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Government to Make Employee Share Schemes User Friendly

Denis Godfrey & James Bourchier | November 2016

Introduction

The Government has recently released a consultation paper seeking comments from the public on changes to the Corporations Act disclosure regime that would make employee share schemes (ESSs) more user friendly. This GRG Remuneration Insight provides context and comments on the main areas that appear to require change, and GRG's vision of a framework that genuinely supports equity ownership by all employees.

Consultation Paper

The Government's consultation paper specifically raises several aspects for comments. Some of these aspects are noted below.

Problems with Offer Information Statements (OIS)

The government has raise two main aspects of OISs for discussion, being:

a) The need for the OIS to be accompanied by a copy of a full year financial report that has been audited and relates to a period ending not more than six months before the securities are offered, and

b) No more than $10 million (excluding amounts raised under eligible employee share schemes) may be raised under all OISs in perpetuity.

Senior Manger Exemption

Whether the senior manager exemption from disclosure requirements (including OISs) should be extended to other employees has been raised for comment.

Derivatives

Whether offers of derivatives should be made easier has also been raised for comment.

Unfortunately the issues raised in the consultation paper appear to suggest that the Government is considering tinkering at the edges rather than setting up a regime that is more appropriate to employee remuneration arrangements in the 21st century. However, the Government also broadened the scope to cover any aspect that the public may wish to raise, which is welcome and is here the focus of this GRG Remuneration Insight.

Current Situation

There are a series of provisions of the Corporations Act that need to be considered in relation to employee equity plans. These include those dealing with; disclosure, licensing, subsequent sale offers, hawking, financial product advice and advertising. Of these, the disclosure provisions are the ones that attract the most attention when implementing employee equity plans.

Offers of securities (not derivatives) are exempt from disclosure under s708 of the Corporations Act for offers that fall within one of the following exemptions:

- Small scale offerings (20 persons raising no more than $2 million),
- Senior managers, and
- Sophisticated investors.

The sophisticated investor exemption is replicated for offers of derivatives. However, the senior manager exemption is not replicated for derivatives, thereby discriminating against their use.

The Australian Securities and Investments Commission (ASIC) has recently released two Class Orders that deal with equity plans. They are:

- Class Order 14/1000 which deals with ASX listed companies, and
- Class Order 14/1001 which deals with unlisted companies.

Class Order 14/1000 provides extensive relief for all types of plans using various forms of instruments and making offers to a wide variety of participants.

When a Class Order or one of the disclosure exemption provisions does not apply, it is necessary to use some form of disclosure document be it a prospectus, a short form prospectus, an offer information statement or a product disclosure statement (PDS).

Class Orders released by ASIC result in two broad categories of plans/offers based on whether they are dependent on a financial contribution by an employee or not.

Each of these is discussed below.

Non-contributory Plans

Non-contributory plans are those where contributions on either a pre-tax or after tax basis are not made. The main forms of non-contributory plans include:

- Long term incentives (LTI),
- Compulsory deferral of short term incentive (STI) awards into equity, and
- Company sponsored equity grants that are in addition to other forms of remuneration.

ASIC Class Order 14/1000 extends disclosure and other relief to a wide range of non-contributory plans and participants. It does not distinguish between securities and derivatives. It also does not distinguish between senior managers and employees generally.

The main problems with Class Order 14/1000 are:

- Total issues in reliance on the Class Order must not exceed 5% of issued shares over a rolling 3 year period, and

- ASIC must be notified not later than one month after the first offer is made under a plan in reliance on the Class Order, which appears to have been something of a trap for many companies that have previously relied on the Class Orders without the requirement of notification.

The 5% seems to be arbitrary as it will be very restrictive for some companies and not restrictive at all for other companies. If shareholders approve the plan then the purpose of this requirement is unclear.

The need for ASIC to be notified is also unclear and seems to a bureaucratic imposition.

Contributory Plans

Any plan which is funded by pre-tax or after tax contributions from participants is seen as a contributory plan. Thus, salary sacrifice plans which allow employees the choice of whether or not to participate would be classified as contributory plans. The main forms of salary sacrifice involve sacrifice of:

- Fixed pay,
- STI awards, and
- Director fees.

None of the relief provided under Class Order 14/1000 is available to contributory plans. Limited disclosure relief is available under s708 but only if securities are offered. Contributory plans that use indeterminate rights or other forms of derivatives, which is the form that most modern incentive plans take, do not qualify for disclosure relief except for sophisticated investors. Accordingly, offers of derivatives under general employee contribution plans of the same type generally do not qualify for disclosure relief.

If securities are offered then disclosure is required using either an offer information statement, a short form prospectus or a full prospectus. There are challenges in using an OIS (the simplest to produce) which mean that it can be an impediment to the introduction of a general employee equity plan. As noted in the foregoing, the main problems with OISs have been raised for comment in the Government's consultation paper.

If derivatives are offered then a product disclosure statement may be used. It is not a complex document and does not represent an impediment to the implementation of general employee equity plans that use derivatives.

New Separate Regime Needed

By distinguishing between contributory and non-contributory plans the Government has already recognised the fundamental differences between the various types of equity plans operated by listed and unlisted companies.

GRG's view is that non-contributory plans should be excluded from the Corporations Act provisions which are designed to inform and thereby protect investors, effectively the public. Non-contributory plans are remuneration plans which aim to align the interests of employees with shareholders. Whether they are settled in securities or cash is not relevant as there is no need to protect employees as they are not being asked to invest money. Both STI and LTI plans that use key performance indicators not related to the value of a company's shares and are settled in cash do not fall within the disclosure, advertising, hawking and financial advice provisions of the Corporations Act. It is illogical to apply the Corporations Act provisions to those incentive plans where awards are determined by reference to a company's share price or are settled in the company's securities. Further, the same position should apply irrespective of whether the company is listed or unlisted. Of course, employees will need to consider the liquidity of securities in private companies when they are making decisions to accept or reject offers or to enter into employment agreements involving such offers.

On the other hand, contributory plans are different in their nature as employees are in effect being asked to invest in the company. Thus, employees should be enabled to make informed investment decisions. In this respect there is a significant difference in risk between ASX listed companies that engage in continuous disclosure and unlisted companies. Potential investors in ASX listed companies have access to large amounts of information about the company and may purchase shares on the ASX without a prospectus needing to be provided. In these circumstances there would seem to be no need for a prospectus for employees.

In cases where companies provide guarantees that employees will not lose the money they contribute to fund the acquisition of equity, there would seem to be even less need for a prospectus or similar disclosure document to be provided.

However, for companies that are not listed on the ASX there is clearly a strong need for employees to be informed before deciding to make contributions to fund equity acquisitions. In unlisted companies it is possible for a tax liability to arise in relation to participation in such plans, which cannot be funded from the equity if there is no market for it at the time. There should also be provisions which make it illegal for participation in contributory plans to be compulsory, in the case unlisted companies.

Conclusion

It is GRG's view that there is a need for a fundamental re-think of the need for employee equity plans to be governed by the Corporations Act. Most plans should not be subject to specific disclosure requirements as they are either not contributory plans or are operated by companies that engage in continuous disclosure. An exception applies to contribution plans operated by unlisted companies.

As usual the Government is trying to catch up with a dynamic area of employee and director remuneration that is rapidly evolving in response to changing community and stakeholder perspectives. As noted, the issues raised in the consultation paper indicate that the Government is considering tinkering at the edges rather than setting up a regime that is more appropriate to employee remuneration arrangements in the 21st century.

Nevertheless, any improvements to help make equity related remuneration arrangements simpler to implement and operate will be most welcome. Whether you share these views or have slightly different views, it is likely that the current process of consultation by the Government would benefit from your contributions. If you wish to express your views, but in a less formal setting, we invite you to make your comments in the LinkedIn forum “Remuneration Committee Matters (Australia)”, and we can then incorporate your views into our own submission.