Australia: Proposed Securities Law Employee Share Scheme Reforms Enacted

In Brief

Securities law reforms aimed at making it easier for businesses to implement employee share schemes have been adopted and will become effective on 1st October 2022. Originally announced last year, the reforms change the way in which offers under employee share schemes (**ESS offers**) are regulated. It is expected that the new law will replace the current exemptions from prospectus and licensing requirements contained in ASIC Class Orders 14/1000 and 14/1001.

Background

As noted in our September 2021 alert, the key exemptions for ESS offers are currently contained in ASIC Class Orders 14/1000 and 14/1001. These exemptions enable companies to make ESS offers without needing to prepare a prospectus (or similar document) or hold an Australian financial services licence (**AFSL**).

The conditions in Class Order 14/1000 are typically easy to satisfy, and the exemption has proved a popular way for listed (i.e., publicly-traded) companies, both Australian and foreign, to operate employee equity plans in Australia. In contrast, Class Order 14/1001, which applies to unlisted (i.e., privately-held) companies, contains a number of restrictive conditions which have made it much more difficult to use. In particular, Class Order 14/1001 can only be used where the total value of awards granted to any one employee in any 12-month period is no more than AUD 5,000.

The new law inserts exemptions into the *Corporations Act 2001* (Cth) (**CA**) which are analogous to the existing Class Orders. However the new law, like the exposure draft legislation before it, departs from the Class Orders in a number of ways which will likely make it more attractive, at least for companies that are offering awards for no monetary consideration. For awards that require monetary payment, the picture is less clear-cut - particularly where the issuing company is unlisted. The new measures contain some key advantages over the two Class Orders, but they also introduce some additional disclosure requirements and sources of potential liability which may be concerning to some companies.

Key Takeaways

The new law introduces a number of key changes to the regulation of ESS offers. These include:

- **Removing the 3-month listing requirement**

  Companies don't need to be publicly-traded on a major stock exchange for 3 months in order to be treated as "listed" for the purposes of the new rules. This contrasts with Class Order 14/1000, which is only available to companies that have been listed (without interruption) for at least 3 months.

- **Distinguishing between ESS offers that do and do not require monetary payment**

  ESS offers by listed or unlisted companies that do not require payment (whether upon grant or at exercise/vesting) can be made without the need for an AFSL and without any prescribed form of disclosure, provided that the offers state that they are being made under the new rules.

  In contrast, ESS offers which require monetary payment (whether upon grant or upon exercise/vesting of the awards and issue of the underlying shares) must be accompanied by an "ESS offer document" and must comply with an issue cap (generally 5% for a listed company and 20% for an unlisted company, although these limits can be raised by amending the company's constitution).

- **Raising the monetary cap for ESS offers made by unlisted companies**

  ESS offers made by unlisted companies that require monetary payment will need to comply with a monetary cap, the base limit being AUD 30,000 per employee in any 12-month period.

- **Share purchase and loan plans offered by unlisted companies**

  Subject to meeting the relevant requirements, unlisted companies will be able to operate share purchase plans and loan plans. Again, this is in contrast to Class Order 14/1001, which specifically precludes these possibilities. However, in the case of unlisted companies, the exemption for loan plans is only available if plan participants are not shareholders of the relevant company.

- **Removing the notice requirement**

  There is no longer any requirement to file a "notice of reliance" with ASIC. However, ASIC can require companies to provide ASIC with their ESS offer documents, together with any other information that ASIC deems relevant in determining whether the new rules have been complied with.

- **Retaining other statutory exemptions**

  The existing statutory exemptions (such as the senior manager and the 20-in-12 exemptions for offers of securities) will remain available for offers that are not covered by the new rules. However, as noted below, there is some uncertainty regarding the interaction of the new rules with the 20-in-12 exemption.

The reforms also seek to address a number of shortcomings in the original exposure draft legislation (discussed in our September 2021 client alert), including the regulation of offers to independent contractors, the requirement for foreign company accounts, and the regulation of options and "incentive rights" (i.e., RSUs and phantom awards) offered by listed companies.

The New Rules in Detail

The new rules distinguish between ESS offers that do and do not require monetary payment. Offers that do not require monetary payment are not subject to any specific disclosure requirements. In contrast, offers that require monetary payment must be accompanied by certain specified disclosures. ESS offers falling in this second category that are made by unlisted companies are subject to additional requirements.

ESS offers that do not require monetary payment - all companies

ESS offers that do not require payment (either upon grant or upon exercise/vesting of the awards and issue of the underlying shares) can be made without the need for an AFSL and without any prescribed form of disclosure. This is the case both for listed and unlisted companies. The only requirement is that such offers state that they are being made under the new rules.

ESS offers that require monetary payment - all companies

ESS offers which require monetary payment must be accompanied by an "ESS offer document". The ESS offer document must contain:

- the terms of the offer (or a summary of those terms, together with statement that a copy of the full terms will be provided on request within 10 business days);
- general information about the risks of acquiring and holding the interests being offered;
- a statement that any advice given in relation to the offer does not take into account the participant's objectives, financial situation and needs (together with a suggestion that the participant obtain appropriate advice);
- a statement of the period (the **application period**) during which the person may accept the offer; and
- in the case of a listed company - the acquisition price (if any) of the interests being offered and also an explanation as to how the participant can ascertain the company's share price.

As further discussed below, ESS offers must also contain a term to the effect that employees cannot acquire any interest (i.e., an award) under the offer until at least 14 days after receiving the ESS offer document.

ESS offers that require monetary payment - unlisted companies

Unlisted companies are subject to additional requirements. If an unlisted company wishes to make an ESS offer requiring monetary payment, the offer must comply with:

- additional disclosure requirements; and
- a monetary cap.

Additional disclosure requirements - unlisted companies

In addition to the general disclosure requirements, the ESS offer document must:

- include a statement that the ESS interests may not produce any value for the grantee and that the value of the ESS interests will depend on future events that may not occur; and
- be accompanied by:
  - a copy of the company's most recent accounts, being accounts that the company is otherwise required to file with ASIC or (if it doesn't file accounts with ASIC) a balance sheet and profit and loss statement prepared in compliance with either Australian or "international accounting standards" (i.e., standards made by the International Accounting Standards Board);
  - "valuation information", consisting of either:
    - a valuation of the interests being offered that has been prepared consistently with an applicable method approved by the Commissioner of Taxation under section 960-412 of the *Income Tax Assessment Act 1997* (**ITAA**);
    - a current Australian disclosure document (such as a prospectus); or
    - a copy of either a draft or executed agreement under which interests in the same class are to be acquired on arm's length terms by a third party who is not an associate of the person making the offer, where the agreement specifies the amount of monetary consideration to be paid for such an interest (if the agreement is a draft only, the relevant awards cannot be acquired until a sale agreement that is not materially different from the draft has been executed).

In the case of options or incentive rights that are granted for free, the company's accounts and the "valuation information" do not need to be provided with the ESS offer document. However, if the options or incentive rights are only exercisable or only vest upon monetary payment, participants must be given the company's most recent accounts, together with the "valuation information" described above, at least 14 days before the relevant awards are exercised or vest (again, if the "valuation information" is a draft sale agreement, the relevant awards cannot be exercised or vest until a sale agreement that is not materially different from the draft has been executed).

M**onetary cap - unlisted companies**

The exposure draft legislation imposed a "value" cap of AUD 30,000 on any ESS offers made by unlisted companies which require monetary payment - that is, a cap on the value of awards received by any one participant in any 12-month period.

In contrast, the new law imposes a "monetary cap" on the amount of money payable by a participant in any 12-month period.

Furthermore, whilst the base monetary cap is AUD 30,000, participants can make additional payments up to:

- 70% of any dividends paid in the relevant 12-month period on interests acquired under the relevant employee share scheme; plus
- 70% of any performance-dependent cash remuneration received in the relevant 12-month period.

The exercise price for unexercised options or incentive rights may also be accruable for up to 5 years, in which case that unpaid exercise price will be added to the AUD 30,000 monetary cap.

In calculating whether payments fall under the applicable monetary cap, certain amounts are excluded, such as:

- after-tax salary deductions paid under an employee share purchase plan (however, such amounts are included at the point that they are used to acquire shares); and
- amounts that only become payable during or immediately before a liquidity period for the underlying shares, where a "liquidity period" includes a period during which the shares are listed. This means that amounts payable to acquire shares or to exercise options won't be counted if the company is, or is about to be, listed.

Other Matters

Independent contractors

Under the reforms, offers to independent contractors are treated in the same way as offers to employees, meaning that the "ESS offer document" and related requirements will only apply if the relevant offer requires a monetary payment. This contrasts with the previous exposure draft legislation, which treated all offers to independent contractors on the same footing as offers that require monetary payment.

Unlisted options and incentive rights

ESS offers by listed companies can include unlisted options and incentive rights. This corrects a drafting error in the previous exposure draft legislation, which provided that listed companies could only offer options or incentive rights if those awards were either listed or had both a zero grant and a zero exercise price.

Problems with the New Law

As with the exposure draft legislation, it is not all good news.

Liability regime

The new rules contain an elaborate liability regime which, whilst it is intended to protect employees, may be problematic for some companies. For example, offers requiring monetary payment must now include terms that specifically make issuing companies, their directors and third parties named in the offer documents (which could potentially cover an auditor or independent valuation expert) responsible for correcting any misleading statement given to employees, and that make them liable to employees for such statements (subject to certain permitted defences).

These provisions are supplemented by a statutory liability regime under which:

- the exemptions provided by the new law automatically cease to apply if an ESS offer breaches a relevant requirement (e.g., the monetary cap);
- a company or its directors can be criminally liable for materially misleading statements or omissions in an ESS offer document (or any accompanying documents); and
- ASIC can issue stop orders (i.e., an order that no ESS offers be made) if it is satisfied that an ESS offer document (or any accompanying information) does not comply with the applicable requirements, or is "not worded and presented in a clear, concise and effective manner".

Additional disclosures by unlisted companies

As noted above, unlisted companies that have to provide an ESS offer document will also need to give employees a copy of their most recent accounts. This disclosure requirement improves on the equivalent provision in the exposure draft legislation, inasmuch as the accounts of foreign companies that are not required to file accounts in Australia do not need to comply with Australian accounting standards (they can comply with international accounting standards instead). However, the requirement may still present difficulties for such companies, since they may regard their accounts as commercially sensitive and be unwilling to disclose them to employees.

If an unlisted company has to provide an ESS offer document, it must also give employees "valuation information" at the time of grant (if the awards have an upfront purchase price) and at the time of exercise/vesting (if the underlying shares issued upon exercise or vesting have a purchase price). This may prove to be an onerous requirement, especially since any such "valuation" may need to comply with a valuation method approved by the Australian Commissioner of Taxation.

14-day wait period

As noted above, ESS offers which require monetary payment must contain a term to the effect that employees cannot acquire any interest under the offer until at least 14 days after receiving the ESS offer document. This may prove problematic for companies (such as many U.S. companies) that grant options or similar awards before any offer documents are sent to employees.

Drafting problems and anomalies

The new rules appear to contain a number of drafting anomalies - for example:

- **The new rules and the 20-in-12 exemption**

  Whilst the new rules do not preclude the availability of pre-existing statutory prospectus exemptions, there are some drafting anomalies which make the picture less clear-cut than it ought to be. On their face, the new rules apply only to offers that are expressly stated to be made under them. This strongly suggests that a company proposing to grant awards can elect to do so either under the new rules or, if appropriate, under one or more existing statutory exemptions. However, new section 1100R(2) appears to contemplate that offers made in reliance on the 20-in-12 exemption (otherwise known as the "small-scale offering" exemption) will need to comply with additional requirements if the offers involve a trust or a loan, or are made under an employee share purchase plan. If this is the intention of this section, in our view it has miscarried. In our view, offers can be made in reliance on the 20-in-12 exemption without needing to comply with any of the requirements under the new law.

  However, the potential for confusion on this point is exacerbated by the Explanatory Memorandum to the new law (**EM**), which states that *"offers made under subsection 708(1), the small-scale offering exemption, will be required to comply with the trust, loan and contribution plan requirements"* under the new rules.

  It is possible that this issue reflects a more endemic confusion within the new law - namely, whether it is intended to operate:

  - as a regime that issuing companies can elect to utilise for their ESS offers, either on its own or in parallel with pre-existing statutory exemptions (we believe that this is the correct view, based on a literal reading of the new law); or
  - as a mandatory regime governing all ESS offers to the exclusion of any other provisions of the CA (as suggested by some statements in the EM).

- **"Approved" valuation methods**

  As noted above, certain ESS offers made by unlisted companies will need to be accompanied by "valuation information", which will typically consist of a valuation prepared consistently with a method approved by the Commissioner of Taxation under the ITAA. Unfortunately, whilst the Commissioner of Taxation has issued some approved methods, those methods only cover companies that are eligible for the Australian start-up tax concession (including that they have been in existence for less than 10 years and have an aggregated turnover of no more than AUD 50 million). For unlisted companies that do not meet these start up eligibility criteria, it is not clear what amounts to an "approved" valuation method.

- **Employee share purchase plans**

  Offers under employee purchase plans must be on terms that allow employees to cease participating (and receive a refund of their salary deductions) at any time. However, unlike Class Order 14/1000, the new rules do not provide for a 45 day notice period. Instead, they merely state that any and all salary deductions standing to the credit of the participant's account must be repaid within 45 days. Presumably this just reflects imprecise drafting, but if read literally it would mean that if an employee withdrew with only a day's notice (i.e., a day before the relevant purchase date for the shares), the company would have to refund their salary contributions rather than use those amounts to purchase the shares.

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