

14th May, 1999

The Committee Secretary
House of Representatives Standing Committee
on Employment, Education and Workplace Relations
Suite R1 116 Parliament House
CANBERRA ACT 2600

Dear Sir,

EMPLOYEE SHARE OWNERSHIP IN AUSTRALIAN ENTERPRISES

In response to your letter of 19 March, 1999 addressed to the Company's Managing Director, we are pleased to respond to your invitation to make a submission to your inquiry into Employee Share Ownership in Australian Enterprises.

The detailed submission is attached.

Thank you for granting us an extension beyond the nominated deadline.

We look forward to an opportunity to address the Committee, if appropriate, on any issues that the Committee wishes to explore in depth. In this regard, please contact Bill Patullo (03) 9609 3870 in my department.

Yours sincerely,

(Signed by)
T.F.R. BROWN

SUBMISSION ON
EMPLOYEE SHARE OWNERSHIP IN AUSTRALIAN ENTERPRISES
TO THE
STANDING COMMITTEE ON EMPLOYMENT, EDUCATION
AND WORKPLACE RELATIONS

This submission reports on the extent of employee ownership schemes in The Broken Hill Proprietary Company Limited (“BHP”); comments on the impact of such schemes; and raises issues for further consideration.

Summary of main points

1. Share ownership in BHP

BHP has conducted employee equity participation programs since 1984 and currently there are 51,000 employees holding shares or options representing 7.6 % of the Company’s capital.

2. Purpose of equity participation for employees

The rationale for equity participation programs is multi faceted, traversing financial, social, economic and employee relations considerations. Equity plans may be used variously as an incentive vehicle with contingent reward value, as a savings medium or as a substitute for base remuneration.

3. Employee ownership and workplace relations

Measurement of the impacts of the programs in the workplace is inconclusive in an environment of restructuring, asset review and global re-positioning.

There is a positive sense of entitled sharing among employee shareholders when the share price rises, but there is a negative impact if there is any downside risk for employees in an era of uncertainty of tenure.

4. Legislation and regulation

The legal, tax and regulatory environment should continue to be supportive and concessional in relation to employee equity participation programs. There is a need for it to be more facilitative of efficient conduct of such programs and the following recommendations indicate what is required :

- (i) Review of the Corporations Law relating to
 - i) “insider trading” is recommended to ease prohibition on on-market purchases for directors of a company, where such purchases are under an approved employee share acquisition scheme or where the purchase has been specifically approved at a general meeting of the (public)

company's shareholders; and

- ii) prospectus requirements of public companies is recommended to exempt all employee share acquisition schemes approved at a general meeting of shareholders from this obligation.

(ii) Review of the Income Tax law to :

- i) allow the continuation of the practices adopted under the previous law which permitted companies to calculate the market value of employee shares and options, for the purposes of calculating any taxable gain, based on the five business days immediately before, or following, announcement of an equity issue to employees;
- ii) make it clear that no discount is to be included in a taxpayer's assessable income where the taxpayer is a non resident of Australia and who has not provided any relevant employment services which generate Australian source income;
- iii) remove the cessation of employment as a cessation time in Sections 139CA and 139CB for determining when any discount is to be included in assessable income;
- iv) modify the current valuation tables for options which currently are unfair and inappropriate where the share or right cannot be transferred;
- v) remove or amend the exemption condition (Sec 139CE(2)) regarding the forfeiture of ownership of shares or options where the employee equity plan includes that the cessation of employment due to fraud or evasion by the employee results in the cessation of entitlements under an employee share acquisition scheme;
- vi) amend the exemption condition in Section 139CE(3) regarding restrictions upon disposals to allow for the recipient to dispose of the shares or options a week (7 days) prior to cessation of employment where the cessation of employment occurs within three years of acquisition of the shares or options; and
- vii) apply the tests for employment in Section 139CD(3) and DD(3) in determining "qualifying shares" only at the time of acquisition, otherwise a takeover will trigger a failure of the test.

FULL SUBMISSION

1. Share ownership in BHP

BHP's active equity participation programs date from 1984 and have been conducted both to enable employees in Australia and overseas to widen their stakeholding in the Company and to serve as a long term incentive vehicle for senior management.

Presently, there are approximately 51,000 employees holding shares or options representing 7.6% of the Company's capital.

The shares have generally been issues of new capital to employees in Australia under the Employee Share Plan and on a basis that employees may borrow all of the purchase price (which is usually at a 2½% discount to prevailing market price) repayable without interest via half yearly dividends over a period not exceeding 20 years. Each employee shareholder has immediate voting and dividend rights. He/she must hold the shares ordinarily for a minimum of three years. The most recent issue was made in October 1997.

The options are rights to acquire new shares, also under the Employee Share Plan, for Australian and overseas employees at an exercise price close to market price of BHP shares at the time of the options issue. The most recent options issue was in April 1999 to eligible employees worldwide and this was the first such issue to apply performance hurdles in the form of comparative Total Shareholder Return index performance against the Australian Stock Exchange Top 100 and a selected group of 19 global comparator resources and manufacturing companies over a period of not less than three years.

From time to time, changes to the Rules of the Employee Share Plan have been approved by shareholders at General Meetings in order to improve the plan, adapt it to new tax or corporations law and to introduce new elements. Changes approved by shareholders in 1998 included a loan extension arrangement for employees leaving the Company so as to address the downside risk involved in employee commitment to loan-backed shares and to take advantage of the ability to issue options in the future with a longer life than the previous legal limit of five years.

Performance Rights were approved by shareholders at an Extraordinary General Meeting earlier this year for issue to the Company's Managing Director as part of his negotiated employment contract. These Rights are somewhat in the nature of "restricted stock", with their value being dependent upon fulfilment by the Managing Director of requisite service and performance conditions.

The Company's Executive Share Scheme, which hitherto issued partly paid shares to a small group of executives as a long term incentive, has been discontinued in favour of the Employee Share Plan options program involving performance hurdles.

2. Purpose of equity participation for employees

Our view is that the rationale for employee equity participation programs and the value of such programs is multi faceted and includes :

- (i) supporting the mixed (public and private) ownership economy of Australia by giving wage earners opportunities to comprehend and experience how the private sector functions financially;
- (ii) justification of the profit motive in terms of risk return for investors and the need to retain profits for future product and market development;
- (iii) providing employees with the same perspective and information as is received by non employee shareholders, thereby encouraging employees to take a more active interest as co-owners of the company and for them to look beyond their local domain;
- (iv) contributing to a productive mindset among employees;
- (v) as a potentially valuable savings investment supplement to superannuation;
- (vi) being an attractive employer in a competitive market place;
- (vii) using shares or options as an incentive based contingent reward in executive recruitment negotiations;
- (viii) advancing the public image of the company as a progressive corporate citizen.

Hence, it is evident that employee equity participation programs may be used as :

- (a) an incentive, where value to the employee is dependent upon achievement of some predetermined performance targets;
- (b) a capital base where the potential value for the employee is in share price growth and dividends; or
- (c) a partial substitute for base remuneration.

Whether the shares involved are sourced from new capital issues or from on-market purchases is best left to the individual judgment of the Boards of the companies involved, having regard to their particular corporate circumstances.

3. Employee ownership and workplace relations

There has been no trade-off of wage increases for employee share plan issues in BHP, nor has there been any share or options issue made contingent upon prescribed employee work performance.

BHP's equity participation programs have been a part of the total culture of employment, but not on a basis that would constitute a regular remuneration component.

It is appreciated too that there are corporate governance aspects that the Board of Directors of public companies must consider in any employee equity program because of potential impacts that it can have on the actual or perceived value of other equity that is held by non employee shareholders.

In view of the above and also with regard to the continuing environment of asset review and workforce restructuring, it is not possible to isolate the benefits or other impacts of BHP's employee equity programs from the effects and attitudes resulting from the major organisational changes continuing to take place.

The presence of downside investment risk is a natural feature of share ownership among non employee shareholders, but it has proven to be difficult to sustain for employee shareholders who have loan repayment obligations and whose jobs become redundant through closure, sale or restructuring of a business. In BHP's circumstances, that issue has been addressed (as explained in an earlier section of this paper).

Nonetheless, anecdotally, there have been many instances of favourable responses when employees have been able to liquidate capital gains accrued during the period they have held shares or options and, conversely, there have been reports of disappointment when capital gains evaporate or are denied when BHP's share price falls. All of this, of course, demonstrates to employees the connection between profitability and share price movements.

4. Legislation and regulation

(a) Employees - the disadvantaged investor?

It needs to be recognised that, even though the nature of their equity participation may be similar in some respects, employees can be in quite different circumstances from the non employee shareholder as co-owners in a company. In some ways, employees may be classed as disadvantaged investors.

Unlike the outside shareholder, employees do not have the same choices in terms of type of investment, timing of investment, freedom from restrictions in trading nor an entirely uninfluenced context for making their investment decisions under an employer sponsored equity plan. The employee is offered an investment opportunity only in the employer company, at a time and on conditions that generally are set by the employer. Further, the employee may face restrictions in terms of both minimum and maximum holding periods as well as (at the executive level) restrictions on trading to limited windows following periodic profit announcements. Employees may also feel influenced positively or negatively by the opinions of their colleagues and by their attitudes to their work situation.

Accordingly, there is an ongoing justification to continue with supportive legal and regulatory environments in relation to employee equity programs.

(b) Taxation on employee share ownership

The tax regime impacting on employee equity programs should be favourable, simple, consistent and stable.

While it is difficult to describe any tax system as ideal, the current relevant law in Australia is supportive and many major employers evidently are able to progress their employee equity participation satisfactorily under it. There are a number of technical matters that have carried over following the change in legislation a couple of years ago and which are raised again now to point out that some fine tuning of the law

would improve the efficacy of employee equity programs without detriment to the Federal Treasury.

The specific recommendations involved are as follows :

- (i) The current income tax law should allow the continuation of the practices adopted under the previous law which permitted companies to calculate the market value of ESP shares and options for the purposes of calculating any taxable gain based on the five business days immediately before, or following, announcement of an ESP offer.

The current income tax law, which is based on the market value of ESP shares and options on the date of issue, provides both uncertainty for employees considering ESP offers, and significant administrative difficulties for companies which issue share and options progressively over a period which could cover several weeks to thousands of employees in numerous locations;

- (ii) The current income tax law does not contain any source rules for the taxing of discounts on employee shares.

It is recommended the current tax law be amended to make it clear that no discount is to be included in a taxpayer's assessable income where the taxpayer is a non resident of Australia and who has not provided any relevant employment services which generate Australian source income;

- (iii) The legislation introduced in 1995 requires a number of technical corrections, details of which have previously been submitted to the Treasury and the Australian Taxation Office. The main matters requiring amendment relate to:

- the removal of the cessation of employment as a cessation time in Sections 139CA and 139CB for determining when the discount is to be included in assessable income. This would prevent undue financial hardship where for example the employee was retiring;
- the valuation tables for options which are unfair and inappropriate where the share or right cannot be transferred i.e. the non transferability means the options have a lower market value;
- the removal or amendment of the exemption condition (Sec 139CE(2)) regarding the forfeiture of ownership of shares or options where the scheme includes that the cessation of employment due to fraud or evasion by the employee results in the cessation of entitlements under an employee share acquisition scheme;
- the exemption condition in Section 139CE(3) should be amended to allow for the recipient to dispose of the shares or options a week (7 days) prior to cessation of employment where the cessation of employment occurs within three years of acquisition of the shares or options.

The current exemption condition gives rise to practical difficulties where the employer has provided finance to the employee for the acquisition of

the shares or options and that finance must be repaid by the employee prior to cessation of employment; and

- the tests for employment in Section 139CD(3) and DD(3) in determining “qualifying shares” should only apply at the time of acquisition, otherwise a takeover will trigger a failure of the test. For example, a takeover or corporate restructure could result in the employer ceasing to be the employer or a holding company of the employer.

(c) Review of legal and regulatory restrictions

There are two restrictive areas which we believe warrant attention.

- The insider trading provisions of the Corporations Law can currently operate to restrict on-market purchases of shares when an executive of a company exercise options under an employee share plan.

Although in some cases this is appropriate the restriction is not necessarily fair in all circumstances. For example, under an employee equity participation arrangement, an option may be zero-priced and used as a form of remuneration, whereby the executive, paying no exercise price, will gain an assessable benefit from exercise of the option at any time, irrespective of the market price or their knowledge of future movements of the market. Therefore, it is difficult to comprehend any insider trading motive that could exist in that type of situation.

- Employee share plans are currently given relief by ASIC from the requirement to prepare a prospectus under the Corporations Law if shares issued under the plan constitute less than 5% of the company's capital. This is an arbitrary limit and consideration should be given to its removal. This may be effected either by amendment to the Corporations Law or by appropriate consultation with ASIC.

The number of shares currently on issue under a plan is not relevant to whether a prospectus exemption should be given - the issue is the employees' familiarity with the entity in which shares are being offered. Larger schemes approved by shareholders should also have the same access to the prospectus exemption.

END OF SUBMISSION

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