31 October 2022

Corporations Team
Australian Securities and Investments Commission
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By email: ess@asic.gov.au

Dear ASIC

Employee share schemes - response to ASIC Consultation Paper 364

1 Introduction

1.1 Thank you for the opportunity to provide feedback on ASIC's proposed modifications to the employee share scheme (**ESS**) regime as outlined in ASIC Consultation Paper 364 (**CP 364**).

1.2 Johnson Winter & Slattery regularly advises a wide range of businesses on their ESS requirements, including ASX-listed companies, multinationals, privately-held Australian companies, and private equity & venture capital sponsors and their portfolio companies.

1.3 Our comments on CP 364 are below. We would be happy to discuss our comments with AISC and provide any supporting explanation if that would assist.

2 Secondary sale exemption (Proposal B1) (s1100ZD)

2.1 We support the proposed modification. The secondary sale exemptions in CO 14/1000 and CO 14/1001 (the **Class Orders**) is a critical feature, without which ESSs would be significantly less useful for attracting and motivating staff; especially for listed companies or companies that may list in the medium term.

2.2 The costs of the modification not being granted are difficult to quantify. The likely response from companies will be to change the structure of their ESSs (e.g. imposing 12-month holding periods, materially undermining the utility of the ESS as a reward & incentive device) or expose the company to the risk of needing to provide a cleansing notice (where possible) or transaction-specific prospectus whenever convertible securities are converted; with associated burdens in terms of cost, distractions to management, and most significantly, potentially affecting companies' ability to plan and negotiate major transactions (e.g. fundraising and potentially control transactions) or other material business plans.

3 Foreign accounting standards (Proposal B2) (s1100X(2))

3.1 We are broadly supportive of the proposed modification. We advise many foreign companies not registered under the Corporations Act that are not *required* by the laws of their place of origin to adopt a particular set of accounting standard, but which nevertheless voluntarily adopt such standards. For instance, many companies domiciled in the United States are not required to adopt US GAAP as a matter of law (often even if listed on ASX), but adopt it voluntarily to satisfy their investors or lenders.

3.2 However, we consider the proposed requirement of a reconciliation between the financial standards adopted and the standards required by s1100X(2)(c)[1] (or a confirmation of no material differences) would in many cases be quite disproportionate to the benefit to potential participants, at least where the accounting standards adopted are already consistent with IFRS or are consistent with generally accepted accounting principles accepted by ASX[2] (e.g. US GAAP) or the standards typically used by entities listed on any other foreign financial markets the subject of a determination by ASIC under s1100K(2). In many cases, Proposal B2 would still oblige many such businesses to take highly specialised (and therefore expensive) cross-border accounting advice to facilitate offers to a small number of Australian participants.

4 Valuation of financial products that are not ordinary shares (Proposal B3) (s1100X(3)(a))

4.1 We have no objections to the proposed modification. We consider this a helpful and sensible change.

5 Contribution plans and salary sacrifice arrangements (Proposal B4) (s1100T)

5.1 We have no objections to the proposed modification.

6 Period over which ongoing disclosure obligations apply (Proposal B5) (s1100Z)

6.1 For the most part, the period over which the ongoing disclosure obligations in s1100Z are intended to apply is not very clear.

6.2 Whereas directors and other persons mentioned in items 2, 3 and 4 of the table in s1100Z(2) (**Individual Obligors**) only bear an obligation to notify the entity of the relevant information until the end of the application period (per s1100Z(1)(d)), the obligation of the entity to provide updated disclosure to ESS participants is not qualified in this way. Rather, the entity must just do so 'as soon as practicable' after it becomes aware of the matter (s1100Z(1)(b)).

6.3 The corresponding obligation in relation to the subsequent disclosures for options exercisable for monetary consideration[3] (per the terms required by s1100Y(4)) contains no time limitations for either Individual Obligors (s1100Z(1)(e)) or the entity itself (s1100Z(1)(c)); even if the options are exercised.

6.4 We understand that Parliament could have intended the obligations to provide updated disclosure to apply:

(a) in the case of disclosure at the time of the offer – until the end of the application period (or alternatively, until the time the offered securities are issued); and

(b) in the case of the subsequent disclosures for options exercisable for monetary consideration:–

(i) until the time the options become exercisable; or

(ii) alternatively, the time they are in fact exercised (or they expire) (but see paragraph 6.7 below),

provided that in the case of Individual Obligors:

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1 In this letter, all legislative references are to the *Corporations Act 2001* (Cth) (**Corporations Act**).

2 See ASX Guidance Note 4 at p20.

3 In this letter (for brevity), references to options exercisable for monetary consideration apply equally to incentive rights exercisable for monetary consideration – e.g. in relation to disclosure obligations under s1100Y(4) and the operation of the monetary cap in ss1100ZA & 1100ZB.

(c) their obligations under s1100Z(1)(d) and (e) would not apply to information obtained by them after they ceased to be a person mentioned in items 2, 3 or 4 of the table in s1100Z(2); and

(d) their personal liability under s1100Z(1)(f) only applies to contraventions that occur during the time that they are a person mentioned in items 2, 3 or 4 of that table.

6.5 If that was the intention, we consider it would be helpful for ASIC to give guidance on this to the market, so offer terms can be expressed in a form that more clearly communicates this to prospective participants (bearing in mind that s1100Z imposes these obligations by requiring that the offer contains terms to that effect).

6.6 If however the intention is to require offerors and Individual Obligors to commit to an indefinite obligation to update the disclosures, that will create a significant burden on entities and will in many cases be so impractical that it will be impossible for them to make offers under s1100Q at all.

6.7 In that event, we submit that s1100Z should be modified to achieve the results described in paragraph 6.4 above. In our view, the position in paragraph 6.4(b)(i) should be favoured over paragraph 6.4(b)(ii). Even an obligation described in subparagraph (ii) will create a significant burden for entities that wish to offer long-dated options (e.g. 10 or 15 year terms are very common).

7 Guidance on triggers for ongoing disclosure obligations (Proposal B5) (s1100Z)

7.1 Even if our submissions in section 6 above are accepted, it is possible that the ongoing disclosure obligations required by s1100Z could operate for a lengthy period. Given this, we expect that some companies would benefit from guidance from ASIC as to how to interpret s1100Z.

7.2 In particular, it is not clear from the face of s1100Z whether an entity would be required to proactively obtain and disclose a new valuation if it is aware that some of the assumptions underpinning the original safe harbour valuation (or other valuation reference document) no longer hold.

7.3 We trust that this was not the effect intended by Parliament, as it could be extremely onerous in practice,[4] and often difficult or even impossible for directors to apply – so it would be helpful to clarify to companies that the obligation does not extend this far.

7.4 Rather, even though this is not express on the face of s1100Z, we consider that a better interpretation of s1100Z is that updated valuation disclosure would only be required if the directors become aware of:

(a) a new valuation actually being adopted (by way of expert valuation, third party acquisition agreement or the agreement to acquire securities under a disclosure document); or

(b) a fundamental change in the nature of a business (say, a minerals exploration company becoming a digital technology company) and the previously-disclosed valuation document described the previous nature of the business.

[4] It would be even more onerous than a listed company's continuous disclosure obligations, where it is within the power of directors to provide a short narrative update to the market where they consider that a false market may exist – as opposed to spending the time and money commissioning a new external valuation every time the directors suspect that, if one were to be obtained, it would produce a different result to the prior valuation or valuation implicit in a third party acquisition agreement or disclosure document.

8 Unlisted entities that subsequently becomes listed (s1100Y(4)) (Proposal B5)

8.1 Where a body corporate is unlisted, s1100Y(4) requires that the terms of the offer include an obligation on the offeror to disclose certain financial and valuation information at least 14 days prior to the time that an option becomes exercisable (where monetary consideration is payable); and the options cannot be exercised until that information is provided. The particular information that those offer terms must require to be disclosed are the equivalents of those referred to in s1100X. Section 1100X only applies where the body corporate is unlisted.

8.2 Where the body corporate lists between the time of the offer and the time that the options would otherwise become exercisable, the information requirements of ESS participants become equivalent to those specified in s1100W(2)(f)(ii), but the terms required by s1100Y(4) do not appear to accommodate this.

8.3 In this situation, the ongoing application of the offer terms contemplated by s1100Y(4) would mean that:

(a) every time a tranche of options becomes exercisable for a particular participant, the offeror would need to provide new financial and valuation information. The provision of valuation information in particular will involve significant cost and administrative burden in circumstances where participants could instead look to current market prices as a free, and more current, basis for determining the value of the underlying shares;

(b) listed companies would need to track the exercise windows and vesting of each parcel of options or incentive rights and give regular disclosure of that information. Whereas this issue can be managed in an unlisted context (e.g. by tying vesting and exercise windows to a liquidity event), that is not commercially practical once a company is listed and would represent a substantial administrative burden for no real benefit to participants. We regularly act for companies that grant ESS options that vest in either monthly or quarterly tranches (usually after a one-year 'cliff'), in response to norms in the hiring markets in which they compete for talent; and

(c) if our submissions in section 6 above are not accepted, a listed company would be required to provide a new expert valuation of its shares to its ESS participants every time there is a material movement in its share price (assuming no third party sale agreement or disclosure document was available at the time).

8.4 Given this, we submit that s1100Y(4) should be modified to permit offer terms that can be satisfied by the disclosure of the information in s1100W(2)(f)(ii) if, at the time the options become exercisable, the underlying financial products are quoted on a financial market covered by s1100K. (We expect that many companies would do this at the time of listing, so the wording of the modification should permit this.)

9 Monetary cap – liquidity period (Proposal B5) (s1100ZB(4) & (7))

9.1 We refer to the discussion in paragraphs 44 and following of CP 364, describing why ASIC was not presently minded to consider modifying the definition of liquidity period in s1100ZB(7) to cover a situation where an entity is selling all or a substantial part of its business. ASIC mentions sales of all or substantially all of the assets of the business, although we note that this can also be achieved by the exclusive licensing of the material intellectual property of some businesses (especially technology businesses).

9.2 If ESS participants have significant option holdings (such that the monetary cap materially limits the exercise of their options), the narrow definition of 'liquidity period' will rob them of the ability to participate in the value accretion, significantly *undermining* investor protection.

9.3 For equivalent reasons, we consider that the liquidity period should also cover agreements to acquire ESS interests that could be acquired on exercise of the relevant ESS interests. If an acquirer is willing to acquire the options, then there is no need for them to be exercised and the exception to the monetary cap in s1100ZB(7)(b) is irrelevant. But if an acquirer is not willing to acquire the options, the participant should be able to exercise the options in order to be able to sell the underlying share and participate in the value accretion it represents. Again, to require otherwise would be to undermine investor protection.

9.4 Investor protection is one of the central themes to the ESS regime. ESS participants holding options should not be prevented by these technicalities from being able to participate in the value uplift from their labour; especially given the low risk to investors in such circumstances as described in the Explanatory Memorandum to the bill.[5] The ESS rules already permit participants to acquire large numbers of options (for no upfront monetary consideration) – with an aggregate exercise price well beyond what the monetary cap would permit – on the proviso that the participants cannot expend more than the monetary cap other than in the context of a listing. Some participants may accept a remuneration package on that basis in the expectation that a listing is likely (even imminent). If circumstances were to change (say, a more attractive private buyout offer emerges instead), these investors should be able to participate in an equivalent low-risk exit such as an asset sale (/exclusive licensing) or conditional exercise & share sale.

9.5 For these reasons, we submit that the objectives of Parliament are sufficiently clear and it would be an appropriate – indeed, extremely desirable – use of ASIC's powers to modify the 'liquidity period' concept as described in paragraph 47 of CP 364 (but extending the asset sale concept to also cover exclusive licensing of intellectual property).

10 Monetary cap – other issues (Proposal B5) (ss1100ZA & 1100ZB)

10.1 The monetary cap provisions can become very complicated to apply in practice, especially in circumstances where an entity already has ESS interests on issue (e.g. having offered them in reliance upon the Class Orders or via other relevant exceptions in the Corporations Act).

10.2 We consider that the market would be aided by guidance from ASIC in relation to the following matters:

(a) **Clarifying whether the payment of the exercise price on options granted before 1 October 2022 will count towards the monetary cap (where the monetary cap applies to a subsequent grant)**.

If the answer is yes, then we submit it would be desirable to modify ss1100ZA and 1100ZB to achieve the opposite outcome. Very few securities issued before 1 October 2022 will have contained restrictions on the extent to which they can be exercised having regard to the effect of the monetary cap (were it to apply to a subsequent offer of options), and in our experience, most options are exercisable over a period of many years.

Consequently, if an ESS participant already has options outstanding, they will eat into (or potentially exhaust) the monetary cap available for any new grant.

The alternative would be for the entity and participant to agree new restrictions on the extent to which the pre- 1 October 2022 options may be exercised; which could materially undermine the value of the previous option grants to those ESS participants.

[5] See in particular [4.98]-[4.99], including the statement that '*Greater expenditure is appropriate in these circumstances because there is limited financial risk as the participant will have accurate information as to the market value of their interests…*'.

(b) **Clarifying whether for the purposes of the monetary cap, the first 12-month period can be before 1 October 2022.**

In many cases, pre- 1 October 2022 plans need not be replaced, and can merely be amended to facilitate grants under the new ESS rules (or may even permit such grants already). So if a participant has previously been issued securities under the plan, it would appear that their first 12-month period commenced with the earlier grant. But this is not especially clear on the face of ss1100ZA and 1100ZB, so we consider the market would benefit from guidance to that effect. Or if that is not the intention, we submit that the provisions should be modified to make the intended effect clear.

(c) **Clarifying the order in which carry-forward amounts under the monetary cap are utilised.**

For instance, the legislation could be interpreted to permit any of a FIFO, LIFO, or current-year-then-FIFO approach. This could materially affect the extent to which a participant can rely on the monetary cap in subsequent years.

11 Issue cap – counting offers made outside this jurisdiction (Proposal B5)

11.1 We did not agree with all of the discussion in paragraphs 41-43 of CP 364, describing why ASIC was not presently minded to consider modifying the operation of the issue cap to more closely align it with the position under the Class Orders. We are particularly concerned in relation to the effect this may have for overseas issuers with Australian staff that would customarily issue traditional equity incentives with monetary consideration – commonly share options with a cash exercise price.

11.2 ASIC's explanation rests on the fact that entities can increase the issue cap in their constitution. However, we submit that this is not a practical solution in many cases. For instance, if a large US-domiciled, NASDAQ-listed company wished to offer ESS interests to a proportionally limited number of Australian staff members, s1100V(1)(b) now requires that the numerator for the issue cap calculation includes offers to all US- (and other overseas) ESS participants under the plan in the past three years. It is not realistic to expect that the company would be commercially able to put to its stockholders a proposed resolution to amend its bylaws for the purposes of changing the calculation of a technical formula relating to the offer of ESS interests to a small subset of its global staff.

11.3 For many companies in that position, it would not then be practical to say that a proposed offer to Australian staff should therefore be restructured to rely on s1100R or s1100P. In our experience, where multinational businesses are required to deviate too much from their standard structure and approach to offering ESS interests in order to be able to make ESS offers, the need for consistency will often prevail and the business could then refrain from making offers to Australian staff at all.

11.4 This would of course be an unfortunate outcome, contrary to the objective of ESSs as articulated in the Explanatory Memorandum; namely, to '*allow business to attract and keep employees*'.[6]

11.5 The Explanatory Memorandum went on to say that ESSs '*are not intended to allow a body corporate to raise funds. If a body corporate wishes to raise funds it must use other means (for example, issuing shares under a prospectus).*'[7] We submit that this effect is already achieved by the formulation in the Class Orders, at least as regards offerees in this jurisdiction. And in relation to offerees outside this jurisdiction (to whom s1100V(1)(b) now also looks), we submit that is a matter for regulation by authorities overseas.

6 At [4.73].
7 Also at [4.73].

11.6 By comparison, s1100V(1)(b) as currently drafted could render a company incapable of making offers under s1100Q for three years if the lookback (having regard to offers made overseas) produced a calculation of more than 5%. It is difficult to imagine that this was Parliament's intention.

11.7 We therefore submit that even if ASIC is not prepared to modify s1100V so that offers covered by ss1100P and 1100R are excluded from the numerator of the calculation in s1100V(1), ASIC should nonetheless modify s1100V to exclude offers received outside this jurisdiction.

Yours sincerely,

Sent electronically without signature

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