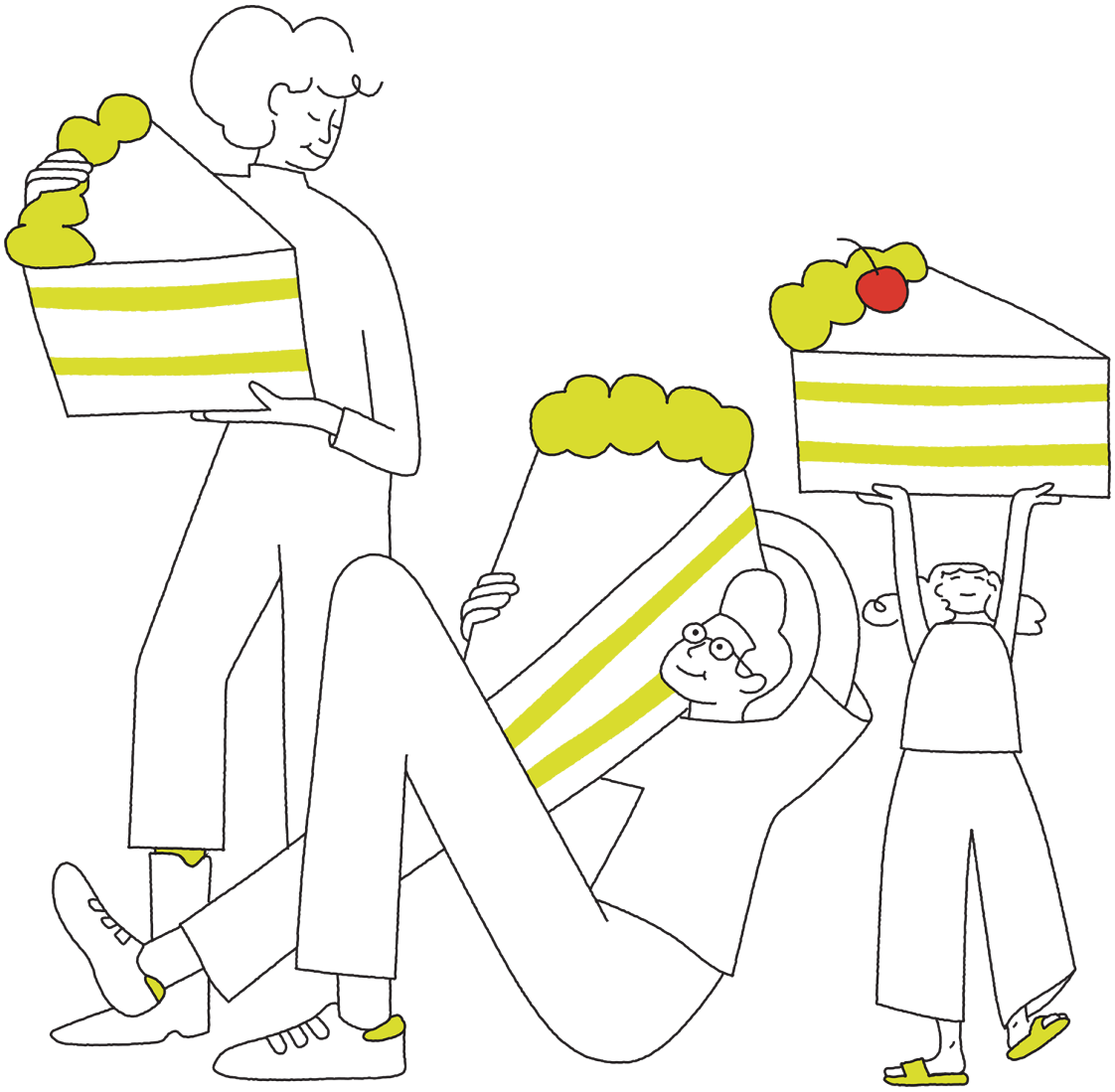


Employee Share Option Plans

A PRACTICAL GUIDE

Cake.

Contents

Employee Share Option Plans – A practical guide

An Employee Share Option Plan (**ESOP**) is one of the best ways for a company to incentivise employees, increase productivity, and foster a long-lasting team-focused culture.
Below we provide a comprehensive summary of how a Start-up Concession ESOP works, and how it can help a company succeed. Cake can set up your ESOP in minutes. Get in touch today.

**This Guide is designed and intended to provide general information in summary form on general topics, current at the time of publication, for general informational purposes only. The material may not apply to all jurisdictions. The contents do not constitute legal, financial or tax advice, are not intended to be a substitute for such advice and should not be relied upon as such. You should seek legal advice or other professional advice in relation to any particular matters you or your organisation may have. If you do have any queries, please get in touch and we can refer you to the best suited professional advisor.*

What is an ESOP?

An ESOP is a method of granting equity (or ownership) to an employee (or contractor), over a period of time.

An ESOP is a type of an Employee Share Scheme (**ESS**). However, the difference between an ESOP and an ESS is that in an ESOP, the employee initially receives options, instead of shares. We explain the advantages with this further below.

At a high level, an ESOP works as follows:

- the employee or contractor receives **options** (or rights),
- to be issued **shares**,
- as long as she/he complies with the **rules** of the ESOP (**Plan Rules**).

While there are multiple variations of Employee Share Schemes around, ESOPs are the most common form of employee incentivisation for small and start-up businesses. They are also becoming increasingly popular in the listed company space.

Early stage investors will often request that an ESOP is implemented prior to their investment, as they recognise their potential value for the company.

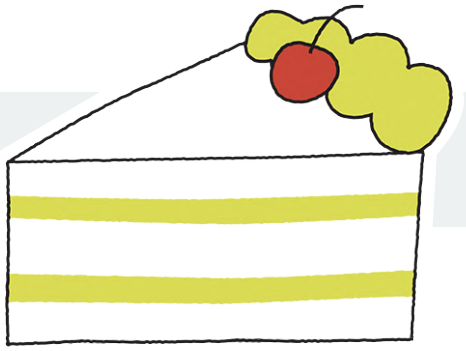
Where an ESOP is provided under the 'Start-Up Tax Concession', it can provide a tax efficient way for employees to be rewarded for their efforts, and can allow an employee to benefit significantly from any increase in the company's value over time. We discuss the Start-Up Tax Concession further below.

Where a company grows substantially or is acquired or listed, an ESOP can allow an employee to share in that financial success - this form of incentivisation has been proven to be more effective for the company as a whole than any other method.

How Cake can help

Cake has created a simple and efficient way to plan, create, and manage, your own ESOP.

The Cake software has been custom designed to take the headache out of managing offers, vesting rules, documentation, and everything else. Cake also has legal and accounting partners that can take you through the process, in a start-to-finish manner.
Get in touch to get started today.



Glossary of Terms

ESOP means employee share option scheme

ESS means employee share scheme

Exercise means the process of converting a vested option into an ordinary share. An option can be exercised when the option has vested, and the Exercise Price is paid.

Exercise Price means the amount to be paid by the employee to Exercise the option. This is determined through an ATO approved valuation method.

Exercise Period means the period in which an employee can exercise the options. Often, an employee won't exercise options straight after vesting, and will wait to exercise them later on.

Grant Date means the date the options are granted to the employee or contractor under the Offer.

Offer means an offer for options made to an employee or contractor, made through an ESOP offer letter.

Option Price means the price to be paid by the employee to be granted the Options. This is usually set at zero for Start-Up Concession ESOPs.

Plan Rules mean the rules that accompany each offer. The rules set out all the terms in relation to the ESOP, including the process for buy-back of leaver shares, and how the options are treated in the event of a listing or business sale.

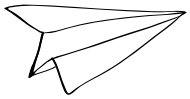
Start Date means the date the Vesting Period starts counting. This can be the start date of employment, or another date.

Start-Up Tax Concession means the start-up tax concession introduced by the ATO introduced by the ATO in 2015. We provide more information (including eligibility criteria) for the Start-Up Tax Concession below.

Vesting means the process through which the option holder earns their options, to allow them to be converted to shares. This can happen by way of meeting certain time-based vesting conditions, or other performance-based milestones. Only vested options can be exercised to become shares.

Vesting Period means the time from the Start Date, to the date the last options can vest under the vesting conditions.

What are the benefits of ESOP?

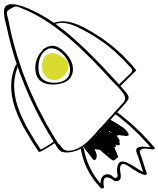


Retention: Most ESOPs are subject to vesting rules that encourage employees to stay with the Company. Studies show that Companies who use ESOPs have a significantly lower staff turnover, and in turn increased profits.

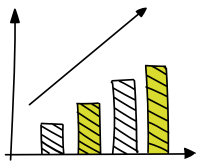
Talent Attraction: It goes without saying that start-ups may struggle to meet market salaries to attract top level talent. Through ESOPs, start-ups can top-up remuneration packages in options (tax free), and this will often be enough to get that high flying employee on board.

Salary Substitution: In tough times, a company is sometimes required to make the difficult decision to reduce staff salaries. To keep employee morale up (and keep the staff around), a company can use an ESOP to 'top-up' the pay cuts with proportionate equity.

Incentivisation and workplace culture: ESOPs provide a better form of incentivisation than individual bonus plans by allowing all employees to feel part of a team striving for the same goal. ESOPs can also encourage employees to work smarter, in order to ultimately increase the value of their own equity.



Ownership: An ESOP provides an employee with the opportunity to share in ownership of the company. Employees with an ownership stake in the company are inherently more motivated and passionate about the company's long term success. The ESOP will encourage all participants to think and act like founders.



Opportunity to share in increases in value: An ESOP allows an employee to obtain shares in the company at an earlier fixed price, and therefore she/he can benefit from the increases in value of the shares of the company over its lifetime.

Tax benefits: Start-up Concession ESOPs are eligible to receive substantial tax concessions, where the employee is not taxed on those options until they receive some form of direct financial benefit from them (for example, they sell them at a profit). This can be extremely beneficial in comparison to being rewarded in cash bonuses of the same value, which would be taxed as part of the taxable income.

Frequently Asked Questions

Below we set out the most frequently asked questions in relation to setting up an ESOP. Got more questions? Just ask!

How does an ESOP work?

Under an ESOP, the company creates an 'option pool' where it sets aside options that can be allocated to employees. The standard option pool size is often 10% of the fully diluted capital in the Company, but it can vary. The documents required to set up an ESOP include:

- The Plan Rules, and
- The Individual Offer Letters.

You may also need to get board and member approval - Cake can assist with this through the platform, including by facilitating the electronic sending and signing of resolutions.
Under an ESOP, an employee is granted options, which can be 'exercised' to become shares in the company. The options can only be 'exercised' when they 'vest'.

What is vesting and how does an option vest?

Under an ESOP, an employee is not able to 'exercise' the option, until that option 'vests'. This means that the option cannot be converted into a share, until the option has vested. Until the option is exercised, the option holder does not have any shareholder rights (voting rights etc).

The purpose of having 'vesting' conditions is so that the options are tied to some obligation of performance or retention. This is how ESOPs are able to incentivise employees to stay at the company longer, and work smarter towards the longer term goals of the company.
Vesting happens either by way of

- time-based vesting,
- milestone vesting, or
- a combination both:

A. Time-based Vesting
Time based vesting can either occur by way of a Cliff, Periodic Vesting, or both.

- Under a Cliff, a certain amount of options vest after an initial period has passed. For example, 25% of Tracey's options will vest 12 months following her Start Date (Cliff Date).
- Under Periodic vesting, the options vest gradually over a period of time (Vesting Period). For example, 50% of Tracey's options will vest quarterly, over 3 years of working for the company, starting from the Cliff Date.

What is vesting and how does an option vest?

A. Time-based Vesting (cont.)
The Vesting Period will usually start from the employees 'Start Date' of employment. However, it can also be set to start at whatever date the company likes. For example, a company will often create an ESOP where the Start Date for vesting is the same for all employees, regardless of when they started.

B. Milestone-based Vesting
Under Milestone based vesting, options will vest on the achievement of some defined milestone or performance hurdle. For example, the remaining 25% of Tracey's options will vest on her reaching $200k in sales for the company during 2020.

If the options don't vest (for example, because the Milestone is never achieved), they lapse. This means they can no longer be vested or exercised by that employee. They can then be recycled back into the option pool, where they can be allocated for other employees or other offers.

Under an ESOP, you can also structure the vesting rules so that certain options will vest immediately for a participant.

The Cake platform tracks the vesting, and is able to automatically update option registers as vesting events occur. It will also notify the Company and the employee.

The platform will automatically carry the option holders into the share registry when they exercise their options to become shareholders - no need to open up that spreadsheet!

Where are the Vesting Conditions located?

The vesting conditions for an ESOP offer will be set out in each individual Offer Letter, and if not, they will be in the Plan Rules. Both the Company and employee will be able to keep track of the vesting schedule in the Cake account, and the vesting conditions can be easily set through the Cake platform.

Grant
Options are provided to the Employee under the Employee Share Option Plan Rules. All Vesting conditions and rules are in the Plan Rules and the Offer Letter.

Vest
The Options Vest either by way of time-based vesting, or milestone vesting, or both. Once Vested, and until the Options are Exercised, they are still just Vested Options (not Shares).

Exercise
The Vested Options are Exercised to become Shares. This will involve the payment of the Exercise Price. After the Options are Exercised to become shares, they are afforded Share rights (voting, dividends, etc.)

Does an employee have to pay to exercise the options?

The Offer Letter will set out the Exercise Price which must be paid to exercise the options (to turn the option into a share).

The Exercise Price represents the market value of the shares; however, the amount can be calculated by varying approved methods, which can yield different valuations.

This means that in many cases, the employee will not necessarily have to pay any substantial amount to exercise their options, despite them potentially being worth more under a different form of valuation. For example, sometimes a company can set the Exercise Price at $0.01 per option, even where the company is doing very well.

The need to pay an Exercise Price often confuses ESOP recipients. For example, if an employee received $25k worth of options as a subsidy for a salary cut, it would not make sense for the employee to have to pay $25k cash to exercise those options.

To resolve the above, there are a couple of ways the ESOP can be structured to be as beneficial as possible to the employee. Either the Exercise Price could be calculated by an ATO approved method which yields a lower market value, or alternatively, the employee can hold off on exercising the options until there is value to do so (discussed below).

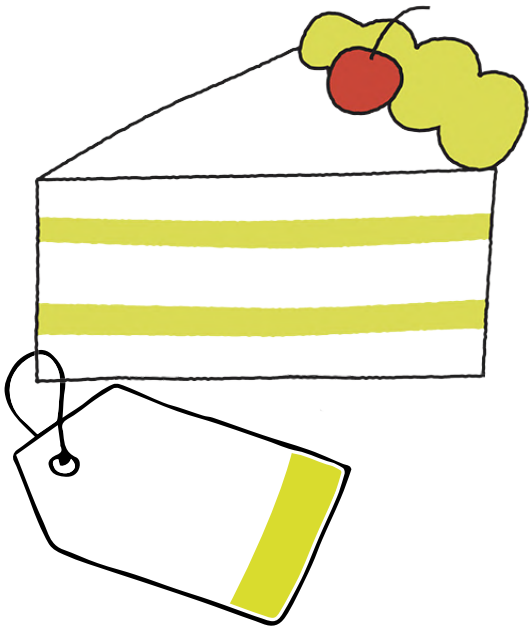
When the Exercise Price is high and the employee wants to hold off on exercising the options, they could keep the options as 'Vested Options', and not exercise them either until:

- an exit event is occurring (ie, a business sale or a listing), and they can be part of the sale or listing as a shareholder, or
- they leave the company and the employer wants to buy them back at the increased value.

How do I value my Company for an ESOP?

Cake has expert valuation partners that specialise in providing valuations under the safe-harbour valuation methods, for ESOPs. They will walk you through the process, and can turn around your ESOP valuation in days, or less!

Often, a company will initially value their company internally to determine how much equity they want to give to each participant, and then use the ESOP valuation to set the Exercise Price in compliance with the tax requirements.



What if the employee leaves the Company? What will happen to the options or shares?

The Plan Rules will contain general 'buy-back' provisions, which allow the company to buy shares back from employees in certain circumstances.

One of those circumstances is when the employee leaves the company. The Plan Rules will set out the price which the Company must pay to buy-back shares when the employee leaves. The price will be based on the circumstances in which the employee leaves - ie, whether they are a good leaver, or a bad leaver.

It will define what constitutes a good leaver and bad leaver, and the process to be followed, in order to prevent any disputes at a later stage.

Why would I do an ESOP instead of an ESS?

ESOPs are the most popular method of granting employee ownership for start-up companies. The main reason for this is that they require much less administration than an ESS.
Under an ESS, the employees are issued shares up-front, which are then subject to vesting. If the employee does not satisfy the vesting requirements, then the company is able to buy those shares back at a nominal value ($1).

However, if, for example, a company offers shares under an ESS to 15 employees, and only 5 of those employees satisfy all of the vesting requirements, then the company would be required to conduct share buy-backs for the 10 employees where the vesting criteria was not met. This can be a time consuming process, as it will require cap table updates, members resolutions, buy-back agreements, and ASIC updates.

Additionally, under an ESS, as shares are issued up-front, the cap table is required to be updated and the dilution of the company may not be as clear for investors (for example, working out which shareholders have shares subject to vesting criteria, and which shareholders own their shares outright).

Comparatively, under an ESOP, where an employee does not meet the vesting requirements, the options will simply lapse, and then can be recycled into the unallocated option pool to be used for further offers.

No ASIC update, share registry update, or members resolutions is required. The options are also displayed in a separate 'option register' until they are exercised, which provides a clear overview of the ownership structure of the company to investors and founders.
Cake is able to automate all of the vesting events for ESOPs, and therefore the company is able to have the peace of mind that everything is being kept up to date.

Can an option holder sell the options or shares?

Under most ESOPs, options and employee shares generally cannot be transferred for:

- 3 years from the date the option is issued; or
- the date the employee ceases working for the company, whichever is earlier.

This restriction on disposal is required to meet the Start-Up Tax Concession criteria. The Plan Rules will set out all the rules relating to selling options and shares, and will often allow a disposal to an affiliate, for example, a direct family member, or a family trust.

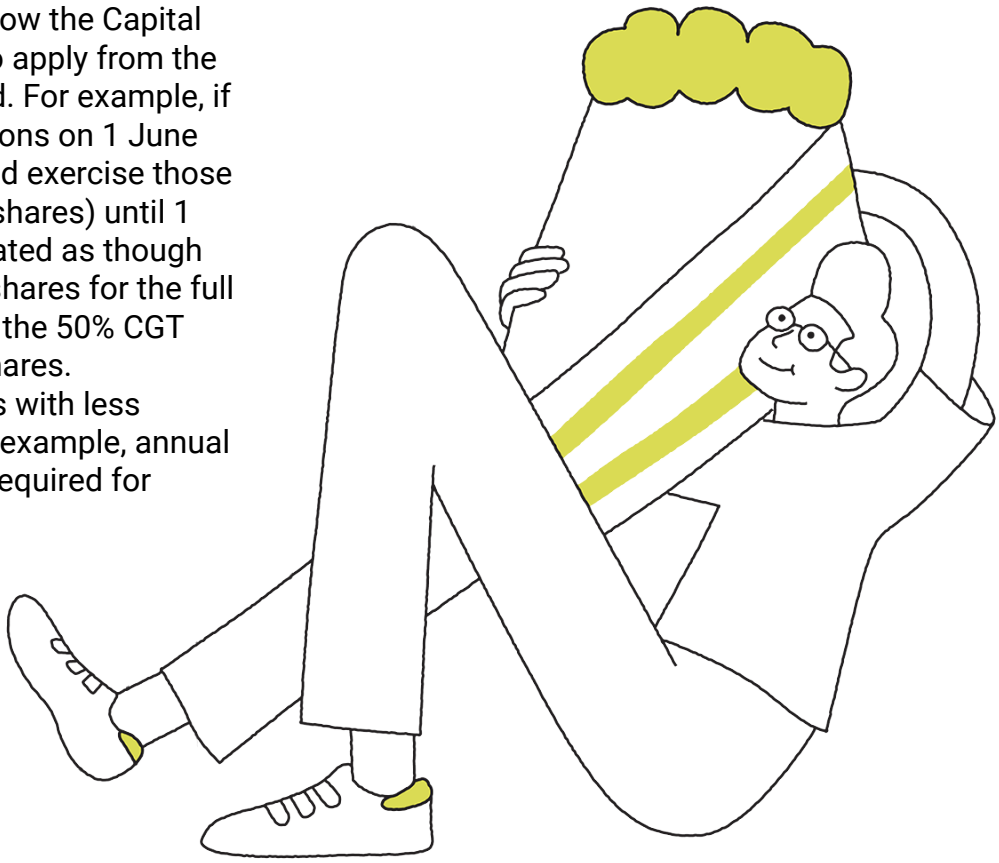
How is an ESOP taxed, and what is the Start-up Tax Concession?

If an ESOP offer is made under the 'Start-Up Tax Concession' (Concession), this indicates that the recipient will not be taxed up-front on the grant, vesting, or exercise of the options. In short, the Concession will make the offer for ownership in the company much more valuable for the recipients.

The ATO introduced the Concession in 2015. It was designed to make it easier for start-up companies to incentivse their employees with ownership in the Company.

The Concession will allow the employee or contractor to only be taxed on the options received when they get a direct financial benefit. This means they won't actually be taxed on the grant of the options. Instead, they will be taxed when they dispose of them. For example, when they dispose of them by way of an IPO or acquisition, or by selling them back to the Company.

The Concession will also allow the Capital Gains Tax (CGT) discount to apply from the time the options are granted. For example, if an employee is granted options on 1 June 2020, and they don't vest and exercise those options (convert them into shares) until 1 June 2021, it will still be treated as though the employee has held the shares for the full 12 months to be eligible for the 50% CGT when they dispose of the shares.
The Concession also comes with less administrative burden – for example, annual reporting to the ATO is not required for recipients.



To complete an ESOP under the Concession, your Company needs to meet the following basic criteria:

COMPANY MUST BE LESS THAN 10 YEARS OLD	The company (and any holding or subsidiary company) must be incorporated less than 10 years before the end of the year company's most recent income year before the participant acquired the options.
OWNERSHIP OF PARTICIPANT MUST NOT BE MORE THAN 10%	A participant cannot hold a beneficial interest in more than 10% of the shares in the company (including options), and cannot control the casting of more than 10% of the maximum number of votes at a general meeting.
OPTIONS FOR ORDINARY SHARES ONLY	The options granted to the participant must be in relation to ordinary shares only.
EXERCISE PRICE SET AT MARKET VALUE	The Exercise Price of the options myst be set at least the fair market value at the date of the grant of the options. This can be set through the Safe Harbour Methodologies approved by the ATO.
TURNOVER UNDER $50 MILLION	The company (and any connected entities) must have a turnover of no more than $50 million in the most recent income year before the employee acquired the options.
SHARES NOT LISTED ON STOCK EXCHANGE	The company's shares (and the shares of any holding or subsidiary company) cannot be listed.
AUSTRALIAN COMPANY	The employer company must be an Australian resident.
PREDOMINANT BUSINESS NOT IN INVESTMENTS	The predominant business of the company cannot be the acquisition, sale or holding of shares, securitites or other investments.
EMPLOYEE STATUS	The participant must be employed or engaged by the company at the time of acquiring the options.

Cake and its expert valuation partners can assist if it is not clear whether the Concession applies for you.

What if the concession does not apply?

Outside of the Concession, the employee would generally be taxed on the value of the options as if it is part of their annual income, in the income year of grant. This occurs despite the fact that there may not yet be any liquidity in those options or shares yet, and despite the fact that the options are subject to vesting. In other words, the employee can be hit with a new tax bill and nothing extra to cover it!

It is possible to set up share and option schemes that defer this taxation, however these kinds of schemes require more specific criteria to be satisfied. These schemes will also have stricter compliance and reporting requirements.

What happens if the Company is sold or listed?

The Plan Rules will specify what happens to the options if an Exit Event, like a takeover, occurs. Usually, the employee will be provided an opportunity to exercise any vested, but unexercised options, to become part of the sale or listing as a shareholder.

The Plan Rules will also set out what happens to Unvested Options in the occurrence of an Exit Event. All of this can be customised to suit the company intention.

Will the options and shares be diluted?

Just because an employee is offered options equal to '3% ownership' of the Company at the time the ESOP offer is made, it does not mean they will always own 3%.

Unless the ESOP includes anti-dilution rights (which is rare), the percentage ownership will be 'diluted' each time more shares in the Company are issued.

For example, if after making the offer, the Company does a Capital Raise and offers new shares for 20% ownership in the Company to an investor, the potential 3% ownership, has now become 2.4%, and so on.

However, this is not necessarily a bad thing. If the Company is getting more investments, it usually means the price per share is increasing. So the employee will now own a smaller part,of a bigger Cake.

Where can I view the holding and vesting progress?

Both the company and the employee will have the ability to view the vesting schedules. The company can manage the option pool, create new ESOP offers, and view the vesting schedule of the employees in a simple dashboard format.

Once the employee has accepted your offer, the company can send them an invitation for an account with Cake, where they can login and see their own option (or share) holding, and exercise their options once they have vested. Here, they can also see the vesting schedule, milestones, and ESOP related documents.

The employee will also receive instant notifications each time any of the options vest, and can keep their contact details up to date online.

Cake Can Help

Cake is on a mission to make equity easy.

Whether you're looking to raise capital, incentivise a team, manage equity transactions or just generally get rid of that constant 'founder headache', we are here to help.

Get started today at www.cakeequity.com

**This Guide is designed and intended to provide general information in summary form on general topics, current at the time of publication, for general informational purposes only. The material may not apply to all jurisdictions. The contents do not constitute legal, financial or tax advice, are not intended to be a substitute for such advice and should not be relied upon as such. You should seek legal advice or other professional advice in relation to any particular matters you or your organisation may have. If you do have any queries, please get in touch and we can refer you to the best suited professional advisor.*