AUSTRALIAN EMPLOYEE OWNERSHIP ASSOCIATION

The Secretary
Senate Economics References Committee
PO Box 6100
Parliament House
CANBERRA ACT 2600

17 July 2009

Dear Mr Hawkins

Re: Submission to Senate Economics Reference Committee ESS Inquiry

The Australian Employee Ownership Association (AEOA) was formed in 1986 and is the only non-profit membership based Association in Australia representing the interests of broad based Employee Ownership for both privately owned and publicly listed corporations. This Association has long been concerned about community unawareness of the significant benefits employee share and option schemes (ESOP's) can contribute to the modern capitalist economy and sincerely appreciates the opportunity to put our views to the Senate Economics References Committee. We trust that these views will not again fall on deaf ears.

This submission has attempted to show that capital formation by employees can provide an effective way to increase: - productivity, income, national savings, and employee participation in company operations and will detail:

1. *The nature and purpose of Employee Share Ownership Plans (ESOP's),*
2. *The nature of ESOP's in Australia,*
3. *The nature of ESOP's in the United States of America, and*
4. *How ESOP's contribute to workplace relations and productivity.*

1. The Nature and purpose of ESOP's

An ESOP is a financial structure designed to enable employees to buy a share of the business which employs them. The purchase by an ESOP of shares in the employer's company can be funded by loans (whether from the employer or from third party financiers), out of profit, performance bonuses, fixed wages and salary, or by some combination of all of these.

Uses:

- ***Capital objectives:*** *They can be used to transfer ownership of part or of the whole of a company to the employees and/or used by employees and employers to increase the existing capital of a company.*

- ***Workplace change objectives**: Shares delivered through an ESOP can also be used to 'change the culture' of a company. In this case share ownership is used as a means of breaking down perceived 'class barriers' in the work place, as a way of attempting to solve problems posed by the sometimes apparent mutual detachment of employers, managers, and owners from each others' interests,*
- ***Remuneration objectives**: ESOPs can be used as a remuneration and employee-incentive vehicle. In this case, shares in the employer's company are used as a performance-related supplement to existing salary and wages and as a means of enabling employees to share in the long term growth of a business.*

Each of the above three major purposes of employee ownership can co-exist though, at particular times and in particular cases, one of the major purposes will tend to dominate. All of them act to save jobs by ensuring that companies have the right combination of flexibility and robustness to survive in a crisis.

2. ESOP's in Australia

Extent of ESOPs in Australia

In Australia, employee ownership is still at an early developmental stage and the AEOA is concerned that many in Australia are not aware, that confusion arises because Corporations law is silent on how the shares and options can be distributed to employees.

It is clear from anecdotal feedback to AEOA committee members that many in the community mistakenly believe that Division 13A of the Australian Income Assessment Act, which requires that 75% of permanent employees have been at some time entitled to acquire shares issued in accordance with Division 13A, governs all Australian Employee Share plans.

Unfortunately it is not so. Many Australian companies that use the provisions of Division 13A also have additional, separate share plans just for senior executives. This results from the structure of Division 13A and the competing interests of remuneration policies designed to attract, promote and retain senior management.

This confusion, the AEOA believes, means that too many Australians have come to view Employee Share Plans as simply another vehicle to further executive largess.

Notwithstanding the need for the Senate Select Committee to distinguish the legislative differences governing many executive and broad based share plans, ASIC prospectus requirements are nonetheless problematic for both owners and employees, particularly in the SME sector. While shares issued to executives and employees of listed companies are covered by prospectuses required for the listing of company 'stock'; unlisted companies face significant prospectus hurdles when contemplating issuing shares to their owners and employees.

In our opinion, the need for unlisted companies to issue a prospectus in the current onerous form is the single greatest obstacle in the way of expanding employee ownership in the unlisted company sector of the Australian economy.

3. Extent and Nature of ESOPs in USA

Employee share ownership is a significant workplace phenomenon in the USA, Great Britain, France and Japan. Employee ownership is also a powerful force in Italy and Spain, though in these countries it manifests itself through the co-operative movement which, unlike the Anglo-Saxon world, has reached a high level of complexity, sophistication, and social integration. The seed of employee ownership has also been planted in Eastern Europe chiefly as a by-product of the privatisation of state-owned enterprises.

Given that employee share ownership in the USA is probably more advanced, widespread and deeply rooted than elsewhere, and given the fact that Australian ESOP practice has drawn upon American experience, it might be useful to look at the US situation for some pointers as to where Australia could be headed on employee ownership. [For an up to date comparison of employee share policies of the UK, the United States and Australia, readers of this submission should also read a recent report compiled by David Hetherington, from Per Capita and available at: http://www.percapita.org.au/01_cms/details.asp?ID=208]

Regretfully this report finds that, *'despite the wider economic benefits of employee share plans, ordinary Australian workers have little or no incentive to participate in them'.* By and large, this is due to misguided taxation treatment applying in Australia.

The Kelso ESOP

According to figures supplied by the US National Centre for Employee Ownership2 (NCEO), there was at the time, about 11,000 firms in the States with Kelso ESOPs and stock bonus plans covering over 7.7 million employees who own, as a result, an estimated $US400 billion worth of company stock.

Comparability between US and Australian figures, however, poses a problem. The American ESOP, strictly so termed, hardly exists at all in Australia. To American employees and employers an ESOP is a leveraged share purchase instrument which enables employees to substantially buy into - their employer over a period of, approximately, 3 to 5 years. It works in the same way as a corporate takeover. Alternatively, the ESOP can be used to finance expansion of a company's capital base.

US 401(k) Employee Ownership Plans

In the USA there are other kinds of employee share plans. One of the most important is the so-called 401(k) plan named after the section of 1974 Employee Retirement Income Security Act (ERISA) which gave the plan legal foundation.

Unlike the Kelso ESOP, the 401(k) is not leveraged. It is typically funded out of remuneration.

Employee profit shares, salary sacrifice, and matching employer contributions are used to purchase not merely shares in the employer's company but also shares in other listed companies.

The US Congress obliged 401(k) plans to invest partly in non-employer equities as a prudential measure. In establishing the 401(k) plan, Congress sought to develop an alternative to the Kelso ESOP so that workers could take a stake in their employer's company without having all their eggs in the one basket. This prudential management approach was drawn to the attention in evidence given before the Senate Tax and Economics Committee in 1994 when the FBT provisions of Division 13A were being reviewed and later rejected by the Senate. The government at that time felt that superannuation would be sufficient to provide savings for retirees. The passage of time would, with respect, suggest a review of this dismissive approach is warranted. Superannuation itself is not enough.

The 401(k) is important to a discussion of employee ownership in Australia for a number of reasons.

One is the way it is financed. In this regard the 401(k) is more akin to Australia's typically unleveraged ESOPs. A second reason is that the 401(k) has proved a very effective way of increasing worker ownership. On top of the $US 400 billion owned by employees through traditional Kelso ESOPs, an estimated $US 250 billion is owned by about 2 million employees through the agency of some 2000 401(k) plans. Furthermore, approximately 3,000 US companies, covering another 7 million employees, give 'stock options' to all their full-time employees. This is a more recent development and is currently the fastest growing employee ownership sector.

Taking Kelso ESOPs with 401(k)s and stock option arrangements together shows that employee share ownership has grown rapidly growing in the USA. Finally, a major difference between the USA and Australia is that here ESOPs are limited, for all practical purposes, to listed companies, while in the United States the overwhelming majority - according to the some estimates, 90 per cent - of ESOPs are in unlisted businesses.

4. ESOPs, Workplace Relations, and Productivity

When examining the legislative basis for ESOPs in Australia and assessing its adequacy, it is important to say something about the connection between employee ownership and company performance.

One rationale for implementing an ESOP is to change the 'workplace culture' from one where employees, allegedly, are 'alienated' from the interests of owners and investors and from the success of the company as a business enterprise. Employee share ownership has been proposed as an antidote to this problem on the grounds that substantial levels of employee ownership have the effect of identifying the interests of workers with those of other stakeholders. This raises the question of whether ESOP companies really are more productive than non-ESOP companies.

While the body of research into this question is not large, what work has been done confirms what commonsense would predict: that employees who have a significant direct equity stake in a business have a strong tendency to work and think like owners to the great advantage of the business which employs them.

Some key research projects into ESOPs and company productivity have made the following findings:

- *A comparative survey of US companies showed that those which introduced an ESOP improved their productivity by about 3.5 per cent per year compared with industry peers which did not have an ESOP. When the best performing ESOP companies were compared with the other ESOP companies, it was found that the most successful had high levels of employee participation expressed by a variety of formal and informal arrangements intended to encourage employees to exercise judgment and to assume additional responsibilities.*

- *A study of Japanese ESOP companies indicated that companies enjoyed a 4 to 5 per cent increase in productivity increase after implementing an ESOP, although the productivity effect took from 3 to 4 years to manifest.*

- *A study undertaken for Hewitt Associates and Professor Hamid Mehran, formerly of the North Western University's J.L. Kellogg Graduate School of Management and presently with the Federal Reserve Bank of New York, indicates that companies which introduced an ESOP experienced a Return on Assets 2.7 per cent higher than industry peers without an ESOP for each year of a four-year study. The ESOP companies also had a cumulative four-year Total Shareholder Return 6.9 per cent higher than the average returns of non-ESOP companies in the study.*

Concluding Remarks

Whilst the Federal Government is proposing to spend $600 Million to save Australian jobs, an AEOA proposal, based on capital creation made possible by Kelso style ESOP's is yet to raise Bureaucratic interest. A clear sign that few in the government sector really appreciate how Employee Share Schemes utilising Employee Share Trusts can save jobs by:

- *Securing capital investment,*
- *Improving employee productivity,*
- *Facilitating strategic change otherwise quite difficult, and*
- *Cost effectively remunerating Staff at all levels.*

Notwithstanding the urgent need to ensure that Employee ownership flourishes in Australia and the pressing need to simplify the prospectus problem, the AEOA trusts that the information above makes clear the advantages ESOPs can bring to a modern Australian economy if only Employee Share Schemes can be transformed into broad based medium term savings vehicles and not left to languish as special purpose remuneration schemes delivering predominately risk based remuneration.

AEOA Recommendations

To advance and diversify ESOP uptake in Australia in order to provide an effective increase in:- productivity, income, national savings and employee participation, the AEOA recommends that the Senate Reference Committee endorse:

(a) Simplification of ESOP prospectus requirements,

(b) Enacting a single piece of Employee Share Scheme legislation to bring under one Act all laws governing all employee share plans, their structure, taxation treatment, reporting and disclosure requirements.

(c) Establishing an Employee Share Plan Regulatory Agency consisting of all relevant interests, including but not limited to; the ATO, ASIC, APRA and Employer/Employee Representatives,

(d) Establishing an Employee Share Plan Promotional Unit within the proposed Employee Share Plan Regulatory Agency to develop and make available to employers and employees, *model* or off-the-shelf plans, and

(e) Permitting Employees and Employers to reach an agreement to trade wages and conditions (but not superannuation entitlements) for participation in an employee share plans.

On behalf of the AEOA I wish to thank the Senate Economics Reference Committee for the opportunity to make known our Association's views on the development of Employee Share Schemes in Australia and trust that the Committee will find the information contained in this submission helpful when formulating its report. If requested, this Association will gladly provide expert clarification and elaboration on the contents of this submission.

Yours faithfully

Ian Woods
AEOA President