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Official Committee Hansard

**HOUSE OF
REPRESENTATIVES**

STANDING COMMITTEE ON EMPLOYMENT,
EDUCATION AND WORKPLACE RELATIONS

Reference: Employee share ownership in Australian enterprises

THURSDAY, 24 JUNE 1999

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HOUSE OF REPRESENTATIVES
STANDING COMMITTEE ON EMPLOYMENT, EDUCATION AND WORKPLACE
RELATIONS

Thursday, 24 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, Dr Emerson, Ms Gillard, Dr Nelson, Mr Sawford and Mr Wilkie

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

COSTELLO, Mr Chris, Managing Director, Remuneration Planning Corporation Pty Ltd	31
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Committee met at 9.08 a.m.

COSTELLO, Mr Chris, Managing Director, Remuneration Planning Corporation Pty Ltd

CRICHTON, Mr Ian Stockwell, Director, Executive Remuneration and Employee Share Plans, Remuneration Planning Corporation Pty Ltd

FITTON, Mr Gary David, Director, Remuneration Planning Corporation Pty Ltd

CHAIR—Welcome to the public hearing this morning. I also welcome the observers and those who have an interest in the inquiry. I declare open this third public hearing of the inquiry into employee share ownership plans and welcome the witnesses and others in attendance. We will be taking evidence today from the Remuneration Planning Corporation. The purpose of this inquiry is to identify the extent to which employee share ownership plans have been established in Australian enterprises and to assess the impacts of those plans on workplace relations, productivity in enterprises and on the economy.

I now call on representatives of the Remuneration Planning Corporation to give evidence. I remind you that the proceedings here today are legal proceedings of the parliament and warrant the same respect as proceedings in the House itself. The deliberate misleading of the committee may be regarded as contempt of the parliament. The committee prefers that all evidence be given in public, but if at any stage you should wish to give evidence in private you may do so and the committee will consider your request.

Would you like perhaps to give us a 10-minute overview of your submission, and then we will flesh out the issues in questions and answers.

Mr Crichton—I would like to start off the proceedings, if I may. Firstly, we do not envy your committee's work in understanding this much misunderstood specialist field of corporate endeavour. We have observed at close hand the boardrooms of Australia struggle with effective ESOP implementation for the past decade, some with limited success. Australia is still a long way behind best ESOP practice in other countries, most notably the USA and the UK.

We have tabled through the committee secretary our respective personal profiles and our organisation's corporate profile. Suffice to say, Gary, Chris and I have spent a large part of our working lives assisting companies to solve their complex remuneration incentive and employee share plan problems. You have our submission dated 15 May 1999, which provides the incidents and trends in employee share plans in Australia's top 350 public companies over the last seven years.

Today, we would like to try and assist the committee by sharing our real life experiences as specialists to industry. All our data and all our anecdotal evidence indicates that, in the significant majority of cases, ESOPs are of benefit to organisations that implement them. Work force productivity is improved, staff turnover is reduced and organisational financial performance improves. It follows that ESOP practice should be further encouraged.

There is an invalid assumption that ESOPs are all about tax and that Division 13A qualifying plans are good and all other plans are bad. If only our clients' remuneration and share plans needs could be so easily corralled. ESOPs are about organisational behaviour, paying executives and employees for performance, human resource delivery, and pay and reward in a dynamic market. ESOP practices are responsive to and affected by domestic and international competitiveness issues. They are about retention of highly skilled executives and the motivation of general employees.

The expertise necessary for effective employee share plan implementation is multidimensional. It requires taxation expertise dealing with Division 13A issues, capital gains tax issues, FBT issues and others. It requires Corporations Law speciality. There are prospectus requirements, shareholder approval issues and managed investment issues. It requires remuneration consultant expertise, because you are dealing with reasonable remuneration issues under the Corporations Law and you need to understand the appropriate mix of reward, and the size and value of allocations.

It also requires communication skills because the information that is put into the hands of employees must be complying, and it must be understood by the participants and reported clearly and precisely. It then requires advanced administration skills to ensure that all entitlements are properly recorded and that distributions to the individuals are recorded and taxed accordingly.

Because they are highly technical and highly regulated, ESOPs are difficult, time consuming and costly to implement properly. This discourages many companies. Division 13A qualifying plans have helped, but they are not of themselves the panacea. They are no more than a basic tool in the construction of an effective employee share plan structure—the foundation stone of a multistorey building, if you like.

I will now move onto some examples that are real life that highlight the limitations of Division 13A. The first problem; a private company wishes to retain voting control but transfer economic equity to its employees. Division 13A solution; there is no solution. Any benefit in this circumstance would be immediately taxed.

The second example: a public structure which is listed, but listed through a unit trust, wishes to transfer equity or units to employees to aid in the retention or award performance of employees or key executives. The Division 13A solution? There is none. The benefit is immediately taxed under FBT.

The third example: an owner of a small business with, say, 20-odd employees wants to plan for retirement and, in doing that, wants to sell a controlling interest in the business over several years to the employees. It is worth noting that in the US it is estimated that one in eight employee share plans are established for this purpose. The division 13A solution in Australia? There is none. The benefit is immediately taxed.

The fourth example: a public company awards options to executives based on performance or anticipation of performance. Shareholders want the executive to hold the shares beyond the date of exercise to create a truly long-term incentive. The division 13A solution? The benefit is taxed on exercise. This has the impact of forcing the executive to

sell the shares to pay the tax. This defeats the long-term incentive intent of the ESOP, and in fact it could be argued creates an incentive for the individual—or certainly the means for that individual—to leave the company, which is completely at odds with the ideal design of a long-term incentive arrangement.

The fifth example: a small private company wants to reward key management with an equity interest and five per cent is just too little. The division 13A solution? There is none.

The sixth example: a company with, say, 100 staff wants to award a \$1,000 share benefit to each employee under a qualifying exempt plan. The benefit to staff under division 13A is tax free. However, in a circumstance like that, the costs of implementation, compliance, tax sign-off and administration would significantly erode the benefit, to the extent that it would be more cost beneficial to award a similar benefit in cash, fully taxed.

The seventh example: a company wants to attract a new key executive with an equity interest. However, it fails the 75 per cent figure because it is a one-off transaction. The division 13A solution? There is none. The benefit is immediately taxed.

The eighth example: a company with 10,000 eligible employees has a bad year financially. To comply with division 13A, the company must have made an offer to at least 75 per cent of eligible staff before they can use their ESOP on a discriminatory basis. That is, at the time when the company most needs a motivational, performance based reward, they are effectively precluded from using it by division 13A, other than by awarding rights, rather than shares, in the form of options.

The ninth and final example today: a listed company has unreasonable volatility in its share price. This is typical in high-tech companies and resource companies. Accordingly, to provide an effective reward that is acceptable in a prudential sense, it would like to have the reward delivered partly in company shares and partly in other shares to provide a risk control, if you like, for the reward. Under division 13A there is no solution, and that benefit is immediately taxed.

We could cite hundreds of examples where organisations have a genuine desire to encourage equity participation by employees, but cannot do so if division 13A is deemed the sole taxation regime for employee share plans. Division 13A is good, but it is not complete, nor is it comprehensive.

These genuine practices should be nurtured and encouraged, not crushed by the sledgehammer of legislation, by press release, as has happened recently. Acceptable guidelines need to be developed, with a dialogue occurring between the administrators, namely the ATO, the ASIC and the ASX, industry participants and consulting groups that have a long-term vision of this industry. Implementation and the use of employee share plans is growing tentatively. The encouragement to ESOPs embodied in division 13A has been well received. It is a start, not the finish, of development initiatives that are required. Generally, industry is still very nervous about government backflips in this area.

In summary, there are 10 points of policy initiatives that, in our opinion, need to be considered and encouraged to develop the tentative ESOP industry in Australia and which

will greatly assist in curtailing any malpractices. The first point: the taxing point on all ESOP benefits, either share or options, should be deferred until the date of realisation of the benefit; that is, the sooner of the sale, encashment, retirement or termination of employment of the individual. This is a nil cost to revenue scenario. In fact, it has been independently shown that it is actually revenue positive—and I refer you to the Fitzgerald report of 1993 that has been tabled.

The second point: the five per cent rule in division 13A has no foundation. All equity participation should be encouraged, particularly where it is not a controlling interest. The third point: implementation procedures need to be simplified and the tax, Corporations Law and listing rules need to be aligned to facilitate.

The fourth point: there is urgent need for prospectus relief rules that are simplified for ESOP participation. ASIC consultation with practitioners and industry would greatly enhance the likelihood of improvement in this area. PS49 is currently very unpredictable in its outcomes for relief.

The fifth point: consideration to be given to asset diversification to reduce investment and financial risk for employees. This is along the lines of section 401 case style plans in the US and PEPS plans in the UK, which involve tax deferral and CGT relief within limits for diversified investments as part of share plans. These systems have been dramatically successful in encouraging savings, investment and capital formation for many employees.

The sixth point: consideration should be given to portability. The seventh point: equity participation arrangements in private companies should be encouraged along agreed guidelines recognising their special needs. This will significantly deal with perceived malpractice and mischief by the ATO. The eighth point: restrictions of division 13A to ordinary shares should be reconsidered as it is unnecessarily restrictive. Non-share equity, for example units in a trust, should not be discriminated against. The ninth point: the market value definition in division 13A can be dramatically simplified and will reduce unnecessary administration costs.

The tenth point, and in summary: we believe the government should establish a consultative body to further develop policy and regulatory improvement initiatives. Useful examples and precedents are Proshare in the UK, EISA in Canada and the National Center for Employee Ownership in the USA. We would welcome questions on our submission or on any aspect of your committee's inquiry. Thank you.

CHAIR—Do you have anything else to add, Mr Costello or Mr Fitton?

Mr Costello—Thanks, Mr Chairman. I would like to add that a broader framework of the inquiry is to look at the 'what' of employee share plans, to a limited extent, the 'how', and should maybe look a little more at the 'why' and show that framework and the impact on stakeholders at a micro and a macro level, so that we have a better view of what we are looking at and what the results of it are likely to be, which I think is pertinent to the overall objectives of the inquiry.

I would like to hand out a document. Firstly, if we can look at that role, we really see an employee share ownership plan and the whole area of endeavour as relating to a long-term incentive. We see employees' remuneration as one issue—that employees should be paid appropriately in terms of their role as an employee. How do we then cross to a position where we believe that they should be entitled to a share of the returns in the organisation, whether it be profit, whether it be some other measure of gain-share or success as measured in the short term?

You can achieve that in part by profit share, gain share et cetera. The link that is missing is that employees, we believe, should be entitled to a share of the increased underlying value of the entity for which they are employed and that they have a role in terms of contributing to that success. We see that as very much what can be achieved utilising an employee share plan. There may be another form of long-term incentive, but we see the totality as a very important positive loop.

We have the employee long-term incentive plan being the employee share plan; we see the first impact in box one that leads to increased employee savings and investment; we are talking of a population by and large where their savings ratio is almost non-existent; and we are looking at typically one hundred per cent consumption. Those people are trapped, by and large, in a total consumption, very limited savings position. An employee share plan can facilitate them moving into a savings mould for the first time and develop a savings culture and a savings capacity that hitherto has not existed in Australia.

Unlike other suggestions for improving Australian savings, virtually all the dollars that flow into an employee share plan across the board for general employees are going to add net new additional savings. Other initiatives that might be indexing bank accounts, et cetera, simply run the risk of transferring existing savings from high net worth individuals to themselves. So we see it as a very effective mechanism of genuinely increasing savings and investment.

We see it as a critical way of increasing a transfer of ownership to Australian employees. We see medium sized enterprises taken over by multinationals or overseas companies as being often the only way that a company can have a way forward, or a way for proprietors to realise their gain.

An appropriate employee share plan structure and strategy can allow for a transfer of ownership to employees on a direct ongoing basis on whatever means—funded out of profit share, funded out of entitlements—where the proprietor realises a full return, is not forced to sell the bike shop to Pacific Dunlop and have the bike shop shut down as the typical past pattern.

Look at a client such as Baulderstone Hornibrook: a decade ago we put an employee share plan in when they were an Australian, Adelaide based company. They are no longer an Australian, Adelaide based company; they are a German owned, Sydney based subsidiary, but being a hundred per cent multinational does not mean that those Baulderstone employee workers cannot be denied a share of the company. So, in fact, we have put a plan into Baulderstone Hornibrook where the construction workers can have a share in the parent

company that enables that company not to be 100 per cent non-Australian. It can be increasingly and significantly Australian owned.

Companies have increasingly realised the impact of improved employee relations. Honeywell worldwide has a plan to be 15 per cent employee owned by the year 2002. It is currently eight per cent and that eight per cent is entirely achieved in North America. So Honeywell are delighted that their Australian participants, through the employee share plans that we are installing, will be able to help achieve that objective. The reason they have that objective is obviously that they see having employee share ownership and employee share plans as aligning the goals of employees and other stakeholders.

Other clients like Parke Davis, or Warner Lambert as the parent company in Australia and New Zealand, utilise similar plans. So the plan we have introduced in New Zealand mirrors the one in Australia. They do not have enabling legislation over there, but you can achieve the same result within the law and within the intent of the law. So take Parke Davis, for example, in Australia and New Zealand. If they achieve their sales plan everyone will be given \$500 worth of shares at no cost to them, their remuneration or their financial wellbeing. If they achieve their profit plan, they all receive another \$500 of employee shares. So there are a number of different things.

We have provided the committee with a copy of a report we commissioned several years ago by Vince Fitzgerald, *Saving through the firm: employee sharing plans—context, role and implication for enterprise performance, saving and taxation*. We submit that that report has a significant impact. If we move to plans that have an appropriate tax position, our view by and large on tax is that tax should be paid and should be paid fully, but it should be paid once and it should be paid when the recipient has the funds to pay the tax; not before, not after. So when the shares are sold, or when the employee terminates, or when they realise the gain, that is when the tax is paid.

That is why we see the effective date being one year, two years, three years or four years—whatever date the shares are sold or realised by the employee—as the appropriate taxing point. The Fitzgerald report demonstrates that that approach to tax, which is obviously sound—that is, taxing someone when they have the benefit, rather than when they do not, or you simply would not have a viable plan—has a dramatic potential to increase tax revenues in present value terms.

Prior to those plans, we typically had loan plans for employees and executives. The tax take on those plans is really a financing mechanism, rather than a proper employee share plan. The tax take is dramatically lower than under any other form of share plan. The tax take under a plan where I receive my \$10,000 bonus and I pay tax in four years' time on the total value of those shares at that stage, shows a potential to increase the tax take by up to a factor of two in present value terms. The tax take under that plan is higher than if I received my \$10,000 bonus, paid tax at 48.5 per cent, put the remainder in a bank account and paid tax every year on the interest at 48.5 per cent.

We are talking about a potential here to increase net new additional savings in a dramatic way, ultimately in a way more significant than superannuation. We are talking about empowering a far wider range of owners, rather than having an increasing concentration of

ownership, so that the ownership base in terms of numbers increases many fold. We have figures from reports that we have done over the years. As to results, a study we did in 1995—which looked at listed companies in Australia, asset management, return on efficiency and return on equity—basically showed that the companies with an employee share plan compared to the companies without on average had about twice the return of those companies without. Whether that is cause or effect is irrelevant. It is simply showing that those companies are going to have dramatically higher total realisable returns, a far more dramatically higher tax base in terms of the corporate tax base, and a dramatically higher tax base from the employee/owners that have been created.

The equitable distribution of wealth is part of why we see employee share ownership as having appeal, regardless of political spectrum or where individuals, politicians, practitioners or voters might lie on that spectrum. We have a genuine win-win position, where there is a broadening of the capital base. It obviously has appeal to what was, in the past, called the right wing by creating more capitalists and more owners. Or, from the traditional viewpoint of the Left, we are empowering the workers to own the means of production, have a say in their working life and simply lift themselves beyond being seen as the servants of capital. They are shareholders in capital; they share that control.

They have a voice and they have a right to the results, but in a position where everyone can win, where we have a framework set up for microsuccess at the entity firm and employee level, macrosuccess in terms of increasing our international competitiveness and our overall savings, and creating a better balance in Australian reward practices, where, instead of simply having cash that people take now and is consumed now and the superannuation left to retirement days, we have a position where the gap between those two is filled and we have payments through the employee share plan, but which supplement the purpose of cash and immediate consumption and allow people to get beyond that. They complement retirement diversified savings by providing a direct interest in the organisation that employees work for and put Australia, our tax base, our savings base and the wellbeing of our people on a far stronger footing.

CHAIR—Thank you very much. Could you just expand on this concept of a consultative body to progress the development of employee share ownership programs? For example, I was surprised when the Australian Taxation Office presented to us that they have no relationship, as I understand it, with any of the organisations that actually are trying to develop and progress these sort of things. Can you just explain how it will work and who would be in it?

Mr Costello—If we went back a decade, we would probably have a better understanding of some of the limited views of the Australian Taxation Office, because those views were not dissimilar in parallel to the views of other stakeholders. What we did a decade ago was to get together groups that had an interest, and what we found was those groups in many ways opposed employee share plans. So we looked at that and said, ‘Why is that the position?’

If we look at the Australian Shareholders Association—and they represent the small investor, the mums and dads—their reason for opposing was that the plans they saw typically were the tip of the iceberg. They were the excess. They were ones where huge allocations

might have been made in terms of options and where they were already in the money. They saw that as a way of providing executives with what should have been more transparent as a cash bonus and taxed appropriately, as opposed to, say, one of the newspaper groups which had an option for \$1.70 and gave the shares out at a dollar. That sort of practice—the days of IXL and what they saw in the press—concerned them. So we got them involved. We got IFSA involved, which represents the funds management groups.

From an institutional viewpoint, when you start to look at the statistics that I quoted before, if you simply invest in companies with an employee share plan, you can sack your whole investment management team, because you are going to do better than they have done in year one, year five or year 10. Simply look at that total framework of a win-win position, and we make sure that people play within the boundaries and we do not become preoccupied with what is outside. If it is not an employee share plan, it is not genuine and it is not going to be passed by the ATO, it is not going to be passed by shareholders and it is not going to be acceptable or appropriate to employers.

CHAIR—Would this be some sort of statutory authority or would it not have that sort of status?

Mr Costello—Not necessarily. The group that we developed through the AUA now involves the Australian Shareholders Association and it has IFSA as a visiting member occasionally. The ASX used to be involved and ASIC sometimes attends. It is hosted by the Australian Institute of Company Directors. The ACTU and sometimes a union member is involved, but they do not have a formal part. They were a further group that initially were dubious and negative to employee share plans. You will see through the paper *Employee share plans: handle with care* that we wrote for them some half a decade ago, that they now endorse employee share plans.

It is more saying that there is a lack of understanding of the prime impact and role of employee share plans. It is going to emerge as something in our view that will overtake superannuation in importance over the coming decade.

CHAIR—I have got the basic idea.

Mr Fitton—Could I say something here as well?

CHAIR—Yes.

Mr Fitton—We did have a dialogue with a senior member of the Australian Taxation Office last year. We found that extremely helpful. We were developing guidelines for application, especially in the small to medium enterprise area. Much of RPC's work over the past 12 years has been innovative. We have created structures which facilitate what is called new generation employee share plans, which are particularly attractive for corporate funding of employee share plans. So the funding was coming from the profit and loss account and not from employees' own resources, nor was there a need for loans or risk exposure. We lost that dialogue and the guidelines seem to have been lost in the tax office when that person was terminated from the tax office.

CHAIR—I think we have got the basic idea here, and it is a very good idea. It should include unions, industry groups and saving investment organisations. In relation to Vince Fitzgerald's report and his forecasts for the positive impact that this would have on national savings, if employee share ownership programs were developed and spread across more of the work force, would it increase the total amount of national savings, or would we just see people saying, 'Because I have got employee shares, I will have less in superannuation or less in other kinds of saving vehicles?'

Mr Crichton—It might be helpful to understand an example there. You take a circumstance where someone may receive a bonus and they have two choices in how they receive that bonus. Firstly, they can take \$2,000 in bonus that is taxed. They are then left with \$1,000, which in a sense is then consumed—spent and forgotten—which almost sets up in itself a bonus habit. They want more money next year to be able to continue their consumption pattern.

If we stop that cycle of consumption through the bonus and direct it into savings in the firm through an employee share plan, then there is actually a real incentive for them not to take it and spend it. Because in taking it, it triggers that tax liability. If they save it, it grows. Therefore, that creates a savings pool, but it also stops the bonus habit, because they can see their wealth being created and improved, and they have learnt to live without the consumption of that bonus. It becomes self-fulfilling.

Mr Costello—The short answer is that, as we would see it, for every dollar that goes into an employee share plan you are looking virtually at \$1 of net new additional savings where those workers were incapable of saving before. They simply were in a consumption bind that meant 100 per cent commitment of their existing earnings. We are creating not just a range of new owners, but a range of new savers.

Mr SAWFORD—I have a couple of questions but before I ask them I just wondered that for the benefit of the committee you could tell us something about your organisation. How old is it? How did it develop? How is it funded? Could you give us a brief background?

Mr Costello—It is 100 per cent Australian employee owned, formed in 1987 and owned by the employees. There are about 30 individuals involved. It is completely independent. The core of our activities are employee share plans, administering those plans and administering effective remuneration strategies and structures. The reason for our advantage is that we are very specialised. As Ian said in the introduction, to cover the area appropriately it requires expertise in law, accounting, industrial relations, economics, and software. So all disciplines need to be grouped. The people in RPC have a very different range of not just personalities, but qualifications and interests in terms of where they come from, their politics, et cetera.

Mr SAWFORD—Do you basically market ESOPs?

Mr Crichton—We each have individual roles. Our aim is to sell to public and private companies the means of providing remuneration, whether it be base remuneration, short-term incentive or long-term incentive. Long-term incentive is most effectively delivered through employee share plans. Then we help them in the implementation process, the approval

process, the regulatory process and in the ongoing administration process. So we are a one-stop shop in that sense.

Mr WILKIE—They can come to you and you do the lot.

Mr Crichton—That is right.

Mr SAWFORD—In your introduction concerning employee share ownership you mentioned that there was a lot of how and what, but not much why.

Mr Costello—Yes.

Mr SAWFORD—I very much appreciated that. It just seems to me, and I would be interested in your comment, that when the purpose is capital formation, which we greatly need in this country, it seems very straightforward in terms of what follows next. When you start off with rewards, it really gets messy and people start talking about tax avoidance—you cannot help it. I look at the arguments that people put forward, and I do not really have a problem with it, but when the ‘why’ becomes reward, it just seems to get very messy. Would you like to comment on that?

Mr Costello—Yes. If you go back one step, you may want capital formation, or you may want a more equitable ownership of that capital and a spreading base rather than a narrowing base. So we know the purpose. If we look at the how, we have traditionally been negative on employee loan plans as being inappropriate. They have a limited tax impact, so tax-wise it is almost a negative gearing problem where you do not receive adequate tax. We see the exposure to the employee as being completely inappropriate. If the exposure lies with the employee—which it should—they are geared into one stock which also happens to be their employer.

One of the reasons why groups attacked employee share plans before was because the approach was, ‘Okay, if things go wrong we will wipe the debt.’ What does that do to the mum and dad shareholders and the institutions? It makes them hugely antagonistic. They say ‘Now we have had \$1 million wiped out for the debt and another \$1 million in debt waiver FBT, and we have carried the can when things have gone wrong.’

So, a loan is not the answer. Employees do not have the money. They do not have the savings. Shareholders are not generous enough to simply give them part of their stake, by and large. So how do we enable them to cross that gap? The answer becomes that they have an entitlement to be paid at competitive remuneration levels and that is their reward as an employee.

We go one step further and say they should also have an entitlement to a share of profit or annual success. Potentially that becomes, ‘Okay, if we give them that, rather give them \$5,000 in cash and have it consumed, let’s allow that \$5,000 to be taken as cash or as employee shares.’ We have suddenly then enabled them to fund their way in a way that does not have a debt exposure, that increases the tax base and enables them to start saving for the first time.

That strategy has to be put up as part of the total to shareholders. Again, this is why shareholder groups were anti past plans because the option plan and everything was stuck out the side. The organisations pretended this had nothing to do with reward. That to us is bull dust. You have to say, 'Here is the total plan. Here is how we are all going to be stakeholders. Here is how it is going to be funded. Here is the transparency in terms of the impact. Here is the impact in terms of dilution. Here is the impact in terms of cost. Here is the impact in terms of profit share and the proposals.' So that total scenario is seen by shareholders, be they a private company, a large company or whatever it might be. They understand the merits, the purpose and the impacts in a bull market, a bear market or whatever might be the position, and it is one that suits that total. We have to get back to reward in part to overcome that gap of: how the devil do we get some funds to employees if in fact one way or another they have not been earned?

Mr SAWFORD—I have a second question. If you widen the ownership base—and intrinsically there is a limited use in all of that—isn't the real issue in terms of influence within a company?

Mr Costello—One follows the other. If someone is an employee owner, they are going to have a different view. Profit is no longer a dirty word. They are not going to put up with some scheme or some activity where they see inappropriate largesse to senior managers or other ways in which they might be being rewarded but, at the same time, there are not going to be attacks on a practice that has an impact overall. Also, they are going to see, if there is rationalisation in times of change that we need now, it is not all 100 per cent negative. It means, yes, we are going to be in a position where all of us will ultimately be better off.

Going back to the reward issue or opportunity, another important issue is that, with the past approach where everyone would be paid \$100—the traditional approach where we would all be paid a certain fixed amount—that amount would have no correlation, even though it is the biggest cost to the entity, with the success of the organisation as it goes forward. That, to us, is a crazy Australian anachronism. The sooner that is realised the better. We say that \$100 is appropriate, but 20 per cent of the profit—or whatever it might be—should be going to the employees. They should be able to buy more and more of the enterprise so that their compound ownership goes from one per cent to five per cent to 20 per cent. In Lend Lease's case, it is around a quarter of a multibillion dollar enterprise from that compounding impact. Rather than taking my \$4,000 and having it taxed, ultimately I have \$104,000, even though I might be simply the construction worker. I have a major stake in the company.

Mr Crichton—Just to reinforce that, in the crash of the early 1990s or the late 1980s, employers were left with falling revenues and fixed cost employment. Their response was to retrench everybody that they did not need. In a better world, you would have a component of fixed reward and a component of variable reward so that, in response to economic change or setbacks, you could reduce the variable reward but still maintain a larger portion of your work force.

Mr SAWFORD—But the companies in that particular period that maintained their staff were the only companies to maintain their market share and increase it. The companies that downsized also lost market share. That is also a truism. Anyway, I have taken up too much

time. Can I just make one comment. There is no such thing as win-win in human endeavour. There are always losers.

Mr Costello—That is a cynical politician's view.

Mr SAWFORD—No, that is human reality because, if the employer and the employee win, the taxation office can lose and the general community can lose. There is no such thing as win-win. Okay, we will not go into that.

Mr Crichton—The total pool grows, so therefore everyone wins.

Mr Costello—If there is increased tax revenue, and that can be proven—tax revenue is one win—and if there are net new additional savings—savings is another win—we have got a macro win. We are more internationally competitive. If the employee is now saving and still has more disposable income than they had before, they are winners. If every stakeholder from the union side and from the individual shareholder side accepts and sees the advantage in the transparency of the plan, they are winners. You can have a position where every single person is a winner. It is not a matter of a dollar moving from that person to here, and therefore someone has lost. That is not the case. It is the closest you will get to a real panacea practically applied if you say, 'What is the impact of the plan? How can it be put through the sieves so that every stakeholder can ensure what the position will be under good news and under bad news?' My stake in that enterprise as an overseas investor is to see exactly what it is. We believe there is very much a win-win-win position.

Mr SAWFORD—Less advanced competitor countries are the losers.

Mr BARTLETT—It seems to me that there is quite an anomaly between the number of companies offering share ownership schemes and the low number of employees taking them up. It is your view, I take it, that tax issues are the main reason for the low take-up rate.

Mr Costello—That is changing amongst the larger companies quite rapidly and quite successfully. In part, it is an encouragement under 13A of the legislation that all employees be involved. We think that, in the broad, that is a good principle to encourage wider ownership. A lot of the plans in the past were limited to a very limited number of people. The impact of those plans designed outside reward, and not being fully explained to people, it was obviously going to reduce their impact. So the numbers involved in employee share plans are going to increase by, we would suggest, probably 100 times in the next five years.

Mr BARTLETT—Without changing the tax legislation?

Mr Costello—Without changing the tax legislation the problem will be that that 100 times will be confined to the big end of town that only employs one in five Australians. For our enterprise, that is a whole lot of work. But the general four and five that are working for small or medium enterprises—in excess of—are going to miss out on what could be a potential to say, 'We will have ownership transfer and succession planning that is genuine and complete.' The tax man should do some more homework, look at Fitzgerald and further studies, and have the committee discussed. This way the level of understanding and the level of appreciation can be raised and the cynicism can be removed.

The cynicism was okay for institutional groups before when they saw abuses, and that was all they saw. They did not know enough of the full picture. There are lots of organisations now that still do not realise how well they can put in a plan under the legislation that is already on the table, but it limits those small to medium enterprises. We think that is an area that needs increasing attention. We think the policy of the past government and the current government was excellent in terms of saying that, for every privatisation that happens, there has to be employee participation.

The previous government was partly instrumental in introducing the previous legislation. The new government said, 'There was a lot of opposition: should that be changed?' We said, 'No, we don't want it to create uncertainty and cause the problems that have happened with super where people do not have confidence'. They see it as continually changing. We need a base of certainty. We need a commitment and improvements from that base. That is what the government delivered, saying, 'We accept that. We understand it. We will increase the exemption, and we will increase the \$500 to \$1,000 to send that right message. We will, in fact, stick with the intent of plans being meant to be attractive to companies that offer them across the board and, to facilitate that, we will make it less prescriptive. We will reduce the 75 per cent requirement to two-thirds.'

The government's intent was to reduce that on the basis of trying to get more people in, not less. But again, without proper discussion, the Labor Party saw that as the opposite and thought, 'Ah, they are trying to limit it'. So they voted against it. They were both trying to achieve the same; the result did not go through. Again, in those small areas where improvements could be made, initially, there was a five per cent limit put in. The intention was, 'Let us stop someone who has a big chunk of the company, who is going to have \$10 million, from getting more'. Again, an appropriate view for the large organisations, but how do we make that real for the company that has 20 employees?

Mr BARTLETT—Would it be workable to have different percentage limits for different sized companies?

Mr Costello—Yes, because that would help to achieve the result for the small companies.

Mr BARTLETT—Could something like that work, do you think?

Mr Crichton—Again, it is on a consultative basis in a sense. It is a guideline that needs to be established and then the differences of each case almost looked at on a case-by-case basis. It is very clumsy, but there are so many unique and separate categories that it is very difficult to codify.

Mr BARTLETT—So it is possible that you could have a sliding scale of limits?

Mr Crichton—Yes, it is.

Mr BARTLETT—I have one other question on taxation. You suggested that tax obligations should be deferred until sale of shares: is there any evidence that the 10-year

deferral rule does not provide enough incentive for take-up rates by employees, whereas indefinite deferral might?

Mr Crichton—We have never reached 10 years, obviously.

Mr BARTLETT—No, okay.

Mr Crichton—So we do not know who will be holding shares at that point that are then taxed for holding.

Mr BARTLETT—Sure, but in terms of a reluctance to take up initially, knowing that in 10 years time there will be a tax obligation?

Mr Costello—It is a minor impediment. Initially, five years was proposed and that would have been a major impediment because you would have people selling shares to pay tax. That sends a negative message to other investors who do not realise and who say, ‘Why are you selling your shares?’ Moving it to the 10 years overcame 90 per cent of the problems: we have a shrinking period of holding because people are moving from companies more and more. So we are really looking at an average of about three years now anyway. It used to be more like the five or six. We do not believe it has a revenue impact; it has a small impact in terms of the perception of value. We do not see it as a major priority in terms of the impact.

Mr BARTLETT—An indefinite deferral would not really be much of a boost in terms of take-up rates then?

Mr Costello—It is a small help. The key you were able to capture at the taxing point when people terminate—and they are going to do that a lot earlier than 10 years for the most part—or when they sell their shares. With their consumption mentality, they will often do that prior to, as well. It would be a plus, but it is not a major platform.

CHAIR—Some of us describe it as survival mentality rather than consumption mentality.

Dr EMERSON—I would like to focus on and ask questions about the impact of employee share ownership proposals on national savings because I must confess to being unconvinced about that. We have got a sustained stock market boom in Australia. That is, lots of people, not necessarily employees, are holding shares and doing very well out of it. Yet the national household savings ratio is at an all time low. I think what happens is that people moving into a new saving instrument substitute out of an old one basically. They have in mind what they think is an appropriate level of savings for themselves whether it be for their holidays or for their retirement, or whatever. By providing a new savings vehicle, they just get out of one and go into the other. That is why, in Australia, according to the budget papers, household debt is now about 90 per cent of income and the household savings ratio, I think, is about two per cent.

CHAIR—Forecasts are a lot lower.

Dr EMERSON—I am not saying therefore that employee share ownership schemes are bad or anything like that. But on that criterion, I am just not at all convinced about the claims that it is going to boost national savings. Therefore, I would like to go beyond the anecdotes. I think your example was of a fellow who consumes everything—the employee who consumes everything. But he then gets an employee who takes up some shares, and who does not consume everything. That is great; this is a non-zero sum game. Some money got created somehow and he has now got more money and so he consumes and I do not think that is right.

Mr Crichton—Let us then take the example of the person who now saves and invests as you describe. He receives \$1,000. He pays \$500 tax and saves \$500. Through an employee share plan, he would save \$1,000—double the national saving.

Dr EMERSON—We are just talking about a tax deferral.

Mr Crichton—That is all we are talking about.

Dr EMERSON—So basically let us dismantle the argument and say what we are really doing is trying to provide a tax break for savings. That is all we are on about.

Mr Crichton—No, but it is more than that.

Dr EMERSON—You can do that much more broadly by getting the Treasurer to announce at the next budget that there is going to be a tax break for all savings.

Mr Crichton—But it is more complete than that.

Dr EMERSON—Let us call it what it is.

Mr Crichton—But it is more complete than that, because you are linking his interests to the performance of the firm that he works for.

Dr EMERSON—That is a different argument. That is a completely different argument. That is why I said that I am not against employee share ownership *prima facie*, but I am unconvinced about the argument that it is going to suddenly increase national savings. There is a completely separate argument about what that does to the incentives of an employee and the way he or she behaves in the workplace to increase the wealth of the workplace and so on. It is a completely separate and probably very respectable argument.

Mr Costello—Just on your point, if you look at potential normal savings initiatives, for example, index bank accounts and have a tax free threshold on the first \$5,000, I suspect you would find, if you commissioned Fitzgerald or others, that the net new additional savings out of that would be a loss of 75c in the dollar. It would be a transfer of existing savings because anyone out there in the community that has money could shift it around.

Dr EMERSON—And transfer public savings to private savings.

Mr Costello—They are going to shift their existing savings.

Dr EMERSON—That is the surplus—

Mr Costello—If you are saying we are looking at employee share plans then we are limiting it to people who are employees. They are the ones who do spend, by and large, all they receive. Their savings ratio is not two per cent, it is 0.2 per cent, I would suggest. You are limiting it to that group. You are facilitating them not being exposed to a loan but to take additional parts of profit share or other incentive and to have those invested in the organisation. That is why Fitzgerald is pointing out we have net new additional savings transfer.

Compared to any other savings initiative, we are saying, 'We're going to have close to \$1 going into the plan. We'll be close to \$1 net new additional saving.' With the bank accounts scenario, I suggest 25c additional savings. The tax cost of the bank account one is dramatic and immediate. The tax cost of here is a premium to tax, not a cost to tax. That is where further study, further understanding, needs to be undertaken. We have got to say, 'It's not a shade of black and white whether there is a win-win, that should be simply a question of fact. Let's prove it up and then see because otherwise we're not going to be relaxed in terms of what that position is.'

Dr EMERSON—Mr Chair, could I ask for that evidence that it is basically \$1 net new savings under employee share ownerships from Vince Fitzgerald, because we spoke to him at our living standards committee last Thursday. Vince is a strong advocate of superannuation. I have not heard him championing employee share ownership schemes as being the most effective way of lifting national savings. I would appreciate that.

CHAIR—Yes, I would appreciate that because his work still does not convince you, I must say. I support employee share ownership programs but I am not sure whether that is really a substantive argument, or perhaps we are not yet able to see it.

Mr BARRESI—You mentioned that 80 per cent of the top 20 companies have a plan in their year return of inflation 2½ times compared to those top 20 companies that have no plan. Are there any other positive outcomes from a company's perspective? I am trying to get away from improved employee motivation and satisfaction, those sorts of things. Are there any other sorts of measurements out there that you have been able to identify and say, 'Yes, there is a correlation between those who have and those who don't?'

Mr Crichton—The work in Australia is fairly limited. I think it was in 1995 when we looked at pure financial performance. We took a basket of companies in the top 350 that had a plan and those that did not and put the financial measures on the table, which is in the report. That showed, as I think Chris mentioned, that companies with a plan outperformed those without a plan to the tune of about 2:1.

Unfortunately, it is anecdotal in a sense because they might do a whole lot of other things better than those companies as well. So, it is not pure. But there was a study done in Canada, and there was a study done in the United States by a group called Jones and Cato. They did a thorough analysis of the benefits of employee share ownership in that country in

the early 1990s which was undoubted in terms of its impact on the firm. I can provide copies of that, but I do not have those reports with me today.

Mr Costello—Just on the financials, there was a Canadian study by the Toronto Stock Exchange of 640 companies, companies with and companies without a five-year profit growth. With companies with a plan it was 123 per cent higher. The net profit margin of the companies with a plan versus those without was 95 per cent higher. The return on equity for those with a plan was 93 per cent higher. That is because employees said, ‘We’re part of the action, we’re not going to goof off and stand by while the directors or management put these abuses in. Profit is not a dirty word, rationalisation is not a dirty word.’ They have an interest in the share price, they have an interest in rationalisation.

We introduced a share plan in a hotel group last month and one of the housemaids said, ‘What is the long-term vision of the company?’ The chairman was quite knocked about by some of the questions coming from people who before could not give a darn in some instances. They were unconcerned whether the flu had gone through and cleaned people out. Such a scheme gives a much greater feeling of shared success. It does a lot for the dignity of the person to be in a position where they are saying, ‘I am an employee. I am an entrepreneur. But I am also an owner, to whatever degree.’

Mr BARRESI—If those indicators transfer across to Australia, shouldn’t you have a fairly easy time convincing companies to introduce share plans?

Mr Costello—We do.

Mr BARRESI—This relates to what Rod asked you earlier on. What are you actually doing from a proactive point of view to get that message across? I know you are working with companies and you are assisting those, but are they knocking on your door? Is there some sort of material that goes out at the stock exchange as companies become listed? What is happening out there to convince companies to start share plans?

Mr Costello—We are not a big organisation but if we get in front of a remuneration committee and put down what can be done and say why it should be done, and here is why other stakeholders will tick it, 99 per cent will say, ‘Go ahead.’ They will tend not to be aware of what can be done. They will tend to think of past practice where if the chairman got up with the plan, he would be slammed at the annual general meeting by the mum and dad shareholders, or outvoted by the institutions.

The last several years have turned that around and there is better understanding. That is why the chairman’s questions regarding a wider array of input and understanding from the various stakeholders at all levels would help greatly because we are underestimating. When I say that it is going to grow by 100 times, I am confining that to less than 20 per cent of employees. It should be opened up for the total.

Mr Crichton—Ninety per cent of the companies that we speak to in the public arena have an employee share plan. They think they know what they are talking about.

Mr BARRESI—But most of those are senior executives, aren’t they?

Mr Crichton—That's right. But again, it is walking in there and saying that what you are doing is an inappropriate use of your existing plan, or it is poorly designed, or it does not actually deliver the full worth of an employee share ownership plan. We have to convince them that they have got a bad plan. We then have to convince them to take that back to shareholders. We have to convince them to go through the regulatory route. That can be a year's process and it will involve possibly a dozen people within an organisation. I have sat in a boardroom, with more people in the room than this, designing an employees share plan. It requires an enormous amount of energy and effort to get it moving.

Mr BARRESI—Most medium to large companies, not small companies, would have some form of job evaluation process as opposed to job appraisal. They would have the evaluation and the setting of grades. Has any of them, such as your Hay Management Group or others, tried to link in an evaluation process with a share plan as part of a remuneration package?

Mr Costello—There is not a huge relevance. Those sorts of systems have some pluses but they are largely outdated. It is really saying, 'Here is a system developed by Edward Hay in 1954 which is appropriate for manufacturers for limiting and defining and demarking our role.'

Mr BARRESI—But there are variations to the Hay plan. There are a whole lot of others as well out there now. There are Cullen Egan Dell and a few others.

Mr Costello—That pertains more to saying, 'Here is the right remuneration for the fixed amount and we will look at the market and what should our relative value be internally.' That is all that does. It says that between the three of us this is how we should be ranked as the engineer and the accountant. The reality is that the market is paying so much to the engineer and the accountant that that is going to override it.

That is one issue but we are really saying an employee share plan should not just be for the top few, it should not be excessive, it should be limited precisely to the role of employee reward. That corrals it in terms of those net new additional savings, it is not those that are already out there.

Each organisation then simply says, 'We can implement this in a way that will be seen as a major initiative by our employees. Our job valuation program is seen as a major perk by employees. We are all going to be evaluated; we all get interviewed; we all do the process.' Nothing comes of it. That leads to disillusionment of employees. They see that as HR touchy feely and not needing a share plan. They say, 'We now have a say; we are going to have a vote; we are going to stand up and be counted, but we are going to do so in a productive way because we are not going to shoot ourselves in the foot.'

It is much more substantive and direct. Some might say, 'Here are the gradings and the number of shares will be 10 per cent each of your remuneration as reflected back to the grades'. That may be appropriate because what we have is enabling framework for legislation. Then different organisations need to use that framework to fit their particular strategy. I think it is a plus that the Corporations Law now has a requirement. Organisations must explain their reward strategy to stakeholders in their reports. It is increasing the trend

to transparency and, as soon as you have all of the veils removed and everything having to be justified, then you are in a position where you can get to a very positive outcome.

Mr Crichton—Just to answer you another way, those systems deal very well with base pay and relativities. What we are dealing with here is typically variable pay. The evaluation of variable pay is much less refined than the pay systems that you described.

Mr BARRESI—Employee protection concerns me. With only 10 per cent of employees taking up the share plans, while we are trying to increase that number, how do we actually go about protecting the work force from the investment they have made in case that company collapses or whatever? You mentioned something about having portability. Perhaps the answer to portability is through investment diversification; I do not know. It just seems to me the whole concept of portability will not work with share plans.

Mr Fitton—The problem that employee share plans have per se is that you have a very narrow risk spread, so it is hard to alleviate that risk exposure due to investing in one security. In America, under section 401k plans, it is compulsory that employees have a choice through other investments apart from the share. For example, for one very large Australian whose share prices recently dropped from \$20 to around \$10, there is a dramatic exposure under their loan plan. There is also a tremendous deterrent for staff to participate in their employee's share plans without a substantial amount of downside risk protection.

Downside risk protection is dramatically limited. In fact, the risk is exacerbated by the use of loan plans and partly paid plans which are now outdated and discredited. We can have share plans funded by the company out of their profit and loss account for a dollar worth of expenditure by the dollar worth of share as remuneration for the employee. We find that the greatest way of alleviating a downside risk exposure to participating employees at all levels of the organisation.

Ms GILLARD—I have a question about the limits of the possible spread from your point of view. Obviously, in a public company the arguments in favour of spreading employee share plans from the executive class down to the other classes is clear, but you mentioned at one point during your presentation a company with 20 employees. Isn't the reality that a company with 20 employees is most likely to be a proprietary limited company. That is true very widely of our small business sector. This really is not a useful structure in that kind of setting, when you cannot trade the shares.

Mr Costello—What is the future of that company if it has no succession? Does it simply wind up or have nowhere to go? What we see is, if those proprietors realise that they are not in a position where they simply have to sell to Pacific Dunlop and the bike shop can actually be sold to the employees, it gets back to rewards. We say to the employees, 'We are going to introduce a 20 per cent profit share, but that profit share has to go into shares for those who want it and cash for those who do not.'

What you will find over the medium term is that you have enabled those employees to gradually take an increasing stake of ownership in that organisation. Just as Lend Lease went from zero to 25 per cent employee owned, you can have a position where the bike shop goes from 100 per cent proprietor owned and zero employee owned to 25 per cent to 50 per cent

to 75 per cent—and potentially 100 per cent—employee owned. Full value has been transferred. Full tax has been paid on the gain by the proprietor because they have been paid out, so the tax take becomes real as opposed to the enterprise just saying it has no value.

We dominate the remuneration market in Australia. We dominate the employee share plan side. We have created virtually every share plan structure. We had a major role in input to division 13A, yet we are not a big organisation. The multinationals—the TPF&Cs, the Hewitts, the Hays—do not get near us. They cannot get near our staff. They are not employee owned organisations as ours is. We are unassailable because our people own what they are about.

Ms GILLARD—You get to a limit where it is not feasible. The husband and wife \$2 company that runs the local furniture store or whatever might have five or six employees but the shares are valueless in a real sense. If I worked there and was given a parcel of shares—

Mr Crichton—There is the cost of implementation—

Ms GILLARD—They are in control of everything. They are going to fix price. I cannot transfer it.

Mr Crichton—There is a cost of implementing an employee share plan. Very small organisations are precluded because the cost burden would outweigh any benefit.

Ms GILLARD—And there is no benefit to the employee in holding them really.

CHAIR—No, unlisted shares—

Mr Crichton—Not in that circumstance, certainly.

Ms GILLARD—No.

Mr Fitton—Unlisted companies or organisations have special problems or issues when it comes to employee share plans or employee equity participation. The first is valuation. What is the company worth? Then it is a provision of shares that have to be warehoused. Then you have to create its own particular marketplace so those shares can be traded, those shares have value.

Ms GILLARD—In the small business sector, that is not true. There is no marketplace.

Mr Fitton—In the small business sector, it is true if we use certain trust or corporate structures to create that marketplace and to warehouse the shares. We have to replace the stock exchange with its own internal marketplace where shares are traded and funded by the company. That works. We are saying preserve that and encourage that and make it work properly.

CHAIR—Finally, do you have any hard data on succession in medium sized businesses that it does or can work? Have you any hard illustrations?

Mr Fitton—We have examples of actual cases.

Mr Crichton—We have 500 private companies that we are trying to deal with on that issue at the moment. Whether it is successful or not, I will tell you next year.

CHAIR—Okay. If you have anything further to add in terms of your submission in that regard, please send it along.

Mr Fitton—That is the hardest area. That is where most problems occur, which is at the SME market. Regulatory restrictions are extremely unsympathetic. It is extremely expensive for compliance with tax and, say, prospectus issues, which arise all the time.

Mr Crichton—And Mr Carmody's sledgehammer has damaged the initiatives in that market significantly with that recent announcement.

Mr BARRESI—On one of your pages, which is marked confidential—and I will be very circumspect about how I ask this—you have there—

CHAIR—No, you can't.

Mr BARRESI—I just want to know about—

CHAIR—You cannot even mention this. It needs to be done in camera if you want to even refer to it.

Mr BARRESI—Okay. I have a very general question.

CHAIR—Unfortunately, you have just prefaced it by—

Mr BARRESI—Okay, I will not ask it.

CHAIR—This is for your protection as much as anything else.

Mr BARRESI—I will ask once the meeting is over.

CHAIR—Okay. If any of the members of the committee have any issues they wish to discuss privately with the witnesses, they may feel free to do so after the meeting. I would like to thank you for coming along again and providing a submission. If you follow the course of the inquiry and see other submissions or things that are said or put to us in hearings with which you agree or disagree or if you have any comment, can you send that on to us.

Resolved (on motion by **Ms Gillard**):

That the committee receive as evidence and include in its records as exhibits for the inquiry employee share ownership plans, the documents received from the Remuneration Planning Corporation entitled, 'Analysis of employee share acquisitions schemes prepared for Lend Lease Corporate Services', dated December 1993, and 'Saving through the

firm' report for the Remuneration Planning Corporation by V. Fitzgerald, dated December 1993, and the diagram showing the role of employee share ownership.

Resolved (on motion by **Mr Wilkie**):

That this committee authorises publication, including publication on the parliamentary database, of the proof transcript of the evidence given before it at the public hearing this day.

Committee adjourned at 10.26 a.m.

