Securities Alert: SEC Proposes Disclosure Rules on Hedging Policies

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CLIENT ALERT | 2.12.2015

Background

On February 9, 2015, the Securities and Exchange Commission (SEC) proposed rules to implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which directs the SEC to require, by rule, each public company to disclose in any proxy or consent solicitation material for an annual meeting of the shareholders of the company whether any employee or director, or any designee of such employee or director, is permitted to hedge the company's equity securities. The new disclosure requirements are intended to inform shareholders "if executives are allowed to purchase financial instruments to effectively avoid compensation restrictions that they hold stock long-term, so that they will receive their compensation even in the case that their firm does not perform."

Disclosure of material policies on hedging by named executive officers is already required under Compensation Discussion and Analysis (CD&A) rules. Additionally, the disclosure of officer and director ownership of company stock required under Item 403(b) of Regulation S-K also requires disclosure of the number of shares that have been pledged as security for hedging transactions. Furthermore, Institutional Shareholder Services (ISS) announced in 2012 that it considers hedging of company stock by directors or executives to constitute a "failure of risk oversight" that may lead to voting recommendations against individual directors, committee members or the full board of directors. As a result of existing rules and the ISS policy position, many public companies already have anti-hedging policies and disclose their policies in their proxy statements. The proposed rules would expand the nature of the required disclosure as well as the types of companies required to provide it.

Summary of Proposed Rules

The proposed rules would add a new paragraph (i) to Item 407 of the corporate governance disclosure requirements in Regulation S-K. The proposed Item 407(i) would require, in proxy or information statements

with respect to the election of directors, disclosure of whether the company permits any employee or director, or any of their designees, to purchase financial instruments or otherwise engage in transactions that are designed to, or have the effect of, hedging or offsetting any decrease in the market value of equity securities (1) granted to the employee or director by the company as compensation or (2) held, directly or indirectly, by the employee or director. The proposed rules do not require companies to prohibit hedging by employees or directors.

Categories of Covered Persons

The proposed rules clarify that the term "employees" includes "officers." The disclosure would also apply to any employee's or any director's "designee," a status that would be determined by a company based on the particular facts and circumstances. If any permissions regarding hedging apply to certain, but not all, persons covered by the proposed rules (e.g., executive officers but not other employees), companies will need to disclose which categories of persons are permitted to hedge and which are not.

Covered Equity Securities

Equity securities covered by the proposed rules would include those issued by the 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 Securities Exchange Act of 1934 (the Exchange Act).

Covered Transactions

The disclosure required under the proposed rules is not limited to any particular types of hedging transactions and would "cover all transactions that establish downside price protection – whether by purchasing or selling a security or derivative security or otherwise, consistent with the statutory purpose." A company would be required to disclose the particular types of hedging transactions it permits and those it prohibits.

Covered Entities

The proposed disclosure would apply to all companies with securities registered under Section 12 of the Exchange Act, including smaller reporting companies, emerging growth companies and listed closed-end funds. Foreign private issuers would not be required to provide Item 407(i) disclosure.

Disclosure Location

The proposed disclosure would be required in proxy or information statements for meetings (or consents) at which directors will be elected, regardless of whether they are annual meetings. To reduce duplicative disclosure, the proposed rules would include an instruction to Item 402(b) indicating that a company may satisfy the CD&A requirement in Item 402(b)(2)(xiii) to disclose policies on hedging by named executive officers, if material, by including a cross-reference to its Item 407(i) disclosure.

The proposed rules would not require Item 407(i) disclosure in registration statements or in Annual Reports on Form 10-K, even if, as is typically the case, the Part III disclosure is incorporated by reference from the company's definitive proxy or information statement. An instruction would provide that 407(i) information will not be deemed to be incorporated into any filings made pursuant to the Exchange Act, the Securities Act of 1933 or the Investment Company Act of 1940, except to the extent specifically incorporated by reference by the company.

Comment Period

The SEC will seek comment on the proposed rules for 60 days following their publication in the Federal Register. SEC Commissioners Gallagher and Piwowar, while voting to approve release of the proposal, issued a joint statement expressing concern over the scope of the proposal. Both the proposing release and the joint statement identify several topics on which the SEC is specifically requesting comments from the public.

2015 Proxy Season

There is currently no effective date specified for the proposed rules, but, given the timing of publication and request for comment, the rules cannot come into effect until late April 2015, at the earliest. The new disclosure will therefore not affect the 2015 proxy season currently underway. However, companies should take the proposed rules into account when reviewing whether their insider trading policies and codes of conduct adequately address their policies on hedging transactions and when drafting proxy statement disclosure regarding company hedging policies.