SEC Adopts Hedging Disclosure Rule

December 21, 2018

New rule will apply to most U.S. public companies beginning in 2020

On December 18, 2018, the SEC adopted a **final rule** implementing Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires U.S. public companies to disclose whether they permit their employees, officers or directors to hedge the value of equity securities granted as compensation or held directly or indirectly.[1] The rule is generally consistent with the SEC's **original proposal** nearly four years ago, which we discussed in an earlier **memorandum**, but contains a number of modifications that respond to commenters' suggestions.

The new rule, Item 407(i) of Regulation S-K, requires a company to describe any practices or policies regarding the ability of its employees, officers or directors to purchase securities or other financial instruments or engage in transactions intended to hedge or offset a decrease in the market value of equity securities granted as compensation to, or held directly or indirectly by, the employee, officer or director.

Companies may summarize their practices or policies for these types of hedging activities or disclose their practices or policies in full. If a company does not have a practice or policy, it must disclose that fact or state that it generally permits hedging transactions.

The rule does not direct companies to have practices or policies regarding hedging, or dictate the content of any such practice or policy. Although no company will be required to comply with the new rule until the fiscal year beginning on or after July 1, 2019 at the earliest, we expect that many companies will review their existing practices and policies and consider whether, for governance purposes or otherwise, any substantive changes should be considered.

Q: Which companies are subject to the hedging disclosure requirement?

A: All U.S. public companies other than funds.

The hedging disclosure requirement applies to all U.S. public companies, including smaller reporting companies (SRCs), emerging growth companies (EGCs) and business development companies, but excluding mutual funds, closed-end funds and exchange-traded funds.

Foreign private issuers are exempt from the requirement.

Q: When will hedging disclosure first be required?

A: Companies that are not SRCs or EGCs are required to comply with the new disclosure requirements for fiscal years beginning on or after July 1, 2019. SRCs and EGCs are provided with an extra year to comply.

For calendar-year companies, the hedging disclosure requirement will apply in 2020 (or 2021, for SRCs and EGCs).

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[1] The SEC also provided a press release, containing a Fact Sheet summary, which is located **here**.

Q: Which filings will require hedging disclosure?

A: Proxy and information statements covering the election of directors.

Although the Dodd-Frank Act refers to “any proxy or consent solicitation material for an annual meeting of shareholders,” the rule mandates hedging disclosure in any proxy solicitation materials required to be filed on Schedule 14A, as well as information statements filed on Schedule 14C by companies that do not need to solicit proxies for the election of directors.

The disclosure is not required in Securities Act or Exchange Act registration statements or in a proxy solicitation not involving director elections. Additionally, the rule provides that the disclosure is not deemed to be incorporated into Securities Act registration statements.

Q: Where in a proxy statement or information statement is the disclosure located?

A: Companies have flexibility in where to present hedging disclosure, with implications for the say-on-pay vote.

Disclosure required by the new rule can be provided within or outside of the Compensation Discussion and Analysis (CD&A). Companies are already required to disclose, if material, policies on hedging by named executive officers (NEOs) in the CD&A pursuant to Item 402(b) of Regulation S-K. If a company provides the new disclosure outside of the CD&A, the new rule provides that the company can satisfy the existing requirement with a cross-reference to the new disclosure.

Given this flexibility, a company can choose to:

- Include the new disclosure outside of the CD&A and provide the Item 402(b) NEO hedging disclosure as part of the CD&A without a cross-reference; or
- Incorporate the new disclosure into the CD&A, either by directly including the information or by providing the new information outside of the CD&A and adding a cross-reference within the CD&A.

As a practical matter, incorporating the new disclosure into the CD&A would mean it is covered by the advisory say-on-pay vote required by the Dodd-Frank Act.

Q: What types of transactions are covered by the hedging disclosure requirement?

A: The rule applies to the purchase of securities or other financial instruments or engagement in transactions that hedge or offset, or that are designed to hedge or offset, any decrease in the market value of equity securities either (1) granted as compensation to the employee, officer or director or (2) held, directly or indirectly, by the employee, officer or director.

Although the Dodd-Frank Act refers to the *purchase* of financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds), the new rule also requires disclosure of transactions with the same economic effects – to hedge or offset any decrease in the market value of equity securities – as the transactions specified by the statute.

While the SEC acknowledged some commenters’ observations that the language of the proposal could be far reaching, potentially including transactions such as portfolio diversification or broad-based index transactions, the SEC decided that requiring disclosure of any practice or policy the company has adopted regarding these types of transactions should alleviate these concerns. For example, the rule notes that a company would only need to describe portfolio diversification transactions, broad-based index transactions or other similar types of transactions if its hedging practice or policy addresses them.

The SEC believes that by focusing on the company’s practices or policies, the rule avoids adopting a definition that could prove either over- or under-inclusive while allowing flexibility to address new downside price protection techniques as they develop.

Q: Does the requirement apply only to equity compensation?

A: No.

In addition to equity securities granted as compensation, the new rule covers hedging policies with respect to equity securities held directly or indirectly by employees, officers and directors. This would cover, for example, any shares held by an executive officer or director for the purpose of satisfying a stock ownership commitment.

Q: Which individuals are covered?

A: All employees, officers or directors, or any of their "designees."

A number of commenters suggested that the definition of "employee" be limited either to directors and executive officers or a subset of employees who participate in making or shaping key decisions that influence the company's stock price. The SEC did not find these arguments persuasive, and the new rule includes all employees, officers or directors of a company. However, the SEC clarified that a company's policy need not apply to its entire employee base, and a company that discloses a policy that covers only a subset of employees would not be required to further disclose that it does not have a policy with regard to the company's other employees, officers or directors.

Q: Who is a "designee" of an employee, officer or director?

A: The rule does not provide much clarification.

Congress required the SEC to include the term "designee" in the disclosure obligation. Rather than clarify what this vague term means, the SEC stated that "whether someone is a 'designee' depends on the particular facts and circumstances involved." Because the new rule focuses on disclosure of a company's particular practices or policies, our view is that the company itself should be able to make the determination. For example, if a company's hedging policy covers immediate family members of an employee or director, the company's disclosure should note that fact.

Q: How is "equity securities" defined?

A: The rule covers equity securities issued by the company and its parents, subsidiaries or subsidiaries of the company's parents.

In a useful change from the proposal, the rule uses the term "registrant equity securities," rather than "equity securities," to indicate that its scope is narrower than *any* equity security, but broader than just an equity security issued by the particular company that is the employer or on whose board the director sits.

The rule does not limit coverage to equity securities that are registered under Section 12 of the Exchange Act, and therefore covers convertible debt securities and preferred stock, whether or not listed on a stock exchange.

Q: What does "held, directly or indirectly" mean?

A: The rule does not say.

Several commenters recommended that the SEC provide guidance on the meaning of "held, directly or indirectly," for example by reference to the well-understood term "beneficial ownership." However, as with the term "designee," the SEC declined to interpret the congressional mandate. Our view is that a company will be able to address any ambiguity by clearly describing what securities are subject to its policy.

Q: Is a company required to disclose hedging transactions that have occurred?

A: No.

Companies are currently required to disclose pledges of equity securities by NEOs and directors. While comments were mixed on whether to require similar disclosure of hedging transactions, the SEC believes that such disclosure would be largely duplicative of disclosures required by existing Section 16 reporting requirements, which investors can review to determine if officers and directors are in fact hedging.

Q: Is a company required to disclose any waivers of its hedging policy or violations of its hedging policy?

A: No.

The new rule does not specifically require disclosure of any waivers of its policy or hedging that has occurred in violation of its policy, although any such hedging may become apparent to the extent reported in Section 16 filings.

Q: How much detail must be disclosed?

A: The rule requires only a description of any practice or policy and the categories of persons covered.

Under the proposed rule, a company would have been required to disclose the categories of persons who were permitted to engage in hedging transactions, as well as which categories of hedging transactions were permitted and which categories of transactions were prohibited. In order to address potential implementation challenges, the rule as adopted requires companies to either:

- provide a summary of any practices or policies it has adopted (whether written or not) with respect to hedging, including the categories of persons covered and any categories of hedging transactions that are specifically permitted or specifically disallowed; or
- disclose the practices or policies in full.

If a company does not have hedging practices or policies, it must disclose that fact or state that hedging transactions are generally permitted.

Q: Does the hedging disclosure requirement impose any substantive requirements or prohibitions with respect to hedging?

A: No.

The rule specifically states that it does not direct companies to adopt any practice or policy with respect to hedging, or dictate the content of any such practice or policy.

Next Steps

Although companies are not required to comply with the hedging disclosure rule until fiscal years beginning on or after July 1, 2019 at the earliest:

- Each company may wish to review its existing practices and policies with respect to hedging, including any anti-hedging policies.
- Each company may wish to consider what the disclosure under the new rule will say and whether, as a governance matter or otherwise, consider whether they may wish to make any substantive changes to its practices and policies (for example, if a company has an anti-hedging policy, does it cover the appropriate categories of transactions, appropriate categories of individuals at the company, etc.?).

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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