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DISCLOSURE

SEC Proposes Long-Awaited Hedging Disclosure Rule: What Does It Mean and What Should You Do Now?

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On Feb. 9, the SEC proposed a long-awaited rule on disclosure of company equity hedging policies, as required by the Dodd-Frank Act (13 CARE 321, 2/13/15) (13 CARE 376, 2/20/15). The proposed rule would require companies to disclose whether they permit any employees, officers or directors, or any of their "designees," to purchase financial instruments or otherwise engage in transactions that are designed to have the effect of hedging or offsetting any decrease in the market value of company equity securities:

- granted as part of compensation; or
- held by them, "directly or indirectly."

The disclosure would be required in any proxy statement or information statement relating to an election of directors. The widespread view is that this disclosure is unlikely to be required during this current proxy season, ending June 30.

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The SEC has proposed a disclosure rule only, which does not require companies to prohibit hedging or adopt hedging policies. The major proxy advisory services, however, are vocal in their belief that allowing executive officer and director hedging is a problematic practice, and companies will undoubtedly continue to feel pressure from shareholders to adopt anti-hedging policies for those individuals.

Highlights of the Proposal

Covered Companies. The proposed rule, Item 407(i) of Regulation S-K, would generally apply to all issuers, including smaller reporting companies, emerging growth companies under the JOBS Act and listed closed-end funds. It would not apply to open-end mutual funds, exchange-traded funds or foreign private issuers.

Covered Hedging Transactions. Although the Dodd-Frank Act referred to the *purchase* of financial instruments, including prepaid variable forward contracts, equity swaps, collars and exchange funds, the SEC took a principles-based approach and proposed a rule that would require disclosure of transactions with "economic consequences" comparable to the purchase of specified financial instruments. The SEC was concerned that identifying specific instruments would result in incomplete disclosure or the creation of perverse incentives for employees and directors to seek down-

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side price protection through other means—for example, the proposal specifically identifies short sales and the selling of security futures as ways in which a person might seek downside price protection.

Companies must disclose which categories of hedging transactions they permit and which categories of transactions they prohibit. Companies may indicate that they expressly permit or prohibit all hedging transactions by employees and directors. If applicable, companies could list the few transactions that they permit or prohibit and indicate that all other transactions are prohibited or permitted. In addition, if some or all hedging transactions are prohibited for certain categories of individuals (e.g., directors and executive officers) and not for others (e.g., other employees), disclosure of this fact would be required.

Covered Individuals. The SEC's proposal requires disclosure of hedging policies applicable to directors, officers and all other employees. Accordingly, the proposed disclosure would need to indicate, for example, whether an issuer's policy applied only to directors and employees above a specified level, to all employees receiving equity-based compensation (other than 401(k) plan investments) or to the entire workforce.

Equity Securities. The term ''equity securities'' would mean any equity securities (as defined in Exchange Act rules) issued by the company, any parent of the company, any subsidiary of the company or any subsidiary of any parent of the company, if the securities are registered under Section 12 of the Exchange Act.

Forms That Require Disclosure. Although the Dodd-Frank Act referred to any proxy or consent solicitation material for an *annual* meeting of shareholders, proposed Item 407(i) would apply to any annual or special meeting of shareholders, as well as in connection with an action authorized by written consent. The disclosure would not be required in Securities Act or Exchange Act registration statements, in a Form 10-K or for a company that is not conducting a solicitation for the election of directors but is otherwise soliciting proxies at an annual meeting.

Possible Areas for Public Comment

The SEC has requested comment on the proposal by April 20, and, while it has asked the public to consider a number of questions, we focus on four areas:

Covered Companies. There has been much discussion as to whether there is sufficient benefit from this proposed rule, as applicable to smaller reporting companies and emerging growth companies. This may be an area ripe for comment.

Scope of Covered Hedging Transactions. The SEC is soliciting comment on whether the scope of covered transactions should be clarified, noting 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.'' The SEC seems to be considering not requiring disclosure of a company policy that permits trading of broad-based index funds, as an exception to an otherwise strict anti-hedging policy. We think commenters will encourage the SEC in this line of thinking.

Indirect Ownership of Equity Securities. By using such terms as ''any employees (including officers) or directors of the registrant, or any of their designees,'' and by focusing on securities ''held, directly or indirectly, by the employee or director,'' the proposed rule may be reaching a broader (or, in some cases, a narrower) pool of securities than those ordinarily considered to be ''beneficially owned'' by an employee, officer or director. While the terms ''designee'' and ''directly or indirectly'' are in the Dodd-Frank Act and other sections of the securities laws, it is unclear why the SEC did not use the more familiar concept of ''beneficial ownership'' in this instance, and we expect public comment seeking clarification.

Treatment of Non-Officer Employees. The SEC is soliciting comment on whether the definition of ''employee'' should be limited to the subset of employees who participate in making or shaping key operating or strategic decisions that influence the company's stock price. In this regard, Commissioners Gallagher and Piwowar issued a joint statement stating that, while they voted to support release of the proposal, they are concerned about it in several respects, including the covered individuals. They believe that the SEC should have exempted disclosure relating to hedging policies applicable to employees who cannot affect the company's share price. Their view is that the legislative history and the SEC staff's economic analysis seem to indicate that disclosure about whether these employees are permitted to hedge is not useful information to investors. In their view, the SEC has the authority to craft a more narrowly tailored disclosure requirement.

What Should Companies Be Doing Now?

Given that the SEC's rule is still at its proposal stage, and the strong likelihood that it will not be in effect this current proxy season for most calendar-year companies, there is no immediate substantive action that companies need to take at this time. However, we would recommend the following:

1. Consider how the company's existing hedging policy (which is often embedded within a broader securities trading policy) would be required to be disclosed under the proposal, and whether any changes would be desirable. Aspects to consider may include who the policy should cover and the scope of transactions that should be covered, as well as whether the policy should be applied uniformly across all covered individuals or in different ways, depending on the individual's role within the company. Many existing policies do not cover rank-and-file employees and query whether, if a policy were expanded to cover this population, how compliance could be ensured.

2. Inform the company's board of directors or the relevant committee(s) of this development. Once the rule is finalized, even though it is a disclosure-only rule, it may result in the company wanting to adopt a hedging policy (if it does not have one at all) or making changes to its existing policy.

3. Consider commenting on the SEC's proposal (or asking your counsel to comment on the proposal), espe-

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cially in the areas noted above. The SEC will not be able to take action without commentators providing that impetus.