SEC Proposes Rules for Hedging Disclosure

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Introduction

On February 9, 2015, the SEC proposed rules that would require domestic public companies to disclose in proxy and information statements whether the company permits any of its directors or employees (including officers) to purchase financial instruments or otherwise engage in transactions designed to "hedge" or offset any decrease in the market value of any equity securities owned by the employees or directors. Comments are due 60 days after the proposed rules are published in the Federal Register.

Supporters of this change contend that allowing company employees and officials to engage in hedging transactions results in a misalignment between their personal interests as equity holders and the interests of shareholders generally, and that shareholders should know what company policies are in this regard.

The SEC's proposed addition of Item 407(i) to Regulation S-K was mandated by the Dodd-Frank Act.

Disclosure Under the Proposed Rules

The proposed rules simply require disclosure of a company's hedging policies; that is, they do not require that companies have a policy on hedging, nor do they require that companies prohibit hedging. The rules would cover all employees and directors, regardless of the covered person's importance to the company or how the covered person acquired the securities. Under the rules, a company would have to disclose what its policies are, which categories of individuals are permitted to engage in hedging transactions, which categories of individuals are not, and the hedging transactions the company permits and prohibits.

The SEC does not provide a definition for "hedge," but proposes instead that the new rules cover any transaction that establishes downside price protection. Amended Item 407(i) would expand the list of examples of hedging transactions covered by the disclosure. Such transactions would include the purchase of financial instruments such as prepaid variable forward contracts, equity swaps, collars, and exchange funds, as well as any other transaction that provides a similar economic outcome as the purchase of one of these financial instruments. Additionally, the disclosure requirement would apply not only to equity securities of the company, but also to equity securities of its parent, subsidiary, or any subsidiary of any parent of the company that are registered under Section 12 of the Exchange Act.

Current SEC Reporting Requirements

The proposed rules would expand disclosure of hedging policies beyond these existing SEC requirements:

- Regulation S-K, Item 402(b)(2)(xiii). Item 401(b)(2), generally referred to as Compensation Discussion and Analysis (CD&A), requires among other things that companies disclose policies "regarding hedging the economic risks of [security] ownership" that are applicable to the named executive officers. However, CD&A disclosure about hedging does not apply to smaller reporting companies, nor does it require disclosure for individuals other than named executive officers.
- Regulation S-K, Item 403(b) requires disclosure of the amount of shares *pledged as security* by named executive officers and directors, which could in part reflect hedging transactions.
- Exchange Act Rule 16a-3 requires prompt filings by directors and executive officers of transactions in equity securities, including

> transactions in “derivative securities,” defined in Rule 16a-1 to mean, generally, “any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security” with certain exceptions. Various types of hedging instruments are likely to involve derivative securities and thus require reporting.

In contrast to these somewhat patchwork requirements, the proposed rules would extend Item 407(i) disclosure requirements to emerging growth companies, smaller reporting companies, and closed-end investment companies that list shares on a national securities exchange. The new requirement would not extend to foreign private issuers, non-listed closed-end funds, open-end funds, or unit investment trusts.

A Prototypical Anti-Hedging Policy

Many public companies have anti-hedging policies already in place, such as this one:

> **Hedging Transactions**: Certain forms of hedging or monetization transactions, such as zero-cost collars and forward sale contracts, allow a director, officer or other associate to lock in much of the value of his or her stock holdings, often in exchange for all or part of the potential for upside appreciation in the stock. These transactions allow the director, officer or other associate to continue to own the covered securities, but without the full risks and rewards of ownership. When that occurs, the director, officer or other associate may no longer have the same objectives as the Company’s other shareholders. Therefore, these types of transactions are prohibited by this Policy Statement.

Consequences of No Anti-Hedging Policy

Not surprisingly, the two leading proxy advisory firms will object to the absence of a policy that prohibits hedging by insiders. For example, Institutional Shareholder Services states in its proxy voting policies that any amount of hedging of company stock by insiders will be considered “a material failure of risk oversight” that could result in a recommendation against individual directors, the company’s governance committee members, or even the whole board. Glass Lewis takes a similar position.

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