Law Council
OF AUSTRALIA
*Business Law Section*

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Dear Peng

**ASIC CONSULTATION PAPER 218: 'EMPLOYEE INCENTIVE SCHEMES'**

**INTRODUCTION**

The Corporations Committee of the Business Law Section of the Law Council of Australia (**Committee**) welcomes the opportunity to make submissions on Australian Securities and Investments Commission (**ASIC**) Consultation Paper 218 'Employee incentive schemes' (**CP 218**).

The Committee is generally supportive of ASIC's proposals to update and broaden its current employee share scheme class order relief and regulatory guidance in the manner contemplated by Option 2 of CP 218 (described in paragraphs 24-28 and Table 1 of CP 218). The Committee considers that widening the relief available in the manner contemplated by Option 2 will better facilitate the offer of financial products under an employee incentive scheme and will provide greater flexibility in the way employee incentive schemes can be structured. In particular, expanding the classes of financial products that may be offered under an employee incentive scheme to include cash settled as well as equity settled instruments is welcome recognition that approaches to incentivising employees have evolved considerably since [CO 03/184] was introduced.

Accordingly, the Committee has responded to the questions posed by ASIC in Option 2 of CP 218 on an 'exceptions only' basis (ie. the Committee has only responded to those questions in CP 218 which it believes require further consideration and analysis by ASIC when formulating its new employee incentive scheme class order).

**QUESTIONS IN CP 218**

***SECTION C - 'WHO CAN RECEIVE OFFERS'***

*C1Q1: Do you agree with our proposal to extend our class order to offers of eligible products to contractors? If not, why not?*

While the Committee agrees with ASIC's proposal to extend the class order to cover offers of eligible products to contractors, the Committee is of the view that ASIC should consider further extending the relief to cover prospective contractors of issuers on similar basis to which ASIC proposes to permit offers to be made to prospective employees of issuers in Section C.2 of CP 218 (ie. that the offer is made at the same time that the contractor is initially engaged by the issuer and can only be accepted if the contract is accepted and that the offer is made under an existing employee incentive plan of the issuer). The Committee is of the view that there is no compelling reason for treating prospective employees and prospective contractors differently. To ensure mutual interdependence between the parties, a condition of the relief could be that the contract is for a minimum period (ie, 6 months).

Extending the class order in this manner is likely to assist smaller or start-up companies with limited cash resources to attract and retain contractors by remunerating them with equity incentives rather than cash.

*C1Q2: Do you agree that offers to contractors should include individual contractors engaged personally, or through a company (whether controlled by the individual contractor or a third-party professional services contractor that provides the services of many individual contractors)? If not, why not?*

While the Committee agrees with this proposal, the Committee is of the view that ASIC should consider expanding the scope of the relief available for offers made to contractors to cover an offer made to a company which is *controlled* by the individual contractor performing the work under the contract (rather than a company all of whose directors/members are individuals who perform work under the contract). The company may have one or more directors who do not perform work under the contact (eg. a husband and wife). Provided the person performing the work controls the company, there is no basis for excluding the company from obtaining the benefit of the relief merely because one or more of the directors is not a contractor.. Expanding the relief in this manner is also consistent with the disclosure relief provided to a body corporate which is controlled by a 'senior manager' or their spouse, parent, child, brother or sister under section 708(12)(b) of the *Corporations Act 2001* (Cth) (**Act**).

*C1Q4: Do you agree with the work history criteria applying to contractors and to casual employees, as outlined in our proposal? If not, why not? Are there other criteria that may be more appropriate?*

The Committee agrees with the work history criteria which is proposed for casual employees. However, the Committee does not agree with the requirement for contractors to have performed work as a contractor for the issuer for a period of 12 months prior to the date that the issuer proposes to make an offer of incentives to the contractor.

In some circumstances, an issuer will want to retain a senior individual who was previously employed or engaged by the issuer (whether as an employee or non-executive

director) who wishes to be engaged by the issuer in the capacity as a contractor for the future provision of services to the issuer. While not having worked for the issuer in the capacity of a contractor for the 12 month period preceding the offer, the individual in these circumstances will have been previously employed or engaged by the issuer in another capacity. In addition, the Committee believes that the proposed requirement that the issuer must have an on-going intention to continue employing the contractor on an equivalent basis for at least the next 12 months is sufficient to establish a level of interdependence between the contractor and the issuer without the need to also impose an additional requirement that the contractor must have performed services for the issuer for 12 months before the offer is made by the issuer.

*C3Q1 & C3Q2: Do you agree with our proposal to only provide limited conditional relief for non-executive directors? If not, why not? Do you agree with the proposed specific conditions in Table 3 for offers to non-executive directors? If not, why not?*

The Committee agrees in principle with ASIC's proposal to extend the class order to cover offers of eligible financial products made to non-executive directors.

However the Committee considers that offers made to non-executive directors should not be restricted to quoted shares, depositary interests and stapled securities (as currently proposed) but should be broadened to include the grant of all securities and financial products covered under the proposed new definition of 'eligible products' (set out in paragraph 73 of CP 218). There are numerous issuers which currently remunerate their non-executive directors with other financial products such as options. (which may or may not be subject to tenure or time based conditions to exercise) but have to seek to rely on other disclosure exemptions under the Act.

The Committee also sees no reason why the relief available for offers to non-executive directors should not be broadened to cover an offer of 'eligible products' made to a non-executive director of an unlisted company with similar conditions or relief as those set out in Section G of CP 218.

The Committee also takes the view that it should be for the issuer to confirm (in the case of listed issuers, having regard to their obligations under the ASX Corporate Council's Corporate Governance Principles and Recommendations (**ASX Recommendations**)) the terms and conditions on which the incentives are to be issued to non-executive directors (ie. whether they are linked to performance of the issuer or not).

While the Committee notes ASIC's comments regarding Box 8.2 of ASX Recommendation 8, the ASX has noted that the ASX Recommendations 'are not prescriptive and are simply guidelines, designed to produce an outcome that is effective and of high quality and integrity'. Furthermore, the ASX Recommendations do not prescribe a “one size fits all” approach to corporate governance. Instead, 'they suggest practices designed to optimise corporate performance and accountability'. If a company considers that an ASX Recommendation is inappropriate to its particular circumstances, it has the flexibility not to adopt it provided that it explains to its shareholders in its annual report the reasons why it has decided not to comply with the relevant Recommendation. The ASX Recommendations also provide guidelines for a listed company to determine the 'independence' of its directors, however, recognise that it is for the company (having regard to its particular circumstances) to determine the independence of its directors.

Furthermore, certain studies (eg. GRG Remuneration Insight, '*Share Ownership for Non-executive Directors'* published in February 2013) have suggested that companies whose non-executive directors have a vested interest in the company's performance have tended to outperform those companies where non-executive directors did not have such an interest.

Ultimately, the terms and conditions on which an issuer offers incentives to its non-executive directors should be a matter for the issuer to determine (rather than being imposed by regulatory requirements which prescribe a one size fits all approach). The Committee also recognises that a number of smaller or start-up companies with limited capital to attract and retain appropriately qualified non-executive directors will often remunerate those non-executive directors with equity based remuneration as opposed to cash. The Committee is of the view that there is no reason to impose more restrictive conditions on non-executive directors than those which ASIC proposes to apply to other employee incentive scheme participants.

***SECTION D:' WHAT FINANCIAL PRODUCTS CAN BE OFFERED BY LISTED BODIES'***

*D1Q1: Do you agree with our proposal to extend relief in our new class order to cover offers of Australian CDIs where the underlying security is a share or stock? If not, why not?*

The Committee agrees with this proposal subject to the comments below.

The Committee considers that ASIC should ensure that the new class order is drafted so as to provide relief for the on-sale of the CDIs (and the underlying securities) the subject of the incentives issued under the employee incentive plan such that if a CDI issued under the employee incentive scheme (including on exercise of an option or vesting of a performance right) is converted into the underlying security (and vice versa), the conversion does not trigger the on-sale provisions of the Act and require the issuer to issue a cleansing notice each time there is a conversion between CDIs and the underlying security in order to permit such securities to be freely tradable. This will similarly apply to issues of UK CDIs and ADRs.

The Committee also considers that the new class order should be drafted so as to ensure that the issuer is able to take advantage of the 'self-dealing' exemption in Chapter 7 of the Act with respect to the issue of CDIs to investors under an employee incentive scheme. This will similarly apply to issues of UK CDIs and ADRs.

*D3Q2: Do you consider the proposed definition of 'performance right' is broad enough to cover the conditional rights usually offered under an employee incentive scheme? If not, what other rights do you think should be included in the definition?*

ASIC's proposed relief does not appear to cover cash settled options. The Committee sees no reason why the relief should not be extended to such products if they are granted on similar terms to cash settled performance rights.

***SECTION E: 'WHAT STRUCTURES CAN BE USED BY LISTED BODIES WHEN MAKING OFFERS?'***

*E1Q1: Do you agree with our proposal to extend our new class order to include offers of underlying eligible products, regardless of whether a trustee holds specific products on*

*trust for specific participants, or the trustee holds underlying eligible products in a pool on trust for participants generally? If not, why not?*

Except as set out below, the Committee agrees with this proposal.

*E1Q2: Are there other ways of using a trust structure to offer underlying eligible financial products to participants that we should expressly include in [co 14/xx]? Please provide examples.*

The Committee is aware of foreign schemes using feeder funds or sub-funds for individual offerings of products under an unallocated trust structure where offers are made at different times. The offer is to acquire units in the feeder or sub-fund the proceeds for which are used to acquire the products. Once the products are acquired the feeder or sub-fund may be merged with the principal fund.

Provided the principal fund and feeder or sub-fund is regulated under the law of an approved jurisdiction (one corresponding to an approved foreign market) consideration should be given to extending the relief proposed in the new class order for trusts to cover the feeder or sub-funds.

*E1Q4 Do you agree with the proposed conditions of relief in respect of unallocated products? If not, why not?*

The Committee believes that there are circumstances where it will be appropriate for the trustee of a trust holding unallocated financial products to exercise voting rights attached to those products, namely where:

- the trustee is directed or otherwise exercises its discretion how to vote by reference to a vote or poll by the beneficiaries that may become entitled to the unallocated products (perhaps based on their contingent entitlement at the time);

- the trustee is directed or otherwise exercises its discretion how to vote by reference to a recommendation of one or more independent proxy advisors (relevant interests of the proxy advisor may have to be considered);

- voting decisions made by the board of the trustee or a committee where the decision is made by a majority vote and the board or committee is constituted by a majority of employees of the issuer or its related bodies corporate; or

- the trustee is a trustee company as defined in Part 5D of the Act.

It may be that ASIC's proposed relief would permit the trustee to vote on the basis of a direction of the kind contemplated by (a) or (b) above but it would be preferable for this to be made expressly clear to avoid uncertainty.

In relation to the 5% cap on unallocated products, the Committee agrees with ASIC's analysis of the benefits of using trusts to hold unallocated products set out in paragraph 121 of CP 218. It may be that there will be circumstances where these benefits will outweigh the benefits ASIC considers will flow from imposing the 5% cap, particularly if the trustee is permitted to exercise voting rights in limited circumstances as suggested above. The Committee believes that ASIC should consider allowing the 5% cap to be increased with shareholder approval.

*E1Q6: [CO 03/184] currently provides licensing relief for associates of issuers. Do you consider that other types of trustees (that may not be associates of issuers) also require licensing relief in the context of employee incentive schemes? If so, please provide examples and explain why such relief is needed.*

The Committee is of the view that consideration should be given to providing licensing relief to foreign non-associated professional trustees and custodians of foreign funds where the funds are established under the regulatory supervision of an approved foreign jurisdiction. For example the French Monetary and Financial Code and the French Commercial Code. See also relief granted under ASIC Instrument 13-0038.

*E3Q5: Are there any other conditions that should be imposed in respect of employee incentive schemes involving contribution plans?*

While the Committee broadly agrees with ASIC's proposed conditions for offers involving contribution plans, the Committee does not agree that the contribution plan should provide for accumulated interest to be repaid to a participant after the participant opts out. The following matters need to be considered:

- interest earned on funds contributed for the acquisition of eligible products is not applied to the acquisition of those products;
- it is the participants choice to opt out. The participant should exercise that right quickly and not simply leave, or be given a right for those, funds to accumulate interest;
- the amount of interest is likely to be small and will be accumulated in a pooled ADI account and there will be a disproportionate administrative burden calculating the interest on the particular participants funds; and
- it is not market practice to account for interest where funds are lodged for the acquisition of, for example, shares under a prospectus.

Trusts through which employee incentive schemes are operated would normally require registration as a managed investment scheme under section 601QA(1)(a) of the Act. Relief from section 601ED of the Act should be considered when drafting the new class order consistent with the relief under paragraph 3 of the Second Exemption in the existing CO 03/184 for contribution schemes.

***SECTION F: 'WHAT ARE THE CONDITIONS OF RELIEF'?***

*F2Q1: Do you agree with our proposal for calculating a 5% share capital limit for employee incentive schemes? If not, why not? Please give details of any alternatives that you consider to be appropriate.*

The Committee notes that ASIC proposes to include in the calculation of the 5% share capital limit the number of underlying eligible products that are used to determine the cash amount where performance rights are only able to be cash settled. ASIC's rationale for this is to prevent a significant exposure being created which may materially prejudice creditors' interests. The Committee does not agree with this "one size fits all" approach.

The Committee considers that the directors of an issuer are best placed to assess and manage the issuer's exposure to settlement obligations under cash settled performance rights, and the additional "protection" proposed by the inclusion of in the 5% calculation is not appropriate. The Committee is of the view that the 5% cap would be at best a blunt instrument for addressing material prejudice to creditors as the financial situations of issuers can differ substantially. At worst, it may offer no protection at all.

If, contrary to the Committee's view, ASIC considers cash settled performance rights create a creditor risk that is not adequately addressed by existing corporate law and fiduciary constraints imposed on directors of issuers, a better approach may be to predicate the class order relief for such products on the directors reasonably forming the view that the offer does not materially prejudice creditors' interests.

The Committee notes that the same analysis applies in respect of any financial products offered under an employee incentive scheme that require the issuer to expend cash to settle its obligations under the products (for example, performance rights that are settled with shares purchased on-market using funds provided by the issuer and cash settled options).

*F4Q1: Do you agree with the proposed new condition to impose a partial 12-month holding requirement? If not, why not?*

The Committee does not agree with ASIC's proposal to impose a partial 12-month holding requirement. The Committee is of the view that the directors of an issuer are best placed to determine how to incentivise employees and best align their interests with those of the issuer and its shareholders. Those directors are already subject to significant market and statutory compulsion to ensure an appropriate incentive structure (for example, the "two-strikes" rule).

An arbitrary 12-month holding requirement is not appropriate as it does not give directors the flexibility they require to best incentivise employees. In some circumstances no minimum holding period will be appropriate (eg where shares are issued to a senior executive in lieu of a sign-on bonus). In other situation a minimum holding period of more than 12 months will be appropriate.

Any minimum holding period would need to be subject to appropriate carve-outs to deal with situation where it ceases to be appropriate to require participants to continue to hold their incentives (eg to enable them to accept a takeover offer or where their employment ceases during the minimum holding period).

As an alternative to a minimum holding period, ASIC could also consider making an intention on the part of the issuer to employ a proposed participant for a minimum period a pre-condition to class order relief in a manner similar to the approach proposed for contractors.

*F4Q2: Do you agree with our proposal that the relevant minimum period be 12 months? If not, why not? Would your response be different if the proposed minimum period were three years to further support our policy objective of ensuring offers are made for the purposes of creating a relationship of interdependence? If so, why?*

For the reasons set out in our response to F4Q2 above, the Committee does not agree with the proposed new condition to impose any holding requirement.

*F4Q3: Do you agree with our proposal that a significant portion of a participant's entitlements means 25% or more of their entitlements under each participant's offer? If not, why not?*

For the reasons set out in our response to F4Q2 above, the Committee does not believe that ASIC's relief should require any portion of a participant's entitlements to be subject to a minimum holding requirement. It is a matter for the directors of an issuer to determine the best way to incentivise employees and align their interests with those of the issuer and its shareholders.

***SECTION G: 'WHAT RELIEF IS AVAILABLE FOR UNLISTED BODIES?'***

The Committee makes the following observations with respect to the relief which is proposed to be made available for unlisted bodies making an offer under an employee incentive scheme.

As acknowledged in the Treasury's discussion paper in relation to employee share schemes and start-up companies, employee share schemes are important tools for cash constrained start-ups, as they offer an option for attracting and retaining talented people (which is particularly important and challenging for innovative start-up companies), while ensuring sufficient capital is available to allow growth of the start-up. However, the current arrangements for employee share schemes in Australia are complex, costly and create a barrier or disincentive for many start-ups to set up an employee share scheme, which puts Australian start-ups at a distinct competitive disadvantage in international markets and impacts the ability of start-ups to attract and retain the skilled employees needed to grow the company.

The proposed relief in Consultation Paper 218 in respect of offers of ordinary shares by unlisted bodies for no consideration up to a value of $1,000 per year is of limited value for start-ups as it is restricted to companies which have only one class of shares (being fully paid voting ordinary shares) whereas by the nature of their funding structures, most start-ups will necessarily have different classes of shares. Further, the limit of $1,000 per employee per year is insufficient to significantly assist start-ups in attracting and retaining talented employees while at the same time preserving capital.

The proposed relief in respect of offers of options and performance rights by unlisted bodies is also of limited value to many start-ups due to the requirement that the body has only one class of ordinary shares on issue (for the reasons set out above) and also due to the complexity and likely cost of complying with the specific conditions in Table 8 on page 70 of Consultation Paper 218.

Acknowledging the difficulties in providing separate classes of relief for unlisted start-ups (in particular in providing an adequately comprehensive definition of "start-up"), a more appropriate means of providing the necessary flexibility and simplicity for start-ups to be able make greater use of employee share schemes would be for the exceptions to the disclosure obligations in section 708 of the Act (in particular in relation to small scale offerings and offers of non-transferrable securities such as options) to be extended along the lines of the much broader exceptions to disclosure obligations available under UK legislation.

**FURTHER DISCUSSION**

The Committee welcomes further discussion of the foregoing. In the first instance, please do not hesitate to contact the Committee Chair, Bruce Cowley, on or via email: to arrange any further discussion.

Yours sincerely,

John Keeves
**Chairman, Business Law Section**