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SEC Adopts Final Rule on "Clawback" Policies

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On October 26, 2022, the SEC issued a final rule[1] aimed at ensuring that executive officers do not receive "excess compensation" if the financial results on which previous awards of compensation were based are subsequently restated because of material noncompliance with financial reporting requirements. Such restatements would include those correcting an error that either (1) "is material to the previously issued financial statements" (a "Big R" restatement) or (2) "would result in a material misstatement if the error were corrected in or left uncorrected in the current period" (a "little r" restatement). The final rule implements the mandate in Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act")[2] under which the SEC is required "to adopt rules directing the national securities exchanges . . . and the national securities associations . . . to prohibit the listing of any security of an issuer" that has not adopted and implemented a written policy providing for the recovery of incentive-based compensation (IBC) under certain circumstances.

The final rule requires issuers to "claw back" excess compensation for the three fiscal years before the determination of a restatement regardless of whether an executive officer had any involvement in the restatement. The final rule also requires an issuer to disclose its recovery policy in an exhibit to its annual report and to include new checkboxes on the cover page of its annual report to indicate whether the financial statements "reflect correction of an error to previously issued financial statements and whether [such] corrections are restatements that required a recovery analysis." Additional disclosures are required in the proxy statement or annual report when a clawback occurs. Such disclosures include the date of the restatement,

[1] SEC Final Rule Release No. 33-11126, *Listing Standards for Recovery of Erroneously Awarded Compensation*.
[2] The SEC also recently finalized other compensation-related rules required by the Dodd-Frank Act. For more information about the pay-versus-performance disclosure requirements, see Deloitte's September 2, 2022, *Heads Up*.

the amount of excess compensation to be clawed back, and any amounts outstanding that have not yet been clawed back.

The concept of clawbacks is not new. Section 304 of the Sarbanes-Oxley Act of 2002 contains a recovery provision that is triggered when an accounting restatement results from an issuer's misconduct. The provision applies only to CEOs and CFOs, and the amount of required recovery is limited to compensation received in the 12-month period after the first public issuance or filing of the improper financial statements with the SEC. In addition, in the interim period before the issuance of the final rule, many companies already had voluntarily adopted compensation recovery policies based on investor sentiment and good governance practices. However, it is likely that even those companies will be required to make substantial changes to their policies in light of the following aspects of the final rule:

- The inclusion of a broader list of executive officers, including former executive officers, within the rule's scope.
- The broader events that would trigger recovery analysis ("Big R" and "little r" restatements).
- The "no-fault" nature of the final rule.
- The longer look-back period of three completed fiscal years.

This *Heads Up* discusses key provisions of the final rule as well as their potential accounting and tax consequences.

The Final Rule's Provisions

Scope of Recovery Policies

The final rule requires issuers to adopt a written policy related to the recovery of "excess" IBC awarded to any individuals (including former employees) who served as an executive officer during the three most recently completed fiscal years preceding the date on which the preparation of an accounting restatement is required, provided that the executive officers were awarded more IBC than they would have received if the financial statements had been prepared correctly. Unlike many of the recovery policies adopted by companies to date, the policies required by the final rule would mandate recovery of executives' excess IBC even if the executives were not involved in preparing the financial statements or did not commit misconduct that led to the restatement. That is, the final rule requires companies to adopt a "no-fault" policy under which executive officers must repay any excess IBC awarded to them regardless of whether they contributed to the restatement. Even restatements attributable to an inadvertent error would potentially subject executive officers to the recovery of previously received IBC. See When IBC Is "Received" below for further details.

Issuers and Securities Subject to the Rule

With very limited exceptions, the final rule requires exchanges to apply the disclosure and recovery requirements to all listed issuers. Note that the final rule applies to emerging growth companies, smaller reporting companies, foreign private issuers (FPIs), and controlled companies, since the SEC believes that the objective of recovering excess compensation is as relevant for these types of companies as it is for any other listed issuer. While some exchanges currently allow FPIs to follow the rules of their home countries in lieu of certain U.S. corporate governance requirements, the final rule does not permit the exchanges to exempt FPIs from complying with the rule's disclosure and recovery requirements.

The listing standards apply to issuers regardless of the types of securities they have issued, including issuers of listed debt or preferred securities that do not have listed equity.[3]

Restatements Triggering Application of the Recovery Policy

Under the final rule, a listed issuer must adopt a written compensation recovery policy that will be triggered in the event that the issuer is required to prepare an accounting restatement that corrects an error in previously issued financial statements that (1) is material to the previously issued financial statements or (2) would result in a material misstatement if the error were corrected, or left uncorrected, in the current period. The final rule reflects a broad interpretation of the phrase "an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws" because it applies to both types of restatements caused by material misstatements that either exist in previously issued financial statements or would exist in the current period.[4]

In the SEC's view, "material noncompliance" encompasses both "Big R" and "little r" restatements. In the case of a "Big R" restatement, the material noncompliance results from an error that was material to previously issued financial statements. In the case of a "little r" restatement, the material noncompliance results from an error that would be material to the current-period financial statements if the error were left uncorrected or if the correction were recorded only in the current period. A "little r" restatement further differs from a "Big R" restatement with respect to the form and timing of reporting as well as the required disclosures. With a "Big R" restatement, for instance, an issuer must file Form 8-K, Item 4.02, and "amend its filings promptly to restate the previously issued financial statements." On the other hand, a Form 8-K, Item 4.02, is typically not required for a "little r" restatement; rather, SEC Staff Accounting Bulletin No. 108 notes that, in such circumstances, the issuer may make any corrections "the next time [it] files the prior year financial statements."

The SEC clarifies that when an error originated in previously issued financial statements but is corrected in the current-period financial statements, the correction would be considered an out-of-period adjustment. In such cases, "the error is immaterial to the previously issued financial statements, and the correction of the error is also immaterial to the current period." Accordingly, an out-of-period adjustment would not trigger a compensation recovery analysis under the final rule because it is not an "accounting restatement." Therefore, the final rule requires a compensation recovery analysis for both "Big R" and "little r" restatements but not for out-of-period adjustments.

The final rule reminds issuers that they are already required to perform a materiality analysis[5] for each error by considering "the effects of the identified unadjusted error on the applicable financial statements and related footnotes" as well as by evaluating "quantitative and qualitative factors." Further, the rule points out that "[r]egistrants, auditors, and audit committees should already be aware of the need to assess carefully whether an error is material by applying a well-reasoned, holistic, objective approach from a reasonable investor's perspective based on the total mix of information." The rule also indicates that one qualitative factor an issuer should consider in determining materiality is "whether the misstatement has the effect of increasing management's compensation" (e.g., bonuses or other forms of incentive compensation).

[3] The final rule does, however, provide an exemption for listings of (1) security futures products, (2) standardized options, (3) securities issued by unit investment trusts, and (4) securities issued by an investment management company that is registered under Section 8 of the Investment Company Act of 1940, if such an investment management company has not awarded IBC to any executive officer of the company in any of the last three fiscal years, or in the case of a company that has been listed for less than three fiscal years, since the listing of the company.

[4] The original proposed rule focused only on restatements resulting from errors that are material to the previously issued financial statements.

[5] Issuers should consider SAB Topics 1.M (SAB 99) and 1.N (SAB 108) when determining whether an accounting restatement due to material noncompliance is required.

The final rule notes that application of the recovery policy would not be required for certain types of changes to previously issued financial statements. Specifically, the rule states, in part:

> [U]nder current accounting standards the following types of changes to an issuer's financial statements do not represent error corrections, and therefore would likewise not trigger application of the issuer's compensation recovery policy under the listing standards:
>
> - Retrospective application of a change in accounting principle;
> - Retrospective revision to reportable segment information due to a change in the structure of an issuer's internal organization;
> - Retrospective reclassification due to a discontinued operation;
> - Retrospective application of a change in reporting entity, such as from a reorganization of entities under common control;
> - Retrospective adjustment to provisional amounts in connection with a prior business combination (IFRS filers only); and
> - Retrospective revision for stock splits, reverse stock splits, stock dividends or other changes in capital structure. [Footnotes omitted]

Date on Which the Issuer Is Required to Prepare an Accounting Restatement

Under the final rule, the date on which an issuer is required to prepare an accounting restatement (i.e., the trigger date) is the earlier of:

- "The date the issuer's board of directors, a committee of the board of directors, or the officer or officers of the issuer authorized to take such action if board action is not required, concludes, or reasonably should have concluded, that the issuer is required to prepare an accounting restatement."
- "The date a court, regulator or other legally authorized body directs the issuer to prepare an accounting restatement."

Under the final rule, both "Big R" and "little r" restatements trigger an analysis of whether IBC should be clawed back in accordance with the recovery policy. The trigger date is generally determined as follows:

- For a "Big R" restatement, an issuer must file a Form 8-K, Item 4.02, within four business days of a determination that "previously issued financial statements should no longer be relied upon." The trigger date is expected to coincide with that determination.
- For a required "little r" restatement, no Form 8-K would be filed since the error is not material to previous periods. Therefore, the trigger date would be the date on which an issuer concludes or reasonably should have concluded that a restatement of the prior periods is required in a future filing to avoid materially misstating the current year. Note that it is possible for this date to occur before the exact amount of the error has been determined.

Executive Officers Subject to the Recovery Policy

Under the final rule, the definition of "executive officer" includes "the issuer's president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division, or function (such as sales, administration, or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer."

Further, the final rule clarifies the scope of the term as follows:

> Executive officers of the issuer's parent(s) or subsidiaries are deemed executive officers . . . if they perform such policy[-]making functions for the issuer. In addition, when the issuer is a limited partnership, officers or employees of the general partner(s) who perform policy-making functions for the limited partnership are deemed officers of the limited partnership. When the issuer is a trust, officers, or employees of the trustee(s) who perform policy-making functions for the trust are deemed officers of the trust. Policy-making function is not intended to include policy-making functions that are not significant.

The above definition of "executive officer" is modeled on the SEC's definition of "officer" in Rule 16a-1(f) of the Securities Exchange Act of 1934 and should, at a minimum, include all executive officers identified under Form 10-K, Item 10.

The final rule requires recovery of excess IBC received by a current or former employee (1) after the employee became an executive officer and (2) for the related IBC performance period in which the employee served as an executive officer. Recovery of IBC received while an individual served in a nonexecutive capacity before becoming an executive officer will not be required. As a result, recovery sometimes may be required from individuals who were former executive officers as of the trigger date.

Connecting the Dots

Because the final rule applies to current and former executive officers, companies should consider keeping an updated list of the individuals who served as executive officers over the past three years. It would also be advisable to maintain current contact information for any former employees who served as executive officers.

Definition of IBC

The final rule defines IBC as "any compensation that is **granted, earned, or vested** based wholly or in part upon the attainment of a financial reporting measure" (emphasis added). Such compensation includes both cash-based and equity-based incentives.

Financial reporting measures are defined as (1) "measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements," (2) "any measures that are derived wholly or in part from such financial information," and (3) "[s]tock price and total shareholder return" (TSR). Non-GAAP financial measures are within the scope of this definition since they are derived from the issuer's GAAP financial information. This definition may also include other measures, metrics, and ratios to the extent that they are derived from the issuer's financial statements (e.g., average revenue per user). Financial information is included in this definition regardless of whether it is part of an SEC filing or presented outside the financial statements (e.g., in MD&A). The final rule gives the following examples (not all-inclusive) of financial reporting measures:

- Revenues;
- Net income;
- Operating income;
- Profitability of one or more reportable segments [in accordance with ASC 280[6]];
- Financial ratios (*e.g.,* accounts receivable turnover and inventory turnover rates);
- Net assets or net asset value per share (*e.g.,* for registered investment companies and business development companies that are subject to the rule);
- Earnings before interest, taxes, depreciation and amortization;
- Funds from operations and adjusted funds from operations;
- Liquidity measures (*e.g.,* working capital, operating cash flow);

[6] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

- Return measures (*e.g.,* return on invested capital, return on assets);
- Earnings measures (*e.g.,* earnings per share);
- Sales per square foot or same store sales, where sales is subject to an accounting restatement;
- Revenue per user, or average revenue per user, where revenue is subject to an accounting restatement;
- Cost per employee, where cost is subject to an accounting restatement;
- Any of such financial reporting measures relative to a peer group, where the issuer's financial reporting measure is subject to an accounting restatement; and
- Tax basis income.

If stock price and TSR are the financial reporting measures used to determine an incentive payout, issuers are permitted to use "reasonable estimates" to determine the impact that their restated financial results would have had on those applicable measures. Issuers are also required to maintain documentation of the determination and disclose those estimates.

The final rule's definition of IBC does not include all types of incentive compensation. Any incentive awards that are granted, earned, or vested solely on the basis of whether nonfinancial measures have been achieved (e.g., awards related to achieving safety goals, obtaining regulatory approvals, or opening a targeted number of new stores or franchises) would not be subject to the recovery policy.

Importantly, stock options and other equity awards would be treated as IBC only if the granting, vesting, or earning of the award is based (in whole or in part) on the attainment of any financial reporting measures. Therefore, stock options, stock appreciation rights (SARs), restricted stock, and restricted stock unit (RSU) awards that are granted irrespective of achieving any financial reporting measure and vest solely on the basis of continued service would not be considered IBC.[7]

In addition, the final rule notes that the following types of compensation (not all-inclusive) would be subject to the recovery policy if they are granted, earned, or vested on the basis of whether a financial reporting measure was attained:

- Nonequity incentive plan awards, including cash-based incentive awards.
- Bonuses paid from a "bonus pool" (if the size of the pool is determined on the basis of whether a specified financial reporting measure was achieved).
- Restricted stock, RSUs, performance share units, stock options, and SARs.
- "Proceeds received upon the sale of shares acquired through an incentive plan."

Period Covered by the Recovery Policy

Under the final rule, the three-year look-back period for the recovery policy would consist of the "three completed fiscal years immediately preceding the date the issuer is required to prepare an accounting restatement." As discussed below, an award is considered "received" in the fiscal year in which the reporting measure is attained even if payment occurs in a subsequent period. For example, if a calendar-year company determines in July 2027 that a restatement of financial statements is required because of material noncompliance with financial reporting requirements, the recovery policy would apply to IBC that was "received" in 2024, 2025, and 2026. This would include any IBC paid in 2027 that was based on 2024, 2025, or 2026 performance measures.

For companies that changed their fiscal year during the three-year look-back period, the look-back period generally would be extended to include the transition period.

[7] In addition, base salaries, retention bonuses, and cash incentives based on the attainment of nonfinancial strategic or operational measures would not be considered IBC.

When IBC Is "Received"

Under the final rule, IBC is considered received in the fiscal period during which the associated financial reporting measure is attained even if the executive officer does not actually receive payment or an award is not granted until after the end of that period. The final rule gives the following examples illustrating how the date on which compensation is deemed received may vary depending on the terms of an award:

- "If the grant of an award is based, either wholly or in part, on satisfaction of a financial reporting measure performance goal, the award would be deemed received in the fiscal period when that measure was satisfied."
- "If an equity award vests only upon satisfaction of a financial reporting measure performance condition, the award would be deemed received in the fiscal period when it vests."
- A cash incentive or other nonequity incentive plan award earned upon attainment of a financial reporting measure is deemed received in the period in which the goal is achieved.

The date on which the award is received may differ from the award's vesting date (e.g., additional service-based vesting could be required after the financial reporting measure is attained). Further, any "ministerial" actions or other conditions required to effect issuance or payment (e.g., obtaining compensation committee approval for payment) would not affect the determination of the date on which compensation is deemed received.

Importantly, IBC received by an executive officer (1) before the company's securities become listed or (2) before the date the applicable listing standards are effective would not be subject to the recovery policy.

Determination of Excess Compensation

Under the final rule, the recoverable amount would be "the amount of incentive-based compensation received by the executive officer or former executive officer that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement."

After an accounting restatement, an issuer is required to recalculate incentive compensation payments on the basis of the restated financial reporting measure. The issuer then needs to determine whether an executive officer received a greater amount of IBC than what he or she would have received if the financial statements had been prepared correctly. As discussed in Definition of IBC above, for IBC that is based on stock price or TSR, the recoverable amount may be based on a "reasonable estimate" of the effect of the restatement on stock price. The issuer is required to (1) maintain documentation of its reasonable estimate and (2) provide the documentation to the relevant exchange.

The recoverable amount is determined on the basis of the gross amount paid to the executive (i.e., before any consideration of income taxes paid by the executive) to ensure that an issuer recovers the full amount of excess IBC. The application of the final rule to specific types of compensatory arrangements is described below.

Cash Awards Paid From a Bonus Pool

An issuer that paid cash-based incentive compensation from a bonus pool would recalculate the aggregate size of the pool by using the restated financial reporting measure. If the revised bonus pool is less than the aggregate amount of bonuses paid, (1) the excess amount paid to executive officers would be equal to the same percentage reduction in the bonus pool and (2) the excess amount for each individual executive officer would be determined on a

proportional basis. The final rule does not permit an issuer to use discretion in determining the IBC to recover from each executive officer.

Share-Based Payment Awards

Excess share-based payment awards are recoverable as follows:

- If shares, stock options, or SARs are held by the individual at the time of recovery, the recoverable amount would be the number of awards received in excess of the number that would have been received if no restatement had occurred.
- If stock options or SARs have been exercised but the underlying shares were not sold, the recoverable amount would be the number of shares underlying the excess options or SARs after the restated financial measure has been applied.

Note that if the share-based payment awards have been sold, the "proceeds received upon the sale of shares acquired through an incentive plan" would still be recoverable.

Nonqualified Deferred Compensation

The executive officer's account balance or distributions would be reduced by (1) the excess IBC contributed to the nonqualified deferred compensation plan and (2) the interest or other earnings accrued on the applicable amounts.

Coordination With Section 304 of the Sarbanes-Oxley Act of 2002

To the extent that an executive officer has already reimbursed the company in accordance with the recovery required by Section 304 of the Sarbanes-Oxley Act of 2002, the amount reimbursed would offset the amount of the recovery owed if the company's compensation recovery policy requires repayment of the same compensation by that executive officer.

Connecting the Dots

An issuer that uses a combination of financial and nonfinancial metrics to calculate incentive payouts would first determine the portion of compensation derived from the financial reporting measures. The issuer would then recalculate the affected portion on the basis of the restated financial measure. When an issuer uses a financial metric to fund a bonus pool, there is no excess compensation subject to recovery if the actual aggregate distributions to individual participants were less than (1) the amount that was initially funded and (2) the amount that would have been funded for the bonus pool if the financial statements had been prepared correctly.

Board Discretion in Determining Whether to Seek Recovery

The SEC recognizes that there may be circumstances in which it may not be in shareholders' interest to pursue the recovery of excess IBC. Therefore, the final rule stipulates that issuers must recover erroneously paid compensation unless (1) the direct costs of enforcing recovery (i.e., costs requiring financial payments, such as reasonable legal fees) would exceed the recoverable amount, (2) pursuing recovery would violate home country law,[8] or (3) recovery would be likely to cause an otherwise tax-qualified retirement plan, under which benefits are broadly available to employees of the issuer, to fail to meet the requirements of anti-alienation rules and other plan qualification requirements under the Internal Revenue Code.

Before concluding that enforcement costs would make it impracticable to recover any amount of IBC, an issuer would need to make a reasonable attempt to recover the IBC. The issuer would also be required to document its attempt to recover such IBC and provide that documentation to the listing exchange. The final rule does not include a de minimis threshold, and an issuer would need to attempt recovery of excess IBC before reaching a conclusion of

[8] The relevant home country law must have been adopted in that country before the date on which the final rule is published in the *Federal Register*.

impracticability. Similarly, before concluding that attempts to recover any amount of IBC would violate home country law, an issuer would need to obtain an opinion from home country counsel that seeking recovery would result in a violation.

Any determination that recovery would be impracticable must be made by the issuer's compensation committee (or, in the absence of a compensation committee, a majority of the independent directors serving on the issuer's board).

Connecting the Dots

Many companies have already adopted compensation recovery policies that give the board of directors (or the compensation committee) broad discretion to determine (1) whether to seek recovery of excess IBC and (2) the individuals from whom to seek recovery. The final rule significantly reduces the ability of the board of directors to exercise such discretion.

Means of Recovery

The SEC staff recognizes that the appropriate approach for recovery of excess IBC may vary by company and by type of compensation. As a result, the final rule would allow a company to exercise discretion in determining the best way to recover excess IBC as long as executive officers are prevented from retaining compensation to which they are not entitled in view of the restated financial results.

The final rule does not permit boards to settle for less than the full recovery amount unless they satisfy the conditions demonstrating that recovery is impracticable. Furthermore, the rules do not prevent an issuer from securing recovery through means that are appropriate on the basis of the particular facts and circumstances of each executive officer that owes a recoverable amount. For example, a deferred payment plan may be appropriate depending on the officer's financial situation.

The final rule also requires issuers to recover excess IBC "reasonably promptly," since "undue delay would constitute noncompliance with an issuer's recovery policy."

Disclosure Implications

The final rule requires extensive disclosures related to an issuer's recovery policy and actions taken in the event of a restatement.

Annual Report Disclosures

The final rule amends "the cover page of Form 10-K, Form 20-F, and Form 40-F to add check boxes that indicate separately (a) whether the financial statements of the [issuer] included in the filing reflect correction of an error to previously issued financial statements, and (b) whether any of those error corrections are restatements that required a recovery analysis of [IBC] received by any of the [issuer's] executive officers during the relevant recovery period."

Importantly, when a restatement ("Big R" or "little r") occurs, an issuer would check both boxes as long as its executive officers received IBC during the three-year recovery period, even if the issuer concludes that no excess IBC was received by the executive officers. In addition, the issuer would be required to tag the checkboxes and other specific data points in the recovery policy by using inline XBRL.

The final rule also requires that a listed issuer disclose its recovery policy as an exhibit to its annual report.

Executive Compensation Disclosures in Annual Reports or Proxy Statements

Under the final rule, an issuer must disclose how it applied its recovery policy. For example, the issuer's actions to recover erroneously awarded compensation must be disclosed if either of the following occurred at any time during the last completed fiscal year:

- The issuer completed a restatement that required it to recover excess IBC in accordance with its recovery policy.
- The issuer had an outstanding balance of excess IBC as a result of applying its recovery policy to a prior restatement.

In such situations, the issuer must disclose the following in accordance with SEC Regulation S-K, Item 402 (on executive compensation):[9]

- For each restatement:
  - "The date on which the registrant was required to prepare an accounting restatement."
  - The aggregate amount of excess IBC attributable to the restatement, "including an analysis of how the amount was calculated."
  - The amount of excess IBC outstanding at the end of the last completed fiscal year.
  - The estimates used to determine the excess IBC attributable to the accounting restatement if the financial reporting measures were related to stock price or TSR.
  - If the aggregate amount of excess IBC "has not yet been determined, [an issuer would] disclose this fact, explain the reason(s) and disclose the information required in [the second, third, and fourth bullets above] in the next filing that is required to include disclosure pursuant to Item 402 of Regulation S-K."
- If the issuer determines recovery is impracticable, for each named executive officer (NEO) and all other executive officers as a group, an issuer must disclose "the amount . . . forgone and a brief description of the reason the [issuer] decided . . . not to pursue recovery."
- The name of, and amount due from, each current or former NEO from whom, as of the end of the last completed fiscal year, excess IBC had been outstanding for at least 180 days since the date the company determined the amount owed by the individual.

The final rule also amends the disclosure requirements in Regulation S-K, Item 402(c), related to the summary compensation table. Under the final rule, companies are required to (1) reduce the amount originally reported in the applicable column of the summary compensation table by the amount recovered in accordance with the company's recovery policy for the applicable fiscal year and (2) identify the amount recovered in a footnote to the summary compensation table. The amount reported as total compensation for the applicable year(s) would also be updated. The new requirement would apply in any filing for which disclosures related to the summary compensation table are required for the affected fiscal year(s).

Further, under the final rule, "if at any time during its last completed fiscal year a registrant prepared an accounting restatement, and the registrant concluded that recovery of [excess IBC] was not required pursuant to the registrant's compensation recovery policy . . . , the issuer must briefly explain why application of its recovery policy resulted in this conclusion."

[9] The disclosure requirements would also apply to FPIs. These issuers would file their recovery policies as an exhibit to the annual reports they file with the SEC on Form 20-F.

Indemnification and Insurance

Under the final rule, an issuer is prohibited from "indemnifying any [current] or former executive officer against the loss of erroneously awarded compensation." Issuers are also not permitted to pay or reimburse executive officers for paying insurance premiums on a policy that covers potential recovery obligations. The SEC believes that indemnification and insurance would defeat the ultimate purpose of Section 954 of the Dodd-Frank Act — i.e., to prevent executive officers from retaining compensation that they would not have received if (1) the financial statements had been prepared correctly and (2) there had been no overpayment of compensation.

Accounting Considerations

Companies preparing to comply with, and to incorporate a recovery policy under, the SEC's final rule should consider the potential accounting consequences of adoption.

Depending on the category of the IBC, the IBC subject to recovery may have been accounted for under ASC 718 (e.g., RSUs or stock options), ASC 710 and ASC 450 (e.g., profit-sharing arrangements), or other applicable accounting guidance.

The final rule's accounting implications will be based on a company's specific facts and circumstances. In particular, companies should consider possible effects on the accounting for share-based payment arrangements. Under ASC 718, an equity-classified award issued to an employee is generally (1) measured on the basis of the fair value of the award on the grant date and (2) recognized over the requisite service period.

The discussion below outlines various accounting considerations related to share-based payment awards that companies may need to take into account when applying the final rule.[10]

Establishing a Grant Date

One of the conditions for establishing a grant date is that the employer and its employees must "reach a mutual understanding of the key terms and conditions of a share-based payment award."[11] If the key terms of an award are overly broad, subjective, or discretionary, there may be a delay in establishing a grant date for accounting purposes, which would, in turn, delay the establishment of a measurement date for determining the fair-value-based measure of the award. In addition, if certain conditions are met and the service inception date precedes the grant date as a result,[12] compensation cost may need to be recognized on the basis of the fair value of the award as of each reporting date until a grant date is established, even if the award is classified as equity (i.e., "mark-to-market" or "variable" accounting before the grant date).

Connecting the Dots

We generally expect that recovery policies adopted to comply with the provisions of the final rule will not preclude a company from establishing a grant date because the rule would require such policies to be well-defined and sufficiently objective. Conversely, clawback policies that are subjective or that allow companies to exercise discretion in determining when an IBC clawback is triggered could preclude an issuer from establishing a grant date because the clawback-triggering event would generally be a "key" term or condition for which a mutual understanding must exist. Therefore, in a company's policies, it is especially important for the contingent event that triggers the clawback to be well-defined and sufficiently objective.

[10] While this discussion focuses on share-based payment awards that are classified as equity, some of the same considerations could apply to awards classified as liabilities.
[11] See ASC 718-10-20 for the definition of a grant date.
[12] See ASC 718-10-35-6 and the related implementation guidance in ASC 718-10-55-108.

Modification Considerations

ASC 718-10-20 defines a modification as a "change in the terms or conditions of a share-based payment award." However, an entity is not required to apply modification accounting if the fair-value-based measure, vesting conditions, or classification is the same immediately before and after the modification.[13] Companies will need to consider whether modification accounting is required for changes made to existing awards as a result of the final rule.

Under ASC 718-10-30-24, clawback provisions[14] in share-based payment plans generally are not reflected in estimates of the fair-value-based measure of awards. Accordingly, the addition of a clawback provision to an award would typically not result in the application of modification accounting because such clawbacks generally do not change the award's fair-value-based measure, vesting conditions, or classification.

Further, a company that is preparing to adopt the final rule may decide to make other changes to an award, such as changing its performance or market conditions. Companies should evaluate such changes under the modification framework in ASC 718. See Chapter 6 of Deloitte's Roadmap *Share-Based Payment Awards* for more information.

Accounting for a Recovery

If a company concludes that an accounting restatement is required and that excess IBC has been received by an executive officer, there are additional considerations associated with accounting for the recovery. The final rule requires companies to apply their recovery policy to awards that are "received," which may precede the date the awards may be earned (i.e., vested) under ASC 718.

A company should assess its specific facts and circumstances to determine the appropriate accounting for a recovery. Although the discussion below focuses on two possible approaches that depend on whether the awards have been earned, there may also be other acceptable approaches.

Recovery of Earned Awards ("Clawback")

A company may conclude that clawback accounting, as described in ASC 718, is appropriate for the recovery related to awards that have been earned as of the trigger date. Contingent features, such as clawback provisions, are not reflected in the fair-value-based measure of an equity instrument on the grant date and do not affect the recognition of compensation cost if they are triggered after the equity instrument is earned.[15] Therefore, a clawback provision has no day 1 impact on the accounting for an award, and the clawback would be accounted for only if and when it is triggered by a contingent event (i.e., an accounting restatement).

The guidance in ASC 718 addresses how to account for clawbacks of awards that have been earned (i.e., vested).[16] Under that guidance, a clawback of IBC would be recognized when (1) the material restatement triggering the clawback occurs after an award has been earned and (2) the consideration is received or receivable. At that time, the company would recognize (1) the consideration returned by the individual; (2) a receivable for such consideration; or, if the individual returns shares, (3) treasury stock at the fair value of those shares. The company also would recognize as other income the fair value of the consideration received to the extent that it previously recognized compensation cost for awards that were subject to the clawback; any excess of the fair value of the consideration received over the previously recognized compensation cost would be recognized as an increase to additional paid-in capital.[17]

[13] See ASC 718-20-35-2A.

[14] ASC 718 states that a clawback feature is an example of a "contingent feature of an award that might cause the grantee to return to the entity either equity instruments earned or realized gains from the sale of equity instruments earned." The final rule requires companies to have a recovery policy that could extend beyond equity instruments earned under ASC 718. Thus, a company may adopt a recovery policy under the final rule that could extend beyond what is described as a clawback under ASC 718.

[15] See ASC 718-10-30-24 and ASC 718-10-55-8.

[16] If the award is not vested, see Recovery of Unearned Awards.

[17] See ASC 718-20-55-85.

Recovery of Unearned Awards

For an award within the scope of ASC 718, as of the trigger date, if excess IBC is deemed received on the basis of the final rule but the requisite service period has not been satisfied and the award has not yet been vested under ASC 718, the company would still be required to apply the recovery policy. Effectively, the company's recovery policy would reduce the number of units that could be earned.

Under ASC 718, if an award has a performance condition, accruals of compensation cost should be based on the probable outcome of that performance condition. That is, compensation cost is accrued only if it is probable that the performance condition will be achieved; otherwise, no compensation cost is accrued. Compensation cost is not recognized if awards are forfeited because a performance condition is not satisfied.[18] However, if the award has a market condition, compensation cost is recognized even if the market condition is not satisfied, as long as the requisite service is rendered. This is because a market condition is not a vesting condition; rather, it is reflected in the fair-value-based measure of the award on the grant date.

ASC 718 addresses how to account for changes in estimates if an award has not been vested. For example, assume that an award is based on a performance condition with a three-year performance period ending in the issuer's 20X1 fiscal year but is subject to service-based vesting for two additional years beyond the performance period. If the issuer concludes in late 20X2 that its 20X1 fiscal year is subject to a material restatement that triggers recovery for awards received in 20X1, that award would be deemed "received" under the final rule in 20X1 because the performance condition is "attained" (i.e., the performance condition is achieved), even if the award is subject to additional vesting (i.e., has not been earned). In this situation, the company may conclude that when considering the effect of the restated financial statements, it is not probable that the award will vest (i.e., on the basis of the restated financial statements, the performance condition will not be achieved) and any compensation cost previously recognized would be reversed.

If, on the other hand, there is a material restatement and it is determined that the market condition was not achieved, compensation cost is still recognized even if the market condition is not satisfied, as long as the requisite service is rendered.

Tax Considerations

Companies may also want to consider the final rule's potential tax consequences, including implications for their executives whose compensation is subject to clawback.

Consequences for the Company

When amounts paid as compensation must be repaid to a company in the same calendar year, the company would not claim a tax deduction for the amounts that were subject to the clawback. If the company receives a clawback payment from one of its executives in a subsequent tax year, any tax deduction previously taken for the compensation that was subject to the clawback would be reversed to the extent of the repayment.

Consequences for the Company's Executives

Before the Tax Cuts and Jobs Act of 2017 (TCJA) was enacted, an executive may have been entitled to a miscellaneous itemized deduction for the amount that must be repaid under a clawback provision. In practice, the deduction may not have been available, since miscellaneous itemized deductions were only deductible to the extent that they exceeded 2 percent of adjusted gross income (the "2 percent floor"). However, the TCJA suspended the deductibility of miscellaneous itemized deductions subject to the 2 percent floor for tax years 2018 through 2025.

[18] See ASC 718-10-25-20 and ASC 718-10-30-12.

Section 1341 of the Internal Revenue Code, which codifies the "claim of right" doctrine, provides an alternative mechanism for claiming a tax deduction or credit for the amount that must be repaid under a clawback provision. If Section 1341 applies, the taxpayer is entitled to a tax deduction or credit based on the decrease in tax for the year of inclusion that would result solely from exclusion of the item from gross income. The key issue in the determination of whether the Section 1341 claim of right doctrine can be used is whether it appeared that the payment recipient had an unrestricted right to the amount when paid. Companies must analyze all relevant facts and circumstances in making this determination. Accordingly, in assessing whether Section 1341 applies to a clawback situation, executives and their advisers will need to review the terms of the payment, the clawback requirements, and other facts related to the repayment.

Next Steps

Transition and Time Frame for Implementation

The time frame within which companies must implement the mandatory compensation recovery policy is as follows:

Event	Time Frame
Exchanges' filing of new listing rules	90 days after publication of the final rule in the *Federal Register*
Effective date of new listing rules	No more than one year after publication of the final rule in the *Federal Register*
Companies' adoption of a compliant recovery policy	No more than 60 days after the effective date of the new listing rules

Given the above timeline, we expect that companies will need to have a compliant recovery policy in place by the end of 2023 or early 2024.

In addition, the final rule requires companies to recover all excess IBC received by current and former executive officers after the effective date of the applicable listing standards. In other words, grants that were made before the effective date, but that are received after the effective date, would be subject to clawback.

Connecting the Dots

Companies should consider doing the following in preparing to implement their clawback policies:

- Reviewing existing **recovery policies** and considering changes that may need to be made to comply with the SEC's final rule.
- Examining executive officers' **employment agreements, letter agreements, or both**, to (1) determine whether there is any potential conflict between the terms of the agreements and the final rule and (2) consider whether those agreements need to be amended.
- Reviewing the terms and form of **stock award agreements**, annual bonus plans, and long-term incentive plans to determine whether they permit the recovery of excess IBC and whether they should be updated.
- Inventorying current IBC awards to determine which payouts are based on financial and market-based metrics. For awards with market-based performance conditions (e.g., TSR or stock price), an entity may need expert advice on determining what constitutes a **"reasonable estimate" of the amount to be recouped**.

- Evaluating **internal processes/controls and governance frameworks** to establish how clawbacks will be implemented if there is a restatement and who is accountable for overseeing these decisions (e.g., audit committees and compensation committees would most likely need to collaborate).
- Assessing **disclosure and reporting** needs related to the new requirements, including both details of the newly adopted policy and the framework for its application.
- Developing **communication plans** for executives who will be covered under the new rules. Note that this group may be broader than that under a company's existing clawback policies.

In performing the above actions, companies may need to establish a cross-functional team that includes members of the human resources and legal departments.

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