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ASIC

Australian Securities & Investments Commission

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Dr. Brendan Nelson

Chairman
Employee Share Ownership Inquiry
House of Representatives Standing Committee
on Employment, Education and Workplace Relations
Suite R 1 116 Parliament House
CANBERRA ACT 2600

Dear Dr. Nelson,

INQUIRY INTO EMPLOYEE SHARE OWNERSHIP IN AUSTRALIAN ENTERPRISES

I refer to my attendance, along with my colleagues Mr. Richard Cockburn and Mr. Shane Tregillis, before your Inquiry on 13 July 1999.

I agreed that the Australian Securities and Investments Commission (ASIC) would provide you with further information on:

1. issues relevant to ASIC when considering the protection of employees in companies especially in proprietary companies;

2. the regulation of employee share schemes in comparable jurisdictions and specifically, any problems encountered by the regulators administering these regimes.

1. Employee protection issues

Informed decision making by investors

Australian corporate law requires informed decision making by investors, whether or not these investors are also employees. When people are asked or induced to purchase securities they should be provided with sufficient information to make an informed decision. This is in part because the decision is not without risk and that risk should be undertaken only in an informed way. Generally this is done by providing the investors with a prospectus.

However, there are two situations in which a prospectus may not be required:

1. if there is a specific exemption in the Corporations Law; or

2. if ASIC has granted an exemption for the particular activity.

Specific exemptions under the Corporations Law

No prospectus is required under the Corporations Law if the offer is of shares for no consideration (gift); is made to executive officers (senior managers) of a corporation; or is made personally to no more than 20 persons in a 12 month period.

Many offers to employees in small proprietary companies (ie unlisted) would fall within the exemption above for 20 personal offers in a 12 month period (a proprietary company may have a maximum of 50 non employee shareholders but there is no restriction on the number of employee shareholders).

The rationale for this type of exemption is that a small number of personal offers to individuals in a limited time frame outweighs the regulatory costs of full compliance with the Corporations Law. In essence this allows for small scale fundraising without the attracted costs.

In the case of shares being offered to employees in small businesses, this exemption could be used several times, provided the 12 months time limit had expired. In any case, most small businesses would not have more than 50 employees.

In addition, in the case of employee share schemes, the rationale for relying on this exemption would also include the assumption underlying employee share plans, namely, that they are designed to foster an on going relationship between the employee and employer based upon mutual interdependence and as such there may be a lower level of risk for the employee.

ASIC recognises that it may not always be the case that employees in small businesses are at a lower level of risk. In particular, the following risk factors may be present:

1. lack of liquidity because of a lack of a market therefore resulting in difficulties of pricing and on sale of the securities;

2. unequal bargaining position of the parties as a result of the employer/employee relationship, or where purchase of the securities is linked to employment;

3. “eggs in one basket” problem where an employee may be relying on an employer for recovery of wages, savings (being the investment in the shares) and superannuation.

ASIC believes that the Corporations Law as currently drafted seeks to provide an appropriate balance between the competing interests of employees and their employers, based fundamentally on size. Where the company wishes to offer securities to more than 20 people in 12 months, then it must comply with the provisions of the Corporations Law and bear the costs of preparing a prospectus.

CLERP proposals

The proposals under the Corporate Law Economic Reform Bill 1998 significantly liberalise the regulatory environment within which employee share schemes for small businesses would operate. The most relevant proposed reforms are:

1. relaxing the current exemption referred to above by enabling unlimited personal offers leading up to 20 issues in a 12 month period with a ceiling of $2million in funds raised; and

2. the introduction of the Offer Information Statement (as opposed to a prospectus) for raisings of up to $5million.

The Explanatory Memorandum to the Bill provides that these exemptions will "reduce the costs of small business when making small scale offerings and will free them from constraints in fundraising without exposing investors to unnecessary risks".

ASIC exemption for employee share schemes for listed companies

An exemption for a particular activity will be granted by ASIC where it considers that the regulatory detriment is minimal and is outweighed by the net regulatory benefit (therefore resulting in commercial

benefit). In determining this, ASIC will seek to protect consumers, whether they be employees or shareholders.

In the case of employee share schemes, specific factors that ASIC has relied on in providing relief from the prospectus requirements to listed companies (as outlined in ASIC's Policy Statement 49-previously provided to you) include:

1. as mentioned above, an assumption that employee share plans are designed to foster on going relationships between the employee and employer based upon mutual interdependence and as such there may be a lower level of risk for the employee;

2. reliance upon the existence of a market on an exchange (either domestic or overseas) as a means by which the current risk elements in the securities are priced objectively by an informed market. This enables employees to make a relatively easy assessment of the current worth of the offer;

3. that employees will receive adequate information about the terms and conditions of the plan from the documents they receive;

4. that ASIC class order relief does not extend to partly paid shares nor options for which a consideration other than a nominal one applies;

5. the ASIC class order limit of 5% of the capital of a company being used for employee share schemes was designed to restrict this relief to small scale employee shares scheme where the primary object was not to raise capital for the company. This limit also reduces the possibility of a major change in the control of the company's equity being effected through an employee share scheme.

ASIC's views

ASIC believes that the way in which the Corporations Law sets out frameworks under which capital may be raised including offering shares to employees, combined with a wide discretionary modification and exemption power vested in the regulator, enables it to remain responsive to changes in the market place. The current demarcation between “small” and “large” businesses is appropriate in terms of providing flexibility to smaller businesses and reducing regulatory costs.

Although ASIC will keep Policy Statement 49 under review, the question of whether further and more specific reforms are needed to facilitate small business employee share schemes seems best determined after there has been some experience with the operation of the proposed CLERP Bill reforms.

2. Employee share schemes in other jurisdictions

For ease of reference, I have included Attachment A which is a brief comparison of the regulation of employee share schemes in jurisdictions comparable to Australia (USA, UK and Canada (Ontario)).

In short, all of these jurisdictions give employee share schemes some type of relief from the prospectus provisions on similar policy grounds as outlined in ASIC's Policy Statement 49. In addition, these jurisdictions reflect similar trends in certain areas to those seen in Australia eg. the expansion of the term "employee" to include casual employees, consultants and others that provide services to the company (but not services in connection with capital raising activities).

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I hope that I have covered all of the issues raised by the Committee. However, if there are further matters you would like to discuss, please ring me on (02) 9911 2001.

Yours sincerely,

ALAN CAMERON, AM
CHAIRMAN

Attachment A - Brief comparative jurisdictional analysis of employee share schemes in the USA, UK and Canada

United States of America

In the USA there are exemptions for both "reporting companies" (ie listed companies and subject to the continuous disclosure regime) and non reporting ("private") companies.

For reporting companies, the Securities Exchange Commission (SEC) has simplified registration of employee benefit plans (on Form S-8). For non reporting companies it has provided an exemption from registration, subject to certain conditions (Rule 701 Exemption).

Exemption for employee benefit plans of non reporting companies and non investment companies-Rule 701 Exemption
In 1988 the SEC adopted Rule 701, which subject to certain conditions, exempts from Securities Act registration, securities issued under a written compensatory employee benefit plan or written contract by a non reporting company or a company which is not an investment company.

The SEC adopted this rule because they considered that it would be an unreasonable burden to require private companies, many of which are small businesses, to incur the expense and disclosure obligations of public companies when their only public securities sales were to employees. Further, these sales were for compensatory and incentive purposes, rather than capital raising.

The employee benefit plan includes any purchase, savings, options, bonus, stock appreciation, profit sharing, pension, incentive or similar plan. The plan or contract must be in writing and a copy given to the employee. There are no general disclosure requirements other than the general fraud provisions.

Rule 701 applies to employees, directors, general partners, trustees, officers, consultants or advisers. "Consultants and advisers" do not include those who render services in relation to capital raising activities or directly or indirectly promote or maintain a market for the issuer's securities

As of 7 April 1999, the SEC harmonised the above definition of "consultants and advisers" to apply to both non reporting and reporting companies (see Form S-8 below) because they found that reporting companies using the Form S-8 were abusing the previous more flexible definition. Misuse of the Form included registering shares to consultants and advisers who did not have sufficient connection and familiarity with the company; receiving securities for capital raising rather than compensatory purposes; and engaging in public distribution of the company's securities.

The Rule 701 exemption was previously subject to the limitation that the securities offered and sold under the exemption during the preceding 12 months had to be at least $500,000 but not exceed $5 million.

From 7 April 1999 the $5 million ceiling on aggregate offers and sales was removed and instead the maximum amount of securities that may be sold in a year is the greatest of $1 million; 15% of the company's total assets; or 15 % of the outstanding securities of that class.

The disclosure requirements under Rule 701 are that issuers need to provide to investors within a reasonable period of time prior to the sale: a copy of the plan or contract; a copy of the summary plan; information concerning risks; and financial statements at a date no more than 180 days prior to sale.

Employee benefit plans of reporting companies - Form S-8
Form S-8 provides a special and simplified registration for employee benefit plans offered by reporting (or public companies). The definition of employee is very broad and includes employees, directors and officers, consultants or advisers (as defined above). To be eligible to use Form S-8 the reporting company must have filed all reports during the previous 12 months.

The Form S-8 prospectus is unique in that, among other things, it is not filed with the SEC. The prospectus has extensive disclosures but can be based on documents prepared for other purposes and incorporated by reference.

Information relating to the plan that must be disclosed includes the employees eligibility to participate, the employers' contributions, forfeiture and penalties, fees and charges etc. The information relating to the plan is part of the prospectus but may take any written form the issuer considers appropriate and can be in one or more documents that together constitute the prospectus. In addition to the "prospectus" each employee must receive the employers annual report

The documents constituting the prospectus are not filed as part of the registration statement and the prospectus is not filed with the SEC. Rather the registrant must retain all such documents for 5 years and make them available to the SEC on request. Even though the prospectus is not filed as part of the registration process, the issuer still remains liable under the prospectus delivery requirements and remains civilly liable for failure to deliver a prospectus.

Canada (Ontario)

Rule 45-503-Trades to employees, executives and consultants
Rule 45-503 of the Ontario Securities Act which came into force on 22 December 1998, provides for exemption from the registration and prospectus requirements of the Securities Act for trades by issuers of their securities to employees. executives and consultants provided the participation of the employee (et al) in the trade is voluntary.

Participation of an employee in a trade is considered voluntary if the employee is not induced to purchase the security by expectation of the employee's employment or continued employment by the issuer or an affiliated entity of the issuer.

This "non-inducement" requirement for employees is not new. It was carried forward from the exemptions provided in the Securities Act for trades to employees.

Under the old section 72(1)(n), which was repealed by Rule 45-503, exemptions were provided for "trade made by an issuer in the securities of its own issue with its employees or the employees of an affiliate who are not induced to purchase by expectation of employment or continued employment".

However, this non-inducement was not a condition of the exemption in the predecessor blanket ruling/rule in respect of trades to non-employee directors.

Staff at the Ontario Securities Commission have advised ASIC that during the public comment process regarding draft versions of Rule 45-503, comment was received regarding this issue and the change made from the blanket ruling/rule which was designed to ensure consistency amongst employees, executives and consultants. The previous draft version of the Rule had imposed the "voluntary participation" as a condition to the use of the exemptions in respect of trades to employees, executives (whether employees or not) and consultants.

The public's comments did not agree with the position that the exemptions should only be available in the case where participation by an executive in a trade is voluntary. Rather, regulators should look favourably on mandatory plans as they do not involve an investment decision on the part of the participant, particularly where purchases are made automatically, and by directors and officers who are sophisticated investors and aware of the issuer's business.

After consideration of comments on this version of the Rule, staff recommended, and the Ontario Securities Commission determined that it was not inappropriate for issuers, if they so wish, to impose share ownership as a condition of being a director without losing the benefit of the exemption.

However, no change was made in relation to employee officers. This condition was imposed under the previous regime in the Act for employees, whether or not they were officers. Therefore the parts of the Rule covering the interpretation of voluntary participation in a trade does not contain a provision regarding directors, but officers are still subject to that requirement. The Ontario Securities Commission noted that different considerations apply in the case of employees as opposed to non-employee directors and it is not inappropriate to deny the exemption if an employee (whether an officer or not) is required to purchase shares as a condition of employment or continued employment.

United Kingdom

Under the Financial Services Act 1986 securities of a private company offered to employees of the company or members of the families of those employees are exempt from the registration requirements. The exemption extends to employees, former employees, spouses and children or step children under the age of 18 years. The exemption does not apply to the provision of advice in relation to such schemes.