SEC Proposes Hedging Disclosure Rule

The Securities and Exchange Commission ("SEC") recently proposed a rule that would require companies to disclose, in their proxy or information statements, whether employees (including officers) or directors are permitted to engage in transactions that hedge or offset any decrease in the market value of the company's equity securities.[1] This rule would implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act by adding new paragraph (i) to Item 407 of Regulation S-K (the "Proposed Rule").

The purpose of the rule is to promote transparency by more fully informing shareholders whether "executives are allowed to purchase financial instruments to effectively avoid compensation restrictions that they hold stock long-term, so that they will receive their compensation even in the case that their firm does not perform."[2] The disclosure would provide shareholders with additional information on whether the company has policies affecting the arrangement of incentives for employees and directors of the company.

The current disclosure requirements relating to company hedging policies are in Item 402(b) of Regulation S-K, which requires disclosure in the company's Compensation Discussion and Analysis ("CD&A") of material information necessary to an understanding of the company's compensation of its named executive officers, which includes, if material, any company policies regarding hedging the economic risk of security ownership.

The key aspects of the Proposed Rule are as follows:

Securities Subject to the Disclosure Requirement

The disclosure requirement would apply only to equity securities issued by the company and its parents, subsidiaries, or subsidiaries of the company's parents that are registered on a national securities exchange or registered under Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act").[3]

The Proposed Rule would require disclosure regarding hedging of all such equity securities, whether granted as compensation to the employee or director, or otherwise held, directly or indirectly, by the employee or director, regardless of the source.

Transactions Subject to the Disclosure Requirement

The scope of the Proposed Rule is not limited to particular types of hedging transactions, but instead would "cover all transactions that establish downside price protection …."[4] As a result, the Proposed Rule would require disclosure regarding whether an employee, officer or director is permitted to purchase financial instruments that hedge or offset any decrease in the market value of equity securities, or otherwise engage in transactions that are designed to, or have, the same effect.

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[1] *See Disclosure of Hedging By Employees, Officers and Directors*, Release Nos. 33-9723; 34-74232; File No. S7-01-15 (Feb. 9, 2015) ("Proposing Release"), available at http://www.sec.gov/rules/proposed/2015/33-9723.pdf.

[2] *Id.* at 5 (quoting Report of the Senate Committee on Banking, Housing, and Urban Affairs, S. 3217, Report No. 111-176 (Apr. 30, 2010)).

[3] The Proposed Rule would apply to closed-end investment companies that have shares listed on a national security exchange, as well as to emerging growth companies and smaller reporting companies. The Proposed Rule would not apply to foreign private issuers.

[4] Proposing Release at 4.

The Proposed Rule would require a company that permits hedging transactions to disclose "sufficient detail" to explain the scope of any permitted transactions. For instance, the company would be required to disclose which categories of transactions it permits and which categories of transactions it prohibits. In addition, if a company permits only some categories of persons to engage in hedging transactions, the Proposed Rule would also require the company to disclose which categories of persons are permitted to hedge and which are not. If a company prohibits or permits all hedging transactions, a description by category will not be necessary.

Manner and Location of Disclosure

The Proposed Rule would require disclosure only in proxy or information statements relating to the election of directors, whether the election is by meeting or written consent. This is meant to promote transparency by enabling shareholders to consider, when they are electing directors, whether the directors "are able to engage in transactions that reduce the alignment of their interests with the economic interests" of other shareholders of the company and any affiliated company in which the employees or directors might have an interest.[5]

The disclosure would not be required in a company's CD&A, and would not be subject to say on pay votes, since the Proposed Rule is considered "primarily corporate governance-related".[6] To reduce potentially duplicative disclosure in proxy and information statements, the Proposed Rule would permit a company to satisfy its CD&A obligation to disclose material policies on hedging by named executive officers by cross referencing the information disclosed pursuant to proposed Item 407(i) to the extent that the information disclosed there satisfies this CD&A disclosure requirement.[7]

The disclosure made pursuant to the Proposed Rule would also not be deemed to be incorporated in any filing under the Securities Act of 1933, the Exchange Act or the Investment Company Act of 1940, unless the disclosure is specifically incorporated by reference.

The SEC is seeking public comment on the Proposed Rule. The public comment period will run for 60 days after the Proposed Rule is published on the Federal Register.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.

[5] *Id.* at 16.

[6] *Id.* at 9.

[7] *Id.* at 30.