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# SEC Hedging Disclosure Proposal Could Cause Companies To Review Trading Policies

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On February 9, 2015 the SEC proposed rules, as required by Section 955 of Dodd-Frank, that would require disclosure regarding whether directors, officers and other employees are permitted to hedge or offset any decrease in the market value of equity securities granted by the company as compensation or held, directly or indirectly, by employees or directors. The purpose of the rules, according to the SEC, is to elicit disclosure regarding whether employees or directors are permitted to engage in transactions that mitigate or avoid the incentive alignment associated with equity ownership. Companies may wish to review their trading policies in light of the proposed rules.

## Overview

The following is a high-level overview of the proposed rules, which would add new paragraph (i) to Item 407, Corporate Governance, of Regulation S-K:

- *Relevant Disclosure Document.* The proposed rules would apply to proxy or information statementsrelating to an election of directors, whether by vote of security holders at a meeting or an action authorized by written consent. The rules would not require disclosure in annual reports on Form 10-K, or registration statements filed under the Securities Act of 1933 or the Securities Exchange Act of 1934 (the "Exchange Act"). This disclosure would be required in the same instances as other Item 407 corporate governance disclosures. To reduce potentially duplicative disclosure in proxy and information statements, the proposed rules would add an instruction to the CD&A rules, Item 402(b) of Regulation S-K, providing that, to the extent that the information disclosed under new Item 407(i) satisfies the CD&A obligation to disclose material policies on hedging by named executive officers, companies may elect to simply cross-reference the new 407(i) disclosure in CD&A. However, that cross-reference would make the disclosure subject to say-on-pay votes.

- *Disclosure or Prohibition Against Hedging.* The proposed rules would require disclosure regarding whether a company permits any employees (including officers) or directors to engage in hedging, but does not prohibit such transactions. The disclosure would identify the categories of persons covered by the hedging policy (and those not covered), as well as the categories of transactions that are permitted (and those that are not).

- *Covered Transactions.* The proposed rules cover a range of hedging transactions, including purchases of financial instruments or other transactions that are designed to have the effect of hedging or offsetting any decrease in the market value of equity securities. The proposed rules are intended to cover all transactions that establish "downside price protection – whether by purchasing or selling a security or derivative security or otherwise."

- *Covered Securities.* The proposed rules cover securities granted to an employee or director as part of the compensation of the employee or director OR held directly or indirectly by the employee or director, regardless of the source. The proposed rules apply to the hedging of Section 12 registered equity securities of a public company, its parent, its subsidiaries, or any other companies that are subsidiaries of its parent.

- *Covered Companies.* The proposed rules would apply to all public companies that have a class of equity securities that is registered under Section 12 of the Exchange Act. Smaller reporting companies, emerging growth companies and investment companies would be subject to the rules. Voluntary filers, debt-only filers and companies that file reports under Section 15(d) of the Exchange Act are not subject to the proposed rules.

The information required by the proposed rules would not be deemed to be "filed," which means that it would not be incorporated by reference into registered securities offerings, except to the extent specifically incorporated by reference. The proposed rules are subject to a 60 day comment period. It is unclear whether the proposed rules will adopted in time for the 2016 proxy season.

## Practical Implications

According to a study by Compensation Advisory Partners, 93% of companies already disclose the existence of hedging policies. This suggests that the proposed rules will not meaningfully alter the disclosure practices of many public companies. However, since the rules apply to a fairly broad set of securities (e.g., the registered equity securities of a company's subsidiary, parent, and certain other affiliated companies), and because the rules require that companies specify the persons and transactions to which the hedging policies apply and do not apply, we expect companies to have to expand their hedging policy disclosures if these rules are adopted. In addition, many companies include their hedging prohibition in their insider trading policies.

The proposed rules present two issues in this respect - first, companies do not always apply the hedging prohibition in their insider trading policies to all of their employees (in some cases these prohibitions are limited to directors and executive officers). Consequently companies may feel pressured to modify their policies to apply them to all of their employees. However, the proposed rules do request comment on whether companies should be permitted to determine whether disclosure about all of its employees would be material information for its investors. Second, the rules focus on transactions that are permitted, while most policies focus on what transactions are prohibited or what transactions are discouraged. Technically, transactions that are not specifically prohibited, and transactions that are simply discouraged, would be deemed to be permitted for the purposes of the proposed rules. Consequently companies may need to review their policies to ensure that they would not be required to disclose that certain hedging transactions are permitted solely because they are not specifically prohibited.

*This post was written with contributions from Reid Hooper.*

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