

ClientAlert

Capital Markets

February 2015

SEC Proposes Disclosure Rule for Company Hedging Policies

On February 9, 2015, the Securities and Exchange Commission (“SEC”) proposed a rule to enhance disclosure of company hedging policies for directors, officers and other employees. This proposal would implement Section 955 of the Dodd-Frank reform law intended to increase transparency of corporate compensation. The proposed rule would add paragraph (i) to Item 407 of Regulation S-K requiring disclosure about whether directors, officers and other employees are permitted to hedge or offset any decrease in the market value of equity securities granted as compensation or held, directly or indirectly, by them. The rule would require only disclosure and would not prohibit, or require a company to prohibit, hedging activities. The SEC believes that increasing the transparency of hedging policies will help investors better understand the alignment of their ownership interests with the interests of directors, officers and other employees. The proposed rule sheds light on hedging arrangements in which directors and employees are able to protect themselves from the risks of long-term stock ownership whereby they financially benefit even if the performance of their company declines.

Proposed Rule

Companies must disclose in any proxy statement or information statement relating to an election of directors whether any:

- employee,
- member of the board of directors of the company, or
- designee of such employee or director,

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 hedge or offset any decrease in the market value of equity securities¹ either:

- granted to the employee or director by the company as part of the compensation of the employee or director; or
- held, directly or indirectly, by the employee or director.

The comment period for the proposed rule is 60 days after publication in the Federal Register.



Gary Kashar
Partner, New York
+ 1 212 819 8223
gkashar@whitecase.com

Colin Diamond
Partner, New York
+ 1 212 819 8754
cdiamond@whitecase.com

David M. Johansen
Partner, New York
+ 1 212 819 8509
djohansen@whitecase.com

Jeffrey Cohan
Associate, New York
+ 1 212 819 2660
jeffrey.cohan@whitecase.com

¹ “Equity securities” means only those equity securities issued by the registrant or any parent of the registrant, any subsidiary of the registrant or any subsidiary of any parent of the registrant that are registered under Section 12 of the Exchange Act.

Covered Hedging Transactions

The intent of the proposed rule is to include all transactions that have the same economic effects as financial instruments designed to hedge or offset any decrease in the value of equity securities. The inclusion of any transactions ensures that the ability to engage in any risk-mitigating strategies which protect from downside losses, such as short sales and sales of security futures, are similarly disclosed. The proposed rule also requires companies to disclose which categories of transactions are prohibited and which are permitted, to ensure a complete understanding of a company's hedging policy.

Covered Individuals and Securities

Under existing disclosure rules, companies are required to describe in the Compensation Discussion and Analysis ("CD&A") section of certain registration statements, annual reports on Form 10-K and proxy and information statements relating to the election of directors, any material policies regarding hedging by named executive officers. Section 16(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), also requires officers and directors of companies with a class of registered equity securities to publicly report transactions involving the equity securities or derivatives of such equity securities.

The proposed rule expands upon existing disclosure requirements to cover all employees and directors, as well as their designees. Companies are also required to disclose which categories of persons are permitted to engage in hedging transactions and which are not. Disclosure, however, is limited to transactions with respect to a company's stock, as well as stock in a parent company, subsidiary company or any of the parent company's subsidiary companies. To reduce duplicative disclosure in proxy and information statements, the proposed rule provides that a company may satisfy its CD&A obligation to disclose material hedging policies by cross-referencing to disclosure made in other registration statements or annual reports on Form 10-K to the extent the information satisfies the CD&A requirement.

Covered Companies

Companies currently subject to disclosure obligations include companies which have at least one class of equity securities registered under Section 12 of the Exchange Act, other than smaller reporting companies, emerging growth companies and listed closed-end investment companies. The proposed rule expands the scope of coverage to companies that are subject to federal proxy rules, which includes smaller reporting companies, emerging growth companies, business development companies and registered closed-end investment companies with shares listed and registered on a national securities exchange.

Investment Funds in general, other than listed closed-end funds, are not subject to the proposed rule because of their external management structure, limited fund-related employee compensation and different regulatory regime that usually does not include annual shareholder meetings. Listed closed-end funds, however, would be subject to the rule because they are normally required to hold annual shareholder meetings to elect directors and their securities are not redeemable and trade on national exchanges at negotiated market prices which provide shareholders with pertinent investment information.

Disclosure requirements would also extend to emerging growth companies and smaller reporting companies. The proposed release suggests that these smaller firms are not expected to face significant compliance costs, although it is unlikely that many of these companies have ever considered implementing hedging guidelines before. The SEC does not believe there is any reason why the hedging policies of these smaller firms are less relevant to shareholders than the hedging policies of other firms. It is noteworthy that two commissioners of the SEC expressed concern about subjecting emerging growth companies and smaller reporting companies to additional regulatory requirements because of the proposed rule's potential disproportionate compliance burden on smaller firms and its attenuated importance in Dodd-Frank implementation.

Conclusion

Hedging activities, particularly by executive officer decision-makers and directors, who receive significant equity-based compensation, are largely perceived as directly counter to the interests of shareholders. The proposed rule provides important corporate disclosure of hedging policies to shareholders with respect to whether the equity interests of officers, directors and employees are aligned with their own. These additional disclosure obligations exceed current proxy statement guidance by expanding both the types of people and companies covered. While the proposed rule will offer investors insight as to the true economic value of corporate compensation, it may yield insignificant information with respect to certain employees and may burden smaller firms.

This Client Alert is provided for your convenience and does not constitute legal advice. It is prepared for the general information of our clients and other interested persons. This Client Alert should not be acted upon in any specific situation without appropriate legal advice and it may include links to websites other than the White & Case website.

White & Case has no responsibility for any websites other than its own and does not endorse the information, content, presentation or accuracy, or make any warranty, express or implied, regarding any other website.

This Client Alert is protected by copyright. Material appearing herein may be reproduced or translated with appropriate credit.