

# *10 minutes on...*

## *Principle 8 changes in the third edition of the ASX guidelines*

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## *The proposed clawback recommendation has been removed and is instead incorporated to a lesser degree as commentary in the ASX guidelines.*

The third edition of the ASX Corporate Governance Principles and Recommendations (ASX guidelines) was released on 27 March 2014. This alert covers Principle 8 (remunerate fairly and responsibly) only.

<p>What were the main changes initially proposed in the consultation?</p>	<ul style="list-style-type: none"> <li>• The main proposed change from a Principle 8 perspective was the addition of a new Recommendation 8.3 dealing with clawback.<sup>1</sup> This proposed recommendation was reasonably detailed, stating that companies should:             <ul style="list-style-type: none"> <li>➢ have a clawback policy</li> <li>➢ disclose a summary of it, and</li> <li>➢ disclose at the end of each reporting period whether any performance-based remuneration had been clawed back under the policy (or why it had not been clawed back if it should have been).</li> </ul> </li> </ul>	<p>Other minor changes to Principle 8 include:</p> <ul style="list-style-type: none"> <li>• <b>Policy limiting economic risk:</b> There is now a separate recommendation suggesting companies should have, and disclose, details of their policy on whether participants are permitted to enter into transactions which limit the economic risk of equity-based awards.</li> <li>• This recommendation is similar to the previous guidance that was in “Guide to reporting on Principle 8” contained in Recommendation 8.4.</li> <li>• Note that key management personnel are already prohibited from hedging their performance-based remuneration under the Corporations Act 2001 (Cth).</li> <li>• <b>Non-executive director (NED) remuneration:</b> There is further clarification on how NED remuneration should be structured. In relation to options, the new guidelines state that “NEDs generally should not receive options with performance hurdles attached”. The ASX Council has inserted the additional wording of “with performance hurdles attached” to address concerns from cash-strapped, start-up companies who use options without performance conditions to attract and retain quality directors.</li> </ul>
<p>What were the actual changes to the clawback provisions?</p>	<ul style="list-style-type: none"> <li>• The ASX Corporate Governance Council (ASX Council) decided not to proceed with the proposed clawback recommendation.</li> <li>• Instead, there is now only very broad commentary under Recommendation 8.2 around how executive remuneration disclosures should include a “summary of the entity’s policies and practices regarding the deferral of performance-based remuneration and the reduction, cancellation or clawback of performance-based remuneration in the event of serious misconduct or a material misstatement in the entity’s financial statements”.</li> <li>• While the commentary provides extra guidance to companies on what the recommendation means, companies are only required to explicitly comply on an “if not, why not” basis with the recommendations themselves.</li> </ul>	

1. Note that while the ASX guidelines refer to “clawback”, they are generally referring to “malus”. Malus refers to the reduction of unvested amounts / awards only, whereas clawback refers to recouping cash amounts already paid (or equity awards already vested).

## ***It will be entirely up to entities to determine how (if at all) they would like to incorporate clawback provisions into their remuneration structures.***

### ***Why was the clawback change not incorporated?***

- The ASX Council decided not to proceed with its clawback recommendation as there were many respondents (via submissions) who were opposed to it and / or who expressed significant concerns about its practicality.
- This is despite the clawback recommendation receiving support from investor groups and proxy advisors.

### ***What is current Australian market practice in relation to clawback?***

- There are approximately 40% of ASX 100 companies who currently have clawback (or malus) provisions in place.
- Many of these provisions apply in broader circumstances than simply in the case of serious misconduct or a misstatement in financial statements.

### ***When do the changes take effect?***

- The changes take effect for an entity's full financial year commencing on or after 1 July 2014.
- For example, entities with a 30 June balance date will be expected to measure their governance practices against the recommendations in the third edition commencing with the financial year ending 30 June 2015.
- Early adoption is encouraged.

### ***What do these changes mean for companies?***

- Outside of APRA-regulated entities<sup>1</sup>, it will be entirely up to companies to determine how (if at all) they would like to structure clawback (or malus) provisions. This is because the proposed legislation around clawback provisions also never progressed.
- Proxy advisors may still suggest that companies have clawback (or malus) provisions in their own guidelines.
- Financial services companies with UK operations that are impacted by CRD IV will need to continue to comply with those requirements in relation to clawback and malus.
- We believe companies should still give consideration to the merits of malus (as opposed to clawback). This is particularly the case when it takes longer than one year for any risks to emerge against the short-term incentive KPIs that executives are rewarded against.
- Companies will need to ensure their policies limiting economic risk apply to all equity plan participants.
- While not explicit in the guidelines, companies have further guidance that it is acceptable to grant options without performance hurdles to NEDs. However, the ASX would likely take the view that this is appropriate only for cash-strapped, start-up companies.

1. APRA regulated entities need to comply with their relevant governance prudential standard. While this is principle based, it does require boards to have discretion to adjust down performance-based pay to respond to significant unexpected or unintended consequences or to protect the financial soundness of the entity. This is typically enforced through clawback (or malus) provisions.

# How can PwC help?

To have a deeper discussion about the ASX guidelines, or broader remuneration and performance issues, please contact:

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