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CORPORATE & COMMERCIAL ALERT

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Walking the tightrope – guidelines for defining your malus and clawback policy

There is a growing trend in South Africa towards businesses adopting malus and clawback policies in relation to their variable pay structures and employee incentive schemes. This trend has been driven by the view that responsible corporate governance requires businesses to be able to assess and, where necessary, adjust or recover variable pay benefits awarded to employees on the occurrence of certain events.

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Walking the tightrope – guidelines for defining your malus and clawback policy

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There is a growing trend in South Africa towards businesses adopting malus and clawback policies in relation to their variable pay structures and employee incentive schemes. This trend has been driven by the view that responsible corporate governance requires businesses to be able to assess and, where necessary, adjust or recover variable pay benefits awarded to employees on the occurrence of certain events.

There are many different variations and trigger events, but a malus and clawback policy essentially permits a business to:

- adjust benefits that have been awarded to participating employees before vesting of the award (malus); and/or
- recover benefits or variable pay from employees after they have vested or even where they have been paid to the employee (clawback).

Despite their clear advantages and growing prevalence, malus and clawback provisions are yet to be tested under South African law. Internationally, malus and clawback policies are recommended and/or mandated in general and industry-specific remuneration and corporate governance codes. In South Africa, however, the only regulation dealing with malus and

clawback policies is found in regulation 43 to the Banks Act, 1990 which obliges banks to disclose the details of a malus and clawback policy in the remuneration report in their annual financial statements. The regulations do not currently prescribe what the malus and clawback policy should contain.

The implementation of malus and, more specifically, clawback provisions by a business may have significant financial consequences for an employee, as well as raise various employment law and income tax implications. As a result, it is vital that a malus and clawback policy is robust enough to stand up to scrutiny.

Here are a number of considerations to assist in shaping your business's malus and clawback policy:

Define the trigger events clearly

The circumstances in which a business becomes entitled to implement malus and clawback provisions should be clearly defined in the business's policy. Grounds for malus and clawback may exist for situations where:

- there has been misbehaviour or material error by a participating employee or where the actions of an employee have resulted in reputational damage to the business;

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The terms of a malus and clawback policy must therefore be clearly specified in a firm's remuneration policy, incentive scheme rules and referenced expressly in the formal letters of award.

- a business suffers material downturn in financial performance or a material failure of risk management;
- awards have been based on material misstatements of the business's financial results or information arises which would have caused benefits to lapse or would have resulted in the board/remuneration committee exercising their discretion differently had the information been known at the time;
- the business has suffered a material financial loss as a result of actions or circumstances attributable directly to an employee or which could have been avoided by the reasonable actions an employee; and/or
- the board or remuneration committee, in their discretion, deems it necessary to apply malus or clawback.

Whatever the trigger events are, ensure that they are well defined to avoid any arguments relating to the grounds on which benefits are adjusted or recovered.

Ensure that the business has a contractual right to enforce the policy

South African employment law places restrictions on an employer's right to deduct amounts from an employee's remuneration. An employer is entitled to require an employee to repay benefits already disbursed in cases where the employee has been overpaid due to an error in the calculation of an employee's remuneration. However, where a business wishes to enforce malus or clawback

following an employee's misconduct, the business will need a contractual right against the employee to do so. The terms of this contractual right should be clearly set out in writing and accepted and agreed to by the affected employee, including the manner of repayment.

The terms of a malus and clawback policy must therefore be clearly specified in a firm's remuneration policy, incentive scheme rules and referenced expressly in the formal letters of award. Employees should be required to confirm in writing that they are aware of and accept the terms of the awards, including that they agree to the business invoking malus or clawback where a trigger event has occurred.

Maintain procedural fairness in the implementation of malus and clawback

Section 34 of the Basic Conditions of Employment Act, 1997 contains certain requirements relating to procedural fairness when deducting amounts from an employee's remuneration and affording an employee a reasonable opportunity to show why deductions should not be made.

It is particularly important to maintain procedural fairness when malus or clawback is initiated at the discretion of the board of directors or remuneration committee. This discretion must be exercised fairly and employees should be afforded the opportunity to make representations in order to mitigate the risk of unfair labour practice claims against the business.

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It is important for the remuneration policy, incentive scheme rules and letters of award to speak to one another to ensure that the malus and clawback policy is consistently embedded in the remuneration practices and policies of the business.

Adoption of a malus and clawback policy

Ideally, a malus and clawback policy should be in place and entrenched in the remuneration policy and incentive scheme rules of a business prior to the making of any awards to employees. However, if a business wishes to adopt a malus and clawback policy in relation to an existing incentive scheme, the rules pertaining to the scheme will have to be followed to the extent that the introduction of the policy amounts to an amendment of the incentive scheme rules.

It is important for the remuneration policy, incentive scheme rules and letters of award to speak to one another to ensure that the malus and clawback policy is consistently embedded in the remuneration practices and policies of the business.

Ultimately, there are a number of significant considerations that need to be made in defining your business's malus and clawback policy. It is worthwhile briefing experienced practitioners in this area to ensure that when it comes to the enforcement of your policy, certain key risks have been foreseen and mitigated.

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