Governance Institute of Australia

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Mr Peng Lee
Senior Manager Corporations
Australian Securities and Investments Commission
Level 24, 120 Collins St
Melbourne VIC 3000

By email: policy.submissions@asic.gov.au

Dear Mr Lee

Consultation Paper 218: Employee incentive schemes

Governance Institute of Australia is the only independent professional association with a sole focus on the practice of governance. We provide the best education and support for practising chartered secretaries, governance advisers and risk managers to drive responsible performance in their organisations.

Our Members are all involved in governance, corporate administration, company secretarial practice and compliance within their organisations, including public listed and public unlisted companies, private companies, public sector agencies and not-for-profit organisations, with their primary responsibility being the development and implementation of governance frameworks. Our Members frequently are those with the primary responsibility for dealing and communicating with regulators such as the Australian Securities and Investments Commission (ASIC).

Governance Institute of Australia welcomes the opportunity to comment on the consultation paper, *Employee incentive schemes* (the discussion paper) and draws upon the experience of our Members in providing our response.

General comments

Governance Institute notes that employee incentive schemes provide companies with a competitive advantage by being able to align the employees' interests with those of the company, and to reward and retain staff in the longer-term. The employee may be provided with an opportunity to derive benefit by realising the value of rights or options at a later time, usually for a higher value than when acquired.

Such incentive initiatives, however, must be balanced against the broader framework in place which regulates the circumstances in which investments in companies can be made. The *Corporations Act 2001*, for example, requires bodies establishing an employee share scheme to provide a prospectus or other disclosure document to employees and, in some instances, to obtain an Australian financial services licence.

The provision of a class order for companies providing conditional relief from such requirements, therefore, is strongly supported where the benefits of the scheme outweigh the risks to employees of participating in an employee incentive scheme. In this light, Governance Institute commends ASIC on producing a well-researched and informed consultation paper on proposals to amend the current relief provided to companies implementing employee incentive schemes. Governance Institute recognises that substantial work has been undertaken in understanding the types of relief which ASIC is being asked to provide, and this is reflected in the sensible suggestions put forward.

There are, however, framework and policy issues with employee incentive schemes which continue to discourage companies from establishing such schemes within their organisations. In particular, Governance Institute notes that there are ongoing regulatory compliance burdens which make it increasingly difficult and cumbersome for companies to maintain incentive-based schemes.

Increased compliance burden

Employee incentive schemes were originally introduced to bring alignment between director, executive and shareholder interests, by ensuring that directors and executives have 'skin in the game'. It has become increasingly difficult, however, for companies to continue to use these types of incentive-based schemes, given that the hurdles to them being efficient and effective are increasing.

We are of the view that that close attention needs to be paid to the conditions which will apply to companies seeking to implement employee incentive schemes to ensure that they do not impose a further compliance burden on companies, in turn rendering such schemes too difficult to administer.

Governance Institute recommends:

- any changes should not impact on the availability of relief to schemes which to date have been able to rely on Class Order 03/184 relief
- any new compliance requirements should not adversely impact such schemes and offers under those schemes
- any new compliance requirements should not result in those schemes and offers now becoming untenable or requiring substantial restructure.

Moving the taxation point

One of the other key framework issues for employee incentive schemes is the current taxation point for employees who receive benefits through an employee incentive scheme.

Governance Institute notes that current taxation rules disadvantages the employee with options, particularly one who resigns from a company. The company retains the options, but the employee is taxed at the point of departure, despite the option not being realised until a later date, if at all. For example, the employee may have an option with an exercise price of ten dollars per share, but at the time of leaving the company, the share price might be five dollars. The employee would still be taxed on the imputed value of the option and there is no refund on the taxation paid. The only alternative for the employee is to claim the difference as a capital gains loss, provided that the employee has a capital gain against which the loss can be offset.

The employee is therefore financially disadvantaged.

If the employee is made redundant, they need to choose whether or not to take up the option, and the same financial disadvantage applies.

Governance Institute strongly supports, therefore, the recommendation made by the Productivity Commission[1] — which was the only recommendation not to be accepted and acted

[1] Recommendation 13 of the Productivity Commission 2009, *Executive Remuneration in Australia*, Report No. 49, Final Inquiry Report, Melbourne.

upon by the government — to move the tax point of share or options schemes to be delayed until the point of realising the value of the share or option even where the executive or employee has ceased employment with the company.

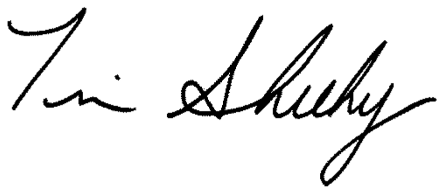
Moving the taxation point is consistent with the desire — expressed by shareholders and the government in various policy initiatives — that companies ensure that remuneration frameworks foster a long-term alignment between the company and its investors. It also removes the need for special tax rulings.

Conclusion

Governance Institute is in agreement with many of the proposals put forward in the paper. Our responses to the questions posed in the discussion paper are set out on the following pages, but given our agreement on many issues, our responses deal with specific proposals and questions by exception. That is, where we have not provided a specific comment on a proposal or question, ASIC may assume that we are in agreement with the proposal and do not have any further significant comment to make about it.

Governance Institute looks forward to seeing the outcome of the consultation and the revised Regulatory Guide concerning employee incentive schemes. We would welcome the opportunity to discuss any of our views in greater detail.

Yours sincerely



Tim Sheehy
Chief Executive

Feedback on list of proposals and questions put forward in the consultation paper

Proposal A1

Governance Institute notes the options put forward by ASIC as the proposed response to address the difficulties with the current regime.

Governance Institute recommends Option 2 as the most appropriate approach.

However, as noted in our covering letter, by specifying additional conditions for companies seeking to access the amended class order, the process may impose further compliance burdens on companies. Governance Institute, therefore, recommends that ASIC remain mindful of the possible imposition of further compliance burdens in the framing of the class order.

Governance Institute recommends:

- any changes should not impact on the availability of relief to schemes which to date have been able to rely on Class Order 03/184 relief
- any new compliance requirements should not adversely impact such schemes and offers under those schemes
- any new compliance requirements should not result in those schemes and offers now becoming untenable or requiring substantial restructure.

Proposal A2

Governance Institute has nothing further to add to our comments in our covering letter which set out the current issues relating to the taxation point on options which hinder the successful implementation of employee incentive schemes.

Proposal B2

Governance Institute agrees with the inclusion and proposed definition of 'associated body corporate'. We note that, although scenarios involving associated bodies might not arise often, the prevalence of international structures means that the framework should be construed widely enough to enable all types of entities, within reason, to access the relief available. As such, allowing for arrangements which include associated body corporates with varying thresholds of ownership, that is, not just wholly-owned subsidiaries, will ensure that different organisational structures are not excluded from the application of the class order.

Proposal C1

Question C1Q1

Governance Institute questions the inclusion of contractors as 'employees' capable of being offered an eligible product by a company. While we acknowledge that circumstances might arise where a contractor is to be rewarded for a period of long and dedicated service, Governance Institute is of the view that contractors are different from employees in that the same level of interdependence between contractors and the company does not exist, and contractors should not expect to receive, therefore, the same benefits as employees. Indeed, contractors receive other benefits from contracting with a company which employees do not receive, such as being able to decide or control how they undertake the work required.

The Australian Taxation Office (ATO), in defining whether or not a contractor is an employee, notes that the 'whole working arrangement' is considered, including the terms and conditions under which work is performed. Governance Institute is of the view that offering 'employee incentives schemes' to contractors might, therefore, provide extra criteria by which a contractor might be considered an employee. This is likely to act as a disincentive for companies considering the inclusion of contractors in their employee incentive schemes. From a broader policy perspective, this situation might also lead to confusion among companies and contractors regarding the status of contractors, given they are being offered employee benefits.

Indeed, Governance Institute believes that ASIC should more broadly consider aligning their definitions with those of the taxation legislation with respect to the categorisation of different working conditions. As noted above, the ATO considers the ‘whole working arrangement’ when considering whether a person is classified as a contractor or employee. By way of example, the ATO’s *Employee/Contractor decision tool* available from the ATO website asks questions about the nature of the employment relationship, including whether or not the worker has the right to pay another person to do the work, and whether or not there is a written agreement in place.

By describing ‘contractors’ differently in the ASIC class order, Governance Institute believes that this may create substantial confusion as to the status of contractors, with the possibility they may be categorised as employees of the company. It could also create further compliance burdens for companies as they will have to reconcile both definitions of contractors before determining whether or not contractors are able to be included in their employee incentive schemes.

There may also be administration and taxation complications which arise from arrangements where contractors are given access to employee incentive schemes. For example, a company will need to keep track of contractors once the contract has been completed, if they are included in an employee incentive scheme.

Governance Institute recommends that ASIC not extend the class order to include contractors but include contractors as a category where ASIC can extend relief as appropriate.

Questions C1Q1—Q4

As explained above, we do not believe that contractors should be considered as part of the class order providing exemptions for companies issuing employee incentive schemes, given that they are not employees.

We are of the view, however, that casual employees should be entitled to be provided with the benefits offered to other employees, including employee incentive schemes.

Governance Institute does not agree with the work history criteria applied to contractors and casual employees. As noted above, we do not agree with the retention of contractors within the class order. However, should contractors be retained in the class order, Governance Institute has concerns with paragraph 52(c) which extends the definition to the situation where the ‘employer has an ongoing intention to continue employing the contractor on an equivalent basis for at least the next 12 months’. Governance Institute believes that evidencing this term creates difficulties for companies where the retention of contractors is uncertain. We are of the view that the wording should be amended to the company confirming that there is no consideration that this will change, rather than an undertaking that the contractor will definitely be retained for 12 months.

Governance Institute recommends that ASIC amend this clause to read:
the employer has no reason to believe that the present arrangements with the contractor will not continue on an equivalent basis for at least the next 12 months.

We also recommend that the words ‘being employed by an issuer or associated body corporate’ should be amended to ‘being employed by an issuer and/or associated body corporate’ to provide for corporate restructures or a restructure within the group of companies.

Governance Institute also suggests an amendment to paragraph 58(b) which states that a casual employee will be entitled to participate in an employee incentive scheme provided that they meet the relevant criteria and 'continue to work on this basis'. We note that casual employees, at some stage, may transition to being full-time or part-time employees and should not be precluded from receiving the benefit of an employee incentive scheme in the event that there is some doubt about their future work arrangements.

We also believe that the requirement that a casual employee has worked the pro-rata equivalent of 40 per cent or more of a full-time position to meet the criteria is unnecessarily restrictive. We note, for example, that in some industries casual employees may only work on specific projects for a short period of time on a yearly basis, such as at major annual sporting events, or be employed as part of overflow management, again, on a yearly basis. In such instances they may be longstanding casual employees — often employed over many years on a casual basis — but with varying timetables which may or may not meet the 40 per cent equivalent of a full-time role. Companies would not be able to reward these employees, despite their consistent work histories, with the opportunity to participate in employee incentive schemes, under the proposed definition.

Governance Institute recommends that ASIC amend this clause to recognise the variety of circumstances in casual employee relations, including longevity of the casual employment relationship, to ensure that ongoing casual employment relationships are included and rewarded.

Proposal C2

C2Q1—Q2

Governance Institute agrees with the proposal to extend class order relief to cover offers to prospective employees. We note that a prospective employee could have accepted an offer of employment but may not commence in the position for some months, or they may be on gardening leave for a period, and this extension allows the company to include them in the offer.

Proposal C3

Governance Institute believes that the express provision of limited relief for participation by non-executive directors in employee incentive schemes creates some confusion when read alongside the already existing provisions exempting senior managers from the disclosure provisions which apply to offers to employees in ss 708(12) and 1012D(9B) of the Corporations Act.

While we understand that non-executive directors are not captured by the current definition of 'employee share schemes' in s 9 of the Corporations Act, we note that non-executive directors may be included in the definition of 'senior managers' as captured and amended by ASIC Class Order 04/899. Section 9 of the Corporations Act defines a senior manager as someone '… (other than a director or secretary) who: makes or participates in making, decisions that affect the whole, or a substantial part, of the business of the corporation …'.

Class Order 04/889, however, expressly amends the definition of 'a senior manager' in s 9, for the purposes of Chapter 6D and Part 7.9 of the Corporations Act, to include a person who:

> …takes part in, the management of the body (*regardless of the person's designation and whether or not the person is a director or secretary* of the body) [emphasis added]…

Governance Institute believes that the express inclusion of a 'director' in the definition already allows companies to exempt non-executive directors from the disclosure requirements for offers of securities or other financial products to senior managers. We note that the provision of proposed separate limited relief in the class order, therefore, will likely create further confusion for companies as to the requirements for including non-executive directors in employee incentive schemes.

Proposal D3

Question D3Q3

Governance Institute agrees with the definition that performance rights should be offered for no more than nominal monetary consideration. While we understand that most performance rights are issued for no monetary consideration, we believe that a broader definition is warranted.

However, we caution that care needs to be taken to ensure that the definition does not inadvertently include contractual entitlements under the employment contract. For example, Governance Institute notes that a value can be attributed to participation in a long-term incentive (LTI) plan in an employee's contract. This value should not be confused with the 'nominal or no consideration' paid for performance rights. The definition, therefore, should remain clear, that if monetary consideration is paid it is not more than nominal and does not include any contractual entitlements under an employment contract.

Proposal D4

Question D4Q1

Governance Institute seeks clarification in relation to ASIC's intent in this proposal. We are unclear if this proposal is seeking to provide guidance on cash-settled equity remuneration. We also have concerns that ASIC may be seeking to clarify that normal commissions and bonuses are not financial products, yet given that these are clearly not financial products, we do not see the need to include relief for something that currently does not require relief.

Governance Institute notes that it would be helpful to understand what doubt this proposal is seeking to address. This in turn will lead to an avoidance of doubt.

Proposal E1

Governance Institute notes that the general conditions for applying to both allocated products and unallocated products when using a trust requires that:

> the trustee must maintain proper written financial records on the activities of the trust and cause those records to be audited annually and made available for inspection…

We note that the proposal in the general conditions to require a trust to have its records audited annually and made available for inspection imposes a higher regulatory requirement than is currently in place. While this may constitute good governance, it does impose a further compliance burden on trusts. In particular, we note that it may lead to more administration, if separate financial statements need to be issued and more fees to be paid to auditors, if separate checks are required.

Proposal E2

Question E2Q2

Governance Institute seeks further clarification on how the five per cent limit has been calculated, noting that there may be different classes of shares which have been provided as part of the employee incentive scheme, and that some may have limited voting rights attached to them, while others may be ordinary fully-paid shares with normal voting rights attached to them. At present it is unclear if the percentage is to be calculated against products with similar voting rights, or against all eligible products irrespective of the voting rights attached to them.

We also note that the calculation appears to suggest that all options or performance rights which have been granted and are unallocated must be included in calculating the percentage given they can be an 'eligible product'. Not all performance rights vest, as not all performance hurdles are met. Rights and options, do not have any voting rights attached, given that they have not become shares, and should not be included in this calculation until they do become shares and are allocated. **Governance Institute recommends** that they not be so included, as this would be an instance of 'over counting'.

Proposal F1

Question F1Q1

Governance Institute supports the proposal to extend relief for offers under employee incentive schemes involving financial products that have been quoted on either ASX or an approved foreign market for less than three month. Previously this was 12 months.

However, we note that a demerger should be able to count the years of trading as a previous entity and therefore be able to seek relief immediately and not be subject to the three-month waiting period or need to seek separate relief.

Governance Institute recommends that it would be helpful if ASIC could include relief for a 'standard' demerger in this class order or a separate class order so that companies can avoid the need to seek separate relief. Governance Institute recognises that such 'standard' relief may not cover all demergers and that in addition some case-by-case relief may still be needed.

Proposal F2

Question F2Q1

Governance Institute supports the proposal for calculating a five per cent share capital limit for employee incentive schemes; however, we also seek clarification as to why the calculation is based on the number of shares in the same class issued during a five-year period, given that most share plans have an escrow or non-exercise period of three years. **Governance Institute recommends** that the proposal align with the three-year period set out in share plans.

Proposal F3

Question F3Q3

Governance Institute does not believe that it is preferable for ASIC to require that options and performance rights be offered for 'no monetary consideration.' As noted in our response to Question D3Q3, we are of the view that the appropriate definition to retain is the one which stipulates that an option or performance right is issued for 'no more than nominal monetary consideration'.

Governance Institute recommends that ASIC retain a definition which require that options and performance rights be offered for no more than nominal monetary consideration.

Proposal F4

Question F4Q1—Q3

Our overarching concern with this proposal is that we do not agree that it is a matter for the regulator to determine the holding period but for each company to determine this according to its particular circumstances. Given that the interdependence of the employee and the company lies at the heart of the employee incentive scheme, it is a matter for the company to determine what period will incentivise its staff.

For example, the company may choose to have different holding periods for different classes of rights. We do not support, therefore, putting into the class order specific conditions which might place some companies at a disadvantage where the conditions of the class order suggest that only one type of employee incentive scheme structure is allowed.

While Governance Institute understands that the 12-month holding period has been proposed as a result of ASIC's experience of employee incentive schemes, the majority of which include a condition that an employee remain in employment for periods between 12 months and three years, we note that there is variance in company practice, and that the decision on the length of the holding period is one for the company to make and should depend on the company cycle. Governance Institute strongly recommends against the regulator determining a particular form of holding plan.

Governance Institute recommends that companies be responsible for determining the length of the holding requirement, and that such a condition should not be contained in the class order.

If a holding requirement is imposed, Governance Institute does not agree with the minimum 12-month holding requirement in all instances. We note, for example, that it would be unfair to require a person who no longer works for the company to continue to hold shares for a 12-month period following the cessation of employment. While we understand that a scheme creates a relationship of interdependence and long-term benefit for both parties, the relationship effectively ends once the employee ceases to work with the company. We are of the view that there is no policy reason to require an individual who ceases to work for a company to continue to hold shares in that company. This should apply whether the individual resigns or is made redundant. We also note that these concerns apply to other ‘good leaver’ categories of employees, such as those who have died or are permanently disabled (whether or not they also cease employment) and as a result have their equity fully vested or released early.

Governance Institute recommends that the class order should not contain a requirement that an individual who has ceased employment with a company should be required to hold shares in that company for a 12-month period and that the class order requirement should only apply to an individual while they are employed by the company.

Governance Institute also believes that, should a holding requirement be imposed, the 12-month holding requirement should be a definitive period no matter what form the instrument is. That is, if a company provides an employee with a six-month right which then converts to shares, the six months for which the right was held should count as part of the holding requirement. This means that the employee is only required to hold the shares for a minimum of six further months to complete the 12-month holding requirement.

Proposal F5

Question F5Q1

Governance Institute notes that the question asks for a brief summary of key risks to be included in the offer document. It is unclear, however, what is meant by ‘key risks’ and how an entity should assess what is to be included or excluded. It is also unclear as to what risks companies are being asked to disclose. For example, should the document disclose risks associated with owning instruments, investing in the company, or other risks?

We believe that a lack of clarity around the requirements of the class order will result in the disclosure of a long list of risks, as is currently found in any offer document. Companies may form the view that they cannot leave out any possible risks, as they will be vulnerable to recourse should any risk not listed later arise. A long list of risks would be at odds with the desire to ensure that the disclosure is ‘clear, concise and effective’. Whereas employee offers currently are usually brief documents, the lack of clarity in the requirements for disclosure of ‘key risks’ will likely make them longer and more complex. Governance Institute notes that an alternative approach might be to allow companies to cross-reference already existing information in relation to risk, as and when required.

From a board’s perspective, if they disclose some risks and not others, or if one risk is detailed and another is not, the disclosure becomes actionable if an undisclosed risk arises or the less detailed risk becomes the one posing a difficulty for the scheme.

Risk is also fundamentally about the sources or drivers of uncertainty around the achievement of an entity’s objectives. In other words, it is uncertainty that generates risk and so risk management will not be perfectly predictive, but a snapshot in time of the risk profile of the entity. Governance Institute is firmly of the view that employees understand better than most the risks currently facing the achievement of objectives.

Governance Institute strongly recommends that the class order not impose the disclosure of 'key risks' in any offer made to employees to participate in the employee incentive scheme.

Should the 'key risks' requirement be retained, **Governance Institute recommends** that the 'key risks' relate to the equity investment (for example, risk of share price falling, risks related to loans if applicable, risk related to early leaving if amounts are still to be paid via salary sacrifice arrangement) and any other risks can be cross-referenced.

Question F5Q5

Governance Institute supports the proposal that the offer document and all other accompanying documents given to participants in connection with an offer under an employee incentive scheme must be made available to ASIC on request. We are of the view that lodging a form is preferable to lodging all documents. We also support that this form should not be placed on the public register. However, **we recommend** that ASIC should be required to provide an acknowledgement that the form has been received, and the company, itself, should be able to request a copy of the form after it has been lodged.

Proposal G1

Question G1Q3

Governance Institute does not agree with the proposed risk disclosure statement required to facilitate offers of ordinary shares for no monetary consideration by unlisted bodies. While we support the concept of disclosure applying to potential investors whereby those contemplating becoming shareholders should be informed about the potential risks attached to the investment, in this instance, the employee is not risking their own money. The concept of risk attends to a financial investment where a person risks their own money to achieve a financial benefit. In this instance, for no monetary consideration, the employee is being provided with a financial benefit — there is no 'risk' to the employee. As such, Governance Institute believes that the requirement for a risk disclosure statement provides no practical benefit but imposes a compliance burden on companies. Governance Institute is of the view that unlisted bodies will not utilise the class order relief, given this requirement and the new one that they must prepare and provide current audited accounts.

Governance Institute recommends that the requirement that unlisted bodies issue a risk disclosure statement and provide audited accounts be deleted.

Question G1Q4

Governance Institute does not agree with the proposed method for calculating the value of the shares to be provided to employees. We note that the conditions stipulate that the process include a 'valuation determined by an independent expert'. We note that unlisted companies are unlikely to take advantage of the ability to issue $1,000 worth of ordinary shares where the process for valuing the shares will likely cost more than the value to be distributed.

Governance Institute recommends that the requirement for a valuation to be determined by an independent expert be deleted.