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ASIC

Australian Securities & Investments Commission

Alan Cameron AM
Chairman

National Office, Sydney

No 1 Martin Place, Sydney
GPO Box 4866 Sydney NSW 1042

DX 653 Sydney

Telephone: (02) 9911 2001

Facsimile: (02) 9911 2010

CCU99/00538

Dr. Brendan Nelson

Chairman

Employee Share Ownership Inquiry

House of Representatives Standing Committee

on Employment, Education and Workplace Relations

Suite R 1 116 Parliament House

CANBERRA ACT 2600

Dear Dr. Nelson,

INQUIRY INTO EMPLOYEE SHARE OWNERSHIP IN AUSTRALIAN ENTERPRISES

I refer to your letter dated 22 November 1999 and apologise for the delay in replying.

As you know the Australian Securities and Investments Commission (ASIC) touched on some of the issues that you have raised in our letter to you of 27 July 1999. The following comments should be read in conjunction with that letter (a copy of which I attach for your convenience).

A. Risk

You have asked for ASIC's views on how employees can be protected against unreasonable risks.

There is of course always an element of risk involved in investing in shares. The approach taken under the Corporations Law (Law) to deal with that risk is to ensure that potential investors are provided with proper disclosure. Under the current Law, prospectuses must include all information that an investor would reasonably require and reasonably expect to find in the prospectus in order to make an informed assessment of the assets and liabilities, financial position, profits and losses and prospects of the corporation and the rights attaching to the securities¹. This would include information about the risks of investing in the securities.

While both civil and criminal liability is imposed under the Law for misleading or incomplete disclosure, ultimately it is left to investors (whether or not they are employees of the issuing entity) to assess what risks they wish to assume.

Under the fundraising provisions of the Corporate Law Economic Reform Program Act 1999 (CLERP Act) which are expected to come into force on 13 March 2000, prospectuses must contain the same kind of information as is currently required (see section 710).

In addition, the new disclosure documents provided for under the CLERP Act, that is, the profile statement and offer information statement, must specifically state the nature² of the risks involved in investing in the securities. As mentioned in our previous letter, it is quite likely that many small businesses will now use offer information statements.

The major risk issues that appear to be particularly relevant for present purposes include the following:

¹ See section 1022

² See subsection 714(1 Xb) and subsection 715(1)(d) respectively

1. the "eggs in one basket" problem where an employee may be relying on an employer for wages, savings (being the investment in the shares) and superannuation.

The possibility of a risk concentration of this kind is a consequence of encouraging employee share schemes and superannuation. It can be ameliorated by limiting the extent to which employees' savings and superannuation are invested in the employer. Some measures are already in place in this regard.

In relation to superannuation, the Superannuation Industry (Supervision) Act 1993 imposes restrictions whereby a new investment by a fund in the assets of its employer sponsor, or associated entities must not exceed 5 per cent of the assets of the fund.

In relation to employees' savings, the degree of exposure of employees to difficulties of their employer can be significantly influenced by the nature and extent of any taxation concessions for employee share schemes. In addition, ASIC only provides relief from the fundraising provisions of the Law for employee share schemes raising up to 5 per cent of existing capital (as outlined in Policy Statement 49). This limits the amount of total funds that can be raised as a direct result of employee contributions (in whatever form that may take, for example, salary sacrifice schemes, contribution plans and other structures).

2. the investment problem, that is, objectively identifying the commercial merits of whether or not to invest in the employers' shares (unless of course those shares are provided for no or nominal consideration).

This is a less significant problem for listed companies for which there is an externally determined share price that generally reflects the market's assessment of the available information about the company. Comparing the price of the offer with the current market price of the shares generally provides a ready yardstick for assessing the merits of the offer, although of course it does not remove the risk of subsequent adverse price movements.

For unlisted or smaller companies, it is an issue about ensuring that employees receive adequate information in order to make an informed decision. Regard must also be given to the cost of providing the information and the extent of the benefit of doing so.

How these competing considerations should be balanced is a matter of judgement. The Parliament recently opined on the matter when it enacted a number of fundraising reforms in the CLERP Act which, according to the Explanatory Memorandum, were designed to "...free [small business] from constraints in fundraising without exposing investors to unnecessary risks". In this regard, the relevant reforms are:

- relaxing a current exemption to enable unlimited personal offers leading up to 20 issues in a 12 month period with a ceiling of \$2million in funds raised; and
- the introduction of the Offer Information Statement (as opposed to a prospectus) for capital raisings of up to \$5million once during the life of a body.

B. Nature of Changes

In terms of whether the law relating to employee share schemes should be amended to facilitate their creation and operation, ASIC believes that the way in which the Corporations Law sets out a framework under which capital may be raised, combined with ASIC's wide discretionary modification and exemption powers³ is both adequate and appropriate. Since Parliament cannot always anticipate or

³ For example section 1084 under the current Law; and section 741(1) under the CLERP Act amendments effective 13 March 2000

respond quickly to new developments in the market, our discretionary powers give us flexibility to facilitate employee share schemes in the context of an ever changing commercial environment.

ASIC currently has sufficient powers to relieve employers offering employee share schemes from the prospectus (fundraising) provisions where appropriate and in fact has done this to the extent outlined in ASIC Policy Statement 49.

Since the CLERP Act changes are quite extensive in terms of the facilitation of small business fundraisings, ASIC believes that whether or not further changes to the Law are appropriate would be best determined after there has been some experience with the operation of the new law. Of course ASIC would implement any changes to the Law that the Inquiry may recommend which have been enacted by the Parliament.

C. Types of shares

You have asked for our views on whether employee share schemes should be permitted to offer equities other than ordinary shares and if other equities were offered, would this promote the employer/employee relationship.

The Corporations Law does not impose restrictions on the types of securities offered under an employee share scheme. In the context of ASIC's Policy Statement 49, relief relates to offers of fully paid ordinary shares (and only on a case by case basis for offers of partly paid shares made to directors in certain circumstances), but there is no legal impediment against the employer offering other equities. Whether or not these other equities promote the employer/employee relationship will depend on the rights attaching to the security.

For example, preference shares take many forms. Typically the rate of return on them is fixed. Sometimes preference shares are convertible into ordinary shares at the option of the holder or they convert automatically at a specified time. Arguably preference shares that are not convertible and which provide a fixed rate of return irrespective of the performance of the company, would not tend to foster an interdependent relationship between employer and employee. In contrast to this, preference shares which are convertible to ordinary shares in the company provide the employee with an interest in the productivity (and profitability) of the company and therefore are more likely to promote the employer/employee relationship.

Ordinary shares are probably the best understood form of company equity. However, it is still necessary to provide some explanation about what rights are associated with the equity being offered. To the extent that the rights differ from those ordinarily associated with making share investments, it is all the more important to ensure that employees are fully informed about what those rights are. It would not be unusual with employee share schemes for there to be some form of restrictions on transfer of the securities tying the benefits of being provided with the shares with the ongoing employment relationship. It is important for these restrictions to be fully disclosed to the employee.

Typically special classes or kinds of equity offered through employee share schemes will not be quoted on the stock market even if the company's ordinary shares are quoted. This means that the comfort that may be derived from there being an externally determined share price will not necessarily be available although it will depend on the extent to which the value of the securities are referable to the value of the ordinary shares. In any event, the information needed by employees to properly assess the merits of participating in the share scheme will be more extensive than what would be needed if the securities were ordinary shares.

Other relevant information to be disclosed to the employee about the security would concern risk. For example:

- some kinds of securities involve risks that are not associated with ordinary shares (for example, options to acquire ordinary shares usually must be exercised within a specified time (after which they are effectively valueless));
- some forms of packaging ordinary shares through trusts or other structures may give rise to risks that do not arise out of holding the shares directly (for example, those arising from the failure of the trustee to perform its duties);
- there are liabilities associated with holding some forms of securities, for example partly paid shares in relation to which the holder is liable to make additional payments when called to do so by the company or on winding up of the company. If such shares are offered as part of an employee share plan, there may also be a condition that the holder pays any outstanding amount on the shares on ceasing employment. Particular difficulties could arise if the amount outstanding is greater than the market value of the share at the time the payment becomes due.

While there is nothing in the Corporations Law that limits the kind of equity that may be offered through an employee share scheme, we understand that in practice the availability of taxation concessions has a significant influence on what securities are in fact offered.

The regulatory framework of the Law is capable of operating satisfactorily in relation to all kinds of securities that may be offered through an employee share scheme in that it focuses on ensuring an adequate degree of disclosure.

Whether concessional taxation treatment should be extended to offers of equity other than ordinary shares and rights to ordinary shares, involves issues that go beyond matters of securities market regulation. For our part, ASIC has not extended the relief provided under Policy Statement 49 to offers of partly paid shares to all employees because of the additional risks associated with the liability to make additional payments on those shares.

D. Employee share schemes and multinational corporations

These difficulties faced by both foreign companies and Australian companies making offers of shares to their employees outside their 'home' jurisdiction, stem from those offers being regulated under the law where they are made rather than under the law of the home jurisdiction. It follows that companies are generally not able to use the disclosure documents that they prepare in accordance with the requirements of their home jurisdiction elsewhere.

Accordingly, both Australian and foreign companies face additional costs in complying with regulatory requirements outside their home jurisdiction that may be out of proportion with the potential benefit where the number of employees in any of those offshore jurisdictions is small.

ASIC has recognised this difficulty in Policy Statement 49 which relevantly states:

" [ASIC] is aware of the difficulties facing foreign issuers making offers under multi-national employee share schemes, where it is necessary to comply with the prospectus provisions for the benefit of relatively few Australian employees. [ASIC] is of the view that if appropriate relief is not granted in respect of employee share schemes, Australian employees may not receive employment related benefits which their employers (domestic or foreign) would otherwise offer" (PS 49.16).

Relief for Australian companies seeking to offer shares to employees in other jurisdictions is a matter for the relevant local regulator.

E. Disclosure

1. Information about employee share schemes required to be disclosed

Prospectuses

The prospectus provisions of the Corporations Law apply to employee share schemes because they are offers and invitations to subscribe for or purchase securities of a corporation.

ASIC Policy Statement 49 provides for conditional relief from the prospectus provisions for offers made under employee share schemes where the corporation is listed on the ASX or on an approved foreign exchange⁴.

Rather than providing a prospectus, the employer must provide the employee with an offer document which sets out the relevant terms and conditions as well as a copy or summary of the rules of the scheme. These documents must be lodged with ASIC within 7 days of making the offer (but they are not available on the public register).

Company full-year financial reports

Accounting standards

Accounting standards enforceable under the Corporations Law require companies which are reporting entities (ie entities which have users dependent on financial statements who cannot command information specifically to meet their information needs) to make certain disclosures in their financial statements.

Accounting standard AASB 1028 "Accounting for Employee Entitlements" ("AASB 1028")

Paragraph 14(d) of accounting standard AASB 1028 "Accounting for Employee Entitlements" requires certain information to be disclosed in relation to each ownership-based remuneration scheme operating during the financial year. An ownership-based remuneration scheme is a share ownership plan or similar arrangement where employees are compensated by being offered an opportunity to acquire equity in the employer.

The information required to be disclosed is:

- "(i) a description of the nature of the scheme, including the number of employees eligible to participate, the group of employees eligible to participate (if the scheme is not open to all employees), the number and types of shares or other equity interests employees are able to acquire and the exercise date or period during which employees can acquire shares or other equity interests under the scheme;
- (ii) the price(s) that employees are to pay for any shares or other equity interests issued under an ownership-based remuneration scheme or, if the price(s) are not determinable as at the reporting date, how such prices will be determined;
- (iii) the number and types of shares or other equity interests that employees have acquired or have become entitled to acquire under the scheme up to the reporting date, the number and types of shares or other equity interests still available to employees under the

⁴ Current approved foreign exchanges are the New York Stock Exchange, the American Stock Exchange, the London Stock Exchange, the Tokyo Stock Exchange, the Frankfurt Stock Exchange, the Bourse de Paris, the Toronto Stock Exchange, the Zurich Stock Exchange, The Amsterdam Stock Exchange, the Milan Stock Exchange, The Stock Exchange of Hong Kong Ltd, the Stock Exchange of Singapore Limited, the New Zealand Stock Exchange or the Kuala Lumpur Stock Exchange (Main and Second Boards) provided that, if any such exchange has more than one board on which securities are quoted, securities shall only be taken to be quoted on that exchange if quoted on the main board of that exchange; or the NASDAQ National Market.

scheme as at the reporting date and the market price of those shares or other equity interests as at the reporting date;

- (iv) the number and types of shares or other equity interests that have been issued to employees during the financial year, the total market value of those shares or other equity interests at issue date and the total amount received and/or receivable from employees for those shares or other equity interests; and
- (v) details of the employer's accounting policy in respect of ownership-based remuneration schemes, and any amounts recognised in the accounts and consolidated accounts in relation to the financial year".

ASIC Class Order 98/0100 only permits rounding of this information to the nearest \$1,000 in certain circumstances.

Accounting standards AASB 1017 "Related Party Disclosures" ("AASB 1017") and AASB 1034 "Information to be Disclosed in Financial Reports" (AASB 1034")

There are also various disclosure requirements in AASB 1017 concerning shares and options issued by a company (or its controlled entities) to its related parties. Related parties include directors but would not normally include employees. There are also a number of specific additional requirements in relation to share and option transactions between a company (or its controlled entities) and its directors or director-related entities.

For transactions concerning shares, options or other equity instruments involving directors or director-related entities, paragraph 4.15 requires the financial statements to disclose:

- the aggregate number of shares, options and other equity instruments acquired by directors and director-related entities, classified by entity and class of instrument;
- the aggregate number of shares, options and other equity instruments disposed of by directors and director-related entities, classified by entity and class of instrument; and
- the nature of the terms and conditions of each type of transaction if it is on more favourable terms that would be expected in an arm's length transaction.

There are also requirements to disclose the aggregate amount of remuneration of directors and the number of directors falling within each band of \$10,000 (paragraphs 4.2 to 4.6). The Urgent Issues Group has determined that this remuneration includes the value of shares and options (refer Attachment to UIG Abstract 14 "Directors' Remuneration"). Similar requirements apply in relation to the remuneration of executive officers of listed companies who earn \$100,000 or more (refer paragraphs 12.1 to 12.3 of accounting standard AASB 1034).

Full-year directors' report

The directors' report which accompanies the financial statements of a company must include specific disclosure requirements in relation to all shares and options issued by a company.

Under s.300 of the Law, the full-year directors' report must include details of.

- (a) any options granted over unissued shares or unissued interests to directors or any of the 5 most highly remunerated officers of the company;
- (b) unissued shares or interests under option as at the date of the report; and

(c) shares or interests issued as a result of the exercise of an option over unissued shares or interests.

Information is required in relation to both the company itself and its controlled entities.

For unissued shares and interests under options disclosure is required of..

- the entity that will issue shares or interests;
- the number and classes of shares or interests;
- the issue price of the shares or interests (or method of determining the issue price);
- the expiry date of options; and
- rights that option holders have to participate in any issue of shares or interests.

For shares issued, disclosure is required of.

- the entity that issued the shares or interests;
- the number and classes of shares or interests issued;
- the amount unpaid on the shares or interests; and
- the amount paid or agreed to be paid for the shares or interests.

For options granted to directors and the 5 most highly remunerated officers, the entity, the name of the person and the number and class of shares or interests to which the options relate must also be given.

ASIC believes that s.300A of the Law also requires the directors' reports of listed Australian companies to disclose the value of the options issued to directors and the named 5 executive officers of the company receiving the highest emoluments. Section 300A requires disclosures of the emoluments of each named individual with a dissection into the elements of those emoluments.

Late last year the Parliamentary Joint Committee on Corporations and Securities recommended that the Law be amended to explicitly require values of options to be disclosed under s.300A because of their concerns about the level of compliance.

2. Level of disclosure of terms and conditions

Prospectus documents

An employee share scheme prospectus must comply with section 1022 of the Corporations Law. How much information is finally contained in the prospectus depends on how material the information is in terms of making an assessment of the matters referred to in section 1022 (namely, the assets and liabilities, financial position, profits and losses and prospects of the corporation and the rights attaching to the securities).

Under ASIC Policy Statement 49 ASIC has given relief from the need to have a prospectus provided that the Offer document contains certain information, including:

- the current market price and the offer price in Australian dollars at the time of the offer; and
- a copy or summary of the rules of the scheme.

Further conditions applying to employee share schemes are contained in ASIC's Class Orders referred to in Policy Statement 49 (a copy of class order 94/1289 is attached for your convenience).

Company full-year financial reports

As detailed in 1 above, AASB 1028 does require the full-year financial statements of reporting entities to disclose the nature of a scheme and the following specific terms and conditions:

- number and types of shares which the employees are able to acquire;
- exercise date or period during which the shares can be acquired;
- and price to be paid or how such prices will be determined.

3. Grant of options

Company full-year financial reports

Under paragraph 14(d) of AASB 1028, the full-year financial statements of a reporting entity must disclose in relation to an ownership-based remuneration scheme, the number and types of shares or other equity interests:

- that employees have acquired or become entitled to acquire during a financial year; and
- issued to employees during the financial year, the market value of those interests, and the amount received or receivable from employees for those interests.

4. Disclosure of value of shares and options

Company full-year financial reports

Accounting standards do not currently require disclosure of the value of options in an employee share scheme. However, paragraph 14(d) of AASB 1028 does require the full-year financial statements and consolidated financial statements of reporting entities to disclose the number and types of shares or other equity interests still available to employees under the scheme at reporting date and the market value of those shares or other equity interests as at year end.

Accounting standards under the Law are made by the Australian Accounting Standards Board. Prior to its dissolution at the end of 1999, the AASB had decided to undertake a project to develop an accounting standard dealing with the valuation and treatment of options. A new Board is in the process of being selected and appointed.

As noted in 1, the value of options issued to directors and certain executives of listed Australian companies should be disclosed in the directors' report and included in remuneration disclosures in the notes to the financial statements.

5. Holders of options

Company full-year financial reports

AASB 1028 requires disclosures in full-year financial statements in relation to employees as a group.

AASB 1017 requires disclosure of information in relation to directors and director-related entities as a group. However, ss.300 and 300A of the Law require information for named directors and certain named executive officers.

6. Level of disclosure

At present, the accounting standards do not require disclosure of a value attributed to rights under employee share schemes nor specify the method for determining that value. Nor do they specify a method of accounting for the rights issued under the schemes (eg whether they give rise to an expense, whether changes in value subsequent to their issue should be recorded, recording the effects of the exercise of those rights).

The new Australian Accounting Standards Board ("AASB") may examine these matters in the future. The previous AASB was dissolved on 31 December 1999 and a new AASB is in the process of being selected and appointed.

It is the role of the AASB to make accounting standards which have the force of law under the Corporations Law. The AASB does so after due process, including public exposure of draft accounting standards.

It is ASIC's role to enforce compliance with the Law, including the requirements of accounting standards. It is not ASIC's role to make accounting standards.

7. Additional voluntary disclosure

Since both annual reports and prospectuses are creatures of statute whose requirements are governed by legislation, it is unlikely that further and additional information would be included (particularly when balancing the costs against the commercial advantages in doing so).

8. Additional information

ASIC believes that the existing requirements for disclosure in relation to employee share schemes in annual financial reports as set out in the Law and the accounting standards (outlined in Part E section 1 above) are generally appropriate. We do however, support the amendment recommended by the Parliamentary Joint Committee on Corporations and Securities to clarify those requirements (also outlined in Part E section 1 above).

Regarding the content of prospectuses, ASIC believes that general disclosure as set out in section 1022 of the Law (and recently re-enacted in section 710 of the CLERP Act) is appropriate.

9. Where are Employee share schemes listed?

The Law and accounting standards provide a basic structure for the presentation of company financial reports.

The annual financial report is accompanied by a directors' report which must contain the information specified in item 1 above. This is not subject to audit.

The notes to the annual financial statements must contain the information required by accounting standards as specified in item 1 above. This is subject to audit.

However, there are no further requirements that the information be shown in a particular location in the directors' report or the notes to the financial statements. The only exception is that the initial section of the notes to the financial statements must contain a summary of accounting policies (refer accounting standard AASB 100 1 "Accounting Policies").

F. Quality Control

You have asked us for our views on the public policy benefits in establishing a public registry of employee share schemes and a separate regulator to register, regulate and monitor such schemes. While

it is not entirely apparent to ASIC what is envisaged in this regard, you may wish to take account of the following comments.

As a result of the recommendations of the Wallis Financial System Inquiry, the number of financial regulators has been rationalised and we have moved towards functional regulation as opposed to regulation of specific products. ASIC acquired new powers in relation to consumer protection and market integrity in the additional areas of banking, superannuation and insurance. It would appear inconsistent with the general direction of these reforms to establish another regulator to separately and exclusively protect the rights of employees and regulate employee share schemes.

Moreover, unless there is to be a fundamental shift in regulatory philosophy applicable to employee share schemes, it would be unnecessary and inefficient to do so. The regulatory approach taken in Australia in relation to offers of securities is based on disclosure and not an assessment of the merit of the product. Investing in shares, whether by employees or non employees involves risks. The role of the regulator is to ensure that these risks are disclosed in the offer document so that the employee can make an informed decision about whether or not to invest. ASIC is well positioned to play this role.

ASIC must, amongst other things, strive to⁵:

- "(a) maintain, facilitate and improve the performance of the financial system ... in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; and
- (b) promote the confident and informed participation of investors and consumers in the financial system".

Having a separate regulator protecting the interests of one group of investors or one class of investments could also lead to market distortions. ASIC must protect and balance the interests of all investors in the company which would include employers, employees and any other third parties that are shareholders. A split in the regulation of the interests of these investors could result in administrative difficulties and be confusing to employees, consumers, investors and the market more generally. It would be difficult to justify an outcome that involved different classes of investors in a company having different remedies in the event of difficulties.

While having a separate regulator for employee share schemes may be a means of visibly increasing the intensity of regulation of those schemes, at the end of the day, it must be recognised that there are risks associated with investment in shares that no amount of regulation can remove. These are business and market risks that are a necessary element of providing capital for a business venture and are therefore a necessary element of any employee share scheme. Risks of this kind are best regulated through proper disclosure (a regulatory approach which ASIC is already well positioned to provide).

Finally, while we see benefits in obtaining accurate sources of information relating to employee share schemes, this needs to be assessed in light of other considerations including: the costs of setting up another regulator, duplication of information and whether there are other existing non-regulatory bodies which could perform this task, for example, the Australian Bureau of Statistics and the Australian Taxation Office.

In the final analysis, we must balance the regulatory benefits against the costs of imposing an additional regulator, always being mindful of the risks that over-regulation could drive investors out of the market altogether.

⁵ See paragraphs 1(2)(a) and (b) of the Australian Securities and Investments Commission Act 1989

If there are specific issues in this letter that you would like to discuss please contact Mr. Douglas Niven regarding the accounting matters raised in section E on 9911 2079, and for all other issues, Ms. Vesna Zuro on 9911 2664.

Yours sincerely,

ALAN CAMERON, AM
CHAIRMAN