SEC Proposes Hedging Disclosure Rule

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On February 9, 2015, the **SEC proposed a long-awaited rule** on disclosure of company equity hedging policies, as required by Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The proposed rule would require companies to disclose whether they permit any employees, officers or directors, or any of their "designees," to purchase financial instruments or otherwise engage in transactions that are designed to have the effect of hedging or offsetting any decrease in the market value of company equity securities:

- granted as part of compensation; or
- held by them, "directly or indirectly."

The disclosure would be required in any proxy statement or information statement relating to an election of directors. Although the rule does not specify when it will go into effect, given the comment period, it cannot go into effect until late April 2015, at the earliest. This means that, for most calendar-year companies, this disclosure should *not* be required during this current proxy season.

The SEC has proposed a disclosure rule only, which does not require companies to prohibit hedging or adopt hedging policies. The major proxy advisory services, however, are vocal in their belief that allowing executive officer and director hedging is a problematic practice, and companies will undoubtedly continue to feel pressure from shareholders to adopt anti-hedging policies for those individuals.

The SEC has requested comment on the proposal within 60 days after its publication in the Federal Register (which has yet to occur). Thus, the comment period should last through mid-April 2015.

Highlights of the proposal include:

Covered companies. The proposed rule, Item 407(i) of Regulation S-K, would generally apply to all issuers, including smaller reporting companies, emerging growth companies under the JOBS Act and listed closed-end funds. It would not apply to open-end mutual funds or exchange-traded funds and would not apply to foreign private issuers, which are not generally subject to U.S. proxy disclosure rules.

Covered hedging transactions. Although the Dodd-Frank statute referred to the *purchase* of financial instruments, including prepaid variable forward contracts, equity swaps, collars and exchange funds, the SEC took a principles-based approach and proposed a rule that would require disclosure of transactions with "economic consequences" comparable to the purchase of specified financial instruments. The SEC was concerned that identifying specific instruments would result in incomplete disclosure or the creation of perverse incentives for employees and directors to seek downside price protection through other means – for example, the proposal specifically identifies short sales and the selling of security futures as ways in which a person might seek downside price protection.

Companies must disclose which categories of hedging transactions they permit and which categories of transactions they prohibit. Companies may indicate that they expressly permit or prohibit all hedging transactions by employees and directors. If applicable, companies could list the few transactions that they permit or prohibit and indicate that all other transactions are prohibited or permitted. In addition, if some or all hedging transactions are prohibited for certain categories of individuals (*e.g.*, directors and executive officers) and not for others (*e.g.*, other employees), disclosure of this fact would be required.

The SEC is soliciting comment on whether the scope of covered transactions should be clarified, noting that there is a "meaningful distinction between an index that includes a broad range of equity securities, one component of which is company equity securities, and a financial instrument, even one nominally

based on a broad index, designed to or having the effect of hedging the economic exposure to company equity securities." The SEC seems to be considering not requiring disclosure of a company policy that permits trading of broad-based index funds, as an exception to an otherwise strict anti-hedging policy. We think commenters will encourage the SEC in this line of thinking.

Equity securities. The term "equity securities" would mean any equity securities (as defined in Exchange Act rules) issued by the company, any parent of the company, any subsidiary of the company or any subsidiary of any parent of the company, if the securities are registered under Section 12 of the Exchange Act.

By using such terms as "any employees (including officers) or directors of the registrant, or any of their designees," and by focusing on securities "held, directly or indirectly, by the employee or director," the proposed rule may be reaching a broader (or perhaps even a narrower) pool of securities than those ordinarily considered to be "beneficially owned" by an employee, officer or director. While the terms "designee" and "directly or indirectly" are in the Dodd-Frank statute and other sections of the securities laws, it is unclear why the SEC did not use the more familiar concept of "beneficial ownership" in this instance, and we expect public comment seeking clarification.

Forms that require disclosure. Although the Dodd-Frank statute referred to any proxy or consent solicitation material for an *annual* meeting of shareholders, proposed Item 407(i) would apply to any annual or special meeting of shareholders, as well as in connection with an action authorized by written consent. In this regard, the SEC's proposal makes clear that the disclosure would be required in proxy solicitation materials required to be filed under cover of Schedule 14A and information statements filed on Schedule 14C.

The disclosure would not be required in Securities Act or Exchange Act registration statements, in a Form 10-K or for a company that is not conducting a solicitation for the election of directors but is otherwise soliciting proxies at an annual meeting.

Relationship to CD&A. Under existing disclosure rules, one of the non-exclusive examples of disclosure to be included in a company's CD&A is disclosure of any company policies regarding hedging the economic risk of company securities ownership, to the extent material. To reduce potentially duplicative disclosure, the proposal includes an amendment to the CD&A rules providing that a company may satisfy its CD&A obligation to disclose material hedging policies and hedging by its named executive officers by cross-referencing to the information disclosed pursuant to the newly proposed disclosure requirement.

Treatment of non-officer employees. The SEC is soliciting comment on whether the definition of "employee" should be limited to the subset of employees who participate in making or shaping key operating or strategic decisions that influence the company's stock price. In this regard, Commissioners Gallagher and Piwowar issued a joint statement stating that, while they voted to support release of the proposal, they are concerned about it in several respects. For example, they believe that the SEC should have exempted disclosure relating to hedging policies applicable to employees who cannot affect the company's share price. Their view is that the legislative history and the SEC staff's economic analysis seem to indicate that disclosure about whether these employees are permitted to hedge is not useful information to investors. In their view, the SEC has the authority to craft a more narrowly tailored disclosure requirement.

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