GRG Remuneration Insight 150

New Employee Share Scheme Regulatory Framework Finalised

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Introduction

In 2022, amendments to the Corporations Act were hastily drafted and passed, with the intention of addressing long-standing problems with the regulation of Employee Share Schemes (ESS). The new law was identified as Division 1A of Part 7.12 of the Corporations Act (the Act). Initially, the changes were to replace the previous framework from 1 October 2022; the previous framework involved a combination of the Corporations Act and Class Orders (Class Order 14/1000 and Class Order 14/1001) issued by ASIC to resolve problems presented by the Corporations Act. However, as GRG and our legal associates worked though the consequences of the new law, it became apparent that while many problems with the old framework were resolved, new and in some ways more significant problems presented themselves. GRG and others subsequently lobbied ASIC to again resolve the problems with the amended Corporations Act, which resulted in ASIC extending availability of the Class Orders until the end of February 2023, undertaking a consultation processing, and ultimately issuing a Legislative Instrument (2022/1021) and accompanying Explanatory Statement. All Employee Share Schemes need to comply with the new framework from 1 March 2023, with the Class Orders no longer being available for new grants, due to the recently released Legislative Instrument 2022/1022. This insight provides a summary of the final framework and key outcomes, actions and issues. **A summary comparison appears on page 3 and a graphic/decision tree appears on the last page.**

Why the Regulatory Framework is of Critical Importance?

In order to avoid breaching the Corporations Act, offers of equity in listed and unlisted companies in Australia must be accompanied by a prospectus or disclosure document as outlined in Part 6D.2 of the Act. The Act also includes prohibitions on many activities commonly associated with the operation of ESS arrangements, including activities that would be classified as advertising or hawking under the Act, and in the case of some ESS arrangements, would require an Australian Financial Services License (AFSL). Given that the compliance costs and limitations arising from the Act would make most ESS arrangements untenable, it is of critical importance that relief from these requirements and restrictions is obtained when operating an ongoing ESS. In the past, there were two methods of obtaining relief from the most onerous requirements and restrictions:

1. Reliance on a Class Order issued by ASIC, alongside notifying ASIC of such reliance:
    a. Class Order 14/1000 for ASX listed companies,
    b. Class Order 14/1001 for unlisted companies,
2. Reliance on Section 708 of the Corporations Act; this part of the Act provided relief in very limited circumstances, most commonly if the employee was classifiable as a "Senior Manager" or "Sophisticated Investor", or if the proposed grant met the requirements to qualify as a "Small Scale Offering".

In order for either form of relief to be relied upon, the ESS terms had to meet specified conditions, for example, that the ESS was not a contribution plan, and number issued did not exceed 5% of issued capital over 3 years in the case of 1.a. above, or that the offer was of "securities" (only) in respect of 2., above.

With the changes to the framework, the Class Orders can no longer be relied upon, and the following methods of relief will need to be considered for all ESS arrangements going forward:

1. Section 708 of the Corporations Act, which remains largely, but not entirely, unaffected by the changes that have recently occurred (see Explanatory Memorandum), and
2. Reliance on Division 1A of Part 7.12 of the Act, and Legislative Instrument 2022/1022 (including the accompanying Explanatory Memorandum), assuming that the terms of the ESS meet the requirements outlined therein.

GRG refers to the latter as “the new ESS framework” and will be the optimal method of relief for the vast majority of both listed and unlisted companies, with very few exceptions.

How were the Problems Resolved?

Some of the most significant uncertainties and issues with the new framework, and how they were resolved, are summarised below:

1. Section 707(3) of the Act effectively restricts or prohibits on-sale of shares within 12 months of their issue.
    a. Most equity plans are operated on the basis of new issues because this minimises the cost of the plan. This issue creates a tax and disposal problem for ESS arrangements.
    b. ASIC previously provided specific relief on this matter under the Class Orders, however this was initially overlooked in the new ESS framework (Corporations Act amendments).
    c. ASIC has since resolved this by providing equivalent relief in Legislative Instrument 2022/1022 for ASX listed companies (only).
    d. There was a (confirmed) view that Section 708 relief could not be relied upon in respect of disposal of shares within 12 months of the issue of shares in unlisted companies. ASIC has clarified that Section 708 relief can now be taken to apply to on-sales of shares for unlisted companies. Most liquidity events would either involve a prospectus/disclosure that meets the requirements for on-sales to occur, or would involve a party that would be considered a “sophisticated investor”. This is outlined in the Explanatory Memorandum.
2. When an ESS is provided to foreign participants in foreign jurisdictions, the framework was unclear regarding whether subsequent sales in Australia by those participants could enjoy the relief outlined in the framework. ASIC has clarified that ESS interests enjoy subsequent relief under the new framework, despite the initial grant not being subject to the framework because it occurred outside of Australia’s jurisdiction, in the Explanatory Memorandum.

What Has Not Been Resolved?

One of the significant problems that has emerged from the new framework is that options (other than zero exercise priced options) are now considered “contribution plans” and face significant additional disclosure, compliance and limit requirements compared to other instruments (see later section). For most companies it will be possible to overcome this problem by switching from options to Share Appreciation Rights (SARs), which are superior to options for all stakeholders while producing identical benefits, except where:

1. The company is operating a start-up plan which offers attractive tax concessions under the Income Tax Assessment Act (Tax Act), or
2. The company is seeking to avail itself of nil up-front tax valuation under the Income Tax Assessment Act Regulations, which can apply to options with a sufficiently “premium” exercise price.

In both cases, the Tax Act requires that the exercise price is paid in cash by the participant, and SARs cannot be used. Unfortunately, it appears that changes to the Tax Act will be required to align with the new ESS framework under the Corporations Act. Unlisted companies operating option plans will need to either rely on Section 708 relief, or otherwise limit grants to the amount specified (around $30,000 per employee per year as valued by the Exercise Price. Note: the safe harbour valuation can be used.) and meet the disclosure requirements which are likely to be challenging for unlisted companies in particular. Listed companies can likely comply with the disclosure requirements, and enjoy a higher limit (5% over 3 years).

The other circumstance that was not resolved, is that if a grant is made in reliance upon section 708 relief (e.g. “senior manager” or “sophisticated investor”), then disposal of the shares within 12 months of their issue would run into problems (s707(3)) unless section 708 or another form of relief could be relied upon

again at the time of disposal as well. This can be problematic for some employees seeking to divest equity if it is not associated with a liquidity event for example.

A final issue that is resolved, but remains significantly sub-optimal, is that "contribution plans" for unlisted companies are so highly regulated and limited as to make them impractical or undesirable for most unlisted companies.

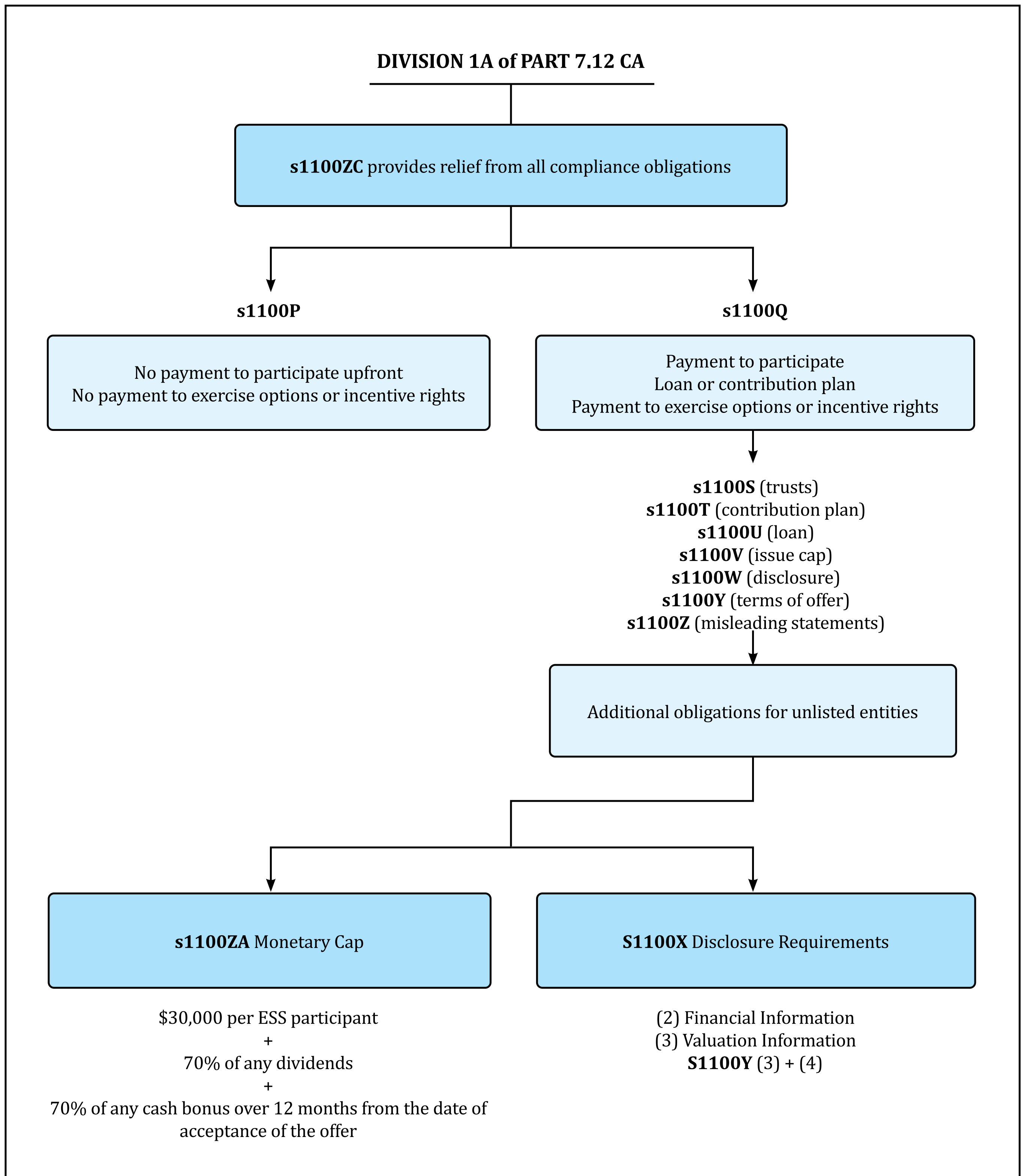
What are the Key Differences in the New ESS Framework?

The following outlines the key differences between new ESS framework, and previous ESS relief approaches:

1. ASIC no longer needs to be notified regarding relief reliance.
2. Most ASX listed equity plans are now unlimited under the new Corporations Act ESS framework:
    a. The 5% of shares issued over 3 years limit (previously a key limit in Class Order 14/1000) no longer applies to listed company equity plans, unless they are "contribution plans".
    b. Listed companies can now better compete with international markets, and local subsidiaries of major international entities, or start-ups, by driving equity opportunities deep into the organisation, and offering new and different types of equity (e.g. sign-on, performance and retention grants for junior and mid-level staff, or option-like Share Appreciation Rights for all staff as an alignment and engagement tool).
3. Most unlisted equity plans are now unlimited under the new Corporations Act ESS framework:
    a. The $5,000 of equity per employee per annum limit (previously a key limit in Class Order 14/1001) no longer applies to unlisted company equity plans, unless they are "contribution plans".
    b. Unlisted companies can now better compete with international markets, and local subsidiaries of major international entities, or start-ups, by driving equity opportunities deep into the organisation, and offering new and different types of equity (e.g. sign-on, performance and retention grants for junior and mid-level staff).
4. Options are now considered "contribution plans" and face higher compliance hurdles than other types of equity which are not considered "contribution plans". As a result, GRG expects that except where special tax concessions are the key determinant of the plan design, all option plans will be replaced with Share Appreciation Rights plans (identical to options with the same terms, but not a "contribution plan").
5. "Contribution plans" which are any arrangements that involve loans or an exercise price paid by the employee, or any payment or salary sacrifice arrangement that involves the employee sacrificing income or paying cash, are now arguably more highly regulated than they used to be:
    a. For most listed companies the additional compliance burden is likely surmountable, although still material; it should be noted that the 5% over 3 years limit will continue to apply to this type of plan in listed companies.
    b. For unlisted companies, the compliance burden is much more severe, and GRG expects that many unlisted companies will choose not to operate a "contribution plan" due to the requirements:
        i. There is a limit on how much that can be issued to each employee each year, which will be insufficient to be meaningful for many employees; while there is some scope for increases based on bonuses or dividends paid, the unadjusted limit is $30,000 per employee per year,
        ii. Financial and price-sensitive information needs to be disclosed, such as company accounts, which is often confidential in listed companies and cannot be disclosed,
        iii. Valuations of the equity need to be undertaken which can often be expensive ($7,500 to $15,000 are typical valuation costs depending on complexity),
        iv. Funds must be handled in accordance with specific requirements,
        v. Opt-out (and potentially refund) processes need to meet specific requirements.

Conclusion

For most equity plans, the new framework will require documentation to be replaced or amended, but is an improvement on the old framework, except in the case of contribution plans. See decision tree overleaf for a short-cut reference to understanding how the framework may impact your plan


DIVISION 1A of PART 7.12 CA
s1100ZC provides relief from all compliance obligations
s1100P
No payment to participate upfront
No payment to exercise options or incentive rights
s1100Q
Payment to participate
Loan or contribution plan
Payment to exercise options or incentive rights
s1100S (trusts)
s1100T (contribution plan)
s1100U (loan)
s1100V (issue cap)
s1100W (disclosure)
s1100Y (terms of offer)
s1100Z (misleading statements)
Additional obligations for unlisted entities
s1100ZA Monetary Cap
S1100X Disclosure Requirements
$30,000 per ESS participant
+
70% of any dividends
+
70% of any cash bonus over 12 months from the date of acceptance of the offer
(2) Financial Information
(3) Valuation Information
S1100Y (3) + (4)