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Extending Employee Ownership

Capital Strategies' Response to the Government's Consultation on Employee Share Ownership

January 1999

Foreword

We welcome the Government's consultation on employee share ownership.

Great progress has been made with employee ownership in the last twenty years, since the first Inland Revenue approved share schemes were introduced. What was once the preserve of a few progressive companies is now accepted business practice. The most successful companies are those that unlock the full commitment, creativity and resourcefulness of their employees by involving them as genuine partners in the business. In many sectors of the economy, talented labour is the scarce resource and intellectual capital the most valuable asset, so patterns of ownership have to adapt to this new reality.

Yet based on American experience we are still just scratching the surface of what could be achieved. For example, employee ownership is still rare in private companies and smaller quoted companies, but we know that it is these companies that form the backbone of the US employee ownership sector.

Some of the barriers are practical and some are financial, and we consider them at length in our submission. They are all removable with targeted reforms. Our proposals are radical but they build on the existing schemes and incorporate US experience, from which we draw much of our inspiration.

By appealing to the self-interest of existing owners of businesses, in whose hands the power to create employee ownership lies, and by modernising some of the principles of existing schemes to reflect business reality, our "New ESOP" provides a powerful incentive tool, a neat succession solution for private companies and an essential adjunct to a management buyout.

We think the Chancellor's target of doubling the number of companies with all-employee ownership is achievable, and we look forward to playing our own part in turning the vision into reality.

Layout of this Report

In Section 3, we discuss the claimed benefits of employee ownership and the quality of evidence to support these claims. Notwithstanding these benefits, we argue that there is still a need for Government to continue encouraging companies to establish employee ownership.

In Section 4, we examine the extent of employee ownership to date, and focus on those sectors where there is greatest growth potential, namely private companies and smaller quoted companies. We comment on the Government's main target of doubling the number of companies with employee ownership. Although not mentioned in the consultation document, we consider the role of ESOPs.

In Section 5, we analyse the five main barriers which have discouraged companies from establishing employee ownership.

In Sections 6 and 7, we propose solutions to these barriers, and justify our solutions. Section 6 covers some stand-alone reforms to the existing employee share schemes. Section 7 covers our proposal for a New ESOP which combines the best of the existing QUEST and profit sharing scheme and incorporates some further reforms.

In Section 8, we consider one of the Government's subsidiary objectives, namely the encouragement of longer term ownership by employees.

Finally, in Section 9, we summarise our proposals.

In Appendix 1, we present the latest results from the UK Employee Ownership Index which show that quoted companies with substantial employee ownership continue to outperform the market.

In Appendix 2, we explain why ESOPs are viewed by existing owners as dilutive and we expand on one partial solution to this problem which involves convertible preference shares.

In Appendix 3, we explain the concept of "vesting" as it applies to the New ESOP.

Section 3 - Benefits of Employee Ownership

Employee ownership, in its various forms, has the potential to:

- increase employees' motivation and improve productivity;
- unlock more commitment, creativity and resourcefulness in employees;
- attract and retain good staff and reduce wasteful labour turnover;
- empower and connect people who might otherwise have little stake in society;
- raise levels of business and financial literacy;
- improve corporate performance;
- anchor businesses in their local communities;
- solve succession in family firms;
- build significant capital sums for employees and spread long term wealth.

These are bold claims. They include micro-economic benefits, macro-economic benefits and social benefits. The Government, in its consultation paper, is concentrating on the micro-economic benefits which flow from aligning employees' interests more closely with those of their employers.

With all these benefits claimed for employee ownership, why are not more companies embracing the concept? Many knowledge-based companies offer employee ownership as a matter of competitive necessity, and some family-owned companies see employee ownership as a succession solution. But large parts of the private sector economy remain untouched.

One reason is that it is hard to prove, and may always be hard to prove, that employee ownership improves corporate performance, so the practical and financial barriers, which we discuss later in Section 5, deter the wary. There is plenty of anecdotal evidence from successful employee-owned companies, and there have been attempts at statistically rigorous surveys to isolate the employee ownership effect. Few if any of these surveys could be called conclusive.

Capital Strategies' contribution to the debate is the UK Employee Ownership Index which tracks the share prices of companies quoted on the London Stock Exchange where more than 10% of the issued share capital is held by or for employees other than directors. The Index has outperformed the main market indices consistently over the last five years (see Appendix 1). Unfortunately, this does not prove that employee ownership improves share prices! The Index contains several biases, and even if it comprised a representative sample of quoted companies, it would be impossible to unravel cause and effect. Successful companies might create employee ownership rather than vice versa.

So, in the absence of convincing proof, many business owners, be they entrepreneurs, venture capitalists or large institutions, remain sceptical that the benefits promised by employee ownership will justify the cost and complexity. And by "cost", we mean not just the transaction cost, but the very real funding cost and dilution cost of subsidising employee ownership. Hence institutional investors impose limits on the proportion of a quoted company's share capital that can be earmarked for employee ownership, and venture capitalists rarely consider it when they invest in a buyout, unless management is willing to accommodate it at their own expense.

Given this reticence, Government needs to make further improvements and provide further incentives to persuade the unconverted to try out the concept. Without such improvements and incentives, the benefits feel too uncertain and intangible for companies to justify the complexity and the very real cost.

Section 4 - Employee Ownership in the UK to date

The consultation document provides a picture of which corporate sectors have experienced the highest and the lowest levels of penetration of employee share schemes. We have combined this data with our own estimates to produce the following table.

Number of companies with all-employee ownership schemes

Market sector	Population of companies	Profit sharing scheme	SAYE scheme	CSOP	Qualifying ESOP	Case law ESOP
Quoted companies[1]	2,268	317	851	1,420	235[2]	200[3]
- FTSE 100	100	65	93	94		
- FTSE 250	250	64	175	215		
- Smaller quoted	1,642	185	554	974		
- AIM	276	3	29	137		
Private companies[5]	50,000	542	350	2,349[6]	35[4]	200[4]
- Larger independent[7]	11,000				25	170
- Venture capital backed[8]	4,000				10	30
- Smaller independent[9]	35,000					
All eligible companies	52,268	859	1,201	3,769	270	400

Source: Treasury consultation paper, Inland Revenue, Capital Strategies' estimates.

Notes to table

1. Although penetration of employee share schemes in the quoted sector is relatively high compared to the private sector, it is relatively low in the smaller quoted and AIM companies. We think there are two reasons for this. Firstly, smaller quoted companies and AIM companies share many of the characteristics of private companies, such as concentrated shareholdings and relative illiquidity in their shares, so the barriers experienced by private companies, which we describe in Section 5, are to an extent experienced by smaller quoted and AIM companies as well. Secondly, the anti-dilution limits set by the representative bodies of institutional investors (which broadly speaking limit the amount of new equity that can be used in employee share schemes to 10% over ten years) are more constraining for smaller quoted companies, since their market capitalisation is typically lower in relation to their labour costs, resulting in a given value of employee benefit consuming more equity. What capacity exists has been disproportionately consumed by discretionary schemes.

2. Nearly all these QUESTs are linked to SAYE schemes and they allow companies to claim a tax deduction on the difference between the exercise price of share options and the market price at the date of exercise. The cost of this relief is likely to be high in relation to the amount of new additional employee ownership it is creating.

3. There are significantly more ESOPs, not counted here, which are set up for executive benefits rather than all-employee benefits.

4. Market penetration of ESOPs in the unquoted sector is much lower than in the quoted sector, but in the former ESOPs will typically own a higher percentage, say 10% to 50%, of the share capital.

5. Defined as all unquoted trading companies not controlled by another company and with turnover greater than £750,000 or profits greater than £45,000. We therefore exclude very small companies and subsidiaries within a group (whether under a private holding company, a UK quoted holding company or an overseas parent).

6. Penetration of CSOPs in the private sector is higher than for other schemes. We think there are three reasons for this. Firstly, options are conditional benefits since they rely on an increasing share price and (usually) on employees' loyalty to the company before they have value. Therefore the cost to the company and to existing shareholders is to an extent performance-related. Secondly, options are more selectively targeted. Thirdly, options are easy to administer since they do not result in actual share ownership until they are exercised and this may not happen until the company is sold or listed; this avoids the problem of widespread individual share ownership in a private company.

7. Defined as unquoted trading companies with more than 20 employees other than venture capital backed companies (see below). They represent 45% of total employees in the unquoted sector.

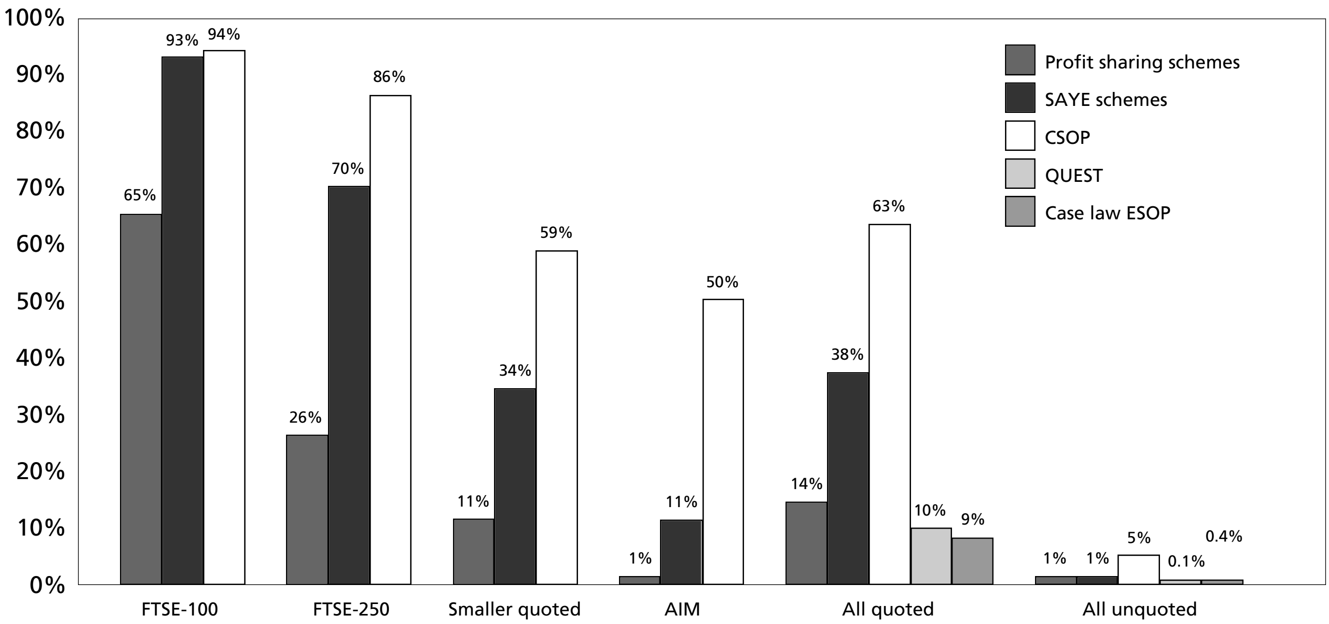
8. Defined as venture capital backed unquoted companies, principally but not exclusively management buyouts and buy-ins (source : Centre for Management Buyout Research). Penetration of employee share schemes is low in this sector because investors dislike the dilution caused by employee ownership and the complexity of widespread individual ownership. Although representing just 8% of private companies, they probably represent as much as 40% of total employees in the unquoted sector.

9. Defined as unquoted trading companies with fewer than 20 employees that are not venture capital backed. They represent just 15% of total employees in the unquoted sector.

It is clear from this analysis that the three sectors with the greatest growth potential are smaller quoted (including AIM) companies, larger independent private companies and venture capital backed private companies.

The data is illustrated most graphically in the following "market share" chart:

Penetration of employee share schemes in different market sectors



Achieving the Government's target

The Government has expressed its target in terms of doubling the number of companies where all employees have the opportunity to own shares. This target has been received with scepticism by many commentators and advisers. Presumably, this scepticism is based on the observation that many quoted companies already operate employee share schemes, and on the belief that it will be difficult to extend employee ownership in the private sector. We do not share this scepticism. We think there is significant untapped potential for employee ownership in private companies, but certain barriers need to be removed. We deal with these barriers in Section 5 and solutions to overcome them in Sections 6 and 7.

The role of ESOPs

Surprisingly, the consultation document makes no reference to the role of ESOPs. They can play an important warehouse role, especially in private companies, capturing a substantial block of shares for employees at the time of a transaction (such as an exit by a founding shareholder or a management buyout) and transferring shares to employees over time or at the date of a subsequent exit. American experience suggests that the ESOP trust is the single most important mechanism for extending employee ownership in private companies. About two thirds of the estimated 8,500 American ESOPs were established to provide an exit mechanism for shareholders in private companies. Therefore, a number of our later proposals deal with possible reforms to the QUEST, which provides a good starting position but which is too restrictive for most companies.

Potential growth based on American experience

We believe the best benchmark of market potential is the USA. The National Center for Employee Ownership estimates there are 8,500 ESOP companies, including companies with all-employee stock option programmes and self-investing savings plans (called 401k plans). This is lower than previous estimates (circa 10,000). Around two thirds of these ESOPs are in private companies, say around 5,700. It has taken 25 years to reach this level and, following rapid growth in the 1980s, the ESOP sector is now in a steady state.

Scaling down for the relative sizes of the US and UK economies, this would suggest a crude estimate of market potential of 1,000 UK ESOPs in the private company sector.

Various factors might cause us to refine this estimate:

- the US ESOP is a form of self-invested retirement plan providing career-long benefits whereas the UK ESOP provides more medium term benefits;
- for the exiting owner-manager in the UK, there are more tax-efficient rivals to the ESOP than in the US;
- the US is arguably more culturally attuned to employee ownership;
- many US trade unions have enthusiastically promoted ESOPs.

Overall, these factors persuade us to scale down our crude estimate of market potential still further, to a target of 500 UK ESOPs in the private company sector over a ten year period. This is a fourteen fold increase on the present number of QUESTs in that sector.

It should be noted that the target of doubling the number of companies with employee ownership is unlikely to result in a doubling of the number of *employee owners*. This is because the penetration of share schemes in larger quoted companies is already high, and most progress in future can be made in smaller companies which will tend to employ fewer people. If the Government wanted to *double* the number of *employee owners*, it might need to *treble* the number of companies with share schemes, a target which we believe is comfortably achievable over a ten year period, provided the fiscal and legal incentives were made as attractive as for the US company.

In Sections 6 and 7, we recommend how this might be achieved, by building on the existing schemes and models. First, we analyse the barriers to growth.

Section 5 - Barriers to Employee Ownership

Over the years, we have met nearly a thousand companies that have considered creating employee share ownership. We have helped many of them establish successful schemes, but many more have not reached that stage.

Based on this experience, and on specific feedback from clients and contacts, we have identified five main types of barrier, and we give examples of each.

Lack of flexibility

The "similar terms" principles that underlie the main all-employee share schemes are too narrowly interpreted. It is difficult for companies to reward good performers. The requirement to include even poor performers is seen as unfair by owners and employees alike. Disloyal leavers can retain their free shares received through a profit sharing scheme. It is impossible to operate devolved subsidiary share schemes in private company groups.

We believe the interpretation of the "similar terms" principles could be broadened without sacrificing the fairness embodied in those principles.

Widespread individual ownership in a private company

Widespread individual employee ownership is a challenge for unquoted companies. They have to create an internal market to deal with transfers of employee shares and this is administratively complex. Whether real or imagined, the transfer of voting rights to employee shareholders in a closely controlled private company raises the fear of workers controlling the boardroom.

We believe that employees in private companies can enjoy the full economic rights of ownership without the need for governance rights other than on key issues.

Tax impediments

The tax reliefs attached to QUESTs are subject to open-ended and draconian clawbacks in the event of wrongdoing by the QUEST trustees. This negates much of the tax benefits, especially for vendors. QUESTs themselves are subject to tax. The levying of income tax on employee shares received in excess of approved limits or outside approved schemes creates a cash cost for the employee at a time when there may be no means of selling shares to pay the tax.

We believe that simple tax reforms would remove these deterrents.

Transaction cost,complexity and uncertainty

A QUEST cannot perform the functions of a profit sharing trust and vice versa, so invariably two trusts are needed, which is complex. The requirement for QUESTs to include elected employee trustees is unnecessarily prescriptive and costly. There is no procedure to clear in advance with the Inland Revenue the value at which QUESTs acquire private company shares, which creates uncertainty for the trustees and for vendors. The sale of a minority shareholding to an ESOP will usually be done at a substantial discount that might be unattractive to a vendor.

We believe these barriers can be partly overcome with structural reform. As employee ownership takes off in the private sector, levels of awareness amongst business owners will rise, standard models will emerge, competition amongst advisers will increase, and transaction costs will fall, creating a virtuous circle.

Dilution cost and funding cost

This is one of the biggest barriers, and the most difficult to explain.

Employees are normally unable to finance the full cost of share ownership themselves, so the company (and ultimately its shareholders) bears much of the cost. Tax reliefs provide a Government subsidy of up to 30p in the £ but shareholders must bear the other 70p in the £. This cost to shareholders will be reduced if employees make a financial commitment to buy shares, or if employee ownership improves the company's performance over and above normal expectations. Nevertheless, when combined with the other barriers, the cost barrier is often "the straw that breaks the camel's back".

The dilution cost underlies:

- the anti-dilution limits set by the representative bodies of institutional investors in quoted companies which, broadly speaking, limit the amount of new equity that can be used in employee share schemes to 10% over ten years. These limits, which apply across the board to all quoted companies, bite especially hard on smaller companies with relatively high payroll costs in relation to market capitalisation, because a given magnitude of employee benefit will consume more equity;
- the unwillingness of venture capitalists to fund ESOP companies;
- hence, the tendency for ESOP buy-outs of owner-managers to be financed by bank debt and vendor debt. Debt obligations limit the price which an ESOP can justify paying to a vendor, and the amount of immediate cash consideration which can be offered to the vendor;
- the superiority of the share buyback as the solution to a partial exit route for a shareholder in a private company (this point isexpanded in Appendix 2 with the help of an illustration);
- the superiority of a trade sale or wholesale management buyout as the solution to a complete exit route for shareholders in a private company.

These are daunting barriers, but we believe they can be partly overcome with structural reform. American experience shows that transaction structures which use different classes of shares can significantly reduce the dilution cost to a level where the ESOP is a more neutral addition to the deal.

Section 6 - Reforms to Existing Employee Share Schemes

In this Section, we suggest a number of reforms to the approved profit sharing scheme and QUEST. We also propose a number of changes to other pieces of legislation.

Under each heading, we note which of the barriers identified in Section 5 would be addressed by each proposal, namely:

- lack of flexibility;
- widespread individual ownership in a private company;
- tax;
- transaction cost, complexity and uncertainty;
- dilution cost and funding cost.

Profit sharing scheme

Limited discretion to exclude non-performers
(Lack of flexibility)

The similar terms principle can operate unfairly. In particular, inability to exclude poor performers can have a de-motivating effect on good performers and wastes scarce equity. We therefore recommend that a company be permitted to exclude from participation up to a maximum of 10% of eligible employees.

Greater flexibility in ratio for matching offers
(Dilution and funding cost)
(Lack of flexibility)

For companies operating a matching offer scheme, an employee could be required to purchase (or deposit) up to four shares for every one free share appropriated. An employees' willingness to buy shares tests commitment and reduces the cost to other shareholders.

Cash alternative
(Dilution and funding cost)
(Lack of flexibility)

Presently, it is possible for a profit sharing scheme to be operated with a cash alternative, but never with complete certainty. Allowing companies to offer a taxable cash alternative would encourage more companies currently paying annual bonuses to all employees to offer a free share alternative. Such companies could create employee ownership at no additional cost.

Subsidiary companies
(Lack of flexibility)

It should be possible to establish a profit sharing scheme in a non-dependent subsidiary company of an unquoted company, using as scheme shares the shares in that subsidiary. The current rule that scheme shares must be in the holding company is inconsistent with the incentive needs of many subsidiaries, operating discrete businesses unconnected with their holding company. The current rule also discriminates against many venture capital backed companies where a number of different investment funds each have a minority economic interest, but through the medium of a single investment management company which itself controls the company.

Revised annual limits
(Lack of flexibility)

Many companies find the annual limits on individual participation complex and difficult to monitor. A more straightforward limit of £8,000 value of shares per participant would be far simpler. It would not offend the similar terms rule; in fact it would benefit lower paid employees, without removing any benefit currently enjoyed by higher paid individuals.

QUEST

Ability to gift shares to a profit sharing trust
(Tax)
(Cost and complexity)

The inability of a QUEST to gift, or transfer at less than market value, shares to a profit sharing trust frequently causes problems. Typically, a QUEST is funded by company contributions to acquire shares. In order to transfer those shares to employees free of tax through a profit sharing scheme, the company must make a further contribution to the profit sharing trust, so that it can purchase shares from the QUEST *at market value*. This produces an unnecessary cash surplus in the QUEST and can crystallise a CGT charge in the QUEST.

Tax exempt QUEST
(Tax)

Dividends received by QUESTs should be income tax-exempt.

Shares held within a QUEST should be sheltered from CGT.

Tax deductible dividends
(Tax)

Dividends paid to a QUEST by a company should be tax-deductible if used for a qualifying purpose since they represent a cost to the company of operating an employee share scheme.

Ability to grant options under a CSOP
(Lack of flexibility)

The similar terms requirement for distribution from a QUEST is a barrier for many companies that are otherwise enthusiastic about widespread employee share ownership. It is out of place in the meritocratic performance-driven business world. The linkage with SAYE schemes, far from producing a meritocratic outcome, results in arbitrary differentials of as much as 50 to 1 between those who are in a position to save and those who are not.

For these reasons, we suggest that a QUEST should be able to grant options under a CSOP, subject to the proviso that a maximum of 20% of shares acquired by a QUEST be subject to non-similar terms CSOP options.

Excluding poor performers
(Lack of flexibility)

As we have suggested for the profit sharing scheme and for the same reasons, the QUEST should be permitted to exclude up to 10% of eligible beneficiaries.

Company loans to QUESTs not treated as loans to participators
(Tax)

Companies often wish to finance their QUESTs by extending loans to them, but if they do so, and are close companies for tax purposes, they are likely to incur a liability under Section 419 Income and Corporation Taxes Act 1988.

Since a company can make a tax-deductible contribution to a QUEST, it cannot be regarded as seeking to avoid a tax liability by instead making a loan. We therefore propose that a loan to a QUEST, provided it is used for a qualifying purpose, should not be regarded as a loan to a participator under Section 419.

QUEST able to be operated by a subsidiary company
(Lack of flexibility)

It should be possible for a subsidiary company to establish a QUEST, and for the QUEST to acquire shares in that subsidiary. We make a similar suggestion for the profit sharing scheme, and apply the same reasoning.

The inability of any form of subsidiary company to establish a QUEST causes additional practical problems. For example, in a venture capital financed buyout (often the best opportunity to introduce employee share ownership), the venture capitalist will often have a controlling interest in the buyout company, as mentioned above. This means that, unless the buyout shell company already has employees before completion of the buyout (rarely the case), it will not be able to establish a QUEST because it will not be able to appoint employee trustees. Once the venture capitalist has subscribed for its equity, the buyout company will technically be a subsidiary, and a QUEST will be ruled out.

Any such facility should exclude dependent subsidiaries, so that QUESTs could still not be established in companies vulnerable to manipulation of their value by the holding company.

Ability to buy any securities,including convertible preference shares
(Dilution and funding cost)

By permitting a QUEST to acquire different types of security, including convertible preference shares, the dilution cost suffered by existing shareholders of creating a QUEST can be mitigated.

For example, a QUEST could, using company funding, acquire convertible preference shares which carry a reasonable fixed dividend and entitle their holder to a fixed return of capital. They may or may not carry voting rights. However, they would be convertible into standard ordinary shares after a defined period or on a defined event.

By fixing the value of the QUEST's holding over such a pre-determined period, all growth in value of the company over that period would be absorbed by the pre-QUEST ordinary shareholders. This would compensate them for the cost of their company funding the QUEST. However, this ring-fencing of value growth would be time limited, so that the QUEST's holding would, through subsequent conversion into ordinary shares, then participate in capital growth and in any performance linked dividend pari passu with ordinary shareholders.

In Appendix 2, we provide an illustration of the dilution effect of an ESOP and we show how convertible preference shares can reduce dilution.

Valuation clearance
(Cost and complexity)

To eliminate uncertainty on valuation for the QUEST as purchaser and for any vendor to the QUEST, we suggest that the Shares Valuation Division of the Inland Revenue be directed to clear valuations before a transaction takes place.

Remove clawback liability on vendor
(Tax)

A vendor to a QUEST who has claimed CGT rollover relief under Section 227 Taxation of Chargeable Gains Act 1992 faces an open-ended potential liability to clawback of that relief if the QUEST trustees subsequently commit a "chargeable event". The vendor is therefore vulnerable to factors beyond his control, and this has made the QUEST unattractive as an exit route for company owners. The QUEST trustees, not the vendor, should carry responsibility for clawback of relief in this situation.

Single professional trustee
(Cost and complexity)

A QUEST should be permitted to have a single professional trustee (or a single professional director of a corporate trustee). This would be sufficient to ensure probity and compliance with fiduciary duties. The current requirement for at least 50% of non-professional trustees to be democratically selected employees is an unwelcome administrative burden, and deters companies from establishing QUESTs. Owners are often worried about losing control of their company to employees, and this more flexible approach to trustee appointment would therefore remove one impediment. We think the professional trustee is the most effective safeguard against trustee (or company) misapplication of QUEST assets. Progressive companies should not be prevented from appointing QUEST trustees under the current legislation, if they prefer.

Interest relief on vendor loans
(Dilution and funding cost)

One useful means of financing a QUEST is a loan to it by a vendor (effectively a deferred payment by the QUEST). To encourage vendors to offer this form of finance, interest received by the vendor should be relieved against income tax at the basic rate.

Other changes to legislation

Interest relief on employee loans
(Dilution and funding cost)

Interest payments on loans taken out by employees to acquire shares should be deductible against basic rate income tax. Currently, interest relief is only available to acquirors of a 5% interest, those involved in the company's management, or those acquiring shares in an employee-controlled company. This favours directors and senior managers, because only very rarely will an employee share scheme be in, or create, an employee-controlled company. By reducing the cost of share purchase in this way, there will be a greater incentive for employees to participate in matching offer profit sharing schemes (see above).

Tax deductible employee share purchases
(Dilution and funding cost)

An employee acquiring a beneficial interest in shares at market value should be able to claim income tax relief on the purchase cost under the Enterprise Investment Scheme. Existing EIS conditions would apply, save that the employee would not need a 5% holding, nor would relief be restricted to subscriptions for new shares.

CGT taper relief
(Tax)

Currently, to enjoy the more generous "business assets" form of CGT taper relief, it is necessary to hold at least 5% of a company's share capital. This excludes the vast majority of employee shareholders. We think it is consistent with the objective of encouraging share retention that employee shareholders should benefit from business assets taper relief.

More frequent exercise of CSOP options
(Lack of flexibility)

The current "three year rule" limits option holders' scope to spread option exercises into several tax efficient instalments. It substantially reduces the effect of phased annual option grants, since subsequent option exercises must be less frequent. We propose that this rule be removed.

Income tax deferral
(Tax)

An employee who acquires an interest in shares in a private company in a manner that creates an income tax liability should be liable to pay that tax only upon disposal of the shares. As at present, income tax should be on the market value of the shares at the time of acquisition, and capital gains tax should be payable on the growth in value.

At present, an employee faces the tax charge when he receives the shares, at a time when it may not be possible to sell them to meet the tax liability. This proposal would encourage longer term retention of shares.

SAYE options: exclude non-performers
(Lack of flexibility)

We extend our proposal for excluding up to 10% of eligible employees to grants of SAYE options.

Section 7 - The New ESOP

We advocate the creation of a new form of employee share trust, combining in one body the best features of the profit sharing trust and the QUEST:

	QUEST	Profit Sharing Trust	New ESOP
Ability to borrow to acquire shares	✓	✗	✓
Ability to offer CGT rollover relief to vendors	✓	✗	✓
Ability to retain shares in trust	✓	✗	✓
Ability to appropriate shares free of tax	✗	✓	✓
Exemption from CGT and income tax	✗	✓	✓

Allowing a company to establish a single trust would reduce professional costs and management time, ease ongoing administration, and simplify communication to employees.

As well as incorporating the reforms to the QUEST and the profit sharing scheme which we presented in the previous Section, the New ESOP would have the following additional features. As before, under each heading, we note which of the barriers identified in Section 5 would be addressed by each proposal.

Three year vesting schedule
(Lack of flexibility)
(Dilution and funding cost)

Companies should have the facility to make a *conditional* appropriation of shares, to become unconditional ("*vested*") over up to three subsequent financial periods. On leaving, an employee would forfeit unvested shares. This would reduce the number of appropriated shares beneficially owned by former employees and target free shares at more committed employees.

This proposal mirrors the popular concept of vesting found in US ESOPs and implicit in UK CSOPs. It is explained further in Appendix 3.

Existing tax rules would be unchanged, so that where vested shares are sold by an employee within three years of vesting, income tax would normally be payable.

Permanent holding of shares in trust
(Cost and complexity)
(Widespread individual ownership)

Throughout the life of the New ESOP, shares would be held in trust.

- Shares conditionally appropriated to employees would be recorded as such within the trust.

- Vested shares would be recorded in similar fashion.

- Shares which had passed the period of retention would continue to be held by the trust on behalf of their beneficial owner.

- Where an employee had acquired a beneficial interest in shares from the trust by any other means (for example, exercise of share options or simple purchase) the trust would continue to hold legal title to the shares, but the employee would have the rights of beneficial ownership.

- Employees would be issued certificates (but not share certificates) evidencing their rights over shares in the ESOP.

- Sales would be effected by the trust on behalf of employees, and the trust would pass on sale proceeds to employees.

We believe these measures would reduce the administrative burden, by avoiding the need to process share transfers and produce share certificates, without any infraction of shareholders' rights. Employees' rights over ESOP shares in the USA are recorded in this simpler way and ownership through an ESOP trust is regarded as real ownership.

Trustee voting
(Widespread individual ownership)
(Cost and complexity)

We recommend that voting rights in vested or beneficially owned shares need not be passed through to employees other than on key issues. Instead, votes would be cast at the trustees' discretion. This mirrors the reality of governance rights for employee shareholders in a large quoted company and for policy-holders of a large pension fund. As in the USA, voting rights on key issues, such as takeover, liquidation or a major asset disposal, could be reserved to employees directly.

Benefits of the New ESOP

The New ESOP provides the opportunity for Government to re-launch employee ownership. Modelled closely on the successful American ESOP and building on the existing employee share schemes, the New ESOP has the potential to transform the ownership of the private sector. It combines potent incentives, flexibility and safeguards.

By appealing to the self-interest of existing owners of businesses, in whose hands the power to create employee ownership lies, and by modernising some of the principles underlying existing schemes to reflect business reality, the New ESOP could become a powerful incentive tool, a neat succession solution for family companies and an essential adjunct to a management buyout.

Section 8 - Encouraging Longer Term Employee Ownership

The Government invites proposals for encouraging employees to hold shares for longer periods. This objective should be tempered by the recognition that the labour market is becoming more flexible, career horizons are shortening, the relationship between employer and employee is rarely lifelong and an ability to realise the value in a shareholding is a fundamental right of ownership that is important to employees.

CGT taper relief and EIS relief

One way of encouraging employee shareholders to become long term investors is to extend to them the principles of CGT taper relief for "business assets". At present, only significant shareholders (5% or more) qualify for the lowest 10% effective CGT rate on shares held for ten or more years. Yet arguably, an employee shareholder feels the risk of self-investment as acutely as the entrepreneur, and should attract the same lower tax rate in return for loyalty.

If Enterprise Investment Scheme relief were extended to employee shareholders, this would require shares to be held for at least five years.

Unapproved options

Executives do not always set a good example. They invariably sell shares as soon as they become entitled to them, or at least as many as are necessary to meet income tax liabilities. This pressure to sell would be eased under our proposal to postpone an income tax charge on unapproved employee shares in a private company until the shares themselves are sold (see Section 6).

Schemes to encourage retention

Companies are free to design arrangements to encourage share retention, and many will choose to do so.

An example of a voluntary scheme that encourages share retention is operated by FI Group plc. Discretionary options are granted over shares worth twice "pledged" shares if employees voluntarily lock up pledged shares with trustees for the duration of the unexercised option. The pledged shares can be obtained from any source, such as through the Company's SAYE scheme or profit sharing scheme or purchased in the market. Options over shares worth three times pledged shares are granted if employees pledge shares worth more than 10% of salary. The purpose of the scheme is to sustain employee ownership in the Company at a significant level, because it is regarded as a source of competitive advantage. The Company estimates that an employee serving for ten years and participating in the share schemes to the maximum extent will build up a capital stake worth at least four times basic salary.

Venture capital backed companies

It should be noted that, in a venture capital backed company, the longevity of employee ownership is tied to the longevity of the company's life as an independent company. Venture capitalists actively manage their investments to achieve an exit, typically within three to five years. In these circumstances, employee ownership may not be long term, but it is no less potent an incentive for that, especially as employees may enjoy the same geared returns as their MBO leaders. And if the exit is by way of a flotation, or if an acquiror operates its own employee share scheme, employee ownership may live on in a different form in future. This has been the experience of many ESOPs established in privatisation buyouts which were subsequently floated or sold.

Section 9 - Summary of Recommendations

Directed primarily at:		
Private	**Smaller quoted**	
		Profit sharing scheme
✓	✓	• Allow exclusion of poor performers
✓	✓	• More flexibility in setting matching offer ratios
✓	✓	• Clearer regime for cash alternatives
✓		• Ability to use subsidiary shares
✓	✓	• Single £8,000 annual limit
		QUEST
✓	✓	• Ability to gift shares to profit sharing trust
✓	✓	• Tax exempt
✓	✓	• Dividends tax deductible for company
✓	✓	• Link with CSOP
✓	✓	• Allow exclusion of poor performers
✓		• No tax penalty on company loan to QUEST
✓		• Ability to establish in subsidiary companies
✓		• Permit QUEST to acquire a wider range of securities
✓		• System for prior clearance of valuations
✓		• Remove risk of clawback of CGT relief from vendors
✓	✓	• Allow single professional trustee
✓		• Vendors' interest relief on loans to QUEST
		Other changes
✓	✓	• Extend interest relief on employees' loans to acquire shares
✓		• EIS for employees
✓	✓	• Extend business assets taper relief to employees
✓	✓	• Allow flexibility in exercise of CSOP options
✓		• Deferred income tax on unapproved shares
✓	✓	• Allow exclusion of poor performers from SAYE
		New ESOP
✓	✓	• Combined QUEST and profit sharing scheme
✓	✓	• Three year vesting schedule
✓	✓	• Trust to hold shares on behalf of employees
✓	✓	• Limited pass through of voting rights

	Barriers addressed:				
	Lack of flexibility	Widespread individual ownership	Tax	Cost and complexity	Dilution and funding cost
	✓				
	✓				✓
	✓				✓
	✓				
	✓				
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	✓	✓	✓	✓	✓
	✓				✓
		✓		✓	
		✓		✓	

Appendix 1 - UK Employee Ownership Index

Summary

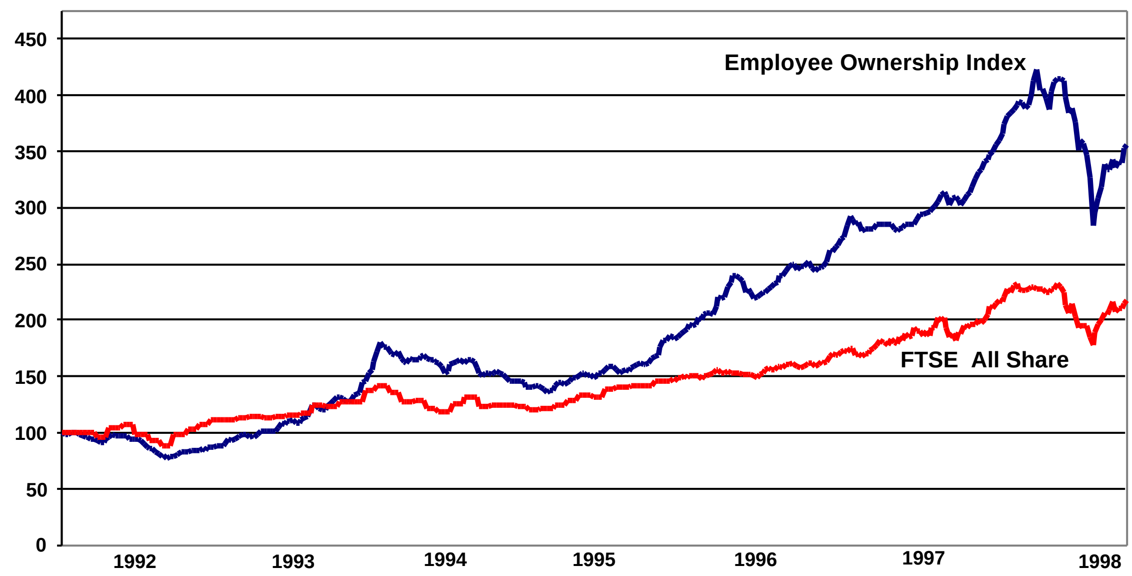
The UK Employee Ownership Index™ measures the relative share price performance of UK quoted companies with significant levels of employee share ownership.

The Index, which presently comprises thirty six quoted companies, is measured against the FTSE All Share index from January 1992. The Index outperformed the main market index in all four quarters of 1998 and in six of the last eight quarters. The performance of the Employee Ownership Index compared to the FTSE 100, FTSE All Share and FTSE Small Cap indices over one, three and five years is shown below.

Performance Period	UK Employee Ownership Index	FTSE 100 Index	FTSE All Share Index	FTSE Small Cap Index
1 Year	12.7%	14.5%	11.1%	-10.4%
3 Years	98.4%	59.5%	48.3%	6.7%
5 Years	150.9%	72.1%	59.0%	N/A

An amount of £1,000 invested in the Employee Ownership Index and the FTSE All Share index on 1 January 1992 would now be worth £3,560 and £2,180 in nominal terms.

UK Employee Ownership Index 1992-1998



Construction of the Index

To define eligibility for inclusion in the Index, we select companies with more than 10% of their issued share capital held directly by, or indirectly for the benefit of, employees other than board directors (clearly, many more Stock Market companies are more than 10% owned by directors). We use a variety of information sources to identify candidate companies, including annual reports, share registers, prospectuses and listing particulars, press reports and analysts' reports. Some companies move in and out of the Index as their level of employee ownership changes. Whilst all thirty six companies in the Index have been verified as eligible for inclusion, it is possible that we are missing a number of candidate companies which satisfy the ownership test but whose ownership is fragmented and therefore not detectable from our information sources. We are surveying quoted companies continuously to attempt to identify these omissions, and to track changes to the status of our present sample. The Index is updated weekly. No account is taken of dividend income.

Origins of the Index

For many years, academics, policy-makers and analysts have attempted to measure the impact of employee share ownership on company performance, but this has often proved to be an elusive goal. There are too many factors affecting a company's performance (whichever performance measure is chosen) to be able to isolate the single effect of employee ownership with any scientific or statistical rigour. Only in the United States, where the population of employee owned companies is sufficiently large, can analysts begin to draw reliable conclusions.

Two landmark studies in the 1980s concluded that sales growth and employment growth were slightly higher in companies with employee ownership, and this margin of superiority was greatest in companies which encouraged other (non-financial) forms of employee involvement and participation. In 1994, American Capital Strategies, building on research by Professors Conte, Blasi and Kruse at Rutgers University, New Jersey, compiled an index of the stock prices of all US quoted companies that were more than 10% owned by their employees. Stock prices of employee owned companies significantly outpaced those of conventionally owned companies over a sustained period. The UK Index is based on the same criteria and methodologies as its US antecedent.

Interpretation

Clearly, share price is only one crude measure of corporate performance and not one that always correlates closely with profitability or durability. But it is clear-cut, unambiguous and readily measurable. So what might explain these results from both the UK and US indices? It would be unwise to claim any direct relationship of cause and effect between employee ownership and share price growth. The UK Index in particular contains a number of biases which may themselves result in superior performance and which may therefore distort the picture. For example, the Index is biased towards smaller companies, towards the support services and transport sectors, and towards companies that have more recently listed.

However, it is clear from Capital Strategies' experience that employee-owned companies tend to feature progressive approaches to management and communication most often associated with best practice and top performing companies. For example:

- there is a more open and informative culture;
- employees are educated to a higher level of financial and business literacy;
- employees are more involved in the issues facing the company, at all levels of the business;
- managers are exposed to a greater degree of scrutiny and accountability (not always welcomed!).

As a result, many companies report incremental improvements in productivity and efficiency and reduced wastage and absenteeism, which can add up to material improvements to "the bottom line".

Appendix 2 - Why ESOPs are dilutive

Employee share schemes, of whatever form, cause two types of dilution:
- dilution in the percentage of issued share capital;
- dilution in the value of other shareholdings.

The former is an inevitable consequence of employee ownership! What matters to other shareholders is the extent to which the value of their investment is diluted.

A scheme in which employees pay the full cost of their shareholding will not be value diluting, so any measures to encourage employees to make a financial commitment to ownership are helpful to other shareholders, though it must be recognised that the capacity of employees to invest personal money and their willingness to bear the risk of self-investment is a limiting factor.

A scheme which results in superior company performance that more than compensates for its cost will not be value diluting either. The margin of improvement would need to be significant to justify a substantial stake for employees.

When faced with a decision to install an ESOP, the business owners will weigh up its costs and likely benefits, and compare it with alternatives. The real cost is not the transaction cost of setting up and maintaining the ESOP (though this is material), but the cost of financing it.

The alternatives which the owners will consider depend on what the company is trying to achieve. For example, if the aim is to incentivise employees, a simple cash-based bonus scheme might be preferred, because it is simpler to establish and, unlike an equity scheme, is reversible. If the aim is to raise development capital or expansion finance, it will be less dilutive to raise bank finance or venture capital finance directly rather than indirectly through an issue of new shares to an ESOP. And if the aim is to provide an exit route for one shareholder, it will invariably be less dilutive to arrange a share buy-back than to arrange a purchase of the shares by an ESOP.

Example:Exit route for shareholders in a private company

Consider a private company which is owned in equal shares by three shareholders, X, Y and Z. Z wishes to exit while X and Y wish to remain shareholders. The company has no debt (though it has borrowing capacity) and is valued at £4 million. A shareholding of 33% is valued at £1 million after applying a 25% discount for a minority shareholding. Projections suggest that the company could be worth £7 million in five years' time because of continued business growth.

Option 1:Share buyback

Assuming the company has sufficient distributable reserves, the company could borrow £1 million and arrange a share buyback. In certain circumstances, this would be treated as a capital disposal for Z. X and Y now own 50% each of a company worth £3 million (the original £4 million value less the £1 million of new debt) whereas they used to own 33% each of a company worth £4 million. So they are attracted by the share buyback because it immediately enhances the value of their shareholding. If the company were sold after five years, X and Y would each expect to realise £3 million.

Option 2:Standard QUEST

Suppose instead that the company establishes a QUEST which borrows £1 million secured by the company to buy Z's shares. Z should qualify for CGT rollover relief, which appeals to him, and the company should qualify for corporation tax relief on contributions to the QUEST, saving £300,000 of corporation tax. If the company were sold after five years, X and Y would each expect to realise 33% of £6.3 million (original value of £7 million less £1 million of debt repayments plus £300,000 of corporation tax relief), i.e. £2.1 million. This is 30% lower than in the share buyback. Put another way, employee ownership would need to improve the company's value over five years by 39% to £9.7 million for the QUEST solution to be non-dilutive. Although X and Y are attracted by the idea of employee ownership, it requires a leap of faith.

The role of convertible preference shares

In these circumstances, one way of softening (though not eliminating) the dilution is to restructure the share capital of the company and create a new class of convertible preference shares for use in the QUEST. Prior to sale to the QUEST, Z's ordinary shares would be exchanged for £1 million of convertible preference shares and then sold to the QUEST as before for £1 million cash. The shares would carry a preferential right to a dividend and a preferential right to a return of £1 million capital on a sale or winding up. They would be convertible into £1 million worth of ordinary shares on a sale of the company or when the value of the ordinary shares in aggregate exceeded an agreed threshold, say £8 million. This is how a performance-related ratchet is structured in a management buyout.

Option 3: QUEST with convertible preference shares

Returning to the example, the distribution of sale proceeds in year 5 is now as follows:

Value attributable to shareholders	£6.3 million
Less value attributable to QUEST	(£1.0 million)
Net value attributable to ordinary shareholders	£5.3 million
Value of X and Y's shareholding	£2.65 million each

Although still inferior to the share buyback, Option 3 requires an improvement of 10% in the company's year 5 value to £7.7 million to make the QUEST non-dilutive. This is more palatable.

US experience with convertible preference shares

There are five main applications of convertible preference shares in US ESOPs:

- to reduce dilution for remaining shareholders, as discussed above;
- to reduce the discount (typically as much as 40% to 90%) that would normally apply to the sale of a minority shareholding in a private company, by giving the convertible preference shares valuable rights, for example rights to a fixed preferential cumulative dividend and rights to a preferential return of capital that rank ahead of other shares;
- to retain control in the hands of ordinary shareholders, because the ESOP's convertible preference shares would invariably be non-voting until converted into ordinary shares;
- to stabilise the dividend income available to the ESOP so that it can meet its interest costs on any loan;
- to underpin the value of the ESOP's stake but in return for constrained upside.

We believe it is imperative that UK ESOPs be permitted to acquire convertible preference shares in private companies so as to be able to tailor ESOPs to fit the commercial needs of a transaction. Indeed, we see no reason why an ESOP should not be permitted to buy any type of security in a private company, including redeemable or debt-type securities, provided the safeguards described below are present.

Safeguards

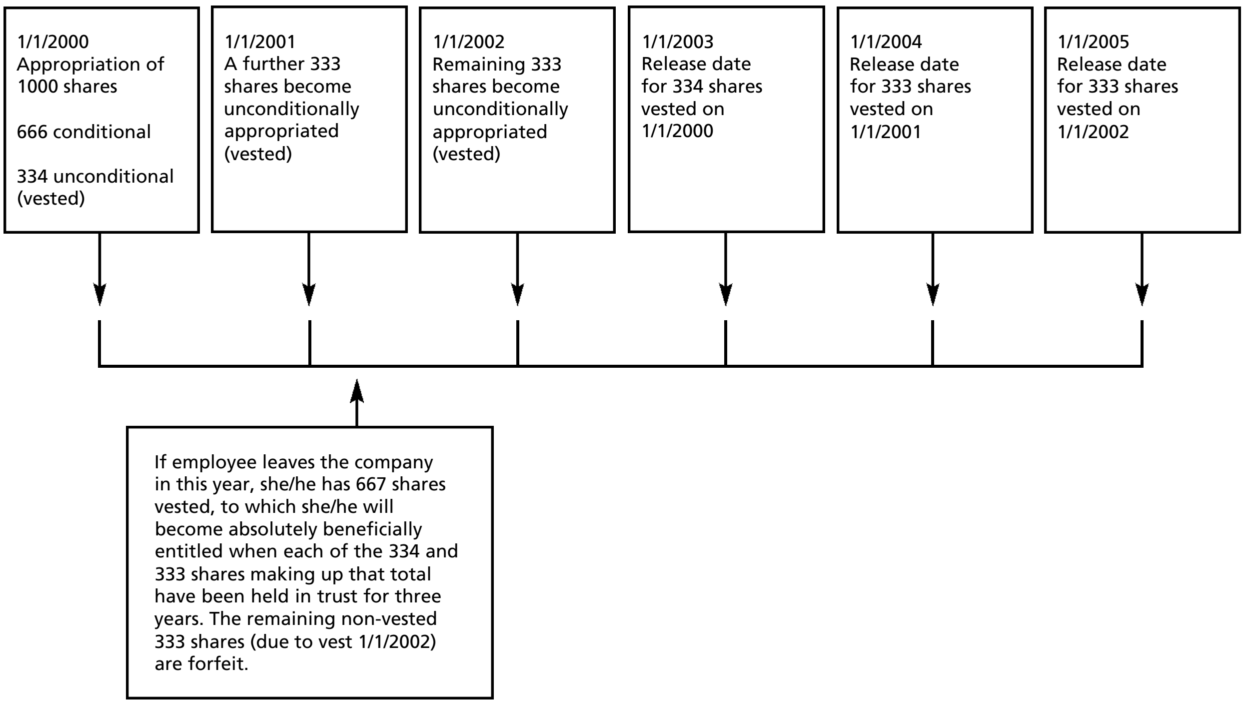
Three simple safeguards would ensure that this innovation was properly used.

- The ESOP must not pay more than open market value for the securities. The trustees would arguably be in breach of their fiduciary duty to beneficiaries if they did so, but this obligation could be reinforced as a statutory requirement, as in the present QUEST.
- The ESOP trustees must either take independent advice as to the value of the securities they are offered or seek advance clearance as to value from the Inland Revenue Shares Valuation Division (a procedure that is not currently available for an acquisition of shares by a QUEST).
- If the securities are convertible, they should be convertible into ordinary shares on a specified event or date rather than at the company's behest. The circumstances of conversion will of course affect the market value of the shares on acquisition by the QUEST.

Appendix 3 - Vesting

The main purpose of vesting is to withdraw conditional ownership rights when an employee leaves the company (cf. unexercised options lapsing). Its effect is to target shares at loyal employees. At present, shares in a profit sharing scheme fully vest on appropriation. An employee leaving the day after an appropriation would be entitled to retain his shares. Under our proposal for the New ESOP, shares would vest in instalments over a period of up to three years (the equivalent period in an American ESOP is five years).

This is best illustrated with an example, as follows:



This illustration shows just one appropriation, on 1/1/2000. However, the company might choose to make annual appropriations, so that ultimately an employee would experience the following in each year:

- release of shares that have been vested for three years;
- vesting of shares previously conditionally appropriated;
- conditional appropriation of further shares, to become vested over the next two years.

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