Hogan Lovells

SEC Update

January 24, 2019

This is a commercial communication from Hogan Lovells. See note below.

SEC adopts requirement for disclosure of hedging policies for employees, officers, and directors

On December 18, 2018, the SEC adopted a requirement for U.S. public companies to provide proxy disclosure of any practices or policies they have adopted regarding the ability of the company's employees, officers or directors, or their designees, to hedge or offset any decrease in the market value of their holdings of company equity securities. The new requirement implements a long-standing mandate of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The hedging disclosure is intended to enhance investor understanding of the ability of the covered individuals to engage in transactions that may reduce the alignment of their interests with shareholder interests based on their equity ownership. The disclosure requirement generally is consistent with the requirement proposed by the SEC nearly four years ago, but contains some modifications adopted in response to comments on the proposal.

In general, companies must include the required disclosure in any proxy or information statement relating to the election of directors during fiscal years beginning on or after July 1, 2019. Smaller reporting companies and emerging growth companies will be required to provide the disclosure in any proxy or information statement relating to the election of directors during fiscal years beginning on or after July 1, 2020. Accordingly, for calendar year companies, the new disclosure requirement will first apply in 2020 (or in 2021, for smaller reporting companies and emerging growth companies).

The SEC's adopting release for the new disclosure requirement (No. 33-10593) can be found ***here***.

Item 407(i)

The SEC adopted the disclosure requirement by adding a new paragraph (i) to Item 407 of Regulation S-K. Item 407(i) requires companies to describe any practices or policies regarding the ability of an employee (including an officer) or director to purchase financial instruments, or otherwise engage in transactions, that hedge or offset, or are designed to hedge or offset, any decrease in the market value of company equity securities granted as compensation to, or held directly or indirectly by, the employee or director.

Companies may satisfy the requirement by (1) disclosing their practices or policies in full or, alternatively, by (2) providing a "fair and accurate summary" of their practices or policies. A fair and accurate summary must describe the categories of persons covered and any categories of hedging transactions that are specifically permitted or disallowed.

If a company does not have any hedging practices or policies, the company must disclose that fact or state that hedging transactions are generally permitted. The SEC indicates in the adopting release that a company without a hedging practice or policy could provide the following disclosure: "Our company does not have any practices or policies regarding hedging or offsetting any decrease in the market value of registrant equity securities."

The new requirement does not direct companies to adopt or maintain practices and policies regarding hedging, or dictate the content of any such practice or policy.

Disclosure considerations

The disclosure required by Item 407(i) must be included in any proxy or information statement relating to the election of directors. Many public companies already present some information about hedging policies in the Compensation Discussion and Analysis (CD&A) section of their proxy statements in response to Item 402(b)(2)

(xiii) of Regulation S-K, which requires disclosure of any material company policies on hedging by the company's named executive officers.

The new disclosure requirement in Item 407(i), however, is broader than the required CD&A disclosure on hedging policies. Item 407(i) also covers hedging policies for directors and for employees who are not named executive officers, and extends to companies that are not subject to CD&A disclosure, including smaller reporting companies and emerging growth companies.

Location of disclosure. To reduce the potential for duplicative disclosure by companies that are subject to both Item 407(i) and Item 402(b), and to provide companies with flexibility in where they present the new Item 407(i) disclosure, the SEC added an instruction to Item 402(b) of Regulation S-K permitting a cross-reference to the disclosure required by Item 407(i).

A company may choose to include its Item 407(i) disclosure outside of the CD&A and to provide a separate Item 402(b) disclosure as part of the CD&A without a cross-reference. Alternatively, it may incorporate the Item 407(i) disclosure into the CD&A, either by directly including the information within the CD&A or by providing the Item 407(i) information outside of the CD&A and adding a cross-reference within the CD&A. The SEC observes that if a company chooses to make the Item 407(i) disclosure part of the CD&A, either directly or indirectly by cross-reference, the disclosure will be subject to the shareholder advisory say-on-pay vote.

Covered transactions. Item 407(i)(1) specifically requires a company to describe any practices or policies adopted by the company regarding the ability of the covered persons "to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds), or otherwise engage in transactions, that hedge or offset, or are designed to hedge or offset, any decrease in the market value of registrant equity securities."

The provision does not define the term "hedge." Instead, the SEC indicates in the adopting release that the term "hedge" should be applied as a "broad principle" to include any transaction designed to offset a decrease in the market value of the company's equity securities. The SEC emphasizes that "downside price protection is the essence of the transactions" contemplated by the new requirement and, accordingly, that the scope of Item 407(i) disclosure "is not limited to any particular types of hedging transactions."

Companies may continue to make their own judgments in determining the types of transactions covered by their hedging practices or policies. Item 407(i) requires only that companies disclose the types of hedging transactions that their practices or policies address.

Covered equity securities. The new disclosure requirement in Item 407(i) applies to the hedging of "registrant equity securities," which includes equity securities issued by (1) the company, (2) any parent or subsidiary of the company or (3) any subsidiary of any parent of the company. Covered equity securities include equity securities granted to an employee or director in connection with compensatory grants, as well as other company equity securities held directly or indirectly by the employee or director. Item 407(i)'s coverage is not limited to equity securities that are registered under Section 12 of the Exchange Act, but rather extends to any classes of equity securities covered by the company's practices or policies.

Companies have to make their own determinations regarding which classes of equity securities will be covered by their hedging practices or policies. If a company maintains different hedging practices or policies with respect to different classes, the company should disclose the differences under Item 407(i).

Covered persons. Item 407(i) requires disclosure of hedging practices or policies that apply to "any employees (including officers) or directors of the registrant, or any of their designees." The SEC has declined to define "designee," explaining that such guidance is unnecessary in light of the fact that a company with a hedging practice or policy will determine which persons fall within its scope.

Consistent with this observation, the SEC notes that companies are free to determine the categories of persons to whom their hedging practices or policies apply. If a company's hedging practices or policies cover only some of its employees or directors, the company will be required to describe only who is covered, and will not be required to disclose that it does not have practices or policies with regard to its other employees or directors.

Covered policies. Companies will have to disclose their hedging practices or policies even if they are not written. The SEC illustrates this principle with the example of a company that does not have a written hedging policy, but reviews, and perhaps restricts, hedging transactions as part of its program for reviewing employee trading in company securities. In this case, according to the SEC, the company should disclose the practice even if it is not included in a written company policy. The SEC similarly believes that a company should disclose any practice of including anti-hedging provisions in employment agreements or equity award documents.

Other compliance considerations

Covered registrants. The new disclosure requirement in Item 407(i) applies to all companies with a class of securities registered under Section 12 of the Exchange Act, including smaller reporting companies, emerging growth companies and business development companies. Item 407(i) does not apply to listed closed-end funds or to foreign private issuers, which are not subject to the proxy statement requirements of Section 14 of the Exchange Act and therefore would not be subject to governance-related disclosure of the type prescribed by the new requirement.

Covered filings. Item 407(i) disclosure is required to be presented in any proxy statement on Schedule 14A or any information statement on Schedule 14C relating to the election of directors. The disclosure is not required to appear in Securities Act or Exchange Act registration statements or in Part III of Form 10-K, even if Part III information is incorporated by reference from the company's definitive proxy statement or information statement.

No incorporation by reference. Item 407(i) disclosure will not be deemed to be incorporated by reference into any Securities Act or Exchange Act filing, except to the extent that the company specifically incorporates it by reference.

Perspectives of proxy advisory firms

In evaluating the advisability of hedging practices and policies, some U.S. public companies have taken into consideration the positions of proxy advisory firms, which generally view unfavorably hedging by a company's directors or executive officers.

The 2018 U.S. Proxy Voting Guidelines of Institutional Shareholder Services (ISS) identify the hedging of company stock as an example of a material failure of risk oversight, which could result in a voting recommendation by ISS against an individual director, committee members or the full board of directors. In its 2019 Proxy Voting Guidelines, Glass Lewis expresses the view that hedging of company stock by executives "severs the alignment of interests of the executive with shareholders." As a result, Glass Lewis states that it supports the adoption of "strict policies to prohibit executives from hedging the economic risk associated with their share ownership in the company."

Looking ahead

U.S. public companies that already include hedging practice or policy disclosure in their proxy statements should consider whether additional disclosure will be needed to comply with the new requirement in Item 407(i). Some companies also may benefit from taking a fresh look at their existing hedging practices and policies to determine whether any changes are warranted for governance or other reasons. Companies that have not yet adopted hedging practices and policies might want to use adoption of the new rule as an occasion to revisit this issue.

This SEC Update is a summary for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or any of the lawyers listed on the following page of this update.

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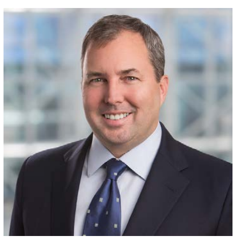

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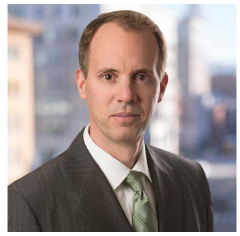

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