CGI
GLASS
LEWIS

CGI Glass Lewis
Suite 8.01, Level 8
261 George Street
Sydney NSW 2000
Australia

Tel: +61 2 9299 9266
Fax: +61 2 9299 1866

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via email: taxlawdesign@treasury.gov.au

General Manager - Law Design Practice
The Treasury
Langton Crescent
Parkes, ACT 2600

Exposure Draft - Tax and Superannuation Laws Amendment Bill 2015: improvements to taxation of employee share schemes

CGI Glass Lewis appreciates the opportunity to comment on the Exposure Draft issued by the Treasury regarding amendments to the tax treatment of employee share schemes ("ESS"). The amendments would change the taxing point for rights, introduce additional taxation concessions for certain companies and facilitate further changes that would streamline the process of establishing and maintaining an ESS.

CGI Glass Lewis is generally supportive of the use of equity-based schemes to incentivise employees to generate and preserve shareholder wealth, and we appreciate that the tax treatment of awards can play a significant role in determining the relative attractiveness of certain types of equity. As such, we support the main thrust of the proposed amendments in the exposure draft, namely to align taxation of ESS awards with the point of exercise as opposed to the current practice of taxation at vesting. With this starting point, the focus of this response is limited to what CGI Glass Lewis sees as the most significant changes in the Exposure Draft and to what we see as additional areas where the current regime on tax treatment of ESS could be improved.

CGI Glass Lewis has been providing in-depth proxy research and analysis on ASX-listed companies from its Sydney headquarters since 1994, and is a subsidiary of Glass, Lewis & Co. (“Glass Lewis”), a leading independent governance services firm that provides proxy voting research and recommendations to a global client base of over 1,000 institutional investors that collectively manage more than US$20 trillion in assets.

Clients use Glass Lewis (and CGI Glass Lewis) research to assist them with their proxy voting decisions and to engage with companies before and after shareholder meetings. Glass Lewis’ web-based vote management system, ViewPoint, provides clients with the ability to reconcile and vote ballots according to custom voting guidelines and to audit, report and disclose their proxy votes. Glass Lewis is a portfolio company of the Ontario Teachers’ Pension Plan Board (“OTPP”) and Alberta Investment Management Corp. (“AIMCo”).

Thank you in advance for your consideration and please do not hesitate to contact us if you would like to discuss any aspect of our submission in more detail.

Respectfully Submitted,

Aaron Bertinetti	Daniel J Smith
General Manager	Director of Research
CGI Glass Lewis	CGI Glass Lewis

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Australia

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Deferral of taxation on ESS rights: We are largely supportive of the proposed amendments that will eliminate the point of vesting as a potential taxing point, with ESS rights instead becoming taxable at exercise. This reversal of the 2009 changes would remove the possibility of employees holding ESS rights being subject to a tax at vesting even though the rights (i.e. share options) are underwater and/or unexercised, which we believe has largely been responsible for the large-scale abandonment of share options as a viable equity incentive tool among many corporate entities in the Australian market.

Similarly, we are supportive of the proposed measures to defer taxation for grants of ESS rights where those rights are subject only to a disposal restriction without those rights also having to be subject to a risk of forfeiture. This will marginally increase the attractiveness of holding locks or other disposal restrictions to employees. Such restrictions facilitate long-term alignment of interests between employees and non-employee shareholders. That said, we question why the Treasury did not extend this deferral provision to shares in addition to rights.

Maximum deferral period: The Exposure Draft contains amendments to the maximum deferral period, from 7 years to 15 years after the employee acquired the rights or shares. We see this as having at least two potential benefits. First, it facilitates a longer term alignment of interests between employees and non-employee shareholders by encouraging employees to hold vested but unexercised ESS rights and shares for longer periods of time. Second, the extended tax deferral period would provide more time for options that are underwater (that is options with an exercise price that is currently less than the prevailing market price of the corporate entity's securities) at the end of 7 years to no longer be underwater. Such an above-water outcome would provide additional value to the employee, to shareholders (by virtue of an increased security price) and to the Treasury (as a result of capital gains tax).

Cessation of employment: We note that the Exposure Draft does not contain amendments to the current provision of taxation of ESS rights or shares upon cessation of employment. This provision represents a tax on cessation of employment and from our vantage contributes to a potential misalignment of interests between employees and non-employee shareholders. We note that APRA has indicated,

> "*It would not be prudent practice for deferred payments to vest automatically upon cessation of employment with a[n APRA] regulated institution. It is preferable for deferral and vesting arrangements to remain in place. The fact that cessation of employment is the taxation point for deferred share schemes has the potential to cause conflict between prudent deferral and taxation requirements. Nevertheless, APRA remains of the view that a prudent remuneration policy will include deferral of some benefits to dates that are independent of and beyond cessation of employment.*"[1]

The current provision of taxation on cessation of employment creates an incentive for employees to negotiate for accelerated vesting provisions for unvested ESS awards that would otherwise vest at some point after the cessation of employment. On the one hand, accelerated vesting provisions would enable the employee to meet the tax obligations that would be incurred at cessation of employment. On the other hand, such provisions

[1] APRA Prudential Practice Guide 511 - Remuneration, para. 66 (see: http://www.apra.gov.au/adi/Documents/cfdocs/PPG511_REM_revised-Dec-09.pdf).

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potentially encourage the employee to attempt to time cessation of employment in order to maximise vesting against any predetermined performance hurdles that are attached to the ESS rights or shares, and to minimise the downside risks of outcomes after cessation of employment resulting from decisions made prior to cessation of employment. Such potential for misalignment could be prevented by removing the cessation of employment as one of the taxing points for ESS rights and shares.

Start-up concessions: In principle, we are supportive of the additional concessions for start-ups, namely the income tax exemption for the discount received on certain shares and the deferral of the income tax on the discount received on certain rights which are instead taxed under the capital gains tax. However, we question the appropriateness of some of the eligibility conditions for corporate entities for these additional concessions, namely that the securities of the entity cannot be listed on an approved securities exchange, that the entity must have been incorporated less than 10 years before the ESS interest was acquired, and that the entity must not have an aggregated turnover exceeding A$50 million.

The time and revenue conditions appear particularly arbitrary--we find it hard to believe that there would be any fundamental difference in the dynamics or entrepreneurial spirit of a business that was incorporated 9 years and 364 days ago as opposed to 10 years ago, or of a business that recorded A$49.999 million and $50.000 million in annual revenue. Furthermore, the proposed concessions do not appear to account for the start-ups in industries including but not limited to biotech, pharmaceuticals, mining and technology that have long lead times between incorporation and product commercialisation.

In respect of the delineation between listed and unlisted entities, we note the Treasury's rationale for excluding listed entities from the tax concession,

> "*The concession is intended to be limited to small start-up companies without easy access to capital and which are difficult to value. A listing of equity interests on an approved stock or securities exchange allows easier access to capital and allows a value for a company to be more easily ascertained. A listing also demonstrates that a company is in a more advanced period in its development where concerns around ESS compliance costs and liquidity are relatively less prohibitive*."

Whilst we agree that listed entities generally have easier access to capital than unlisted entities in Australia, we also note that it is this limited access to capital that often leads entities to list in the first place, not because they have reached some critical stage of development. By contrast, the depth of the private capital market in the United States (including angel investors, crowdfunding, early-stage investors and venture capital) , among other factors, enables start-ups to forestall listing for a much longer period than their Australian counterparts. Furthermore, we do not believe that listing on an approved exchange necessarily reflects the stage of development of a business; concerns about ESS compliance costs and liquidity may be less prohibitive because a company is listed, not because the company has reached a more advanced stage of development.

Ultimately, from the perspective of an employee, whether or not a start-up is listed on an approved securities exchange may not materially change the riskiness of working for that start-up. As such, we believe that any tax concessions on ESS designed to meet the Treasury's goal of stimulating growth of innovative start-ups in Australia do not need to be restricted by the listing status of a start-up.

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CGI Glass Lewis Fact Sheet

CGI Glass Lewis is a subsidiary of Glass, Lewis & Co., the leading independent governance analysis and proxy voting firm with a global client base of 1,000+ institutions that collectively manage more than $20 trillion in assets. Glass Lewis empowers institutional investors to make sound decisions at more than 20,000 meetings a year by uncovering and assessing governance, business, legal, political and accounting risks at issuers domiciled in 100 countries. Glass Lewis is a portfolio company of the Ontario Teachers' Pension Plan Board ("OTPP") and Alberta Investment Management Corp. ("AIMCo"), two of the largest pension plan investors in the world.

CGI Glass Lewis has been providing in-depth proxy research on ASX-listed companies from its Sydney headquarters since 1994 and provides local-market support for all proxy voting clients in Australia and Asia.

Key details regarding CGI Glass Lewis operations include:

Diversity: The Sydney-based team comes from a proudly diverse background representing 7 nationalities, 5 religions, 10 languages, 50% female and a wide variety of professional experience as lawyers, consultants, auditors, investment analysts, taxation analysts, research analysts, financial advisers, managers, client relationship managers, educators, investors, journalists and directors.

Research analysts: The Sydney-based analyst team currently includes 8 permanent research staff with over 50 years combined experience in proxy advisory and educated with more than a dozen undergraduate and postgraduate degrees.

Research coverage: The Sydney-based research team provides comprehensive research for all ASX, NZX and JSE-listed companies. In 2013, this universe included approximately 750 publicly-traded entities. This team also includes specialised local-market support for the global M&A and ESG research teams.

Research technology: Glass Lewis' proprietary research technology enables analysts to efficiently convert unstructured data from company disclosures and rapidly produce structured and consistent research with multi-layered editing that ensures superior quality control and accuracy. Our technology enables us to publish research through multiple channels including glasslewis.net, Equilar, Bloomberg, API, FTP and our proxy voting platform ViewPoint, the leader in usability, flexibility and transparency since its 2005 launch.

Engagement: The Sydney-based research team actively engages with ASX-listed company board members (see page 2), institutional clients, government and other stakeholders/advisers.

Client services: The Sydney-based client services and operations team provides local-market support for all proxy voting clients based in Australia and Asia, which currently oversee in excess of $1 trillion in assets. This team also provides operational support to North American, Asian and European clients.

E & S Advisory Papers: In association with EIRIS' Australian partner CAER, this research and ratings product allows clients to specifically identify and manage E&S risks and opportunities within their portfolios.

Governance & Remuneration Forums: In March 2014, CGI Glass Lewis co-hosted its eighth annual forums in Sydney and Perth (the event is also held biennially in Melbourne). The Forums provide a unique opportunity for institutional investors, corporate executives, non-executive directors and other key stakeholders to have a frank and practical exchange on relevant and current governance topics.

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Corporate Engagement Policy

Corporate meetings: Continuing a practice since CGI's founding, in 2013 the CGI Glass Lewis research team **met with over 200 ASX-listed companies**. The purpose of such meetings is to learn about company practices, foster dialogue and understanding of CGI Glass Lewis policies and services, and to provide transparency.

Corporate subscription: Companies, and other stakeholders, may purchase our research products, but a subscription is not required in order to engage with CGI Glass Lewis.

Transparency: CGI Glass Lewis **discloses engagement in all our proxy research papers**, including whether we have attempted to engage with a company during the year, when that engagement took place and the general matters discussed (we also note if a meeting did not take place). In addition, CGI Glass Lewis also **discloses whether a company has purchased the same research**.

Solicitation period: When CGI Glass Lewis analysts require clarification on a particular issue they will reach out to companies, but otherwise will not meet with companies during the solicitation period to discuss the details of their meeting or the merits of specific proposals. The solicitation period begins on the date the notice of meeting is released and ends on the date of the meeting.

Availability: Outside the solicitation period, CGI Glass Lewis **analysts are open to meeting with any company** to provide clarification as to the CGI Glass Lewis business model, operations, guidelines, and perspective on general governance items, as well as to learn about the specific aspects of that company. However, CGI Glass Lewis **cannot guarantee availability during proxy season periods** (April, May, September, October, November) when timely research for clients is the top priority.

Publicly available information: CGI Glass Lewis proxy research and recommendations are based solely on publicly available information that is available to all shareholders.

Additional disclosures: Companies are also welcome to notify CGI Glass Lewis when additional disclosures have been made during the solicitation period, but subsequent to the publishing of the CGI Glass Lewis research report. If the new information would be useful for clients and there is a reasonable amount of time prior to the meeting date, CGI Glass Lewis **will consider republishing its research report with the new information** and will always highlight whether or not any of its recommendations have changed as a result.

Proxy Talk: Based on client demand, CGI Glass Lewis will host "Proxy Talk" conference calls to facilitate an in depth discussion of a specific meeting, proposal or issue. CGI Glass Lewis clients are able to listen to the call and submit questions to the speakers, with representatives from the CGI Glass Lewis research team serving as moderators. This is an effective way for companies to reach clients directly, empowering clients and fostering improved disclosure and further colour on specific issues.

Contact: A company can **schedule a meeting or purchase research** by emailing CGIGL@glasslewis.com or calling +61 (2) 9299 9266.