IFSA
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Mr John Hawkins
Committee Secretary
Senate Standing Committee on Economics
Parliament House
CANBERRA ACT 2600

Email: economics.sen@aph.gov.au

Dear Mr Hawkins

Re: IFSA submission on the Senate's inquiry into employee share schemes

Thank you for the invitation to provide input on the Senate Economics Committee's current inquiry into employee share schemes. We greatly appreciate the extension of time during this busy period to lodge our submission.

IFSA is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 145 members who are responsible for investing over $1 trillion on behalf of more than ten million Australians. Members' compliance with IFSA Standards and Guidance Notes ensures the promotion of industry best practice.

- The role of employee share schemes

Employee share plans are a key element of a company's remuneration structure, designed to link employees' longer term rewards to the performance of the company and to the returns received by shareholders. Many companies use equity incentive and ownership plans to encourage superior performance by their employees and to assist in retaining them. Appropriately designed employee share ownership plans are good corporate governance and as a practice contribute to national savings by encouraging share ownership.

Employee share ownership plans encourage and promote the achievement of common goals between employees, shareholders and the company. After more than a decade of operation in Australia, employee share schemes encourage alignment with the long term interests of shareholders and the company. The plans play an essential role to build a culture of ownership amongst employees and retain key talent and provide long term incentives designed to align the interests of executives with shareholders.

Participating in an appropriately designed share ownership plan provides an incentive for employees to increase productivity and share the rewards of the success of the company. We also note that Government has previously committed to increasing the take-up of employee

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share schemes given the well recognised productivity improvements associated with the schemes.

The current review of executive remuneration arrangements has arisen as a result of the fallout from the global financial crisis and a decline in confidence in markets. Any changes that are made to employee share schemes should be considered against that background and specific consideration given to whether the changes will exacerbate this problem or create new inequalities

- IFSA's role and Guidelines on employee share schemes

IFSA members, both as the custodians and managers of other peoples' money and as institutional investors in their own right, have a vested interest in ensuring that there is an alignment of remuneration with risk management both in their own operations and the companies in which they invest.

As major shareholders, IFSA members are in a position to promote the adoption of prudent governance practices which influence the design of remuneration. While shareholders are not involved in the day-to-day management of companies, the Corporations Act, ASX Listing Rules and industry best practice provide many opportunities for shareholders to monitor and influence company decision-making which drives ultimate company performance.

In April 2007 IFSA released Guidance Note No. 13 - Employee Share Ownership Plan. This is the third edition of the Guidance Note and was developed in conjunction with a number of key stakeholders, including the Australian Institute of Company Directors, the Australian Shareholders Association and the Australian Employee Ownership Association. Guidance Note No. 13 provides guidance for Boards and shareholders regarding the development of employee ownership and incentive plans that aim to drive improved company performance and thereby increase shareholder value. The guidelines specify key principles that Boards should consider when designing these plans and the process for shareholder approval of the plans.

Compliance with Guidance Notes is voluntary but strongly encouraged and widely promoted as industry best practice. IFSA's Guidance Notes are publicly available on IFSA's website (www.ifsa.com.au) and IFSA members encourage all Australian listed companies to comply with these Guidance Notes.

- IFSA's principles on the design of employee share schemes

The application of sound corporate governance practices relating to remuneration increases confidence in the integrity and efficiency of the Australian capital market. The current governance regime over remuneration in Australia has experienced no systematic failure even in the recent market turbulence. Evidence is growing that the current regime is adjusting of its own accord to the changing financial environment.

We strongly believe that the board should be responsible for the culture and philosophy underpinning employee share ownership within the company. The remuneration committee of the board, comprising a majority of independent directors, should be responsible for determining the parameters of, and processes required to ensure appropriateness of, the employee share ownership plan. Senior management should have the delegated responsibility, with the board reviewing and overseeing, for the design and implementation of the employee share ownership plan within the philosophy and parameters set by the board.

The key principles that boards should consider in designing share plans for general employees and the process for shareholder approval of the plans are:

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a. Structure of share plans

The share plan should be designed to meet the particular needs of the company. The plan should be designed, as far is as practicable, to align employee and shareholder interests and fit with strategic human resource initiatives that encourage improved company performance. Plan types will vary depending on the nature of the company and its particular circumstances. As a general guide, employee share ownership plans that offer shares rather than options or rights to shares are preferable for general employees, because they are less dilutive and provide a clearer alignment of value and benefit.

b. Amount of Shares

The amount of shares issued under employee share plans should be reasonable in relation to the existing capitalisation of the company. The number and value of shares that will be reasonable will vary depending on the nature of the business, the circumstances of the company, the market and the other components of the employees' remuneration.

c. Transparency and Accountability

Companies should provide shareholders with meaningful information to permit them to determine whether to approve employee share plans. All aspects of these plans should be disclosed to shareholders, including their full cost.

d. Non-performance share based payments for employees

Where possible, companies should only offer these benefits by way of on-market purchase and not by way of new issue of shares.

- Government changes to the taxation treatment of employee share schemes

While we acknowledge the Government's desire to promote the integrity and fairness of the regime, IFSA remains concerned with the unintended distortions that may arise out of reforms to the regulatory regime underpinning employee share schemes. Undesirable consequences may include a change to remuneration structures by further encouraging short term actions, including the use of cash remuneration, rather than longer term planning.

We also note that the Federal Government released a Policy Statement on 1 July 2009, setting out the Government's final position on the taxation treatment of employee share schemes and welcome further consideration of the following matters:

Liquidity limitations relating to taxing point

We remain concerned that bringing forward the taxing point for shares held within employee share plans to a date which represents their "vest" date may have the following practical difficulties for certain financial services companies:

- Distortions to share prices - Taxing shares on vesting date may lead to large tranches of company shares being liquidated on the same day. This could lead to material share price declines on days when shares vest to employees, in particular for smaller companies which have less liquid share capital. This is because most companies issue shares in tranches to multiple employees on the same day. If those shares vest, those multiple employees will have a tax liability on that vesting date and the majority of employees will sell vesting shares to discharge the tax liability, leading to large volumes and price distortions. Employees who do not sell shares are taking on significant risk as the tax liability is calculated on vesting date whereas

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the shares could fall in value post vesting, leading to little value being realised once the shares are sold and a tax liability.

- Trading windows - Employees in most companies can only sell shares in designated share trading windows which occur 3 to 4 times a year. Sale of shares outside of these windows is prohibited due to concerns over insider trading activities. It is likely that some employees will have shares vesting outside these trading windows and therefore are unable to sell the shares to discharge the tax liability.

While our preferred position is to extend the taxing point to a time when shares can be sold or later, a suggested solution worthy of further consideration is to adjust the valuation. Specifically, the value of shares for tax purposes would be determined by the sale price achieved in the 3 months period after vesting or for shares not sold, the tax valuation being the 3 months volume weighted price of the share for that 3 months.

Clarify the definition and threshold underpinning 'genuine risk of forfeiture'

We remain concerned that there is uncertainty over the appropriate conditions or scenarios required to meet the test.

The Policy Statement states the real risk of forfeiture test is intended to target schemes which contrive to defer tax without complying with the intent of the proposed law. The Policy Statement also provides for deferral of tax when there is a real incentive to the employee. This suggests a distinction between *contrived* schemes which are ineligible for tax deferral, and schemes which provide a *real incentive* which are eligible.

While 'real' could be defined as 'genuine', it appears that the Policy Statement adopts the alternative definition of "likely". For example the Policy Statement says that "contrived schemes, where the risk is highly unlikely to arise, will not qualify". The Policy Statement provides an example of forfeiture in the case of dismissal for fraud or gross misconduct, and states this is not a real risk because it is unlikely to arise. Such a forfeiture clause does provide a *real incentive* for the employee to act in the best interests of the company and thus should be viewed as a 'real' risk of forfeiture. However this example suggests the test is not whether there is a real incentive, but whether the forfeiture is likely to happen.

We agree with Government that contrived schemes should not provide for tax deferral, however where the forfeiture clause has a commercial basis, it should be sufficient to allow for tax deferral to apply.

Given the significance of the issue and similar deliberations taking place in other jurisdictions, we welcome further consideration by Government (in consultation with industry) on providing additional guidance.

Deferred taxing point and employment status

Many financial services companies use shares and share rights schemes to defer performance based remuneration. Where an employee ceases employment, the present tax rules require an employee to pay tax on deferred shares or share rights at the time employment ceases rather than at the time when the deferral period ends.

While we acknowledge the various mechanisms Treasury propose to ensure all shares or rights are not required to be vested, we remain concerned that Australia will be in the position of being one of the few countries that tax equity compensation on termination of employment. We also believe that this requirement does not facilitate the alignment of an employee's remuneration directly with the fortunes of the company over the medium to longer term.

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We note that under the proposed new reporting requirements, the Tax Office would be able to track the vesting of the shares/options after employment was terminated to ensure compliance. Where the employee has not provided a TFN, the employer would be required to withhold tax. We believe that these measures address the risks of non-compliance. Consequently, the ceased employment taxing point should be removed from the requirements.

Good leaver clause

The Policy Statement states that it is open to the Australian Taxation Office to examine, after the fact, the pattern of forfeitures on termination and retrospectively determine that there was no "real" risk of forfeiture. This will create uncertainty for employers, especially where the plan includes a good leaver clause.

Good leaver clauses will often allow a terminating employee, who would otherwise forfeit their shares, to retain them in certain cases such as death, incapacity, disability, illness, leaving to raise children, redundancy, and bona fide retirement from the industry in which the employer operates. For example it is common for good leaver clauses to include cases of genuine redundancy. In the current financial climate a company may make a large number of employees redundant and allow these employees to retain their shares or options. There are unlikely to be many employees resigning and thus forfeiting their shares. During this period it may be the case that most employees who are terminating employment are allowed to keep their shares, and it is open to the ATO to determine there is no "real" risk based on the actual pattern of forfeitures.

Employers would be extremely cautious and unlikely to allow employees to retain shares which would otherwise be forfeited, even in good leaver scenarios, because of the risk of the ATO determining there was never a real risk of forfeiture. Such a determination would result in all participants in the share plan being subject to tax at time of grant, which could result in unexpected liabilities for employees, plus interest and possible penalties.

The legislation and explanatory material should specify what type of events can be included in a 'good leaver clause', and releasing shares or rights in these circumstances should not cause the ATO to determine that the scheme has contrived a 'real' risk Good leaver clauses should include provisions to allow for the release of shares which would otherwise be forfeited in cases of death, incapacity, disability, illness, leaving to raise children, redundancy, and bona fide retirement from the industry in which the employer operates.

Timing of the taxation of stock options

In relation to stock options, the Policy Statement states that the deferred taxing point is when there is both no longer a real risk of the taxpayer losing the right and no restriction (present at acquisition) preventing the taxpayer from either disposing or exercising the right.

One of the objectives from granting stock options is to encourage employee performance to increase the share price. If there is no increase in share price during the option period the employee does not receive any financial benefit and it is logical that no amount is assessable to the employee.

Where the exercise price is lower than the share price the option should be treated as being subject to a restriction on exercise. In such a case it is not accurate to say that the employee is choosing not to exercise the right, as it is a fundamental feature of the option that exercise only happens if the share price exceeds the option exercise price.

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The deferred taxing point should arise where the share price exceeds the exercise price, and there are no other restrictions preventing the employee from disposing of or exercising the right. If an employee chose not to exercise at this point they would still have a tax event, and if the share price subsequently dropped below the exercise price, this would be an example of a case where no refund is available as it is related to a choice of the employee and a loss in the market value of the securities.

Taxing options at the time of vesting will make using options unattractive to both employers and employees.

Application to expatriates

Under current rules if a participant in an employee share scheme is an Australian tax resident for only part of the vesting period, a tax exemption may be available for the portion of the gain which relates to the period of non-residency. The tax exemption simplifies the tax issues for employees who move between countries while holding shares and rights, and helps to avoid situations of potential double taxation. The legislation should provide a specific tax exemption for periods of non-residency.

In summary, we believe that share ownership plans are an effective means of encouraging share ownership for the purpose of improving employee and employer relations by:

- Aligning employees' focus on the corporate objectives and enhancing their commitment to the company's values and culture;
- Creating commonality of purpose by aligning their interests;
- Communicating with employees through channels normally reserved for shareholders;
- Educating employees about the risks and rewards of share ownership; and
- Adding wealth and value for all shareholders.

While we acknowledge the Government's desire to enhance the integrity and fairness of the regime, it is critical that it balances this need with the potential unintended distortions that may arise out of any new requirements. Limiting or prohibiting employee share schemes has the long term risk of adversely impacting company performance and national savings.

Please feel free to contact me on (02) 9299 3022 if you have any questions with regards to the information provided above.

Yours sincerely

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