WILMERHALE

SEC Proposes Hedging Disclosure Rules

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Key Takeaways:

- SEC has proposed hedging disclosure rules required by the Dodd-Frank Act
- Proposed rules require disclosure of policies permitting or prohibiting directors, officers and other employees to hedge their company's equity securities
- Purpose of the rules is to provide transparency to shareholders about whether directors, officers or other employees are permitted to engage in transactions that mitigate or avoid the incentive alignment associated with equity ownership
- Disclosure would be required in proxy statements relating to the election of directors
- Proposed rules do not require companies to limit or prohibit hedging or to adopt formal policies

On February 9, 2015, the Securities and Exchange Commission proposed rules requiring companies to disclose whether directors, officers and other employees, or any of their designees, are permitted to hedge or otherwise engage in transactions to offset any decrease in the market value of equity securities of the company. The required disclosure would cover equity securities that are granted by the company as compensation or that are otherwise held, directly or indirectly, by directors, officers or other employees. The purpose of the rules, according to the SEC, is to provide transparency to shareholders about whether a company's employees or directors are permitted to engage in transactions that mitigate or avoid the incentive alignment associated with equity ownership. The proposed rules require disclosure only and would not require a company to prohibit hedging transactions or to otherwise adopt practices or a policy addressing hedging by any category of individuals.

The proposed rules implement Section 14(j) of the Securities Exchange Act of 1934 (the Exchange Act), which was added pursuant to Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The proposed rules would require hedging disclosure in proxy or consent solicitation materials and information statements with respect to the election of directors, and apply to companies subject to the federal proxy rules, including smaller reporting companies and emerging growth companies. Foreign private issuers, which are not generally required to comply with the federal proxy rules, would not be required to provide such disclosure.

Requirements for Disclosure

The SEC proposes to amend Item 407 of Regulation S-K to require companies to disclose 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. Whether someone is a "designee" of an employee, officer or director would be determined by a company based on the particular facts and circumstances. The required disclosure would apply to equity securities issued by the company, its parent, subsidiary or any subsidiary of any parent of the company that is registered under Section 12 of the Exchange Act. The proposed rules are intended to cover all transactions that establish downside price protection, whether by purchasing or selling a security or derivative security or otherwise.

A company that permits hedging transactions would be required to disclose in sufficient detail the scope of such permitted transactions. If a company permits hedging transactions by some, but not all, of its employees, officers or directors, then the company would be required to disclose which categories of persons are permitted to engage in hedging transactions and which categories of persons are not. Similarly, if a company permits certain types of hedging transactions, but not others, then the company would be required to disclose the categories of hedging transactions it permits and those which it prohibits.

The proposed Item 407(i) disclosure would not be required in registration statements or in annual reports on Form 10-K. In order to avoid the potential for duplicative disclosure, the SEC also proposes to add an instruction to Item 402(b) of Regulation S-K providing that a company may satisfy its CD&A obligation to disclose material policies on hedging by named executive officers by cross referencing to the Item 407(i) disclosure.

Despite voting to support the issuance of the proposal, Commissioners Daniel M. Gallagher and Michael S. Piwowar issued a joint statement critical of several aspects of the proposed rules, including the failure to exempt emerging growth companies or smaller reporting companies, the requirement that certain investment companies make the disclosures contemplated by the proposed rules, the requirement for disclosure relating to employees that cannot affect the company's share price, and the coverage of securities of the issuer's affiliates, which they consider to be overbroad. In contrast, Commissioner Luis A. Aguilar issued a statement in support of the proposal as a positive step in the direction of providing more information to shareholders as to whether the interests of corporate insiders are aligned with their own.

Request for Comments

Among other things, the SEC has requested comments on whether the hedging disclosure should be implemented by amending Regulation S-K Item 402 instead of Item 407, as proposed; whether

the proposed definition of "equity securities" as equity securities of the company or any of its parents, subsidiaries or subsidiaries of its parents appropriately captures the disclosure that shareholders would find useful or whether the term "equity securities" should be limited to only equity securities of the company; whether the definition of "employee" should be limited to the subset of employees that participate in making or shaping key operating or strategic decisions that influence the company's stock price; whether disclosure of any hedging that has occurred should be disclosed in Form 4 filings and proxy statements; whether the disclosure should be limited only to annual meetings, and not special meetings; whether the proposed disclosure should also be required in registration statements or Form 10-K filings; and whether all funds or additional types of funds other than listed closed-end funds should be required to provide the proposed disclosure.

Comments are due within 60 days after the proposed rules are published in the Federal Register.

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