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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON EMPLOYMENT, EDUCATION AND WORKPLACE RELATIONS

Reference: Employee share ownership in Australian enterprises

THURSDAY, 3 JUNE 1999

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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON EMPLOYMENT, EDUCATION AND WORKPLACE RELATIONS

Thursday, 3 June 1999

Members: Dr Nelson *(Chair)*, Mr Barresi, Mr Bartlett, Dr Emerson, Ms Gambaro, Mrs Gash, Ms Gillard, Mr Katter, Mr Sawford and Mr Wilkie

Members in attendance: Mr Barresi, Mr Bartlett, Ms Gambaro, Mrs Gash, Mr Katter, Dr Nelson and Mr Sawford

Terms of reference for the inquiry:

The extent to which employee share ownership schemes have been established in Australian enterprises and the resultant effects on:

(a) workplace relations and productivity in enterprises; and

(b) the economy.

WITNESSES

HUNT, Mrs Lisa Siomnetta, President, Australian Employee Ownership Association

SCARRABELOTTI, Mr Gary Francis, Executive Consultant, Australian Employee Ownership Association

Committee met at 9.04 a.m.

CHAIR—We might start the meeting. The first part of the meeting is a public hearing in relation to the employee share ownership plan. Perhaps what we might do is continue until 9.45 a.m. on that and then we will do the rest of the business of the meeting. I would firstly like to welcome you this morning. I declare open this first public hearing of the inquiry into employee share ownership plans and welcome witnesses and others who are in attendance. We will be taking evidence today from the Australian Employee Ownership Association. The purpose of this inquiry is to identify the extent to which employee share ownership schemes have been established in Australian enterprises and to assess the impacts of those plans on workplace relations and productivity in enterprises and on the economy.

I now call the officers of the Australian Employee Ownership Association to give evidence.

HUNT, Mrs Lisa Siomnetta, President, Australian Employee Ownership Association

SCARRABELOTTI, Mr Gary Francis, Executive Consultant, Australian Employee Ownership Association

CHAIR—I remind you that the proceedings here today are legal proceedings of the parliament and warrant the same respect as proceedings in the House. The deliberate misleading of the committee may be regarded as a contempt of the parliament. The committee prefers that all evidence be given in public but should you at any stage wish to give evidence in private you may ask to do so and the committee will give consideration to your request. If you could explain what your organisation is about and perhaps give us a 10 minute overview of your submission and then we will discuss it in a question and answer format.

Mrs Hunt—By way of introduction, the Australian Employee Ownership Association, or AEOA, was formed in 1986 to promote the benefits of employee share ownership. We are conscious of the great need for increased consumer credit capital formation in the Australian economy. By way of 'formation' we mean that we believe it provides employees with an effective way to increase productivity, income, national savings and employee participation in company operations. It also encourages the individuals who have the greatest knowledge, experience and commitment to the business to work together with management. I would like to add that this does apply to companies regardless of their size.

In our submission we have commented in five key areas. The first one was the nature and purpose of employee share ownership plans, and this is a background. We actually outline three major purposes here: the ownership objectives, remuneration objectives, and, of course, workplace changes objectives. The workplace change is usually in conjunction with other measures, so employee share plans are introduced in conjunction with other changes going on at the same time. In Australia we are primarily seeing the remuneration and the workplace change objectives as being the underlying purpose of why employee share plans are actually implemented. They are occurring both in Australia and abroad.

We are actually undertaking a study called Study 2000 and that will be finished in approximately 12 months time. That is being undertaken by the AEOA. What we are looking at is research on the extent, nature and perceived value of employee share plans to companies in Australia. However, at this point in time the best evidence we have is from the top 350 listed companies where we see that 74 per cent actually have some kind of employee share ownership plan. Unfortunately, there is no evidence available for the trend in unlisted companies so we only have the top 350 Australian companies to run from. Details as to the experience in the United States of America are outlined in our submission and we can provide additional commentary on those as required at this hearing.

I would also like to recommend to you a report prepared by Hewitt Associates entitled, Unleashing the Power of Employee Ownership. It is quite a good quality report and in it they refer to an emerging phenomenon that they call 'ownership dynamic'. Their report is actually the first in a series which shares information about companies that are creating the ownership culture. We do have copies of that report with us today if anybody has not seen that.

Our third point was in regard to the contribution to workplace relations and productivity. On this point I would like to say that unfortunately because our economic system is so complex the effect of employee ownership on a company cannot be readily isolated. Usually it is a result of a change to workplace culture and what we see is that qualitative measures can actually directly impact on the quantitative so that as one example you see changes in employee attitudes actually affecting the profit of companies. In our submission, Attachment C was actually an employee ownership index which tracked the performance of some 250 stocks in the United States who had 10 per cent or more broad-based employee ownership. I would refer back to the attachment on that point. Also, there are examples in the Hewitt research report that I referred to previously.

Fourthly, we have the assessment of federal legislative provisions for ESOPs. The association's view is that Division 13A does provide a sound and secure basis for the implementation of ESOPs in listed companies but is less effective for unlisted companies. A recurrent problem faced by those who wish to implement and operate ESOPs is the lack of strategic vision by successive federal governments and major political parties on employee share ownership. For example, in regard to the proposed legislative changes and recent decisions, the AEOA recommended that ESOP trusts be exempted from the Ralph Committee proposal to tax trusts as if they were companies. We now understand that it is in the pipeline to consider that recommendation.

Our last point was regarding the future directions for the expansion of employee ownership in Australia. Our position is very well outlined in our policy document: Future Directions in Australian Employee Ownership. The chief reforms and recommendations in connection with the existing legislation, as stated in our submission and our policy document, are: in the case of small companies raising the present limit on individual employees holding through an ESOP more than five per cent of the voting shares; lifting the prohibition against ESOPs using equities other than ordinary shares and to allow for the use of other equity types useful to small business; enabling employees who benefit from a tax deferred ESOP to defer the tax liability on shares acquired until whenever they dispose of their shares; and lifting prospectus requirements imposed by Corporations Law in those cases

where adequate downside risk protection on the value of shares is provided. This we feel is possibly the greatest single obstacle for the implementation of ESOPs for unlisted companies.

The final recommendation in our submission was that to assist to raise the profile of ESOPs at the government level and to assist government in pre-empting the development of legislative and administrative road blocks to the smooth development of employee ownership we recommended the establishment of a standing consultative committee representing the federal government, the AEOA and ESOP companies and consultants so that they can advise government on the design and implementation of suitable measures to promote the growth of employee ownership.

To conclude, employee share ownership provides employees with legal title to part of the business which employs them. This in turn gives employees a clearly definable stake in their company's success. ESOPs provide employees with a method of personal, productivity-linked wealth creation and savings. More importantly, employee ownership is all about enabling people who historically have stood outside the limited membership circle of capital owners to become joint owners of the nation's business enterprises.

CHAIR—Thank you very much, Mrs Hunt. Does Mr Scarrabelotti wish to add anything?

Mr Scarrabelotti—No, I think that is a very good summary. We will just respond as you see fit from here on in.

CHAIR—Each of us will ask you some questions. I will start. Perhaps the first thing I should point out as an overview is that we have different levels of knowledge of all this, so could you give us a rundown on the sort of employee share ownership plans that run in Australia. Are there companies for which it is not suitable and, if so, why?

Mr Scarrabelotti—In very broad terms the different sorts of share plans are, typically, option plans, which is a right to a share; loan plans, where a loan is made by the company to an individual employee to purchase shares in the company and then the dividends from the shares acquired pay off the loan; then there are subscription share plans under Division 13A, which are neither option plans nor loan plans—they are ordinary share plans, funded out of remuneration. They tend to be directed more towards general employees whereas loan plans and option plans tend to be directed more towards executives, though that is not exclusively the case.

If you look at US experience, option plans are being used very widely there now as a way of remunerating employees. There are some companies in Australia which use option plans for all employees, but typically loan plans and option plans usually mean executive and Division 13A subscription plans normally mean the bulk of employees. In crude terms, they are the basic sorts of share plans. There are others that I have not mentioned, such as partly-paid share plans, but the general ones are loan, option and Division 13A subscription.

CHAIR—What sort of companies would employee share ownership plans not be suitable for?

Mr Scarrabelotti—Perhaps if I could start off by not answering the question and say that they are clearly most suitable for listed companies. The primary reasons for that are, firstly, a listed company has a market for the share, namely the stock market, and, secondly, it already has a prospectus covering the issue of equities to employees. So it is very easy for a listed company to implement a share plan. You can use employee share plans as they are constructed, particularly under Division 13A, in unlisted and private companies. However, there are a range of impediments imposed both by Division 13A and by Corporations Law which make it difficult to implement a share plan—and sometimes insuperably so, particularly on the expense side of implementing a prospectus—so that many unlisted companies who start off with a vigorous interest in employee share ownership soon begin to draw the conclusion that it is not for them.

I could go into that in greater detail if you so wish, but essentially it is the unlisted company market that finds it most difficult and that is because of the interaction of Division 13A with the Corporations Law. Just to illustrate how oddly difficult it is, in the United States approximately 90 per cent of all employee share ownership plans are in unlisted companies. I have just confirmed this recently with the National Center for Employee Ownership in the United States. That is the exact reverse of the situation in Australia: almost all of our share plans are in listed companies. Listed companies, of course, employ only 13 per cent of the work force.

Mr SAWFORD—In your view what is the reason for that?

Mr Scarrabelotti—There are several reasons but the fundamental reason connects with prospectuses. In the United States a typical employee share plan uses a trust and the trust acquires the shares on behalf of the employees, holds them on behalf of the employees and disposes of them on behalf of the employees. So the employees are not considered owners of the shares, which is the same as in our law. Now, in the United States, where an employee share plan trust is concerned at least, that solves any prospectus problem because the only person in the view of US law that requires a prospectus, or information about the company and the equity being acquired, is the trustee or trustees.

In Australia we have a completely different situation. We argue that the employees have a prescribed interest in the benefits held for them in the trust and anybody who has the potential to acquire a prescribed interest must be issued a prospectus. So what happens in Australian law is that if you set up a trust the onus for issuing a prospectus shifts from the company to the employee share ownership trust. That is the fundamental problem. In the United States, under a trust the prospectus obligations are simply sealed off completely by the trust, whereas in Australia the prospectus obligations flow through because of the notion of a prescribed interest.

Mr SAWFORD—That is what happens; why does it happen?

Mr Scarrabelotti—Why does it happen? Well, I guess I would have to leave that up to the people who drafted the legislation. I cannot understand why it does happen. It seems to me to be quite—

Mr SAWFORD—I do have a reason why, but perhaps we will go onto that later.

CHAIR—There are two other things I wanted to ask before I invite my colleagues to address questions. One of your suggestions was lifting the Corporations Law prospectus requirements in those cases where adequate downside risk protection on the value of shares is provided to employees. Could you just elaborate on that for us?

Mr Scarrabelotti—This is a proposal we actually made to the CLERP committee when they were doing their exploration into the proposed amendments to the Corporations Law, and they actually took on board our idea. Unfortunately the idea never got from here to the legislation. What we meant by that is if, for example, there was no risk in owning the shares, or a very limited risk, why would you need to have a prospectus? For example, if the shares were offered free, as some companies do offer shares free—and they can do that under Division 13A, they can offer free shares—or alternatively if an option was used that minimises risks radically, why would you need to issue somebody a prospectus when they have an option over shares? In other words, they need never encapsulate the loss that might occur on a share. Secondly, if a non-recourse loan is provided—in other words, there is no downside risk—why would you want to issue a prospectus?

In principle, the CLERP committee took that on, but it has not manifested itself in the legislation. They are some of the key reasons why I think we could get away without issuing a prospectus. Alternatively, we could have ESOP trusts that operate just like American ESOP trusts.

CHAIR—Just finally, you have suggested that the Standing Advisory Committee on Employee Ownership comprise the federal government, the AEOA and ESOP companies and consultants. Is there a place for unions or some representatives—

Mr Scarrabelotti—I hope so. There was intended to be a role for unions in there, yes.

Mrs Hunt—For example, we do have the Financial Sector Union, the FSU, as a member of the AEOA. They have a voice through the membership of the AEOA and it would always be our intention to ensure that we have representation from all interested parties on employee share ownership.

Mr SAWFORD—If I can just concentrate first of all on purpose, I have always had a bias from my parents and grandparents always telling the story about Fletcher Jones and their employee share ownership plan. Whether it is a myth or a reality I am not too sure, but I was told that Fletcher Jones always made quality products because of ownership amongst the workers. I do not have a problem with capital formation as a purpose for employee share ownership plans, but I do have a problem when it gets away from the capital formation and gets onto the American system which basically is not capital formation at all but is a way of dealing with salaries and wages. In America in a lot of those companies the wages have not gone up for 20 years, so people are trying to find an alternative way to make up that gap and they are into the stock market.

I always have a problem with someone who is putting all of their eggs into one basket in the sense of they are receiving salary and wages from this company, now they are expected to invest in that company. In Australia I think that we have to deal with capital formation much more seriously. I do not have a problem with that at all but I would have thought that

the way to do that would be encouraging people not only to invest in the company they are working in but over the whole gamut. But we do not have a good general population attitude to investment. Can I get you to comment on that before I go onto process and outcomes?

Mr Scarrabelotti—Wow, what a question. Honestly, I could talk for half an hour on this. I think it is a penetrating question and goes really to the nub of what employee share ownership is all about. Employee share plans were originally designed to do either one of two things. The first thing was to transfer ownership from one group to another—namely from those that have to those that have not, and I do not mean in any Robin Hood sense but in a literal sense, that there are some people who own and some people who do not own. Employee share ownership plans were not designed as a remuneration device, that simply is a fact of history.

The second thing is that share plans were devised to effect what was not only a transfer of ownership from one place to another—in other words a buy-out or buy-in mechanism by the employees—but also the purest form of the employee share plan was that the share plan would be used to generate new capital for the company, that the share plan would be leveraged, the money would be lent via the employee share ownership plan to the company and the employee share plan would be used to create that new equity of which the employees would become the owners.

Now, there is absolutely no reason why that cannot be done today. The fact that historically there has been a shift from ownership transfer and capital formation towards a remuneration device does not necessarily mean that those original principles cannot be activated, and they could be activated very readily. It is really a question of a philosophical approach before anything else. So, yes, it can be done, and in my view it should be done. Having said that, I am not opposed to the idea of employee share plans having other objectives, and certainly our association is not opposed to the idea of that. My personal view is that if we get away from the ownership objective I think it does have the effect of corrupting what the share plan is because if it just is a way of remunerating people then you are quite right and your particular criticism is then activated. I think what we try to do is to emphasise the full range of uses, and what we are trying to do, particularly in our policy document here, is to try to shift emphasis towards the ownership aspect. That is important for a philosophical reason.

Going to the next question about having their eggs in one basket, I do not think it is quite true that employee share plans in the United States are just a remuneration device. Historically they were not. They certainly have become so, and you see that with the massive growth of option plans and things like that. But the US Congress in the 1970s grasped this precise point about having too many eggs in the one basket and they came up in 1976 with the 401(K) Plan which tried to do two things. First of all it said, 'Employee share plans exist and we support them. The problem with employee share plans is too many eggs in the one basket. We need to create a more prudential share plan where the employees are not locked in to putting shares into their employer's company, that they can invest in a range of investments as well.' A 401(K) plan was set up in 1976 by the US Congress to allow people both to buy shares in their own employer's company and to invest in a range of other equities.

Now, what happened was that historically Australia took the lead from the United States and various people began to implement 401(K) style plans in Australia. You could actually implement that kind of share plan right up to 1993 when the previous government began, alas, to tinker with the employee share legislation, which at that stage was governed by 26AAC of the Income Tax Assessment Act. They eventually brought in Division 13A. Division 13A essentially eliminates the 401(K) option—well, it does not eliminate it outright but it makes it less accessible. What has happened in my view, and I think we give some expression to this in our document here, is there has been a weakening of the capacity of employee share plans to protect employees against this too many eggs in one basket phenomenon. We do not recommend in this document that we should go to the 401(K) option. We do not recommend that not because we do not believe it; it just does not seem to have any political mileage at the moment. That is the answer to your question, I think, that the Americans actually saw this and addressed it with a particular sort of share plan structure.

Mr SAWFORD—But I got the impression, even from reading your submission, that prudential arrangements in Australia were much more secure than they were in the United States?

Mr Scarrabelotti—Absolutely.

Mr SAWFORD—So you do not disagree with that?

Mrs Hunt—No.

Mr Scarrabelotti—I do not.

Mr SAWFORD—I have taken up a fair bit of time, so just one last question. When I went through your submission, I read it through and then went back through it again. It was quite clear in terms of what you were saying before about the capital formation bit. I found the purpose not very clear, and I am glad that Gary has added that information just a while ago, but I did not find any real link in terms of a process to outcomes. When I read through your submission the outcomes to me seem to be basically, ‘We want a tax break.’ Basically that is what the question says, ‘We want a tax break.’ That did not get linked back to capital formation, which I thought would have been a little bit more coherent in terms of your argument. It did not seem to get linked back to anything, it was purely outcome driven and the purpose seemed to get lost. I read your submission twice carefully yesterday and read it when we first had it delivered to us. Your argument just does not seem to be coherent and that is a problem for you in my belief. If I find it incoherent and I cannot link your purpose to your outcome then I think other people will find it difficult.

Mr Scarrabelotti—We do not want to scare the horses. We are not actually after a tax break; the tax breaks, such as they are, are available. What we are asking for is a fine tuning to make the existing legislation more readily usable for unlisted companies. But why would you want to do it at all, that is the question. Why you would want to do it at all seems to me to relate to the fact—and we actually do mention this in passing, but it is a crucial point—of why employee share plans were founded in the first place. When Kelso designed employee share plans he designed them so that people who historically were never in a position to own

could become owners. Now, traditionally you have never been able to own anything unless you had spare savings. Kelso basically attacked this notion head-on, he said, ‘This is clearly nonsense—

Mr SAWFORD—It did not stop anyone else.

Mr Scarrabelotti—It does not stop the rich from owning things because they do not necessarily have savings adequate to purchase the things that they actually buy. The reason they can buy things is that they use corporate structures to buy things. What they do is they use the cash flow from the companies which they acquire to pay for the acquisition price—in other words, you do not come to a buy-out with savings, the things that you buy generate the savings to make the acquisition. What Kelso said is basically what we have to do—create a method where ordinary people who do not have savings and who do not have access to corporate technology can make these same sorts of purchases.

The answer to this is that we want what we want for employee share ownership because we take the view that there are a whole lot of people out there who will never become participants in a free enterprise society or a capitalist society unless they have available to them, firstly, savings and, secondly, technology. An employee share plan is designed to overcome the savings and technology problem which brings non-owners into the ownership circle. That is the phrase that we use. That is the rationale: that is how to bring outsiders into the inside, and perhaps we should have blown more trumpets on that point. A lot of people get scared about that and say, ‘Oh, good heavens, the workers.’

Mr SAWFORD—I think you are certainly right there, I do not disagree at all. Savings, as to how you do the thing, the ownership is what happens. Even when you are talking then, you do not sort of link the purpose—do you understand what I am saying? There is a trinity in human experience that you need a purpose for something, you need a why, a how and a what. You talked about the what, which is ownership, you talked about the how, which is savings, but you do not talk about the purpose.

Mr Scarrabelotti—People would have different purposes. Corporations would implement a share plan because they might have the purpose of wanting to increase productivity—

Mrs Hunt—Gary, perhaps I can add here. I come from a large corporate base in Sydney and I have worked for quite a long time with employee share ownership in corporates and have a knowledge from other corporates. As to why we do it, it is not about replacing remuneration, it is not about not giving people salary increases and giving them normal cash-type bonuses et cetera; it is about taking your employees and trying to get them to focus on what the organisation as a whole is trying to achieve. Take a bank for example. You have a teller on the front counter, you have a customer service officer. What does it really mean to them when a bank delivers a billion dollar profit; what does it really mean? By making each of their employees employee owners, even though they may only have a couple of hundred shares in that company—which is probably fairly small compared to some of the shareholders—they are saying the employee is then taking a much more active interest in the share price, in what the profit is, and that is generally lying behind the why. It is taking that employee one step further in thinking about the company. It is not, ‘I come to work, I get paid this money and I go home at the end of the day.’ They actually have a little bit more

interest. You usually find the why is because they are trying to actually push through a cultural change.

Mr SAWFORD—I will just take 20 seconds to respond. I spoke to my local bank—the women, there are no blokes there any more. They are married women, they are all on part-time remuneration. They have had their full-time jobs all swapped over, they are doing two hours in the morning, three hours in the afternoon. You are talking about banks: essentially they do not give a damn. They do not have any purpose. One of the reasons their PR is so bad is they do not have a purpose.

CHAIR—We have a limited amount of time which we can focus here.

Mr BARTLETT—Let me take that just a bit further because it is related to one of the reasons why you list here that the share ownership was introduced. If that is the case, and I do not doubt that that probably is the case with some companies, is there any evidence to show that that actually is working? Or is it a pipedream? Is it an excuse that companies give for introducing it or are there some actual results you can point to to say that it has made a difference, whether it be in employee turnover, retention rates, productivity levels, efficiencies? Is there some way that you can say, 'Yes, it has worked?'.

Mrs Hunt—From my experience and knowledge what has usually happened is that when the employee share ownership plan has been introduced they have also had some other workplace changes, be it changes to leadership models or their management scales or their operations in how they have set them up. So it is very hard to separate and say it is just the employee ownership. I think Australian companies now are starting to get more into what they call climate surveys. This is where we start to talk more on these qualitative issues and see whether or not we can pull them apart to try to find the impact on the quantitative. But to my understanding, very few Australian companies have proceeded down that path. At this point in time we do not necessarily have the answers and that is what we are hoping to actually try to deliver with Study 2000, to drill in and try to get that answer out of it, because we do acknowledge that that is something that we do not necessarily have the answer to in Australia.

A lot of US research as well indicates that, yes, there is workplace change. That is one of the reasons for introducing employee share plans, but again they will tell you that they cannot necessarily pinpoint and say, 'In year one we introduce this, in year three we achieve these productivity changes and it is all due to that,' because you usually find it is going hand in hand with a couple of other things at the same time.

Mr BARTLETT—Just a quick question about the extent of employee share ownership. You said it is largely limited to the 13 per cent of employees who work for listed companies. Of that 13 per cent, how many would there be involved?

Mrs Hunt—As far as actual number of employees?

Mr BARTLETT—In Australia what is the estimate of actual number of employees?

Mr Scarrabelotti—I do not think we really have an answer to that because basically it all depends on the take-up of the shares in the companies which offer the share plans. That can vary from company to company.

Mr BARTLETT—Do you have an estimate of how many that would be?

Mr Scarrabelotti—No. We may be able to make a guess in the year 2000 when we finish our study.

Mr BARTLETT—Just on a different issue then, on the issue of taxation you have suggested in your submission that ESOP trusts should be exempt from the Ralph Committee recommendation to tax trusts at company tax rates. What is your justification for that exemption?

Mr Scarrabelotti—The key thing simply is the administration of delivering that would be such as to immensely complicate the administration of a share plan trust which is already fairly complicated. We believe that the downside of that is that some existing share plans would just simply go out of existence, that because of the cost of trying to conform to that people would unravel them, or at least hold them in existence and not use them any more. The government has written to us and various of our members have independently approached the government and people on the Ralph Committee. The signals that we are receiving indicate that it is not the intention of the government that employee share plans be caught up in this measure.

However, there is often times a gap between intention and what actually happens. The whole problem here is chiefly an administrative problem which would make the administration of an employee share plan immensely onerous and expensive. Major companies like Lend Lease, for example—who I believe have made a submission—will be able to tell you in very considerable detail the technical answers to this question because it would pose a very serious problem for them, as Australia's major employee owned company, if this legislation were to be drafted and put into effect.

Mr BARTLETT—I do not fully understand how it works, but my understanding would be that the tax obligation only arises if the trust itself makes a profit, as distinct from the employees who own the shares or have rights to the shares making a profit.

Mr Scarrabelotti—I am not a tax expert in this area so I honestly could not answer that. I think that the people who would be able to give you the best answer to that would be Lend Lease or the Remuneration Planning Corporation, who I know also have made a submission. It would be going beyond my ken to give you a proper answer to that.

Mr BARTLETT—Could I just ask one other question on tax. You have said in your submission that the Tax Office's refusal to issue definitive tax rulings is a problem. What sort of evidence do you have that that is a significant impediment to the establishment of these schemes?

Mr Scarrabelotti—I should preface the answer to that by saying that the tax office in recent times has lifted that embargo. It has drawn a circle around Division 13A share plans

and resumed ruling on those. It has issued a ruling related to other financial products, including non-Division 13A share plans. What is the problem? The problem is that whilst it is quite legitimate to set up an employee share plan and implement it without the direct approval of the tax office, it often is the case that companies want to have 100 per cent security about the way their share plan will operate and they will ask the people implementing those share plans to approach the tax office on their behalf to give them a binding ruling—which usually lasts for the lifetime of a plan—on their share plan. In other words, will the employees get the tax benefits, whether it be an exemption or deferral; will the company get tax exemption for funding the share plan out of remuneration? If the answer to that is yes, yes, and yes, the company feels that it has complete security to go ahead on this. So very often a company will ask for a ruling.

Mr BARTLETT—Is there anecdotal evidence that the failure to get such a ruling stopped them setting up a plan?

Mr Scarrabelotti—I would say in my experience you either have a company that gets a ruling or you have a company which says, 'Well, other companies have got the rulings and we'll take a punt on that.' To anybody who decides not to have an employee share plan, that is a secondary question. But, having applied for a ruling and then having some interruption in getting it can create major problems in actually carrying it forward because the companies will say, 'Hang on a minute, are we going to get this tax exemption or not? It's not good enough for us to know that other companies have done it, we want to know whether we're going to get it.'

Mrs GASH—How do people get to know about your association?

Mrs Hunt—A lot of it is through word of mouth obviously. We have a large number of members who actually represent quite a diverse part of the population: corporates, consultants, unlisted companies, individual members, academics, that type of thing. We do a lot of marketing, say through the universities. Obviously we are quite interested in research on what is around so we are doing a lot more—

Mrs GASH—Do you market to companies themselves?

Mrs Hunt—We do.

Mrs GASH—What is your criteria of who you will market to? I know of a number of small companies in my electorate—

Mrs Hunt—Who would not know?

Mrs GASH—No, they have never heard of it.

Mrs Hunt—It is kind of difficult because a lot of us, like myself, volunteer our time to do the jobs that we do. What we usually do is mail-outs a couple of times a year and essentially try to educate people that we are here. What we have probably done is that a lot of the members to date have been more your larger corporates, with individual members et

cetera coming in as well. Probably what we do not have a good blend of is small to medium business.

Mrs GASH—I notice that is one of your criteria here for the advisory committee, and I am very keen on Item 2 which encourages the development of employee share plans in small and medium sized businesses. I could not agree more because those are the people who would also be very interested because they have a closer relationship with their employees.

Mrs Hunt—I am very keen, as the current president, and when I finish my term this year I am going to take a very active role in membership, purely because I feel that there are what I perceive as gaps in our membership and also in the way that we can take information to business about employee share ownership. That is what our association is here for, that is one of its purposes: the education and the understanding in the Australian economy of employee share ownership. We are going to be active in that.

Ms GAMBARO—I may have missed some of your earlier submission. I would like you to take me back to the prospectus requirements and Corporations Law that you were touching on when I came in. You said that we need to relax—perhaps you were talking about legislation. Are you referring to corporations? With Corporations Law, any listed company must provide a prospectus to shareholders. You talked about the low-risk environment that employee share ownership provides, but how do you justify on the one hand providing a prospectus to shareholders of publicly listed companies and not to employee share ownership people? It is still a listed company and there are still requirements. I know you went through some of those low-risk factors, but how can the law be relaxed when you have situations like that?

Mr Scarrabelotti—I think the legislation that is currently in the House, the Corporate Law Economic Reform Program Bill 1998, contains the foundation for that. What is happening here in this legislation is that the government is proposing three options for making it easier to implement a prospectus. Logically it would seem to us that some of these options could actually be applied to an employee share plan. For example, there is a simplified prospectus option, there is an offer of information, there is a profile statement. None of the things in this legislation are specifically connected to employee share plans, but what we would like to see—and maybe this cannot be done except at the administrative end of this new legislation—is for these principles to be applied to employee share plans. We are not suggesting that employees should not be informed, but the onerous nature of implementing a share plan is adequately described here in the government's own explanatory memorandum to the legislation. It reads:

Current regulation results in long and complicated prospectuses with high costs of preparation and distribution to fundraisers. In particular, uncertainty about the liability regime leads to excessive due diligence procedures.

In other words, the lawyers and the accountants will not sign off, except with great caution and high fees. It goes on:

The current rules are a clear barrier to fundraising by small and medium sized enterprises (SMEs).

You could just replace 'fundraising' with 'employee share ownership', and the argument still stands. We are not against their having the information, the question is: can the information

be issued to them in a form which is, firstly, adequate in terms of communication of knowledge and, secondly, commensurate with the ability of the company to provide the information? Let me give you one example. Under the present prospectus requirements you do not have to issue a prospectus if, for example, the shares are being offered to executive officers of a company. That is on the basis that executive officers know a lot about the company and do not need a prospectus.

Now, what happens in a small company where you might have—and this was one client of mine—100 employees in a highly democratically organised company where, by a decision of the owners, all employees are radically participating in the financial management, the production. It is almost a company without a structure, it is a completely flat structure, all the employees are, in effect, executive officers. On finance, they all know what the key figures are, and indeed those of them who do not have responsibility for overlooking the finances actually meet together with the key members of the company who do and have briefings on what the key numbers are. So here you have a company where the people know all the information that executive officers know but because they are not executive officers you cannot issue them shares without a prospectus—

Ms GAMBARO—And yet they are just as fully informed—

Mr Scarrabelotti—They are just as fully informed as anybody else, and that is simply because of the culture of the company.

Ms GAMBARO—Yes, I can understand that.

CHAIR—But you are getting into trouble when you start making laws for exceptions. That is an exception, and when we talked about downside risks earlier one of the things you mentioned was shares being offered free. But they are not really free, they are going to be paid for out of dividends from the other shareholders, presumably. They might be at no cost to the employee, but there is still a risk presumably to the other shareholders.

Mr Scarrabelotti—Or they be dilutionary shares, in other words, new issues. That is a very common phenomenon, and of course that means that the other shareholders have to agree to it at an annual general meeting.

Mr SAWFORD—Can you give us a rough idea, following Ms Gambaro's question, of the cost of a prospectus. If you were wanting to raise $5 million, what would you spend on it?

Mr Scarrabelotti—Anything between $60,000 and $100,000, and then you have to renew the prospectus each year for as long as you wish to raise the money.

Mrs Hunt—That is for a smaller company.

Mr Scarrabelotti—That would be for a typical middle-sized prospectus type float.

Mr SAWFORD—It is a fair amount of money, isn't it?

Mr Scarrabelotti—It is an awful lot of money.

Mr BARRESI—How do we protect those employees, because we have seen quite a bit of this happening these days with redundancies and company mergers? How do we protect employees who have share ownerships in their company, maybe fully owned or partly owned, or whatever, and then their company gets sold or winds up? How are they protected from that sort of situation? We are talking about PAYE earners who have very little money or assets, and yet, out of a gesture of faith in the company or perhaps through peer pressure, engaged in share ownership and now they have been caught up in it. Is there some way that those individuals can be protected or is that simply a risk and you wear it?

Mrs Hunt—In a sale situation where, say, you are having a merger of two companies, if they both had employee share plans in place I think my experience in that situation has been that the employees of the company that is being merged—the company that will no longer exist—are actually paid out of that equity entitlement, or that equity entitlement is turned into an entitlement in the new company. There is generally no risk of significant loss for those individuals because—

Mr BARRESI—Is that through a situation that they make or is it either/or?

Mrs Hunt—It is generally part of when the company is being sold, it is part of the overall process. It is one of the human resource issues and one of the management issues in that if you are selling your company the people who are buying are probably looking at the retention of key personnel, they are looking at maybe redundancy payments, depending on synergies that occur during the sale process. Equity entitlements are becoming a lot more prevalent, particularly with some of your larger corporates. If these mergers were to occur, from experience, the two clear options that I have seen are that in one situation the equity entitlements are paid out, so on the change of control the employees receive in their hand cash which they can then elect to do with whatever they want to, or the other situation that can occur is that for every share they hold in this company they will get at least a share in the other company as well. So they are not significantly at risk at all. In the case of a wind-up, where a company is actually being wound up or liquidated or something, I am not sure how you could actually take the risk away. I think the risk would still be there.

CHAIR—Are there any other questions before we wind up?

Mr KATTER—I am sorry, I came in late, but what are the advantages that the government provides here? Are there tax advantages?

Mr Scarrabelotti—Under Division 13A, which is the principal, although not the sole, legislative mechanism under which employee share plans are developed, the government provides for tax deductibility of company funding of the share plan and it provides to the employee either a tax exemption in one case or a tax deferral in another case on the value of the shares acquired. They are the basic two things that the government provides under Division 13A.

There is other legislation which can be used, and which people do use, to implement alternative share plan structures which are being designed particularly to get around the

limitations of Division 13A so that people in small and unlisted companies can actually have a share plan. Unfortunately, the tax department is not very favourable to non-Division 13A share plans. The tax department likes to pretend that other legislation does not exist and that Division 13A is some sort of sacrosanct island of legislation, but it is not. But to answer your question, on that particular piece of legislation it is tax exemptions for the employees—or tax deferrals for the employees—on the benefits acquired and tax deductions for the funding to the share plan.

Mr KATTER—When you say it is tax deferrals for the employees, it is only deferrals, it is not—

Mr Scarrabelotti—The tax exemption option is that you can offer employees up to $1,000 worth of shares per annum per employee and they do not have to pay tax on that ever. If you offer employees over $1,000 worth of shares per annum per employee you will then fall into the tax deferral option and the taxable value of the benefit acquired is then taxed at 10 years or whenever the shares are sold, whichever is the earliest. If I may point out, this is quite different from US practice—and you will notice this in the back of our policy document where we sum up the United States practice—where a tax deferral is given until whenever the employee sells the shares. So what we have in our system here is an artificial trigger which obliges employees to sell some or all of their shares to meet the tax costs.

CHAIR—And part of your recommendation, of course, was that we should change that?

Mr Scarrabelotti—That is part of our recommendation. But look, 10 years is good. I am not saying that that is some horrible thing, it is very good; but if we had time we could tell you about those occasions when it does not work and why it does not work.

Mr KATTER—What is the trigger again?

Mr Scarrabelotti—The trigger is 10 years. In other words, in our legislation you have to pay tax on the value of the shares you acquire under a Division 13A plan at 10 years or whenever you sell the shares, whichever is the earliest.

Mr KATTER—If the shares go down and they are worth virtually nothing at the end of it do you pay any tax?

Mr Scarrabelotti—No.

Mr KATTER—You pay the tax on the share price at the time that you got them?

Mr Scarrabelotti—In the case of a deferred plan, tax is paid on the value of the shares at cessation.

CHAIR—I would like to thank you for both providing us with a written submission—and the video pack was excellent—and for taking the time to come and speak to us. I presume you will monitor the inquiry as it progresses and if you have any comments,

suggestions, responses from your organisation to what other groups might be putting to us we would very much welcome them. Thank you very much.

Resolved:

That this committee authorises publication of the proof transcript of the evidence given before it at the public hearing this day.

Committee adjourned at 10.01 a.m.