HUNTON & WILLIAMS

Client Alert

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SEC Proposes Enhanced Hedging Disclosure Rules

On February 9, 2015, the Securities and Exchange Commission (the "Commission") proposed rules to require disclosure of a company's equity hedging policies under Section 955 of the Dodd-Frank Act. Specifically, the proposed rules would require a company to disclose, in its proxy or information statement with regard to the election of directors, whether its employees (including officers) or members of its board of directors, or any of their designees, are permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) or otherwise engage in transactions to hedge or offset any decrease in the market value of equity securities granted to the employee or board member as compensation, or held directly or indirectly by the employee or board member.

The proposed rules will be open for public comment for 60 days following the publication of the proposing release in the Federal Register.

Overview

The Commission is proposing to add a new paragraph (i) to Item 407 of Regulation S-K that would implement Section 14(j) of the Securities Exchange Act of 1934 (the "Exchange Act"), as added by Section 955 of the Dodd-Frank Act. The proposed amendment would keep disclosure requirements relating to corporate governance matters together in a single item in Regulation S-K. The Commission stated that it "infer[s] that the statutory purpose of Section 14(j) is to provide transparency to shareholders, if action is to be taken with respect to the election of directors, about whether employees or directors are permitted to engage in transactions that mitigate or avoid the incentive alignment associated with equity ownership."

Covered Hedging Transactions

The proposed rules are not limited to any particular types of hedging transactions and would cover *all* transactions that establish downside price protection. A proposed instruction to proposed Item 407(i) would clarify that companies would be required to disclose the (i) categories of persons who are permitted to engage in hedging transactions and those who are not and (ii) the hedging transactions it permits. Additionally, the disclosure must be in sufficient detail to explain the scope of such permitted transactions, as well as those it prohibits.

Equity Securities

The Commission has proposed that the term "equity securities" would mean any equity securities, as defined in the Exchange Act rules, issued by a company, any parent of the company, any subsidiary of the company or any subsidiary of any parent of the company, that are registered under Section 12 of the Exchange Act.

Covered Persons

The proposed rules cover hedging transactions conducted by *any* employee or member of the board of directors, or any of their designees, of the company. The Commission stated that it believes that the term "employee" should be interpreted to include everyone employed by a company, including its officers.

Filings that Require Disclosure

The proposed Item 407(i) disclosures would need to be provided if action is to be taken with respect to the election of directors, regardless of whether such action is to be taken at an annual or special meeting of shareholders, or in connection with an action authorized by written consent. As a result, the proposed disclosures would need to be included in proxy or consent solicitation materials and information statements with regard to the election of directors.

Relationship to Existing Hedging Disclosure Obligations

The existing disclosure obligations relating to company hedging policies are set forth in Item 402(b) of Regulation S-K, which requires disclosure in the company's Compensation Discussion and Analysis ("CD&A") of any policies regarding hedging by named executive officers ("NEOs")[1] of the economic risk of owning company securities, if material. This disclosure is required in the CD&A only to the extent that it is material information necessary to understanding a company's compensation policies and decisions regarding the named executive officers. The CD&A disclosure requirement does not apply to emerging growth companies, smaller reporting companies, registered investment companies or foreign private issuers. This is part of the Item 402 executive compensation disclosure that is required in Securities Act of 1933 and Exchange Act registration statements, and Exchange Act annual reports on Form 10-K, as well as proxy and information statements relating to the election of directors.

To reduce potentially duplicative disclosure in proxy and information statements, the Commission proposes to amend Item 402(b) of Regulation S-K to add an instruction providing that, in such filings, a company may satisfy its CD&A obligation to disclose material policies on hedging by NEOs by cross-referencing the information disclosed pursuant to proposed Item 407(i). However, the information may be cross-referenced only to the extent that the information disclosed there satisfies this CD&A disclosure requirement.

Companies Subject to the Proposed Rules

Unlike the CD&A disclosure requirement, the proposed Item 407(i) disclosure would apply to emerging growth companies, smaller reporting companies and closed-end investment companies to the same extent as other companies subject to the federal proxy rules. The only companies excluded from the enhanced disclosure requirements of the proposed rules are foreign private issuers and investment companies registered under the Investment Company Act of 1940 that are not closed-end investment companies that have shares that are listed and registered on a national securities exchange.

Concern Expressed by Commissioners

In connection with the proposed rule, Commissioners Daniel M. Gallagher and Michael S. Piwowar issued a joint statement. In the statement they expressed concern over several aspects of the proposal and encouraged robust public comment on them. Their concerns included (i) that emerging growth companies and smaller reporting companies would be subject to the proposed rules, (ii) the fact that the

[1] As defined in Item 402(a)(3) of Regulation S-K, "named executive officers" are all individuals serving as the company's principal executive officer and all individuals serving as the company's principal financial officer during the last completed fiscal year, and the company's three other most highly compensated executive officers who were serving as executive officers at the end of that year, and up to two additional individuals who would have been among the three most highly compensated but for not serving as executive officers at the end of that year.

Commission should have exercised its statutorily granted exemptive authority to exempt disclosures relating to employees who cannot affect the company's share price and (iii) the proposed rules' overbroad coverage of securities, which includes not just securities of a company, but also the securities of the company's affiliates, including subsidiaries, parents and brother-sister companies, which would require companies to engage in a complex, facts-and-circumstances control analysis to determine who is covered by the proposed disclosure requirement.

Additionally, Commissioner Luis A. Aguilar issued a statement supporting the proposed rules, in which he states that the "release is a positive step in the direction of providing more information to shareholders as to whether the interests of corporate insiders are truly aligned with their own."

Conclusion

The proposing release seeks public comment on all facets of the proposed rules. Although the proposed rules are disclosure rules only and would not require a company to prohibit hedging transactions or otherwise adopt practices or a policy addressing hedging by any category of individuals, companies should review their own hedging policies, or lack thereof, to assess where they stand in light of the proposed disclosure requirement. While formal policies prohibiting officer and director hedging are common at larger public companies, these policies are less widespread at mid-cap and smaller-cap companies. Notably, the two largest proxy advisory firms generally oppose any company policy that permits hedging company stock by executive officers and directors, and may recommend "withhold" or "against" votes at directors of such companies. Additionally, companies should consider how they would implement final rules that may be adopted by the Commission.

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