GRG Remuneration Insight 66

Employee Incentive Schemes & New ASIC Class Orders

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OVERVIEW OF CO 14/1000 LISTED COMPANIES

Class Order (CO) 14/1000 was released by the Australian Securities and Investments Commission (ASIC) on 30 October 2014, some 6 months later than the planned release date of May 2014. It relates to employee incentive schemes (EISs) operated by companies listed on the ASX and other specified stock exchanges. A separate Class Order, CO14/1001, deals with such schemes being operated by unlisted companies. This paper focuses mainly on CO14/1000.

While the Class Order has wide application, this GRG Remuneration Insight is mainly focusing on plans using equity as part of remuneration arrangements for key management personnel.

The Class Order deals with relief from the Corporations Act requirements in relation to:

- Disclosure,
- Subsequent sale offers within 12 months,
- Financial product advice,
- Advertising,
- Licensing,
- Hawking, and
- Other incidental relief.

The relief applies to offers:

a) Of financial products under an "employee incentive scheme" which is broadly defined as "offers of financial products of a listed body by the body or an associated body corporate to persons under an arrangement that is designed to support interdependence between the body and those persons for their long term mutual benefit",

b) Of "eligible products" which cover a spread of instruments including: shares, options, rights and derivatives (derivatives were not previously covered in CO03/184) and the inclusion of derivatives represents a significant step forward, as many companies use structures that would now be classified as derivatives to manage termination benefit limit issues,

c) To full-time employees, part-time employees, non-executive directors, casual employees (subject to limitations), contractors and prospective participants, and

d) That do not result in the total number of securities issued or to be issued in relation to the current offer and offers made during the preceding 3 years which relied upon ASIC relief, exceeding 5% of issued securities of the same class.

Specific provisions apply to trusts, contribution plans and loans.

Within one month of first relying upon CO14/1000 in relation to an offer under a particular employee incentive scheme, the company must give notice to ASIC of such reliance. A new notice of reliance is needed for each new scheme and the notice should be accompanied by relevant plan documentation. If documentation is not provided with the notice of reliance it needs to be available so that it can be provided should it be requested by ASIC.

The new Class Order is likely to have a positive impact on EISs in that it expands both the range of products and the

types of roles that may qualify for relief. However, it also has a negative impact through the limit on the total number of potential security issues which may significantly constrain offers under EISs.

ASPECTS OF CONCERN

In the lead up to the finalisation of CO14/1000, Consultation Paper 218 was released by the ASIC in November 2013. It contained observations by ASIC as to its interpretation of the term "security". These observations significantly differed from views that had been held for some years by many advisors including solicitors. This paper therefore also discusses ASIC's observations and their implications for:

(a) future offers under executive long term incentive (LTI) plans, and
(b) past offers where specific relief was not obtained from ASIC.

OFFERS OF SECURITIES

Corporations Act Definition

Offers of securities to investors, including to employees, are regulated under Chapter 6D of the Corporations Act 2001 (Cth). Companies who wish to offer securities to their employees must comply with the disclosure requirements in Chapter 6D.2 of the Corporations Act, unless an exception under the Corporations Act applies, or relief is provided by ASIC. Compliance with CH6D.2 is typically onerous, expensive and time consuming, and most boards are not prepared to meet these requirements in relation to executive employee share schemes for a limited number of participants. Instead most companies rely on exemptions provided for in the Corporations Act, rely on a Class Order, or otherwise seek specific relief.

S708 of the Corporations Act provides exemptions from the need for disclosure documentation to be provided to investors when offers of securities are made in specified circumstances (discussed later). For purposes of s708 the term "securities" is defined in s761A of the Corporations Act as follows:

> *"security" means:*
>
> *(a) a share in a body; or*
>
> *(b) a debenture of a body; or*
>
> *(c) a legal or equitable right or interest in a security covered by paragraph (a) or (b); or*
>
> *(d) an option to acquire, by way of issue, a security covered by paragraph (a), (b) or (c); or*
>
> *(e) a right (whether existing or future and whether contingent or not) to acquire, by way of issue, the following under a rights issue:*
>
> *(i) a security covered by paragraph (a), (b), (c) or (d);*
>
> *(ii) an interest or right covered by paragraph 764A(1)(b) or (ba); or*
>
> *(f) a CGS depository interest;*
>
> *but does not include an excluded security. In Part 7.11, it also includes a managed investment product."*

However, s700 of the Corporations Act excludes (e) and (f) for purposes of s708. Neither rights issues (rights issues referring to regular rights issues, not employee share scheme rights) nor CGS depository receipts are relevant to employee incentive schemes.

Financial products which do not qualify as "securities" will not fall within the scope of section 708 of the Corporations Act and, accordingly, will not be able to rely on the exceptions contained in that section.

The long held view of many advisors has been that paragraphs (a), (c) and/or (d) of the above definition of "securities" applied to executive LTI plans that used shares, rights or options. However, commentary in paragraphs 92 to 101 of Consultation Paper 218 has taken a significantly different view.

Performance Rights

In relation to performance rights Consultation Paper 218 states in paragraphs 95, 98 and 100:

Para 95

> "*Where the performance right has an exercise mechanism and is to be satisfied by way of transfer of an existing share on exercise (i.e. it is held for a particular employee), it may be classified as an interest in a share within the meaning of paragraph (c) of the s761A definition of 'security'.*"
> (underlining inserted)

Para 98

> "*We consider that a performance right may not be a unit in a share if any of the following circumstances apply:*
> *(a) the right is an entitlement to an unissued share;*
> *(b) the right is an entitlement to an unidentified issued share, either:*
> *(i) held in a pool of shares, on trust, for the purpose of transfer to employees on vesting of the rights (as a specific share is not held for a specific employee); or*
> *(ii) to be purchased on-market at the relevant time by a trustee for an employee incentive scheme (as the specific share is not identified at this point); or*
> (c) *on vesting of the performance right, the issuer or trustee for an employee incentive scheme has the discretion to provide the employee with either a new share by way of issue or an existing share*."

Para 100

> *"Accordingly, the offer of performance rights that have the elements discussed at paragraph 98 would, but for relief, be subject to the disclosure requirements under Ch 7 of the Corporations Act on the basis that the performance right is a derivative*."

These paragraphs indicate that ASIC is of the view that many performance rights plans do not constitute offers of "securities" and therefore would be subject to the disclosure requirements contained in the Corporations Act except for the relief now contained in CO 14/1000.

There is one exception which is mentioned in paragraph 97 which states:

> *"We consider that a performance right that confers an automatic right to receive a specified issued share (and nothing else) on the satisfaction of performance or service conditions, absent other terms, is likely to be a unit in a share. Such a performance right may also be classified as a conditional offer of shares, which would also qualify for relief under [CO 03/184]."*

Given that it only relates to previously issued shares that are specifically identified (not in a pool or to be acquired by on-market purchase) this observation offers little assistance to most companies as a new issue of shares is the most common approach to delivering shares when performance rights vest.

Options

Paragraphs 93 and 94 indicate that performance rights could be considered to be options (and therefore securities) if limited features apply:

Para 93

> *"A performance right could be classified as an option and therefore qualify for relief under [CO 03/184] if:*
> *(a) it is to be satisfied by way of issue of a new share on vesting; and*
> (b) *its terms require the employee to exercise their right to the new share, rather than an automatic issue on vesting."*

Para 94

> *"In our view, if a performance right does not have an exercise mechanism, but vests automatically, it cannot be considered to be an option."*

The term "option" is not defined in the Corporations Act.

A definition of options from the **legal-dictionary.thefreedictionary.com** states:

> *"a right to purchase property or require another to perform upon agreed-upon terms. An option is paid for as part of a contract, but must be "exercised" in order for the property to be purchased or the*

performance of the other party to be required. "Exercise" of an option normally requires notice and payment of the contract price."

Many LTI plans have included automatic exercise of rights so as to streamline administration. This feature recognised that executives are not required to pay monetary consideration to exercise vested performance rights i.e. convert them into shares and therefore there is no practical reason to delay exercise. Thus, the view was held that performance rights were options with the exercise being pre-agreed (via the offer or plan rules) but dependent upon vesting conditions being satisfied.

Clearly ASIC has taken a much narrower view which means that performance rights with automatic exercise will not be regarded by ASIC as securities which is a requirement for the exemptions in section 708 of the Corporations Act to apply.

The introduction of "incentive rights" as an eligible product, in respect of which relief can be sought under CO14/1000, will provide greater certainty for entities seeking to offer performance rights under employee incentive schemes. The definition of "incentive rights" in CO14/1000 does not allude to disqualification of a financial product from the definition of "incentive right" on the basis that it is automatically exercised.

IMPLICATIONS

Future Offers

5% Limit

Executive LTI plans that utilise shares, rights, options or derivatives will qualify for relief under CO14/1000. Thus, the definition of security will be less relevant in terms of whether an offer qualifies for relief under CO14/1000. However, the definition of security will remain relevant for determining whether an offer is exempted from certain disclosure requirements under s708 of the Corporations Act and therefore is not counted towards the 5% limit imposed under CO14/1000.

Paragraph 19 of CO14/1000 provides:

"5% issue limit

19. A listed body or an associated body corporate that makes an offer of an eligible product under an employee incentive scheme in reliance on this instrument must, at the time of making the offer, have reasonable grounds to believe that the number of underlying eligible products in a class of underlying eligible products that form part of the issued capital of the listed body that have been or may be issued in any of the circumstances covered by the following paragraphs will not exceed 5% of the total number of underlying eligible products in that class on issue:

(a) underlying eligible products that may be issued under the offer;
(b) underlying eligible products issued or that may be issued as a result of offers made at any time during the previous 3 year period under:

(i) an employee incentive scheme covered by this instrument; or
(ii) an ASIC exempt arrangement of a similar kind to an employee incentive scheme."
(underlining inserted)

This limitation can be restrictive when annual grants with 3 year measurement periods are involved as illustrated in the following diagram.

When calculating whether an offer can be made it will be necessary to take into account:

a) the 2 offers that were made in the prior 3 years assuming that the prior offer was made outside the 3 year rolling window, and
b) the proposed offer.

Of course, if an offer occurred during the 3 years but has since lapsed it would not be taken into account as shares would no longer be capable of being issued.

Thus, a limit of 5% will be maxed out with an annual average offer of 1.66% of issued shares. Given that offers are at the stretch level and typically 50% of grants vest at target performance it may result in actual issues of shares being restricted to a 3 year total of 2.5% or 0.833% on average per annum in relation to planning for target performance remuneration profiles, and allowing for stretch of around double the target (which would be typical).

The Class Order applies to all offers whether made under a long term incentive plan or as deferral of a short term incentive award.

If companies have reasonable grounds to form the view that some of the unvested grants made in the prior 3 years will not vest then those expected not to vest may be ignored when determining the size of the current offers. This may provide additional scope for current offers by companies where prior offers are unlikely to fully vest. In effect this may be seen as rewarding prior poor performance by allowing larger current offers. Alternatively, those companies facing high vesting of prior offers may be constrained in terms of the size of the current offers. Thus, executives in superior performing companies may be penalised compared to executives in poorer performing companies in terms of the size of offers that may be made to them.

It is important to note that the limit only applies to offers made in reliance upon CO14/1000 or ASIC relief on a similar basis. It does not include offers that are specifically covered by s708 of the Corporations Act as they do not rely on Class Orders.

S708 of Corporations Act

Section 708 provides exceptions to the requirement to provide certain disclosure documentation to investors when offers of securities are made in specified circumstances. Amongst others, the following are covered:

1. **Small scale offerings** – not more than 20 investors and not more that $2 million being raised in any 12 month period.
2. Offers to **sophisticated investors** including persons with:
    a. Net assets of a specified amount (currently $2.5 million), or
    b. Gross income for each of the prior 2 financial years of at least a specified amount (currently $250,000),

    as certified by a qualified accountant, within 6 months before the offer is made.

3. Offers to **senior managers** (and relatives) who are concerned with or take part in the management of the body (regardless of the person's designation and whether or not the person is a director or secretary of the body).
4. An offer where there is **no consideration** to be provided for the issue or transfer of the securities (options are treated separately but on a similar basis).

ASIC considers that the "no consideration" exception generally does not apply to employee incentive schemes. This is because ASIC takes the view that the "no consideration" exception generally does not apply if the offer of securities has any connection to the offeree's employment situation, as the offeree is providing services to the employer and this non-monetary consideration is referable to the offer. In this respect, paragraph 11 of Consultation Paper 218 states:

> "*In our view, the exemptions in s708(15), 708(16) or 1012D(5) on the issue or transfer of shares and options for no consideration would generally not apply to offers made under an employee incentive scheme. This is because non-monetary consideration is provided by the employee in an employment situation regardless of whether the employee's remuneration package is structured to specifically include a portion of the payment through participation in an employee incentive scheme*."

As bonus issues are covered by s708 (13) it is difficult to envision a situation when an offer of securities would be made for no consideration at all. One would have thought that this provision was clearly intended to cover offers to employees for no monetary consideration but ASIC is of a different view.

The following table summarises the key provisions of s708 mentioned above.

<table>
<tr><th>Exemptions for Offers of Securities (not derivatives)</th><th>General Employees</th><th>Supervisors, Managers and Professional Executives</th><th>Senior Executives Including Executive Directors</th><th>Non-executive Directors</th></tr>
<tr><td>Small Scale Offerings: total of ≤$2 million raised or ≤20 investors during a year.</td><td colspan="2">This exemption is unlikely to apply except perhaps for small companies.</td><td colspan="2">Could apply provided that total offers in the last 12 months includiing the current offer do not exceed the small scale offer limits.</td></tr>
<tr><td>Sophistocated Investors: If a qualified accountant within the prior 6 months certifies that the investor has assets of ≥$2.5 million or gross income of ≥$250,000 pa for the prior 2 finaincial years.</td><td colspan="2">Generally would not apply but there may be individual exceptions.</td><td colspan="2">May apply to some or all.</td></tr>
<tr><td>Senior manager: person who is concerned in, or takes part in, the management of the body (regardless of the person's designation and whether or not the person is a director or secretary of the body (see CO 04/899).</td><td colspan="2">Not applicable</td><td colspan="2">Applies</td></tr>
<tr><td>Issues or Sales for No consideration</td><td colspan="4">ASIC is of the view that this provison does not apply to emplyee situations as their work constitutes consderation.</td></tr>
</table>

Observations on Future

Modern executive LTI plans tend to use rights that would be regarded by ASIC as derivatives. This is because of the interaction of the termination benefit limit for executive and managerial officers and the taxation treatment of unvested LTI grants on termination of employment. Unvested derivatives are not taxed on termination of employment allowing vesting for "good leavers" to occur after a termination of employment such that the vesting does not constitute a termination benefit.

In relation to future offers, companies will need to be more conscious of the 5% limit particularly when offers to senior managers are not of "securities" as perceived by ASIC. If the limit is likely to significantly constrain

the size of offers then it may be necessary to develop supplementary LTI plans for key management personnel (KMP) that use securities as defined and fall within the exception provisions of s708. Offers under such plans will enable total offers to exceed the 5% limit provided that offers covered by CO14/1000 and similar ASIC exempted arrangements for employee incentive schemes remain within the 5% limit.

Of course, plans that use on-market purchases of shares will not be affected by the 5% limit.

Irrespective of whether securities or derivatives are offered and whether they are acquired by on-market purchase or new issue, companies will need to be mindful of the Corporations Act limit on termination benefits (one times final 3 years average annual base salary) that may be provided to managerial and executive officers without shareholder approval of a higher amount. They will also need to be mindful of the fact that unvested shares and rights to which tax deferral applies will be taxable on termination of employment as that is the maximum tax deferral period.

Past Offers

Many companies have sought and received specific relief for performance rights plans which did not fall within the now superseded CO03/184. Class Order CO14/1000 grants transitional relief under paragraphs 25 to 28 to enable those companies relying on the existing relief to continue to operate their existing employee share schemes with equivalent relief. Other companies have made offers in the belief that CO 03/184 or s708 exemptions applied. In the light of ASIC's observations in Consultation Paper 218 there may now be concerns that their prior belief may be open to dispute by ASIC. If retrospective specific relief were to be sought there may be additional complications if the 5% limit in CO03/184 has been inadvertently exceeded. Accordingly, those companies will need to take legal advice on what action, if any, should now be taken in relation to those earlier offers.

CLASS ORDER 14/1001 UNLISTED COMPANIES

A second Class Order, CO14/1001 has been released and applies to unlisted company employee incentive schemes. It is substantially similar to CO14/1000 except for the following main differences:

1. A maximum of $5,000 of securities applies to each participant, making it of little, if any relevance to senior executive LTI plans,
2. The 5% limit on total offers (securities issued or may be issued, as a result of offers made during the prior 3 years) is increased to 20%,
3. Various documentation including annual reports and director resolutions need to be provided to participants.
4. Certain specified statements need to be included as part of offers.