. While there are ways to manage the issues that arise, these issues make it that much more difficult for smaller (and often unsophisticated) companies in particular to navigate between the applicable requirements, and can discourage them from even trying.

(a) Section 708

In our experience, in offering equity interests to employees, privately held companies tend to rely in the first instance on a combination of the small scale offerings (or 20/12) exemption in section 708(1) and the senior manager exemption in section 708(12). I note in this regard that ASIC appears to believe that an offer to a non-executive director would not come under the senior manager exemption. (See paragraph C3Q4 of the consultation paper.) Our view is that an offer to a non-executive director would be eligible for the senior manager exemption because of ASIC Class Order 04/899, which defines senior manager for purposes of Chapter 6D as ‘a person who is concerned in, or takes part in, the management of the body. . . .’

I also note that we don’t tend to rely on the no consideration exemption in section 708(15) or (16) because there usually is some payment required (even if below market value) either for the issue of shares or upon exercise of options (even if the options themselves are granted for no consideration, which is usually the case). While I acknowledge ASIC’s view (in paragraph 11 of the consultation paper) that these two exemptions generally do not apply to employee incentive schemes because non-monetary consideration is being provided by the employees, we do not necessarily agree with that interpretation.

If the number of employee offerees is too high for a company to be able to rely solely on the 20/12 and senior manager exemptions, we will then suggest that the company should consider using either ASIC CO 03/184 or make offers under an offer information statement. Making offers under this Class Order, however, can mean that the company is precluded from using the 20/12 exemption for any issues of equity interests for 12 months after those offers. This is because under section 708(5), issues under the Class Order are not under any other subsection of section 708 or under a disclosure document, and therefore they count against the 20 investor and $2 million limits of the 20/12 exemption. This can be a significant problem for a small company that needs to engage in regular capital raisings in the early years of the development of its business. While the way around this problem is to do the capital raising (or exempt offers to employees) first, that only works once in a 12 month period.

(b) ASIC Class Order 03/184

Even though our private company clients often offer and issue options to employees (and others), they rarely use ASIC CO 03/184 (if at all), for reasons that I will get to later in this letter. In the context of the interaction between section 708 and the Class Order, I note that the requirement in the Third Exemption of the Class Order that the employee share scheme is extended only to eligible employees of the issuer means that the plan rules for the share scheme cannot allow contractors or consultants who do not meet ASIC’s 80% test to be participants in that share scheme.

In our experience, small private companies often want to offer options to contractors or consultants on the same or very similar terms to those offered to employees. (These companies often rely on the 20/12 exemption in making offers to contractors or consultants.) Excluding this class of offerees from being able to be covered by the same plan rules as employees simply increases (in our view, unnecessarily) the complexity of the company’s documentation (by requiring a separate plan or independent agreements for contractors and consultants). This issue would be eliminated if the Third Exemption were structured to extend the exemption only to eligible employees, rather than referring to the scope of the employee share scheme itself.

(c) Offer information statements

In cases where the number of employee offerees is too high to rely only on the exemptions in section 708, our private company clients tend to prefer using an offer information statement to relying on CO 03/184. The OIS rules have their own disadvantages, however. One of these is the requirement in section 113(3) that a proprietary company must not engage in any activity that would require disclosure to investors under Chapter 6D. (Small private company clients tend to be proprietary companies.) While that section excludes an offer of shares to employees of the company or of a subsidiary of the company, that exclusion on its face does not include options over shares. This suggests that if a small proprietary company wants to issue options to employees under an offer information statement, it must convert to a public company (which many small companies are reluctant to do).

Another issue under the OIS provisions is that the exclusion from the $10 million lifetime limit at the end of section 709(5) applies only to securities or options issued under an eligible employee share scheme. The definition of eligible employee share scheme, however, has a similar issue to the one raised above, in that the scheme must be offered only to employees or salaried directors (and therefore plan rules that allow non-salaried directors, contractors or consultants to participate cannot be an eligible employee share scheme).

Even worse, though, is the requirement that the financial products offered under the scheme cannot be offered without disclosure other than in accordance with section 708(12) (the senior manager exemption). This means that if a company, under a particular employee share plan, offers employees equity interests under the 20/12 exemption or under CO 03/184, it won't be able to rely on the exclusion from the $10 million lifetime limit if it then wants to offer employees under that plan equity interests under an offer information statement.

The different requirements for employee share schemes under CO 03/184 and the OIS rules in theory could lead to a company having three separate employee share/option plans, one for offers under section 708, the second for offers in reliance on the ASIC Class Order and the third for offers under offer information statements. As a practical matter, however, what really happens is that private companies decide that it is all too hard and instead avoid doing any offers under the Class Order or OISs. This means that the number of employees that the company will offer equity interests to each year is no more than the number of senior managers plus 20 (although it can be much less than this because a company may need to use part or all of the 20/12 exemption for capital raisings from investors). This does not facilitate equity ownership amongst rank and file employees.

2 Key issues with ASIC CO 03/184

In the private company context, in our experience, the two requirements of CO 03/184 that cause most concern are the 5% limit on the number of options that can be issued in reliance on ASIC relief, and the requirement that either the company's shares are listed for a period of time or a prospectus is available at all times when the employees' options are exercisable. While the consultation paper proposes to make the latter requirement somewhat more flexible, the 5% limit is to be unchanged.

We understand that ASIC is of the view (as expressed in paragraph 173 of the consultation paper) that the 5% limit is a generous one. While that would usually be the case in the listed company context, private companies invariably have many fewer shares on issue than listed companies, and as a result 5% ends up being a much smaller number of shares. In our experience, it is common for early stage or high growth private companies in particular to want to allocate anywhere between 10% and 20% of its shares to employees (including directors), with 10% to 15% being most common. While such a company can manage the inadequacy of the 5% limit by combining offers under the Class Order with offers under section 708 (which are excluded in calculating the 5% limit), a higher limit for unlisted companies (or even just for small proprietary companies) would be helpful.

Early stage or high growth private companies often view the grant of equity interests to employees as an essential recruitment tool (particularly when they are unable to pay large cash salaries) and as an important way to align the interests of employees with the interests of the shareholders. These types of grants do not have a capital raising purpose, particularly where the equity interests being granted are options that are not currently exercisable. The point of options is to enable the employee to share in the growth in the value of the company over time, and not for the company to receive the exercise price at some undetermined time in the future (when the company may not even have any need for those funds).

In regard to the requirement relating to being listed or having a current prospectus available, under the consultation paper, ASIC proposes to add flexibility in two ways:

(a) by allowing an offer information statement to be available instead of only a prospectus; and

(b) by adding a new alternative where all shares in the issuer are disposed of in a single transaction.

I very much support these proposed changes, with two qualifications - first, the exclusion of offers under the Class Order in the definition of eligible employee share scheme for the purpose of the OIS rules should be fixed, so that the two contexts are coordinated. Second, I believe that the requirement to obtain an independent expert's report in the sale context is not necessary to protect employee option holders, and instead simply imposes an extra cost on the company in the context of a sale. This cost is not insignificant - in our experience, a valuation by an independent expert can easily cost between $8,000 and $15,000, even for a small and relatively straightforward business.

In paragraph 219 of the consultation paper, ASIC gives its reasons for requiring an expert's report. The first reason is to establish that the price is equivalent to the market value of the ordinary shares. In the private company context, however, it can be difficult to determine what the market value of a company is, and as a result the range in values can be so wide as not to be very helpful to option holders. In any event, the sale alternative only applies if all the shares in the issuer are to be disposed of. In that case, it should be safe to assume that all of the shareholders of the issuer would not be selling their shares if they were not satisfied that the sale price was a fair one.

Further, ASIC is not proposing (and it should not propose) that the employee option holders could refuse to sell their shares (or options) to the proposed buyer if the expert's report showed that the market value was more than the price to be paid by that buyer. Given this, the only practical effect of the expert's report may be to make the employees (and perhaps other shareholders) unhappy about the price to be paid by the buyer. As the employees (as well as other shareholders) would usually be contractually bound to sell their shares under drag along provisions, being advised of the market value of the shares would seem to serve no useful purpose.

ASIC also notes that the expert's report will enable option holders to assess how the exercise price for the options compares to the transaction value of the underlying ordinary shares. Option holders do not actually need to know this, however - all they need to know is the difference between their exercise price and the price they will receive from the buyer for their shares, as that tells them what their profit (if any) will be.

3 Other comments on the consultation paper

(a) Proposal C3 - exclusion of non-executive directors: ASIC proposes to limit the extent to which offers to non-executive directors are covered by the Class Order, both in the listed and unlisted company context. While these limitations may be appropriate in the listed company context, I believe they are less relevant in the unlisted company context.

There is not the same distinction between shareholders and management in the unlisted company context as there usually is with listed companies - with unlisted companies, the key shareholders are usually also the key managers of the business. Non-executive directors in this context do not need to be independent of management, because management and the shareholders are one and the same. Also, non-executive directors of unlisted companies tend to have some kind of relationship with the company, such as being a significant investor, adviser or service provider, and accordingly would not be likely to be considered to be independent in the listed company context. That being the case, rules that are designed to apply to independent non-executive directors do not fit well in the private company context.

In any event, because our view is that the senior manager exemption in section 708(12) applies to non-executive directors, there is no need to rely on the Class Order, and accordingly the lack of flexibility in the application of the Class Order to non-executive directors is not a practical impediment to offers to them of equity interests.

(b) Proposal E4 - loans or similar financial assistance: while I agree that the exemptions in the Class Order should extend to employee loans for the purpose of acquiring equity interests in a company, I have the following comments:

(i) While it is very common to have these types of loans be limited recourse, in addition to recourse to the shares that were acquired with the proceeds of the loan, we usually provide for recourse also to the proceeds of any disposition of those shares.

(ii) We sometimes provide for the loan to be repayable from the after-tax proceeds of any dividends or capital returns in respect of the shares (in addition to the loan being required to be repaid from the sale proceeds if any of the shares are disposed of).

(iii) If this proposal were to apply to unlisted companies, the interest free requirement would need to be considered in the context of Division 7A of the *Income Tax Assessment* Act *1936* (Cth).

(c) Proposal F4 - restrictions on disposal for a minimum 12 month period:

(i) While it is very common for there to be vesting requirements or restrictions on disposal over a period of time, that is not always the case. In any event, a requirement like this will have tax implications that should be considered (particularly in the context of the different types of tax concessions that are available for different types of share or option issues to employees).

(ii) ASIC appears to be proposing that the 12 month period should start when the eligible products are granted. Companies sometimes have the vesting or performance periods turn instead on the date of employment, the financial year or some other period (which relates to the particular context of the grant).

(d) Proposal G - relief available to unlisted bodies:

(i) In regard to the requirement that the unlisted body must have only one class of shares, it is common for private companies (particularly ones with venture capital or other professional investors) to have one or more classes of preference or other shares that are convertible into ordinary shares. Given this, it would be more appropriate instead to require only that the options to be offered to employees be options over ordinary shares. While I acknowledge ASIC's desire in paragraph 225 to ensure that participants are treated in an equivalent manner to the substantial holders, the fact is that employee equity holders sometimes are not treated the same as some classes of non-employee equity holders. So long as the differences are clearly disclosed to the employees when they are offered equity interests and they can choose whether or not to accept the equity interests in light of those differences, I think a company with more than one class of shares on issue should be entitled to the benefit of the Class Order.

(ii) See my comments above regarding the requirement for an independent expert's report in the sale context and the 5% limit.

(iii) Offers of $1000 worth of ordinary shares - the accounts of private companies often are not audited, and, as noted above, obtaining an independent expert's report can be expensive. This exemption would be more useful to private companies if the value also could be determined by reference to the price for ordinary shares (or debt or shares that are convertible into ordinary shares) that was paid by one or more non-employee investors in an arms' length transaction within the last 6 months to a year. This would provide a benchmark that reflects the market price for the company's shares (as demonstrated by the amount that a third party investor was willing to pay for those shares).

Please do not hesitate to contact me if you would like to discuss any of the above comments with me.

Yours sincerely

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