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SEC Proposes Equity Hedging Disclosure Rules Under Dodd-Frank

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On February 9, 2015, the Securities and Exchange Commission (the "SEC") proposed long-awaited equity hedging disclosure rules to implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").[1] The proposed rules adopt Item 407(i) of Regulation S-K, which would require issuers to disclose in any proxy or information statement relating to the election of directors whether any employee, officer or director (or the designee of any employee, officer or director) is permitted to purchase financial instruments (including prepaid forward variable contracts, equity swaps, collars and exchange funds) or otherwise engage in transactions that are designed to hedge or offset any decrease in the market value of equity securities (1) granted to the employee or director as compensation, or (2) held directly or indirectly by the employee or director.

Statutory Purpose

Based on its review of the legislative history, the SEC interpreted the statutory purpose of Section 14(j) of the Exchange Act, as being to "provide transparency to shareholders if action is to be taken with respect to the election of directors, about whether employees or directors are permitted to engage in transactions that mitigate or avoid the incentive alignment associated with equity ownership." The proposed rules provide for a "principles based"

[1] The proposed rules can be found at http://www.sec.gov/rules/proposed/2015/33-9723.pdf. The Dodd-Frank Act adds new Section 14(j) to the Securities Exchange Act of 1934, as amended (the "Exchange Act").

approach, rather than a "rules based" approach, to allow for more flexibility to fulfill this legislative purpose. The SEC has noted that the proposed rules would not require an issuer to prohibit hedging transactions or to otherwise adopt a policy addressing hedging. Moreover, the proposed rules do not require disclosure of actual hedging activity, although the SEC has requested comments as to whether it should so require.[2]

Relationship to Existing CD&A Obligations

The SEC elected to include the hedging disclosures in Item 407 of Regulation S-K, which focuses on corporate governance matters, as opposed to Item 402, which focuses on the compensation of directors and executive officers. Item 402(b) requires disclosure in the Compensation Discussion and Analysis (the "CD&A") of any issuer policies regarding hedging the economic risk of stock ownership, if material. To minimize duplicative disclosure, the SEC has proposed to amend Item 402(b) to permit an issuer to satisfy its CD&A disclosure obligations by cross-referencing to Item 407(i).

Covered Issuers

Section 14(j) requires hedging disclosures by all "issuers." While the SEC has broad authority to exempt certain categories of issuers, it did not provide for many exemptions from Section 14(j). As proposed, Item 407(i) would apply to substantially all issuers, including emerging growth companies ("EGCs"), smaller reporting companies ("SRCs") and listed closed-end investment companies. Foreign private issuers and unlisted investment companies (including exchange-traded funds and mutual funds) would not be subject to the disclosure requirements.

The SEC acknowledged that the Jump Start Our Business Startups Act of 2012 (the "JOBS Act") exempts EGCs from certain provisions of the Dodd-Frank Act and that EGCs and SRCs are subject to scaled down disclosure requirements, particularly with respect to executive compensation disclosures.[3] However, the SEC noted that there is no basis for determining that the hedging disclosures would be less relevant to shareholders of these issuers. Further, although EGCs and SRCs are not subject to current hedging disclosure requirements under Item 402(b) of Regulation S-K, and may face greater initial compliance costs, the SEC has reasoned that the proposed disclosure is not expected to impose a significant incremental compliance burden on these issuers.

SEC Commissioners Gallagher and Piwowar issued a joint statement contemporaneous with the SEC release, expressing concern regarding certain aspects of the proposed rules. They noted to the contrary that the proposed rules may cause a disproportionate burden on EGCs and SRCs, as these entities are less likely to have hedging policies in place and, due to the required disclosures, may feel compelled to adopt anti-hedging policies. These Commissioners cautioned that the SEC should proceed "especially carefully" before imposing new burdens on EGCs and SRCs, as doing so could have a significant impact on capital formation.

[2] While there is no requirement to provide a detailed list of outstanding hedging activity, disclosure of many hedging instruments is currently required pursuant to Section 16(a) of the Exchange Act. Similarly, Item 403(b) of Regulation S-K requires the disclosure of hedging transactions that involve the pledging of issuer equity securities as collateral.

[3] Section 102 of the JOBS Act exempts EGCs from: (1) the say-on-pay, say-on-frequency, and say-on-golden parachutes advisory votes required by Exchange Act Sections 14A(a) and (b), enacted in Section 951 of the Dodd-Frank Act; (2) the "pay versus performance" proxy disclosure requirements of Exchange Act Section 14(i), enacted in Section 953(a) of the Dodd-Frank Act; and (3) the pay ratio disclosure requirements of Section 953(b) of the Dodd-Frank Act.

Covered Transactions

Section 14(j) expressly refers only to the "*purchase of financial instruments intended to offset decreases in the market value of equity securities (such as prepaid variable forward contracts, equity swaps, collars and exchange funds)*." The proposed rules would also require disclosure of transactions with "economic consequences" comparable to the purchase of the specified financial instruments. Thus, all policies relating to transactions that establish downside protection—whether by purchasing or selling a security or derivative security or otherwise—must be disclosed. The SEC has reasoned that this principles-based approach will prevent incomplete disclosure and discourage the promotion of certain types of hedging transactions over others.

The SEC requested comments on the scope of covered transactions. For instance, the SEC noted that there is a "meaningful distinction" between an index fund that includes a broad-range of equity securities, one component of which is the issuer's equity, and a financial instrument, even one nominally based on a broad index, designed to or having the effect of hedging the economic exposure to issuer equity. The SEC questioned whether an issuer that prohibited hedging generally, but permitted the purchase of broad-based indices should nonetheless be able to disclose that it prohibits hedging. A failure to exclude these types of indices from the definition of covered transactions would likely complicate both the administration of hedging policies and the required disclosures. It is likely that commenters will recommend that the SEC exclude these types of indices.

The proposed rules clarify that a pledge or loan of equity securities would not be considered a hedging transaction covered by the proposed rules, notwithstanding the fact that such transactions may be viewed as "offers or sales" for purposes of the Securities Act of 1933. The SEC reasoned that a pledge or loan generally contemplates the return of the pledged or borrowed shares, with no consequent change in the employee's economic risks. Proxy advisory firms often link hedging and pledging policies, and it was thought that the SEC might expand the disclosure requirements to include pledging.

Covered Employees and Directors

Section 14(j) requires disclosure with respect to any "*employee or member of the board of directors of the issuer, or any designee of such employee or member*." The proposed rules clarify that the term employee also includes officers. While many expected that the SEC would limit the scope of the disclosure to a subset of key employees that make the operating and strategic decisions that impact the issuer's stock price, the SEC did not do so.

Commissioners Gallagher and Piwowar noted that both the legislative history and the SEC's own economic analysis appear to indicate that disclosures regarding employees that cannot affect the issuer's share price "*fall below the level of information that investors would find useful*" and have encouraged input on this point. Many existing hedging policies apply only to executive officers or some larger group of senior employees. Few issuers disclose company-wide hedging restrictions.[4] Requiring disclosures with respect to the entire employee population will likely result in either (1) policy modifications to expand the covered population, and the ensuing complexities and costs of monitoring these policies or (2) more complex disclosures noting the different policies applicable to senior executives and other employees.

[4] According to Shearman & Sterling's 2014 Compensation Governance Survey, of the 95 Top 100 Companies that maintain hedging policies, 67 apply to both directors and executive officers, 27 apply to executive officers only and one applies to directors only. The Survey can be found at http://corpgov.shearman.com/.

Covered Equity Securities

The proposed rules define "equity securities" to mean any equity securities (as defined in the Exchange Act) that are issued by the issuer, its parents and subsidiaries or subsidiaries of its parents (e.g., brother and sister companies) that are registered under Section 12 of the Exchange Act.

Commissioners Gallagher and Piwowar expressed concern over including affiliate securities in the definition, as it will require issuers to "*engage in a complex, facts-and-circumstances control analysis to determine who is covered by the proposed disclosure requirement*." Most existing hedging policies apply only to the issuer's securities and, if the rule is adopted as proposed, it may increase the costs and complexities of disclosure by causing issuers to modify the scope of their hedging policies in response to the broader definition of covered securities. Moreover, there is not a widespread practice of granting equity awards covering affiliate stock, so the benefit derived from this provision is uncertain. The SEC is seeking specific comments on this point.

Section 14(j) provides that the disclosure rules would apply to equity securities that are (1) granted to the employee or director as compensation, or (2) held directly or indirectly by the employee or director in any proxy or information statement relating to the election of directors. The proposed rules retained this language. Interestingly, the SEC did not define "held directly or indirectly" or "designee" or use the more common concept of "beneficial ownership" under the securities laws. The SEC is seeking comments on this point.

The SEC also requested comments as to whether the disclosures should be further expanded to cover debt securities. As certain forms of today's compensation awards, such as rights to deferred cash payments, are deemed to be debt securities, it will be interesting to see whether commenters support this expansion.

Required Disclosures

Given the broad definition of covered transactions, an issuer must disclose both the categories of transactions it prohibits, as well as which categories it permits. If an issuer discloses that it specifically prohibits certain categories of transactions, the issuer could then disclose that it permits all other types of transactions in lieu of providing a complete listing of specific permitted transactions, and vice versa. Similarly, if an issuer either prohibits or permits all types of hedging transactions, it would not be required to describe the permitted or prohibited transactions by category. The issuer would, however, need to provide sufficient detail to explain the scope of any permitted transactions. Finally, if the issuer's hedging policy covers some, but not all, of the categories of persons subject to the disclosure requirements, the issuer would need to disclose both the categories of those persons who are permitted to hedge and those who are not.

Conclusion

The SEC has requested comments on numerous provisions of the proposed rules. Comments are due on or before April 20, 2015. Although the rules will not be effective for the current proxy season, issuers should take them into account in considering whether to adopt or revise their hedging policies and their current hedging disclosures.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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