Index Ventures response to the Consultation on the Dutch stock options plan

30 June 2021

Introduction:

Who we are:

Index Ventures is an international venture capital firm. We have invested in European technology companies since 1996 and were an early backer of companies such as Facebook, Skype and Robinhood. We pride ourselves on supporting the most ambitious entrepreneurs and helping them drive their vision and innovative ideas to fruition. Index-backed startups today include Netherlands-based Adyen and Otrium as well as international success stories such as Deliveroo, Farfetch, Dropbox and Wise (formerly TransferWise) to name a few. We support founders of startups from the earliest stages, investing at 'seed', and work with them (and invest) as they scale, all the way to IPO.

In 2018 we launched **Not Optional**, a campaign to help startups attract and retain the talent they need to grow by encouraging policymakers across Europe to adopt more flexible rules around stock options. Not Optional has since brought together more than 500 CEOs and founders of Europe's leading startup businesses, and has successfully engaged with several European governments, as well as with the European Commission to bring forth change at both the national and the European level.

We believe employee ownership is pivotal to the health and development of startup ecosystems, and to the emergence and growth of exciting and innovative companies. We have deep experience of employee ownership programs through our portfolio companies and Not Optional members, and have conducted extensive research into policy-approaches internationally. We published our **Rewarding Talent** handbook to help European founders understand the stock options and employee ownership schemes available to them in different jurisdictions, due to the high degree of variation in national rules.

Netherlands stands at a critical juncture:

Employee share ownership has been pivotal to the growth of the US tech industry and the formation of the Silicon Valley culture. A similar dynamic has played out in the UK and Israel, and is increasingly evident in Canada and Estonia. Other European countries have introduced substantial reforms in their national stock option regimes over the past years, most notably in the Baltics and France, which is both boosting their national startup ecosystems and expanding their respective talent pools – the latter being obviously critical, since talent is the lifeblood of startup innovation. Strengthening and expanding the tools at the disposal of nascent companies for hiring and retaining talent will be key to accelerating the recovery and growth of the Dutch economy in coming years, notably in the Netherlands' strategically important and maturing technology sector.

The current state of the Dutch stock options regime does not allow startups and scaleups to effectively attract talent. **Issues including the point of taxation and the high strike prices serve as disincentives for both employees as well as employers from utilising stock options.** Instead, many businesses use phantom shares as an alternative, yet failing in this way to provide 'real' ownership. This, in turn, curbs the competitiveness of the Netherlands vis-à-vis other European countries, such as France or Ireland, as a destination for international scale-ups setting up in Europe in the post-Brexit environment. Following Brexit, many global startups and scaleups are seeking to build up their presence in continental Europe, and the Netherlands has the chance to capitalise here. An effective revision of the stock options regime will be vital to incentivise many of these companies to choose Amsterdam over Paris or Dublin, as their base of operations in the EU and may allow Amsterdam to overtake London as the startup and scaleup hub of Europe.

Attracting talent from major US tech businesses:

The Netherlands has already been very successful over the past few years in attracting majors US tech companies to establish their EMEA hubs in the country (Netflix, Tesla, Uber and Sonos to name a few). This has been great for upskilling of both Dutch nationals, and non-Dutch talent that has relocated to join these companies. Most critically, as part of this upskilling, talent gets introduced to the concept of hyperscaling companies.

The UK has already proven how this talent can be used to accelerate its domestic startup ecosystem, with increasingly more former-Facebook, Google and Amazon employees becoming founders or key employees in UK startups. In the past six months alone, we have invested in 2 former-Facebook founders in the UK, and dozens of employees are hired out of them each month. Stock options are critical for this process, as they provide a way to pull out the most entrepreneurially minded talent to join earlier-stage startups. They are the best way to structure a compelling compensation package for them.

Ireland, home to a wide range of major US tech firms with EMEA hubs (Google, Facebook, Microsoft, Dropbox, Slack, etc), still has a relatively weak local startup ecosystem in comparison to the UK. The poor treatment of stock options in the country is a significant factor behind this differentiation. Ireland is gradually addressing the issue but has not gone far enough to effectively incentivise employees to make the leap and join local startups. The Netherlands should learn from the error of the Irish and push for more meaningful reform of its national stock options regime, rather than just a small victory such as moving taxation from exercise to tradability.

When stock options are taxed as income and are offered with no strike price discount, then employees feel better off working at a listed tech-company, where the equity they receive is liquid and low-risk. It is therefore extremely hard to turn this talent into an advantage for the Dutch domestic startup ecosystem as long as stock options are not appropriately structured to provide the necessary incentives.

<u>Our position:</u>

With an operational stock options regime, talent will be attracted into the Netherlands with much fewer incentives to leave, which in turn will attract Europe's startups and scaleups. Talent already in the country will also be incentivised to move from major tech firm jobs, to the startup environment. If the government fails to make serious improvements to its ecosystem though, the Dutch talent pool will be stunted as a result, and the Netherlands will lose this critical opportunity.

We see the review of Dutch stock options rules as a definite step in the right direction. Nevertheless, we believe the government can make further changes as part of this legislative initiative that will lead to a better startup ecosystem for both Dutch as well as international startups and scale ups in the Netherlands.

Suggested revisions:

In addition to the changes envisioned under the current proposal, we would argue for the inclusion of the below:

<u>Taxation upon sale:</u>

A shift from taxation upon exercise to taxation when acquired shares become tradable is a very positive development. It overcomes the issue of 'dry taxation', which was the case previously if shares were taxed but not tradable. Nevertheless, the government needs to push just a bit further to create a scheme comparable to phantom shares (currently taxed at point of sale). If employees are taxed upon tradability, they are still taxed on a financial benefit they have yet to receive. For employees that are holding shares, yet do not have available liquidity to pay tax at IPO, this measure would in essence force them to sell their shares or at least a portion of them. This is especially the case, given taxation is calculated based on the fair market value of the shares (meaning taxation is likely to also be significantly higher than it would be at point of exercise). Startups' ability to retain talent post-IPO is therefore heavily impaired. Employees deciding to sell their shares to pay their tax no longer have the same incentives to remain.

Strike price:

Netherlands currently has no assured valuation system for the strike price of employee stock options, which means most startups have to use the valuation from their last funding round to avoid additional expenses (including taxes). This in turn leads to high strike prices, which significantly hinders the startup ecosystem. Low strike prices widen the opportunity for 'leavers' to exercise their options upon departure, and to become shareholders. Conversely, high strike prices, as they persist currently in many European jurisdictions including the Netherlands, typically mean that only wealthy employees can afford to exercise the options that they are entitled to, which is plainly unfair.

Thanks to the enabling of exercise, leavers – now shareholders – continue to be ambassadors for the startup brand to customers and talent. They are much more likely to join another startup, confident that they may earn additional shares in a growing company. Ensuring this is critical to the talent environment and startup ecosystem in a broader sense as well. Separately, when startups are providing stock options to employees, these are usually non-preferred shares, with some being non-voting and no-information right shares. These shares should not be valued at the same cost as regular shares. The proposal should therefore establish an assured valuation methodology, with the US 409A method as its basis. The US model has been very successful since it was put in place, and has been widely used in Silicon Valley, the US as a whole, as well as across the globe (ie Canada and Israel).

Phantom shares:

Many Dutch companies choose to use phantom shares instead of stock options to compensate their employees. The tangible difference between the two as methods for recruitment is that the latter provides a sense of 'real' ownership to potential recruits. Nevertheless, phantom shares are currently much less costly with a significantly lower administrative burden. Most importantly, phantom shares are taxed at sale and the company can choose the strike price, therefore making the whole process cheaper and more effective for both parties involved. The lack of a tax-advantaged stock options regime and the benefits of phantom shares have therefore led to a significant portion of Dutch startups going the phantom shares route, as the following case study exemplifies:

Index Ventures case study: Phantom shares

Otrium is an Index-backed, Amsterdam-based, tech startup which acts as an online fashion outlet marketplace that turns unsold inventory into an opportunity by connecting this inventory with interested consumers.

Dutch experience: The startup has opted to use phantom shares instead of stock options. Given the latter has no tax advantages, nor any strike price benefit, Otrium has decided to go with the lower cost phantom shares route.

With a shift of taxation to point of sale, stock options might at least become comparable to phantom shares. Nevertheless, to go further still and make the majority of startups and scale ups use stock options instead of phantom shares, an assured valuation mechanism based off of the US 409A system must be established. With these changes, companies will be incentivised to use stock options, and talent will be attracted to businesses that offer options. This will be critical in attracting talent from across the bloc and making the Netherlands Europe's next tech hub.

Concluding remarks:

When we look at the UK's experience, their Enterprise Management Scheme (EMI) has been exceedingly beneficial in terms of helping startups attract and retain talent, and therefore strengthening the health of the UK startup ecosystem. This yields obvious rewards in terms of job creation in the most innovative sectors of the economy. We are working with the UK Treasury currently and our current estimates are that UK tech startups eligible for EMI (i.e. less than 250 employees) will create at least 25,000 jobs in 2021. This equates to roughly one FTSE-100 company being established each year, without even considering the considerable indirect job creation potential. Those which have 'graduated' to more than 250 employees are expected to create at least 50,000 more jobs.

The Netherlands therefore has an opportunity to augment the growth potential of the startup ecosystem, and to dramatically aid its post-COVID economic recovery as well as its valuable job creation prospects. If the Netherlands makes the above targeted refinements to its framework for stock options, we consider this could give a substantial boost to its startup ecosystem, thus yielding significant employment and growth dividends for the country as well.

The Netherlands currently ranks 16th out of 24 countries analysed in our Rewarding Talent research. Through an adjustment to the above-mentioned rules, the Netherlands can enhance its position as a magnet for world leading talent and investment, as well as a location for pioneering startup innovation.