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Matter 82715162
By Email

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Dear Sir/Madam

HSF submission on CP 364 (ESOP exemptions)

1 Background

We refer to your consultation paper 364 *Modifications to the ESS regime* issued September 2022 (**CP 364**). Our responses to the items raised in CP 364 and the related draft ASIC instrument (**Instrument**) which seeks to modify Division 1A of Part 7.12 of the *Corporations Act 2001* (Cth) (**New Exemptions**) are set out below.

Capitalised terms not defined in this letter have the meanings given to them in the New Exemptions. References to sections in this letter are references to sections in the Corporations Act.

2 Valuations

(a) Under the New Exemptions, certain valuation information specified in section 1100X(3) needs to be provided to the participant:

(1) in or accompanying the offer document when the offer of ESS interests is made by an unlisted entity; and

(2) where the ESS interest is an option or incentive right and monetary consideration is to be provided on its exercise, before the ESS interest is exercised (sections 1100X(1)(b) and 1100Y(4)(a)(ii)).

(b) We are concerned that the language in section 1100X(3) in relation to valuations prepared consistently with an applicable method approved by the Commissioner of Taxation under section 960-412 of the 19 Income Tax Assessment Act 1997 would be unduly limiting as that method is only available for companies that meet the start-up concessions and so cannot apply to options or incentive rights of companies not using the start-up concessions. In our experience, offers by companies that do not meet the start-up concessions make up a significant proportion of the ESS interests offered in Australia.

(c) We note that the draft Instrument proposes to amend section 1100X(3) to insert a new paragraph 1100X(3)(aa) as follows:

"(aa) if the ESS interests are not ordinary shares— a copy of a valuation of the ESS interest prepared by an independent expert;"

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(d) We welcome the expansion of the permitted valuation information in section 1100X(3) but in our view, the proposed modification will be of limited assistance and will not assist many offerors and participants because commonly the valuations that companies obtain relate to the company and the *shares in the company* (not the valuation of the options or incentives for the issue of shares in the company).

(e) We invite ASIC to consider the following expanded paragraph to the Instrument:

"(aa) if the ESS interests are not ordinary shares and are not options or rights to acquire ordinary shares — a copy of a valuation of the ESS interest prepared by an independent expert.

(ab) if the ESS interests are ordinary shares which are not covered by a valuation under section 1100X(3)(a) - a copy of a valuation of the ESS interest prepared by an independent expert; or

(ac) if the ESS interests are options or rights to acquire ordinary shares - a copy of a valuation in relation to the ordinary shares to be issued or transferred on the exercise or vesting of the ESS interests, prepared by an independent expert."

The effect of the amendments would be to give the ESS participant, valuation information in relation to the shares rather than the options in relation to an options or incentive rights offer. We consider that that kind of valuation information:

(1) will be easier to obtain and is more cost efficient to obtain;

(2) is likely to be more useful to the ESS participant (they really need to know the value of the shares that they will acquire through exercising the option and compare that to the exercise price – that is more useful than an option value); and

(3) would be consistent with explanatory memorandum statement that "The policy intent is for a body corporate, where possible, to be able to use the same valuations that they make, to assist participants with determining their income tax liabilities, to conduct the valuation" (para 4.124 of the explanatory memorandum to the New Exemptions).

(f) If it is necessary to provide a valuation of an option, then we invite ASIC to consider permitting the company to utilise the valuation amount determined in accordance with Reg 83A.315.02 of the Income Tax Assessment (1997 Act) Regulations 2021, provided the value of the underlying ordinary share was determined in accordance with an approved method in section 1100X(3), together with a brief explanation of the assumptions in that option pricing model (see reg 83A.315.08).

3 Secondary sales

We welcome the modifications that ASIC proposes to make to section 1100ZD in the form set out in the form set out in the draft Instrument.

Currently, Class Order 14/1000 provides express relief from the on-sale requirements which apply to public sales of vested shares within 12 months (where those shares have been issued). The New Exemptions do not provide that same relief and instead, pursuant to section 1100ZD, give on-sale relief to a participant offering to sell their interest (i.e. performance rights rather than the vested shares) to another participant in the same scheme.

Even without express relief that the on-sale provisions do not apply, we take the view that on-sale is not an issue for a genuine employee share scheme for 2 reasons:

(a) the existing practice of many listed companies is to buy shares on market (to satisfy vesting obligations of allocated incentive rights), so the general on-sale provisions automatically do not apply; and

(b) where a company issues new shares to satisfy the ESS vesting obligations, in our view, the general on-sale disclosure provisions do not apply to genuine employee incentive schemes. In our experience, the offer letter typically makes it clear that the purpose of the offer is to promote mutual interdependence and is not for fundraising.

However, as this position is not clear on the face of the New Exemptions, we welcome ASIC's proposed clarification set out in the draft Instrument.

4 Liquidity period

(a) We consider that where a liquidity event arises in relation to an equity sale (as opposed to a float) the narrowness of the current definition of liquidity period in section 1100ZB(7) may have the unintended consequence of excluding certain types of equity offers that would commonly be regarded as generating liquidity.

(b) The current requirement under section 1100ZB(7)(b) that an offer under a sale agreement is open for acceptance will be difficult to meet in practice because commonly the sale agreement provides for an agreement for the sale of shares (and related options) with a buyer and may result in tag along or drag along rights being exercised under a shareholders agreement but does not commonly result in offers by the buyer of the shares to ESS participants.

(c) We would invite ASIC to consider an additional paragraph for the Instrument to amend section 1100ZB(7)(b) as follows to remove what we consider to be an unintended consequence of the drafting:

"(b) an ESS participant has the right to sell or may be required to sell its ESS interests (or, where the ESS interests are options or incentive rights, the ESS interests to be issued or transferred on the exercise of the ESS interests) in connection with an executed sale agreement relating to the acquisition of ~~constituting an offer to acquire~~ ESS interests ~~in the same class as the ESS interest is open for acceptance~~."

5 Financial market

(a) Section 1100K defines the financial markets recognised under the New Exemptions. It provides that:

(1) "*For the purposes of this Division, the following financial markets are covered by this section:*

(A) a financial market operated by a market licensee;

(B) a foreign financial market determined by ASIC under subsection (2).

(2) ASIC may, by legislative instrument, determine one or more foreign financial markets for the purposes of this section."

(b) We understand that ASIC has not yet made an instrument under subsection (2).

(c) The explanatory memorandum to the New Exemptions provided at paragraph 4.222 that:

"Shares from entities listed on financial markets listed in the ASIC Corporations (Definition of Approved Foreign Market) Instrument 2017/669 will be treated as shares from entities listed in Australia for the purposes of Schedule 4 to the main Bill until ASIC issues an instrument under Schedule 4 to the main Bill prescribing a different set of foreign markets. That instrument prescribes foreign markets that are covered by the rules in CO 14/1000."

(d) For certainty for the market in relation to what is and is not a financial market for the purposes of the New Exemptions, we invite ASIC to clarify in the Instrument that for the purposes of section 1100K, financial market includes all of the financial markets listed in the ASIC Corporations (Definition of Approved Foreign Market) Instrument 2017/669 as amended from time to time.

6 FCPE offers

(a) Employee incentive plans for French companies are commonly structured as *a fonds communs de placement d'entreprise* (**FCPE**) which is a non-corporate trust vehicle with a french trust deed.

(b) FCPEs usually acquire and hold shares in the listed head company in the employee's group and are registered with and regulated by the Autorité des Marchés Financiers in France.

(c) Many global businesses have head offices in France and their global employee incentive plans involve an offer of units in a FCPE which is an offer of an interest in a managed investment scheme. While many of the head companies in these groups are listed, commonly on the Euronext, these FCPE offers do not qualify as ESS interests under the New Exemptions because the FCPE itself is not listed on a relevant exchange (although the shares that the FCPE holds are listed on a relevant exchange).

(d) As a result, employees in Australia who are part of a French headquartered global business will not usually be able to participate in employee incentives under the New Exemptions (because an offer of FCPE units, which in our experience is the common form of offering used by French global businesses does not meet the definition of ESS interest) unless the employer and its parent apply to ASIC for a specific relief instrument for the offers under the FCPE. Making such an application for a specific relief instrument:

(1) takes time (which may affect the ability of the Australian subsidiaries to participate in the global plan, which will operate under one offer timetable); and

(2) results in additional legal and ASIC application fee costs.

These timing and cost considerations do not arise in relation to other types of offers which don't utilise a FCPE.

(e) We are not aware of a policy reason to exclude Australian based employees of French headquartered global groups from the New Exemptions and so we invite ASIC to consider an additional paragraph for the Instrument to extend the New Exemptions to interests in FCPEs by inserting a new section 1100M(1A), as follows:

"1100M(1A) An ESS interest includes units in a fonds commun de placement d'enterprise, authorised by the Autorité des Marchés Financiers in France, and which holds shares in a body corporate that are in a class of shares that is able to be traded on a financial market covered by section 1100K."

7 Foreign financial statements

We agree with ASIC's proposal to notionally modify section 1100X(2) so that foreign issuers not registered under the Corporations Act can provide a balance sheet and profit and loss statement prepared in accordance with accounting standards the issuer is required or permitted use in its place of origin, together with either confirmation that there is no material difference between the financial statements prepared under the foreign standards and the financial statements that would otherwise be required under paragraph 2(c) or a reconciliation of material differences.

We consider that a statement confirming that there are no material differences or a reconciliation of material differences will provide ESS participants sufficient information to determine the comparability of the financial information provided by a foreign issuer who is not registered under the Corporations Act, without imposing an undue cost and burden on the issuer.

Whilst we are not in a position to quantify the costs involved, we would expect that foreign issuers would incur significant additional costs as well as time delays in preparing new financial statements in accordance with Australian Accounting Standards or International Accounting Standards rather the accounting standards the issuer is required or permitted to use in their place of origin.

In our view, mandating the requirement for foreign issuers not registered under the Corporations Act to prepare accounts in accordance with Australian Accounting Standards or International Accounting Standards rather the accounting standards the issuer is required or permitted to use in their place of origin will not necessarily provide additional useful information to ESS participants, particularly where there are no material differences between the financial statements prepared under the foreign standards and the financial statements that would otherwise be required under paragraph 2(c). Instead, it will merely result in time delays and additional costs being incurred by the foreign issuer. In addition, there does not appear to be any logic to imposing additional burdens on foreign issuers in terms of the accounts required to be prepared for ESS participants, merely because the foreign issuer is not registered as a foreign company under the Corporations Act.

Similarly, in our view, mandating a reconciliation of net assets and profit before tax will not necessarily provide additional useful information to ESS participants, particularly where there are no material differences between the financial statements prepared under the foreign standards and the financial statements that would otherwise be required under paragraph 2(c). Once again, it will merely result in time delays and additional costs being incurred by the foreign issuer.

In respect of the draft Instrument, we would suggest the following minor amendment to paragraph 1100X(2)(c)(ii)(A):

> *the foreign financial statements are prepared in accordance with a standard (foreign standard) that is not covered by subparagraph (2)(c)(i)–"; and*

8 Scope of relief when using senior manager exemption

Section 1100N(a)(iii) of the New Exemptions permits that an offer is eligible to be made under Division 1A of Part 7.12, where that offer would otherwise not need disclosure.

Sections 1100R(1) and (2) go on to prescribe existing circumstances under the Corporations Act where offers can be made without disclosure to investors. For example, under section 708 (apart from sections 708(1) or (15)), section 708AA, section 1012D (apart from sections 1012D(5) or (6)), section 1012DAA and section 1012DA.

In our experience, companies may wish to rely on the 'senior manager' exemption in section 708(12) to offer ESS interests to non-executive directors.

We understand that the intention of the New Exemptions is that where offers are made in reliance on the senior manager exemption under section 708(12) those offers do not need to comply with the requirements of the New Exemptions (i.e. the trust, contribution plan, loan plan, disclosure requirements), but that different practitioners have formed different views on this interpretation and to avoid uncertainty on this point we would welcome specific confirmation by ASIC on this.

We invite ASIC to clarify Parliament's intention by amending the 'note' to section 1100R(1) as follows:

> *"This subsection puts beyond doubt that the no consideration exemptions from disclosure in subsections 708(15) and 1012D(5) and (6) cannot be used to exempt an offer of ESS interests from disclosure under Part 6D.2 or 7.9. Where an ESS interest is offered under sections 1100R and 708 (apart from sections 708(1) or (15), section 708AA, section 1012D (apart from sections 1012D(5) or (6)), section 1012DAA or section 1012DA, that offer is not required to comply with this Division 1A".*

Based on the explanatory memorandum to the New Exemptions this expansion to the 'note' is consistent with Parliament's intention. For example:

(a) Paragraph 4.45 of the explanatory memorandum makes it clear that offers under section 1100R(1) 'are not required to comply with the trust requirements'. We acknowledge that offers made under section 1100R(2) must comply with the trust requirements.

(b) Paragraph 4.57 of the explanatory memorandum makes it clear that offers under section 1100R(1) 'are not required to comply with the contribution plan requirements'. We acknowledge that offers made under section 1100R(2) must comply with the contribution plan requirements.

(c) Paragraph 4.69 of the explanatory memorandum makes it clear that offers under section 1100R(1) 'are not required to comply with the loan requirements'. We acknowledge that offers made under section 1100R(2) must comply with the loan requirements.

(d) Paragraph 4.80 of the explanatory memorandum makes it clear that offers under section 1100R(1) and (2) 'are not required to comply with the issue cap'.

(e) Paragraph 4.106 of the explanatory memorandum makes it clear that offers under section 1100R(1) and (2) 'are not required to comply with the monetary cap'.

(f) See also paragraphs 4.171 – 4.173.

9 Application of trust deed requirements

New section 1100S includes mandatory content for a trust deed that must be included in an employee share scheme trust deed in order to access the relief under the New Exemptions.

We have been advising multiple listed companies on the application of these trust requirements to their current employee share scheme structures.

Our interpretation of these provisions is that they could cover an ESS trust that holds allocated shares in a listed company on behalf of ESS participants or is warehousing such shares that may be allocated to ESS participants (**ESS Trust**).

One area of uncertainty and difficulty that has arisen for listed companies offering ESS interests is the how their custodial arrangements (which constitute a 'bare trust') are regulated under section 1100S. For example we assume that where:

(a) the ESS trustee appoints a custodian to hold allocated listed company shares subject to a master agreement between the ESS trustee and a custodian, and that arrangement does not involve the company; and

(b) on the vesting of shares, the shares are transferred to custodian (bare trust) account on a temporary basis in order for the shares to be held on behalf of participants until the participant instructs the custodian to sell or transfer the shares to them,

it is not necessary for the bare trust custodial arrangements to meet the requirements under section 1100S, but we consider that it would be helpful to insert a note in the Instrument to clarify the position, at least for listed company share custody arrangements which are usually on standard market terms and do not meet the section 1100S requirements and are not negotiable, even if the company seeking to rely on the New Exemptions was a party to them.

We request that the draft Instrument be amended to make it clear that section 1100S only applies to an ESS Trust and does not cover any custodian / bare trust arrangements involving ESS interests at least for listed company shares.

10 Transitional arrangements

In relation to the termination of the current class orders 14/1000 and 14/1001, we understand that ASIC's intention is to amend those class orders so they will not apply to offers made after a specified date (expected to be in January 2023) (**Termination Date**) but that all other aspects of the class order relief (including the custody relief for trust arrangements) will continue on a grandfathered basis for offers made prior to the Termination Date.

Where the offers under those class orders made before the Termination Date relate to offers of options or incentive rights and there may be some communications with the participants in relation to the exercise of those options or incentive rights after the Termination Date, it will be important for those offerors and participants to know that the exercise of options or incentive rights offered before the Termination Date are grandfathered and will continue to be within the scope of class orders 14/1000 and 14/1001.

We request that the draft instrument to amend class orders 14/1000 and 14/1001 is clear that the class orders (and the relief they provide) continue to apply in relation to:

(a) offers made before [the Termination Date] and only capable of acceptance for [***X years***] after the Termination Date; or

(b) offers relating to the exercise of options or incentives that were originally offered before [the Termination Date].

We understand that in recent years many options have been offered class orders 14/1000 and 14/1001 with long exercise periods, commonly 3 to 5 years and sometimes as long as 15 years.

We invite ASIC to consider amending the class orders to permit communications with the participants in relation to the exercise of any options or incentives offered before the Termination Date, or if that is not possible, permitting communications with participants in relation to the exercise of any options or incentives offered before the Termination Date for a reasonable period of time after the Termination Date, ideally at least three years.

Absent such changes there will be many participants whose exercise or vesting periods fall outside the grandfathered period, making it difficult for a company to remind the participants about the upcoming exercise period as that may be regarded as an offer in relation to the issue of shares on the exercise, which may result in participants missing out.

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If you have any questions in relation to this submission please don't hesitate to contact us.

Yours sincerely

[sent electronically without signature]

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