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Dear Sir/ Madam

JSE COMMENTS ON ED 2023|5: FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

We thank you for the opportunity to comment on the ED 2023|5: Financial instruments with characteristics of equity, proposed amendments to IAS 32, IFRS 7 and IAS 1 ("**the ED**").

The JSE is the largest stock exchange in Africa, with issuers listed in both debt and equity markets. The vast majority of issuers in our market are required to prepare financial statements in terms of IFRS. As the listing authority we are responsible for both approving the content of circulars to shareholders (for corporate transactions) and for reviewing the financial statements (against IFRS) once released in the market by our issuers. Our comments are based on the experiences we have gained from performing these duties.

The JSE supports the IASB's proposals in the ED. We believe that these will result in better disclosures that investors in our market require and reduce divergent practice (in certain areas) that has developed in our market. We participated in deliberations held in South Africa and we are largely aligned with the views expressed in the comment letters submitted by the FRSC and SAICA. The purpose of this separate letter is to articulate the JSEs unique views on two specific matters – notably questions 5 and 7.

We are happy to engage further, should you have any queries with regards to the content of this letter.

Yours faithfully

T I WIMBERLEY

HEAD: FINANCIAL REPORTING

ISSUER REGULATION

Comments to specific questions

Question 5 — Shareholder discretion (paragraphs AG28A–AG28C of IAS 32)

The IASB proposes:

a) *to clarify that whether an entity has an unconditional right to avoid delivering cash or another financial asset (or otherwise to settle a financial instrument in such a way that it would be a financial liability) depends on the facts and circumstances in which shareholder discretion arises. Judgement is required to assess whether shareholder decisions are treated as entity decisions (paragraph AG28A).*
b) *to describe the factors an entity is required to consider in making that assessment, namely whether:*
    i. *a shareholder decision would be routine in nature—made in the ordinary course of the entity's business activities;*
    ii. *a shareholder decision relates to an action that would be proposed or a transaction that would be initiated by the entity's management;*
    iii. *different classes of shareholders would benefit differently from a shareholder decision; and*
    iv. *the exercise of a shareholder decision-making right would enable a shareholder to require the entity to redeem (or pay a return on) its shares in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) (paragraph AG28A(a)–(d)).*
c) *to provide guidance on applying those factors (paragraph AG28B).*

Paragraphs BC116–BC125 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

We agree that an assessment of the specific facts and circumstances is required when classifying (potential) financial liabilities that involve shareholder discretion and that the matter remains a judgemental one. We believe the factors identified in proposed paragraph AG28A are sufficiently 'principles-based' so as not to be overly prescriptive or rules based.

In our market, shareholder discretion (i.e. approval) is often required for related party transactions and the factors set out in sub-paragraphs (a) – (d) are likely to 'catch' many of these arrangements. We do however request that the IASB consider providing further guidance (to the factors set out in AG28A). An example is set out below to illustrate where we have some difficulty.

Example:

- *In addition to the standard employment benefits, an employment agreement provides an executive director with a put option which gives the individual the right to sell an unspecified number of the issuer's shares back to the issuer at a market related price.*
- *The option is for any and all shares held by the executive – irrespective of how these were acquired (i.e. purchased in the market by the executive or granted to them under a previous share-based payment arrangement).*

- *The exercise of the put option results in a repurchase of shares from a director, which requires shareholder approval by special resolution (approval by more than 75%) before the repurchase can be effected.*

The question is whether the issuer is obliged to recognise a financial liability prior to the put option being exercised by the executive. Would shareholders be 'acting as the company' or are they deemed to be 'separate from the company' when voting on the above matter.

Of the factors identified in paragraph AG28A, sub-paragraphs (a) and (b) appear to be most relevant to the above example and we discuss their application below. We are however concerned that there is still considerable uncertainty as to whether the issuer has an unconditional right to avoid delivering cash:

a) Shareholder decision routine in nature/ ordinary course of business (AG28A(a)):
   - Whilst the approval of executive remuneration may be within the ordinary course of business, a put option and specifically one on *any and all shares* held by the executive (irrespective of how these were acquired) is unusual and does not appear to be within the issuers' ordinary course of business.
   - BC119 explains that non-routine transactions typically involve a higher level of approval (e.g. 75% of the votes). It is not clear whether this suggests that all decisions involving a higher level of approval (i.e. special resolution in our jurisdiction) would automatically be regarded as non-entity decisions. We believe that this matter requires clarification.

b) Identifying who proposed or initiated the transaction (AG28A(b)):
   - The above put option arises from an employment contract between the entity and the executive. Does this therefore make it an 'entity initiated' contract (ultimately it is the entity who seeks to employ or not employ the executive)? If employment contracts are deemed to be initiated by the issuer, the inclusion of the above put option is not a standard employment benefit.
   - It is difficult to determine who initiated the inclusion of the put option clause in the employment contract – i.e. was it offered by the issuer or put forward as a condition of service by the executive? We expect that similar circumstances could arise in situations where it is impracticable to identify which party initiated an action requiring shareholder approval. We suggest that further guidance be provided for situations where the identification of the party initiating the transaction is not straightforward.
   - The basis for conclusion (paragraph BC121(b)) suggests that AG28A(b) is based on management's role in directing activities of the entity, acting within their fiduciary capacity for the interest of the entity and within the relevant corporate governance framework. The types of decisions that require shareholder approval in our market often involve related parties or are of such significance that they are expected to have a material impact to the issuer. Shareholder approval in these instances seeks (in a sense) to obtain comfort from shareholders that management's decisions are in line with their fiduciary capacity. We propose that the IASB consider adding a factor that determines the decision to be 'a shareholder decision' if shareholder approval is being sought as an assurance of managements fiduciary capacity. This could be used as a 'fallback principle' that is applied in circumstances where the identity of the party initiating the proposed action or transaction is not obvious.

Question 7 — Disclosure (paragraphs 1, 3, 12E, 17A, 20, 30A–30J and B5A–B5L of IFRS 7)

The IASB proposes:

a) *to expand the objective of IFRS 7 to enable users of financial statements to understand how an entity is financed and what its ownership structure is, including potential dilution to the ownership structure from financial instruments issued at the reporting date (paragraph 1).*
b) *to delete the reference to derivatives that meet the definition of an equity instrument in IAS 32 from paragraph 3(a) of IFRS 7.*
c) *to move paragraphs 80A and 136A from IAS 1 to IFRS 7. These paragraphs set out requirements for disclosures relating to financial instruments classified as equity in accordance with paragraphs 16A–16B and/or paragraphs 16C–16D of IAS 32 (paragraphs 12E and 30I). The IASB also proposes to expand paragraph 80A to cover reclassifications if there are changes in the substance of the contractual arrangement from a change in circumstances external to the contractual arrangement.to delete the reference to derivatives that meet the definition of an equity instrument in IAS 32 from paragraph 3(a) of IFRS 7.*
d) *to amend paragraph 20(a)(i) of IFRS 7 to require an entity to disclose gains or losses on financial liabilities containing contractual obligations to pay amounts based on the entity's performance or changes in its net assets, separately from gains or losses on other financial liabilities in each reporting period.*
e) *to include disclosure requirements for compound financial instruments in IFRS 7 (paragraph 17A).*

The IASB proposes to require an entity to disclose information about:

a) *the nature and priority of claims against the entity on liquidation arising from financial liabilities and equity instruments (paragraphs 30A–30B);*
b) *the terms and conditions of financial instruments with both financial liability and equity characteristics (paragraphs 30C–30E and B5B–B5H);*
c) *terms and conditions that become, or stop being effective with the passage of time (paragraph 30F);*
d) *the potential dilution of ordinary shares (paragraphs 30G–30H and B5I–B5L);*
e) *instruments that include obligations to purchase the entity's own equity instruments (paragraph 30J).*

Paragraphs BC170–BC245 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with the proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

We are supportive of the objective in paragraph 1(c) of IFRS 7 and the additional disclosures of paragraphs 17A and 20(a) as this will provide crucial information to investors in our market.

We also support the proposed disclosure regarding the nature and priority of claims set out in paragraphs 30A – 30F. As a listings authority we require issuers seeking new listings in our market to provide these types of disclosures in prelisting and similar documents to be placed before shareholders.

Understanding the terms, conditions and priority on liquidation of complex instruments that rank ‘above’ ordinary shares is important for existing and potential future investors. Such information is critical to ensure an understanding by shareholders of their voting rights and the economic interest derived from the holding of a specific security in issue. In addition, such disclosures enable appropriate price formation of such securities traded in our market. As such we currently request that such information be disclosed in the public documentation prepared by companies applying for a listing.

‘Codifying’ disclosure of the nature and structure of an issuer’s share capital in IFRS would assist investors. It would mean that they are not forced to ‘dig through’ historic documents to properly understand the terms of the securities held, the interplay between various securities or other instruments in issue and any potential risks that may be relevant to their security holdings. The proposal in the ED therefore aligns with the requirement that financial statements are comprehensive documents which disclose material information regardless of whether such information is available in other sources (paragraph .25, materiality practice statement).

We also support the proposals in paragraphs 30G-30H and B5I-B5L. Paragraph 30G appropriately explains that users require these disclosures “to understand the potential *dilution to the entity’s ownership structure*”. This is different to the current disclosure requirement of diluted earnings per share in IAS 33 Earnings per Share – which measures the extent to which *current earnings* would have been diluted. Dilutive EPS information presents an aggregated position (rather than per instrument) and takes into account the effect of only those instruments that are currently dilutive (ignoring currently anti-dilutive instruments that may be issued in future periods). The proposed disclosures will provide information of the extent to which control or voting rights may be diluted in future periods as a result of contracts that were entered into in the current and prior periods which we believe is useful to users.

We have found investors in our market to be cautious about events or transactions that may cause their shareholding (or voting rights) to be diluted. As a listing’s authority, we require issuers to identify and quantify potential future dilution events in prelisting statements and when certain transactions are placed before that are placed before shareholders.

As is explained above, codifying the requirements into IFRS for disclosing additional ordinary shares that may be issued will make the information easily accessible to current and future shareholders. In addition to the information being readily available in the AFS, the information will be updated periodically to address transactions which have been exercised or expired and new contracts that may have been entered into (which would be important for us given that smaller transactions do not necessarily always go to shareholders) .