Guerdon Associates
Executive Pay & Governance

31 January 2014

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

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

Dear Mr Peng Lee

Re: Response to Consultation Paper 218 'Employee Incentive Schemes'

Guerdon Associates appreciates the opportunity to comment on ASIC's proposals to expand the relief currently provided in relation to employee incentive schemes.

We support many of the proposals, on the basis that they reduce the regulatory requirements for employers wishing to offer incentive schemes to their employees.

For several of the proposals, we have suggested an alternative approach, which we believe is consistent with the objective of maximising the benefits for all stakeholders whilst ensuring that adequate protection is provided for employees.

We believe it is also appropriate to suggest that ASIC re-examines the justification for its approach to employee incentive schemes, on the basis that many such schemes do not involve an investment decision by employees.

We elaborate on these issues below.

About Guerdon Associates

Guerdon Associates is an independent[1] executive remuneration and board governance consulting firm. Our clients include 20% of the ASX 50 and a significant proportion of the remaining ASX 300 companies. Consulting staff are located in Melbourne and Sydney, with additional support located in offices in Chennai, India (database management and administration) and San Francisco (technology support).

[1] Independence is defined as a specialist provider of consulting services to boards to minimise conflicts of interest that may result from being a broad based supplier of multiple services to both management and boards.

1. COMMENTS ON THE ASIC PROPOSALS

We comment on selected issues in the consultation paper as follows:

Proposed conditions for relief – holding requirement

- The proposed requirement that participants can receive no more than 25% of the entitlement under an offer within 12 months of the offer being made in order "to ensure the relationship of interdependence is observed" would, in our view, unreasonably limit the design of incentive plans eligible for class order relief.

- In practice, it is likely that most plans will meet the proposed ASIC condition, because this suits the arrangements of the parties involved. But different vesting scales will not necessarily mean a lesser level of 'interdependence'. A plan that vests 50% immediately and the balance 12 months later, for example, would also create a culture of interdependence between the employer and the employee.

- Imposing this condition would require an employer who wishes to vest more than 25% within the first 12 months to make an application to ASIC for specific relief – resulting in an increase to the costs of establishing an incentive plan as well as administration for ASIC. And how would ASIC respond to such an application, when refusal would only discourage the employer from making the offer, so the employees would miss out on a benefit they would otherwise receive? Who would benefit from such a refusal? If, in practice, the application would be granted more or less as a matter of course little would be gained from imposing the minimum vesting condition.

- The fact an offer is made by the employer to an employee as a result of the employment relationship should be sufficient – it should be up to the employer to decide how to structure the plan to best contribute to the employment relationship.

Offers to non-executive directors

- It is important that relief is provided for non-executive directors (NEDs) to participate in equity-based incentive schemes. However, the specific conditions of relief for NED participation proposed by ASIC suggest that ASIC is seeking to impose its own governance perceptions in relation to NED equity plans. In our view, the basic condition for relief should simply be that the offer is made by a company to a NED.

- The circumstances in which NED equity plans are offered are many and varied. Limiting relief to quoted shares, depository interests and stapled securities does not recognise that a significant component of the Australian economy has been dependent on the entrepreneurial spirit of directors willing to build start-up exploration companies into major resources companies and receive options in lieu of cash fees. It is also contrary to support given by both the current and previous Australian governments for changes to the taxation and regulatory system to free up equity plan regulation for technology start-ups. We submit that the same definition of 'financial products' should be used for offers to NEDs as for offers to employees.

- Similarly, the proposal that relief be conditional upon directors contributing their own funds (including by way of fee sacrifice) to acquire the financial products would unreasonably limit the circumstances in which the class order relief would be available. There are many situations where it is entirely appropriate that NEDs should not be required to put up their own funds to acquire company securities. The obvious example is where a small company

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with limited cash resources wishes to provide remuneration in the form of options to attract and retain non-executive directors with the skills to give the company the best chance of success (ASIC should be encouraging this, to protect the interests of shareholders in the company).

- We agree that it is generally undesirable from a governance perspective for NED remuneration to be subject to a performance condition, because this may compromise director independence. However, we are strongly of the view that it is a matter for the issuing company and its shareholders to determine the appropriate structure of NED remuneration. Further, such a condition is not required to protect the interests of the NEDs. We therefore support removal of this condition.

Performance rights

- The requirement that a 'performance right' must "automatically vest" if service or performance conditions are met is unnecessary and should, in our view, be removed. While not as common, some company plans require the participant to 'exercise' the performance right as a pre-condition to a share being allocated. The proposed definition would exclude these instruments. We note that the legal characterisation of performance rights should not be an issue – the availability of relief should not be determined according to whether a right offered to employees has an exercise mechanism or not.

- We also consider it unnecessary to specify that there must be 'vesting conditions' attached to the offer for a right to qualify as a 'performance right' within the meaning of the Class Order. This is a matter for the company to determine. It is also inconsistent with the definition of other 'financial products', which do not impose a similar requirement to qualify for relief.

- We suggest ASIC reconsider using the term "performance right". Vesting conditions attaching to a right may be service based only, and not be contingent on performance. Division 83A of the Income Tax Assessment Act 1997 uses the term "share right". Therefore 'Share Right' or 'Equity Right' may be more appropriate terminology.

Offers by unlisted bodies

- We suggest the proposed $1,000 per annum limit on offers of ordinary shares for little or no monetary consideration should be removed, or at least significantly increased. Such a limitation will restrict the ability of cash-poor employers to attract and retain potentially high value-add individuals. In this regard we note the government's current focus on start-up and innovative companies where this would be a major concern in attracting talent.

2. ALTERNATIVE APPROACH FOR ACHIEVING ASIC'S OBJECTIVES

- ASIC states its underlying policy objective as facilitating employee incentive schemes by relieving companies from their obligations under the Corporations Act in relation to certain disclosure, licensing and hawking provisions, provided that appropriate protections are in place to minimise risk for employees. It then imposes conditions on the availability of relief designed to provide the appropriate protection, with the objectives of ensuring that:
  - the aim of the relevant offer is not fundraising;
  - the offer sufficiently supports the long-term mutual interdependence between the parties; and
  - adequate disclosure is provided to investors.

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- The approach taken by ASIC in the proposed new class order is generally appropriate (subject to our comments, above) in relation to employee incentive schemes that genuinely involve an 'investment' by employees. This will be the case where the employee pays some of the share/security price, whether on a post-tax or pre-tax (salary sacrifice) basis – i.e. a 'contribution plan'.

- However, if there is no 'investment' by the employee and there is no risk of financial detriment, then:
  - the arrangement should not be covered under Chapters 6 and 7, which preferably should be amended to specify this; or
  - ASIC should issue specific class order relief to clarify that Chapters 6 and 7 have no application to such arrangements (similar to ASIC's proposed class order relief to clarify that cash bonus plans where the amount of cash payable is determined by a measure other than an underlying eligible product are not 'derivatives' for the purposes of Chapter 7). It would also be appropriate to extend this to offers to non-executive directors.

- This simple approach would minimise compliance costs for employers offering incentive schemes, but still allow ASIC to achieve its objectives.

- In our view, the risks ASIC is concerned about in relation to offers of securities simply do not exist in relation to employee incentive plans or share schemes under which employees are at no risk of financial loss. The main types of arrangements included in this category are equity-based incentive plans, offered in the context of employment arrangements as incentive/variable remuneration, potentially payable in addition to fixed remuneration if specified performance conditions are satisfied. Such arrangements are provided as part of the remuneration of the employee, do not involve any element of the employee making/purchasing an investment in the company, and do not involve any risk of financial loss for the employee (other than the risk of not receiving vested equity if the performance conditions are not satisfied).

- The availability of an EIS may be a factor influencing a person's decision on whether to accept or remain in employment with a company. This is quite separate to the decision to participate in the EIS, and does not make participation an investment decision requiring protection under Chapters 6 or 7 or warranting regulation by ASIC. The practical reality is that employees will accept offers and participate in incentive plans because they have nothing to lose and a considerable amount to gain. ASIC-imposed requirements about the share price information that must be provided to employees will not affect an employee's decision to participate in the EIS. The information to be provided on the rules and the operation of the plan should be a matter for the employer, as part of the employment relationship, and not a matter for regulation by ASIC.

We would be pleased to discuss any queries you may have in relation to this submission.

Yours sincerely

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Principal
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