Client Alert

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SEC Proposes Rule Requiring Hedging Disclosure

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On February 9, 2015, the Securities and Exchange Commission (the "Commission") proposed amendments to its rules to implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which added new Section 14(j) to the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Section 14(j) directs the Commission to require each issuer to disclose in any proxy or consent solicitation material for an annual meeting of the shareholders of the issuer whether any employee or member of the board of directors of the issuer, or any designee of such employee or member, is permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities (1) granted to the employee or member of the board of directors by the issuer as part of the compensation of the employee or member of the board of directors; or (2) held, directly or indirectly, by the employee or member of the board of directors. As noted in the report issued by the Senate Committee on Banking, Housing, and Urban Affairs at the time of adopting Section 955 of the Dodd-Frank Act, this additional disclosure would serve to "provide transparency" to shareholders "to know 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."

The proposed rule is subject to a 60-day comment period following publication in the Federal Register.

BACKGROUND

Hedging transactions may in some cases be attractive to directors, executive officers, and employees of public companies, because often a significant portion of the compensation of those individuals can be comprised of stock of the public company. Therefore, these individuals may seek ways to limit their downside risk. Hedging transactions may allow individuals to achieve this objective, while retaining ownership of their company's stock. Hedging transactions can be accomplished through a number of possible mechanisms, including, but not limited to, the use of financial instruments such as exchange funds, prepaid variable forwards, equity swaps, puts, calls, collars, forwards, and other derivative instruments, or the establishment of a short position in the company's securities.

The practice of hedging company stock by directors, executive officers, and employees has attracted attention from some institutional investors and proxy advisors, who see the practice as inconsistent with the notion of aligning the interests of directors, executive officers, and employees with the interests of shareholders. For example, Institutional Shareholder Services adopted policy changes for the 2013 proxy season which indicated that hedging company stock severs the ultimate alignment with shareholders' interests; therefore, any amounts hedged are considered a problematic practice warranting a potential negative voting recommendation on the election of directors. As a result of the negative attention placed on hedging practices over the past several years, many companies have adopted policies prohibiting or limiting hedging transactions.

THE CURRENT COMMISSION DISCLOSURE REQUIREMENTS REGARDING HEDGING

Item 402(b) of Regulation S-K currently provides that, among the disclosure to be included in the Compensation Discussion and Analysis ("CD&A"), the issuer must disclose all material information necessary to an understanding of a company's compensation policies and decisions regarding the named executive officers. Item 402(b)(2)(xiii) includes, as an example of such information that should be provided, if material, the company's equity or other security ownership requirements or guidelines and any company policies regarding hedging the economic risk of such ownership. This CD&A disclosure item requirement does not apply to smaller reporting companies, emerging growth companies, registered investment companies, or foreign private issuers.

PROPOSED AMENDMENTS TO IMPLEMENT SECTION 14(J) OF THE EXCHANGE ACT

In implementing Section 14(j), the Commission proposes to (1) amend Item 407 of Regulation S-K to add new paragraph (i); (2) amend Item 402(b) of Regulation S-K to add Instruction 6; and (3) amend Schedule 14A to revise Items 7 and 22.

Proposed Item 407(i) of Regulation S-K: The Transactions, Individuals, and Types of Securities Subject to the Proposed Rule. The proposal would add new paragraph (i) to Item 407 of Regulation S-K. Proposed Item 407(i) would specify the types of transactions that are subject to the disclosure requirement. The scope of the proposed disclosure requirement would not be limited to any particular types of hedging transactions or instruments, but would require disclosure of all transactions with economic consequences comparable to the financial instruments specified in Section 14(j). Specifically, proposed Item 407(i) would require disclosure of whether an employee, officer, or director, or any of their designees, is permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) 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 part of the compensation of the employee or director; or (2) held, directly or indirectly, by the employee or director.

The Commission is soliciting comment as to whether the scope of the covered transactions should be further clarified. In this regard, the proposing release notes 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."

Section 14(j) mandates disclosure regarding hedging transactions conducted by any employee or member of the board of directors, or any of their designees. The Commission has specified in the proposed rule that the term "employee" should be interpreted to include everyone employed by an issuer, including its officers. The Commission is soliciting comment on whether the definition of "employee" for the purposes of the proposed rule should be specifically limited to a subset of employees who participate in making or shaping key operating or strategic decisions that influence a company's stock price.

An instruction to proposed Item 407(i) would clarify that the company must disclose which categories of transactions it permits and which categories of transactions it prohibits. If a company specifically prohibits certain hedging transactions, it would disclose the categories of transactions it specifically prohibits and could, if true, disclose that it permits all other hedging transactions in lieu of listing all of the specific categories that are

permitted. Conversely, where a company specifies only the hedging transactions that it permits, in addition to disclosing the particular categories of transactions permitted, it may, if true, disclose that it prohibits all other hedging transactions in lieu of listing all of the specific categories that are prohibited. If a company permits some, but not all, of the categories of persons covered by the proposed amendment to engage in hedging transactions, the company would disclose both the categories of persons who are permitted to hedge and those who are not. In the event that a company permits hedging transactions, a proposed instruction to Item 407(i) would require that the company disclose sufficient detail to explain the scope of such permitted transactions.

Another instruction to proposed Item 407(i) would specify that the term "equity securities," as used in proposed Item 407(i), would mean any equity securities (as defined in Exchange Act Section 3(a)(11) and Exchange Act Rule 3a11-1) 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 on a national securities exchange or registered under Section 12 of the Exchange Act.

An additional instruction to proposed Item 407(i) would provide that the information required by the rule would not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended (the "Securities Act"), the Exchange Act, or the Investment Company Act of 1940, as amended (the "Investment Company Act"), except to the extent that the company specifically incorporates it by reference.

Proposed Amendment to Item 402(b) of Regulation S-K: Cross-reference to Proposed Item 407(i) Will Satisfy Certain Disclosure Requirements. The CD&A disclosure currently required by Item 402(b) of Regulation S-K applies only to named executive officers and is part of the Item 402 executive compensation disclosure that is required in Securities Act 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. The disclosure mandated by Section 14(j) includes within its scope hedging policies applicable to named executive officers. To reduce potentially duplicative disclosure, the Commission proposes to amend Item 402(b) to add an instruction providing that a company may satisfy its CD&A obligation to disclose material policies on hedging by named executive officers by cross-referencing the information disclosed pursuant to proposed Item 407(i) to the extent that the information disclosed there satisfies this CD&A requirement.

Proposed Amendment to Item 7 of Schedule 14A and Item 22 of Schedule 14A: Where New Disclosure Will Be Required. Pursuant to the proposed amendment to Item 7 of Schedule 14A, and, for closed-end investment companies that have shares that are listed and registered on a national securities exchange ("Listed Closed-End Funds"), the proposed amendment to Item 22 of Schedule 14A, the disclosure mandated by Section 14(j) would be required in proxy or consent solicitation materials with respect to the election of directors, or an information statement in the case of such corporate action authorized by the written consent of security holders. The disclosure that would be required by the proposed rule would not be required in Securities Act or Exchange Act registration statements, or in Form 10-K.

ISSUERS SUBJECT TO THE PROPOSED RULE

The Commission's proposed rule would require disclosure regarding hedging policies by the following entities:

- Large Accelerated, Accelerated, and Non-Accelerated Filers;
- Smaller Reporting Companies;
- Emerging Growth Companies; and
- Listed Closed-End Funds.

The Commission has specified that the following entities will not be subject to the proposed amendments, given differing compensation practices or otherwise not being subject to the proxy statement requirements of Exchange Act Section 14:

- Foreign private issuers; or
- Investment companies registered under the Investment Company Act of 1940 that are not listed closed-end funds.

JOINT STATEMENT OF COMMISSIONERS GALLAGHER AND PIWOWAR

On February 9, 2015, Commissioners Gallagher and Piwowar issued a joint statement indicating that while they had ultimately voted to support the issuance of the proposed rule, their position should not be taken as unqualified support for the proposal in the form that it was issued. Among their concerns with the proposal were: (1) the proposed rule does not exempt emerging growth companies or smaller reporting companies; (2) the proposed rule would not require Listed Closed-End Funds to provide the disclosure; (3) the Commission did not exercise its statutorily-granted exemptive authority to exempt from the rule disclosure regarding employees that cannot affect a company's share price; (4) the overbroad application of the rule to not only a company's securities, but also the securities of the company's affiliates; and (5) the rulemaking was inappropriately prioritized over other important Dodd-Frank Act rulemakings.

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