Inquiry Into Employee Share Ownership In Australian Enterprises

Prepared for

House of Representatives
Standing Committee on Employment, Education and Workplace Relations

Prepared by

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Observations by John Egan

The Standing Committee has asked for my observations on the questions set out below. My responses are set out on the pages following. Please note that these comments are primarily in regard to executive share and option plans, as distinct from general employees' share plan participation.

The Committee's Questions

1. The Committee has received evidence about the use of shares and share options as a form of remuneration for executives.

- Do you think this practise is becoming more common in Australia?
- How effective are shares and share options as attraction and retention tools, for executive and non-executive employees?

2. Do you have any evidence that this form of remuneration has long-term benefits for the performance of companies and the interests of shareholders?

3. What do you think the future for this kind of remuneration will be in Australia?

4. Would removing the present cessation requirements and replacing them with a single requirement, that tax is payable on disposal of the shares or options, be compatible with the aims of employee share schemes.

5. The following is an excerpt from the *Business Review Weekly 8* Feb, 1999:

> Whenever Anderson meets staged short and long-term performance benchmarks, the trust will acquire BHP shares. However, Anderson could choose not to exercise his performance

rights for up to 10 years and thus defer tax on the accumulated value acquired by the trust during this period. Meanwhile, he receives all dividends.

If he had taken the conventional course of immediately taking the rights in his own name, he would have had no access to the dividends before the rights were exercised. He receives the double benefit of tax deferral and a large income. Anderson will pay nothing for either the rights or, provided the performance goals are met, the shares themselves.

BHP can claim tax deductions for the cost of providing shares and, under a clause in the FBT Act, employee shares and options held in trust are not subject to fringe benefits tax, provided the securities are in the employer's company. Anderson's "performance rights" are options by another name.

• Are you aware of this case?

• How wide spread are schemes such as this?

6. Is it usual practice to disclose the detail of executive share options plans to share holders?”

Responses

1. Increasing of share plans and their effectiveness in retention

It would be my observation that the use of share and share option programs is becoming more common in Australia. They are becoming increasingly common as they are perceived as a key ingredient in the motivation and retention of senior staff in particular. Recruiters would regard the existence of an executive share or share option plan as a very attractive vehicle to enable them to secure new talent for an organisation, and increasingly, many companies would regard such plans as a valuable tool in the motivation and reward of their senior staff.

There are a number of types of equity plans which are being embraced by Australian companies in both attracting and retaining their key staff. Not all these plans are subject to performance hurdles.

The share option plan or the more recently introduced performance share plans are generally subject to a performance hurdle. The traditional tax deferred loan-back share plan is rarely subject to a performance hurdle, though the benefit of the plan and value to participating employees would generally be a product of the dividend rate and share price growth, the former as it contributes to reducing the debt on the share and the latter as it has a direct impact on the future value of the share.

The share plan, which is generally loan-back, will have a life of up to ten years before the debt has been amortised through a dividend stream or employee salary sacrifice contribution.

The performance share and share option plan has traditionally had performance hurdles and exercise rights which commence after the plan has been running for three years. Some of the more recent e-commence enterprises and companies in the mining sector, often allow exercise after lesser periods, ie one or two years after grant. This may involve the granting of performance shares or options in a series of tranches with say 20% being exercisable in each of the first five years or 25% for the second, third, fourth and fifth years. Again, exercise is often subject to a performance condition.

There would be many organisations which have an option plan where senior salaried staff and middle management receive grants not subject to performance conditions, while senior executives (including the chief executive officer) would receive much more significant grants, though these would be subject to a performance condition.

With the increasing introduction of performance hurdles, a number of organisations' senior management have not received benefits that they may have anticipated under share option plans in particular. This has been because their company has not outperformed a particular index, a level of performance which has been adopted by shareholders as a condition precedent before benefits are payable to staff.

Performance conditions generally relate to the company's requirement to meet either absolute or relative performance hurdles, having regard to:

the company's total shareholder return,

the company's share price growth,

the company's earnings per share, or

the company's return on shareholders' equity.

There are other performance considerations embraced by companies, though they are not common. Some organisations, which do not have a post-grant performance hurdle, have a requirement for specific performance attainments to be realised before grants are made. These would generally relate to the achievement of profit growth, earnings or revenue growth objectives approved by the board, addressing the previous financial year's results.

Given this collage of circumstances, it would be my observation that performance share and share option plans, as a tool for attraction and retention of executives, would be regarded very favourably. It would be my judgement that they are only effective in successful organisations where performance hurdles had been met and in particular where share price growth has equalled or exceeded the ASX All Ordinaries.

The degree to which traditional employee share plans as distinct from option plans are attractive, would again be influenced by the company's prosperity, particularly their dividend policy or the extent to which the company has introduced a tax-exempt share plan and made regular grants of shares to both executive and non-executive employees in recent years. While such plans do not establish significant wealth, they do create a real and tangible benefit under the plan, while being subject to a three-year retention requirement. They are clearly providing employees with value which is well regarded as plans are at no cost to the employee and establish some alignment with improved prosperity by employers.

One of the reasons, in my judgement, that executive share plans and share option plans have become particularly popular in the last five to ten years, is that they provide a real and tangible substitution for the Government's short-sightedness in relation to the establishment of RBLs in superannuation. They have indeed become a substitute for retirement benefits available for the more senior executives who are increasingly retiring at less than 60 years of age.

2. Effect on company performance

Our firm has not collected evidence in a formal sense of any alignment of the benefits arising from executive or employee participation in share plans and the prosperity of shareholders. We are however, highly supportive of the introduction of performance hurdles, particularly for executive participation in share plans. We believe that long-term incentives should be aligned with shareholder well-being and not seen as a right or entitlement of executives or employees. On the other hand, it would equally be our judgement, where a management team supported ably by their employees delivers significantly to shareholders, that it is entirely appropriate that they share in that prosperity, irrespective of the level of wealth generated through such participation.

It would be our general observation that executives in Australia have a level of participation which is significantly less than in many major corporations in North America, though their level of participation is aligned broadly to practices in Europe, including the United Kingdom.

There is clearly a new paradigm emerging in the e-commerce, internet and media sector, where we believe that there will be a much higher level of executive participation in enhanced shareholder value than would traditionally be the case in industrial and resource companies.

3. The future role for share and option plans

In relation to the future role that share or share option or performance share plans may play in remuneration in Australia, it would be our view that their role will increase in relative importance for executives, though I doubt that the level of participation of the average employee will significantly increase.

My view in this context, would be that employee participation in the majority of organisations would be capped at 2% to 3% of the market capitalisation of the company and extend to 5% in more progressive organisations. It would however, be my view that the traditional capping of executive participation at around 1.5% to 2.5% will be substantially extended and that the top team in many large companies, over the next generation of managers, will more than double their current participation rights. This will follow as policy in regard to remuneration for Australian executives becomes more closely aligned to international practice.

I believe that personal capital (an individual's expertise and the mobility of such expertise) will deliver more handsome rewards. This will clearly lead to a separation between the wealth of management and the average employee, particularly in those organisations which are involved in international commerce.

It would be my judgement that those businesses relying almost entirely upon the domestic market will not prosper as extensively as those who seek talent and are required to retain talent which is attractive to international markets.

My judgement would be that the prosperous industries will be selected companies in the service industry sector, business services, financial services, technology, media and resources, particularly the energy sector of the latter.

I do not believe that the proportion of remuneration or ultimate reward derived by an employee over their life with an employer will dramatically change from its present proportion. One thing however, which demographers are revealing is that the next generation of our workforce is unlikely to have the characteristics of previous workforces, in that it is highly probable that employees will work for six to ten employers over their career, rather than establish a school-to-retirement employment model.

I believe it is also relevant to comment that in my judgement only a small (though well publicised) proportion of the workforce are employed in entities which offer their employees equity in the company; as the majority of the workforce are not employed by listed companies, but rather private companies, international subsidiaries or the government sector. As a consequence, it would be my view that less that one in five employees will benefit from equity-based remuneration over the next two generations.

This is not to imply that performance based reward will not be highly significant across the entire private sector. If, as some would foreshadow, the government sector disengages itself from conducting business and only fulfils social service and relevant government policy work, post 2020, then performance pay in these entities becomes a unique challenge and may be best reflected through enhanced superannuation without the imposition of RBLs in order to reward attributes which the government sector may value more highly than other sectors.

4. Taxation of share plan benefits

Present proposals

It would be my judgement that taxation in respect of share and option plans should only be payable at the time the employee disposes of the equity. It would further be my judgement that programs should be supported which encourage executives to exercise their rights under option plans, while holding those shares for an extended period of time, not being required to sell approximately half the shares in order to meet the tax obligation associated with the capital appreciation from the date of grant to the date of exercise, where it is in both the employers' interest and the employees' interest to retain those shares.

There needs to be some clarity in relation to the Ralph reforms and their impact on the treatment of benefits arising under participation in employee share plans, as either income or a capital gain. There is clearly a significant difference between the taxation payable under either alternative.

It would be my judgement that to further appeal to shareholders, many companies will require executives in Australia to retain mandatory holdings of shares in the employer while they remain employed. This is quite common internationally, less common in Australia. This ensures that employees have '*skin in the game*' rather than simply consider their participation in employee share or option plans as remuneration thus losing the desired alignment of interest with shareholders.

Any mechanism which facilitates employees' holding equity once certain restrictions or pre-conditions have been met, in my judgement, is beneficial for their employer. There is however, a disjunction where organisations openly communicate to employees that their participation in employee option plans is deferred remuneration. As a consequence employees simply see their exercising of equity entitlements as a remuneration transaction, as such taxing of such transactions could and might legitimately be considered to be appropriate at the individual's maximum marginal rate of tax.

In the case of employees' holding shares for say, a minimum period of ten years, living with the volatility of the share market and enduring risk associated with that investment, a capital gains tax may be more appropriate and more reflective of that equity-aligned commitment to an appropriate return on their personal capital, that is the expertise that they bring to the company.

Thoughts for the future taxation of benefits from plans

While it is not possible to say whether the growth in the application of equity plans would have occurred independently of other policy initiatives of government over the last generation, there are clearly influencing factors, in my judgement in the utilisation of equity plans for management staff in particular.

With the government capping the opportunity for individual saving in order to optimise superannuation benefits as had existed under defined benefit schemes for the previous two generations and introducing RBLs, it may well be that listed public companies and others using similar vehicles would not have so aggressively pursued equity plan participation as a supplement for the loss of wealth creation and that '*nest egg*' for many employees at the time. Within the confines of these policy initiatives certain taxation concessions have been granted to both superannuation and certain forms of employee share plans.

While equity participation by senior executives is clearly being pursued in the construct of a '*nest egg*', the proportion would vary from circumstance to circumstance and company to company. Though all boards and senior executives would be mindful of their inability to replace their forefathers' retirement benefits because of government legislation, as a result, it would be my judgement that a proportion of the growth in base compensation and the increased leverage in equity plan participation is clearly a product of these initiatives. It is further, in my judgement, a product of an anti tall poppy policy, believing that tall poppies can indeed fend for themselves.

Whether this is true or not true, it would be my judgement that, for the elite of Australia's talent, domestic reward policies will need, in part, to mirror international trends. International trends are already recognising that certain individuals and certain industry sectors have a capacity to add value, for investors and governments, through their payment of taxes and other charges and fees and as a consequence will always command attention.

While government policy endeavours to address the middle 70% of the population fairly, while concurrently forming the view that they will have to support the less able, lower 15%, they equally assume that the top 15% will look after themselves. While again, there may be some truth in this observation, governments and government policy need to recognise that the prosperity of an economy is largely dependent upon the top 15%, who provide scientific, technical, commercial and administrative leadership, supply capital, take the risks, provide employment and stimulate economic welfare.

While they are clearly dependent upon the middle 70% to offer effective commitment as employees, government policy in relation to the taxation of remuneration, the taxation of share plans, the promotion of such participation remains paramount. For the bulk of the 70% it would be my judgement that they do not participate in employee sponsored share plans, though some encouragement might be offered in the unlisted private sector for productivity and performance based awards which are not equity based, though separate from AWAs or enterprise agreements. These awards could attract favourable tax treatment and further attract favourable tax treatment if those earnings were invested and held for a period of time in Australian enterprises.

It would be my judgement that legislators with appropriate advice should do more for the middle 70% and their employers to encourage performance aligned payments, to encourage investment in the sustainability of the Australian economy, particularly in those sectors where we appear to have competitive advantage. There should be tax incentives which encourage the retention of capital for further investment without placing many small businesses and indeed larger businesses entirely at the mercy of major financial institutions for the purpose of reinvestment.

From a cynical perspective, it is obvious that any political party will retain power if they develop policies which appeal to 70% of the middle 70%. Unfortunately, this is political reality, but policies so developed may not adequately be supportive of the disadvantaged and rarely encourage the entrepreneurs and the more talented and hard working members of the community.

There may be some benefit in separating the impact of employee equity participation between the sustainable committed long-term employer/employee-investor, whom it may be appropriate to treat more generously than those using equity vehicles as a remuneration transaction or supplemental form of income. The former's shareholdings may also be considered in the same light as superannuation, if it is providing for the future. The latter may be deemed to be more income than anything else, though the punitive levels of tax on income over $75,000, under the new tax regime, are not globally competitive in relation to the retention of the nation's top talent. If my assumptions are correct, the top talent will seek appropriate compensation for that talent and level of commitment to an enterprise.

I suggest that any decisions on share and options plans must be made in regard to the whole context, putting together the commercial, social, motivational and taxation implications. To review only some of these issues in isolation from others may not prove fair or effective.

5. Mr Paul Anderson and his arrangement with BHP

In the case of Paul Anderson, I am thoroughly aware of the way in which he receives rewards during his employment with BHP. I had an intimate involvement in the design of the package to extract him from Duke Energy in the United States. In the U.S., executives receive a substantial proportion of their reward via equity programs, be they restricted shares, share options or share appreciation rights.

Senior executives have a strong belief that they are offering substantial capital (expertise) to an organisation and in return wish to have their reward substantially aligned with the prosperity that they deliver to shareholders as a result of the application of that expertise and knowledge.

The methodology underlying the Anderson remuneration package, is not widespread – it should be. Australian executives have typically wanted minimal risk in their remuneration, though notwithstanding this circumstance, they have also sought participation in equity plans which require no commitment of their capital. In Paul Anderson's case, he is committing more than half his foreshadowed remuneration benefit to the ownership of shares in BHP.

6. Disclosure of share plans

It is now a requirement for listed companies to disclose the details of senior executives' share option holdings to the shareholders and the conditions under which those options have been issued. Disclosures under this new regime, which has really only been operating for one financial year, are less than perfect and it is clearly incumbent upon the legislators, the stock exchange and the accounting standards body to ensure that a comprehensive disclosure regime is established, that such a regime fully informs shareholders and that shareholders continue to have rights to review those share and share option plans on a three yearly basis. In that context, the establishment of a legislative sunset for plans is highly appropriate.

Having addressed the Australian Shareholders Association and many other bodies, it is obvious to me that many shareholders do not understand the performance considerations that apply to the granting of options or indeed the granting of shares to employees; nor in many instances do they realise the benefits, be they significant or modest, that flow to employees through such participation. There is clearly, in my judgement, a need for continuous education on these aspects. In this context, there is a significant challenge for unlisted entities and private companies to ensure that there is a fairer distribution of wealth created to all employees who have contributed to that circumstance.

Notwithstanding any of the above comments, it would be my judgement that the market will continue to dictate the nature of employee share plans, the level of participation and the benefits accruing to executives or employees alike. It is not possible to legislate executive remuneration or employee remuneration, nor is it appropriate.