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SEC Adopts Final Hedging Disclosure Rules

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On December 18, 2018, the SEC voted to adopt – finally – a proposal, initially released in 2015, to implement section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Section 955 mandated disclosure about the ability of a company's employees or directors to hedge or offset any decrease in the market value of equity securities granted as compensation to, or held directly or indirectly by, an employee or director. According to the legislative history, the purpose was to "allow 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 SEC adopted the **final amendments**, which add new paragraph (i) to Item 407 of Regulation S-K, "along the lines proposed," but with some modifications that should provide increased flexibility to companies subject to the rules.

Most companies will be required to comply with the new disclosure requirements in proxy and information statements for the election of directors during *fiscal years beginning on or after July 1, 2019*. As a result, for calendar year companies, the new requirement will not apply to this upcoming proxy season. And, emerging growth companies and smaller reporting companies, which will be subject to the new requirements, will have an extra year to comply: the disclosure for EGCs and SRCs will be required in proxy and information statements for the election of directors during *fiscal years beginning on or after July 1, 2020*.

Scope of the disclosure requirement. The final amendments require a "fair and accurate summary" of the company's practices or policies (whether or not written) regarding the ability of covered persons to hedge transactions, including the categories of persons covered and categories of hedging transactions permitted and disallowed. Alternatively, the company can disclose the practices and policies in full. This approach differs from the one proposed, which would have required disclosure of whether the company "permitted" hedging transactions. In effect, this new principles-based formulation provides additional flexibility, allowing each company, within the broad outlines of Dodd-Frank and the related rule, to "continue to make its own judgments in determining what activities, if any, should be covered by a practice or policy." As a result, the disclosure will simply reflect the policies or practices the company decides to adopt – or not.

For example, the final amendments do not define the term "hedge," and the scope of the new disclosure requirement is "not limited to any particular types of hedging transactions." Instead, the amendments provide a less prescriptive, principles-based approach, applying to financial instruments identified in Dodd-Frank (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 company equity securities, and to other transactions with the same economic effects as the transactions specified by Dodd-Frank.

Some examples of hedging transactions identified by the SEC are short sales, borrowing or other arrangements involving a non-recourse pledge of securities and selling a security future that establishes a position that increases in value as the value of the underlying equity security decreases. Although some commenters were concerned about potentially overbroad interpretations of the term – such as portfolio diversification transactions – the SEC concluded that the approach adopted mitigated those concerns: "In this regard, a company would only need to describe portfolio diversification transactions, broad-based index transactions, or other types of transactions, if its hedging practice or policy addresses them."

The final amendments will apply to hedging of securities "held, directly or indirectly," by employees (including officers) or directors. The quoted phrase is not defined, but again, the SEC believes that, under the approach adopted, a definition is not necessary; the

company will describe the scope of its policies, which may include the application, if any, to securities indirectly held.

What amounts to a "practice"? Again, the term is not defined but, as an example, the SEC suggests that "a company that does not have a written hedging policy might have a practice of reviewing, and perhaps restricting, hedging transactions as part of its program for reviewing employee trading in company securities. Similarly, a company might have a practice of including anti-hedging provisions in employment agreements or equity award documentation." If there are no hedging practices or policies, the company must disclose that fact or state that hedging transactions are generally permitted. To illustrate, the SEC suggested the following language: "Our company does not have any practices or policies regarding hedging or offsetting any decrease in the market value of registrant equity securities."

There is no requirement for disclosure about specific hedging transactions that have occurred; the SEC concluded that information for executives' transactions would likely be required under Section 16, and obtaining that information for all employees could be very burdensome.

Equity securities covered. Under the final amendments, "registrant equity securities" include equity securities (as defined in Exchange Act section 3(a)(11)) issued by the company, any parent of the company, any subsidiary of the company or any subsidiary of any parent of the company; however, contrary to the proposal, the requirement is not limited to classes of securities that are registered under Section 12 of the Exchange Act. Instead, company policy will determine which classes of securities are subject to the policy. Disclosure is required regarding equity securities, whether compensatory or otherwise held, *regardless of the source of the acquisition*.

Why cover parents and subsidiaries? Because employees and directors may have interests in affiliated companies, for example, where companies may grant to their employees or directors equity securities of affiliated companies that are intended to achieve incentive alignment that is similar to grants in the company's own equity securities (such as where a company creates a publicly traded subsidiary).

Persons subject to the rule. Companies will need to disclose their practices or policies that apply to employees, including officers, and directors, as well as any of their designees. Whether someone is a "designee" will depend on the facts and circumstances; however, because of the approach taken under the final amendments, each company will ultimately determine the categories of persons to which the company's policies apply, and the disclosure will reflect those policy choices. In addition, if a company discloses a policy that covers only a subset of employees or directors, it would not be required to disclose that it did not have a policy with regard to the company's other employees or directors.

Not subject to say on pay. Because the final amendments were considered by the SEC to relate primarily to the alignment of shareholders' interests with those of employees and directors, as opposed to executive compensation, the amendments were adopted as part of the corporate governance disclosure rules, not the compensation disclosure rules. As a result, the disclosure will not be subject to say-on-pay votes, unless, as discussed below, it is incorporated by reference into or directly included in Compensation Discussion & Analysis.

Where disclosure required. The disclosure will be required in the same instances as other Item 407 corporate governance disclosures – in proxy or information statements for meetings (or consents) at which directors will be elected, whether or not they are annual meetings. Disclosure is not required, however, in registration statements or in Annual Reports on Form 10-K, even if, as is typically the case, the Form 10-K Part III disclosure is incorporated by reference from the company's definitive proxy or information statement. An instruction provides that Item 407(i) information will not be deemed to be incorporated into any Securities Act or Exchange Act filing, except to the extent specifically incorporated by reference. Similarly, the disclosure is not subject to forward incorporation by reference under Item 12(b) of Form S-3 or under Item 12 of Form S-1.

Relationship to CD&A. As the release observes, the CD&A rules also potentially call for disclosure regarding hedging policies. The CD&A rules, however, are more limited in their reach in that CD&A applies only to the Named Executives Officers. In addition,

the CD&A rules require a discussion of hedging policies only to the extent material and do not apply to SRCs or EGCs. Nevertheless, because there is some potential for duplication, an instruction has been added to the CD&A rules providing that, in proxy or information statements with respect to the election of directors, if the information disclosed under new Item 407(i) would satisfy the CD&A obligation to disclose material policies on hedging by NEOs, the company may elect to simply cross-reference the new 407(i) disclosure in CD&A. That cross-reference would, however, make the 407(i) disclosure subject to say-on-pay votes. Of course, companies can avoid that result by simply not cross-referencing and including NEO-related disclosure regarding hedging policies directly in their CD&As.

Issuers covered. The final amendments *will apply* to EGCs and SRCs. The SEC believes that shareholders of EGCs and SRCs have the same interest as shareholders of other companies in obtaining information about potential alignment of shareholder interests with those of employees and directors. Although EGCs and SRCs may face higher initial compliance costs because they are not subject to the CD&A requirements and, therefore, may not yet have addressed hedging policies, the SEC did not view the burden as significant, emphasizing that the rules do not require companies to adopt hedging practices or policies or dictate their content. However, to provide an opportunity for EGCs and SRCs to observe how other larger and more established companies implement the new requirements, the SEC adopted a delayed compliance date for EGCs and SRCs. The final amendments will not apply to foreign private issuers.

Observations and commentary

- The SEC makes clear that nothing in the final amendments nor in the adopting release is intended to suggest that companies must have "a practice or policy regarding hedging, or a particular type of practice or policy. These amendments relate only to disclosure of hedging practices or policies." Nevertheless, some might interpret the disclosure-only rule as another instance of that old SEC stand-by: regulation by humiliation. Certainly, as a good governance matter and in light of the new requirements to disclose practices and policies, companies will need to evaluate what to do now:
  - If the company currently has a hedging policy, consider whether to revise that policy – particularly with regard to coverage of some or all employees or others, the classes of securities subject to the policy, and the types of transactions covered, including whether to expressly exclude portfolio diversification transactions, broad-based index transactions or other similar transactions.
  - To the extent an identifiable "practice" regarding hedging is not covered by any hedging policy, consider memorializing or otherwise creating a record of the conduct or events that make up the practice so that it can be accurately reflected in the required disclosure.
  - If the company does not currently have a hedging policy, consider whether one should be adopted. Keep in mind that the failure to adopt any policy against hedging may draw the attention of governance activists, proxy advisory firms and others, with the result that, notwithstanding the SEC's assurances to the contrary, companies feel compelled to take action.
- The proxy advisory firms take a dim view of hedging of company stock by executives and directors, believing that it severs the ultimate alignment with shareholders' interests. ISS generally considers any amount of hedging "a problematic practice warranting a negative vote recommendation against appropriate board members." Glass Lewis believes that "companies should adopt strict policies to prohibit executives from hedging the economic risk associated with their share ownership in the company." The final amendments and resulting disclosure could drive the advisory firms to consider adopting guidelines that focus on the specific terms of hedging policies.
- You might remember that, when the hedging disclosure rules were initially proposed in 2015, although the proposal may have struck many as rather bland and non-controversial, former Commissioners Gallagher and Piwowar voted to release the proposal but added some fireworks by issuing a **joint statement** expressing their concerns about it. Some of these concerns are addressed in the final amendments and some not. First among the former Commissioners' complaints in their joint statement was that the proposal did not exempt EGCs or SRCs, even though they may be disproportionately affected by the direct or indirect costs of compliance (*e.g.*, they may feel compelled to adopt hedging policies). As a result, the two Commissioners questioned whether the benefits of the proposal outweighed the costs. Under the final amendments, EGCs and SRCs will be

subject to the new disclosure requirement, but will have an additional year to comply. The former Commissioners also objected to the application of the proposed rules to listed, closed-end funds, and the final rules do exclude closed-end funds. In addition, they contended that, although the statute specifies that employee hedging should be covered, the SEC should have exercised its exemptive authority to exclude from the rule disclosures relating to employees on the basis that it is not the type of information about which investors have concerns. Similarly, they questioned as "overbroad" the proposal's application to securities of the issuer's affiliates – including subsidiaries, parents, and brother-sister companies. Finally, they objected generally to the "prioritization" given the proposal and maintained that priority should instead be given to those rules "germane to the financial crisis." While the final amendments do not exempt employee hedging or the specified affiliates, with adoption of the final amendments put off for almost four years, these two former Commissioners should take heart that their concerns about prioritization were certainly heard.

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