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Legal Update
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SEC Adopts Dodd-Frank Hedging Disclosure Rule

On December 18, 2018, the US Securities and Exchange Commission (SEC) adopted a final rule requiring companies to disclose their hedging policies and practices for employees, officers and directors.[1] This rulemaking was mandated by Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The SEC originally proposed the hedging disclosure rule in February 2015.

The new hedging disclosure will not be required during the upcoming 2019 proxy season. While the amendments become effective 30 days after publication in the *Federal Register*, public companies that are not smaller reporting companies or emerging growth companies will not need to comply with the hedging disclosure rule until they file proxy statements (or information statements) that relate to the election of directors during fiscal years beginning on or after July 1, 2019 (i.e., the 2020 proxy season).

Smaller reporting companies and emerging growth companies will not need to comply with the new hedging disclosure rule until they file proxy or information statements for the election of directors during fiscal years beginning on or after July 1, 2020 (i.e., the 2021 proxy season). Listed closed-end funds and foreign private issuers are not subject to the hedging disclosure rule, although the rule will apply to business development companies.

Discussion

The new disclosure rule requires companies to disclose whether employees (including officers) or directors or their designees are permitted to purchase financial instruments or otherwise engage in transactions that hedge or offset, or that are designed to hedge or offset, any decrease in the market value of a company's equity securities granted to the employee or director as compensation or held directly or indirectly by the employee or director. The text of new paragraph (i) to Item 407 of Regulation S-K is set forth on *Exhibit A* attached hereto.

The SEC expressly declined to adopt a definition of the term "hedge" because it believes that the term should be applied as a broad principle. Accordingly, the new disclosure requirement is not limited to specific types of hedging transactions but is intended to cover all transactions that establish downside price protection in a registrant's equity securities, whether by purchasing or selling a security or derivative security or otherwise. It applies to the hedging of any equity security issued by the registrant, by any parent or subsidiary of the registrant or by any subsidiary of any parent of the registrant. The new rule requires companies to make clear what categories of transactions a company permits and what categories it prohibits.

Hedging disclosure may either describe hedging policies or practices in full or consist of a fair and accurate summary that describes the categories of covered persons and any categories of hedging transactions that are specifically permitted or prohibited. If a company applies different hedging practices or policies to different classes of its equity securities, the company's proxy statement should address that fact. A company that does not have hedging practices or policies will need to disclose that fact or state that it generally permits hedging.

Following the compliance date, hedging disclosure will be required in any proxy statement or information statement relating to an election of directors. However, hedging disclosure is not required in registration statements or in annual reports on Form 10-K Part III disclosure (even if that disclosure is incorporated by reference from the company's definitive proxy statement).

Many public company proxy statements already discuss hedging policies. The compensation discussion and analysis (CD&A) section of the proxy statement required by Item 402(b) of Regulation S-K must disclose all material elements of a company's compensation policies and decisions for executive officers whose compensation is required to be disclosed in the proxy statement (NEOs). In that regard, Item 402(b)(2)(xiii) of Regulation S-K identifies policies regarding hedging the economic risk of owning company equity securities as an example of the kind of information that may be required to be disclosed in response to this item.

The new hedging disclosure requirement extends beyond the existing CD&A requirement. For example, the CD&A only requires a discussion of hedging policies affecting the NEOs to the extent material to a discussion of their compensation, while the amendment to Item 407 of Regulation S-K mandates disclosure of hedging policies with respect to all employees, officers and directors, whether or not material to their compensation. In addition, the new hedging disclosure rule applies to all companies that are required to comply with the SEC's proxy rules. Therefore, it impacts companies that are not required to provide CD&A disclosure, such as smaller reporting companies, emerging growth companies and business development companies. However, foreign private issuers are not subject to Regulation 14A and therefore will not be required to provide the new hedging disclosures.

The new rule only requires disclosure of hedging practices or policies. The SEC expressly stated in the adopting release that "[n]othing in these amendments or this release should be construed as suggesting companies need to have a practice or policy regarding hedging, or a particular type of practice or policy." The SEC emphasized that "[t]he rule does not direct companies to have practices or policies regarding hedging, or dictate the content of any such practice or policy."

Item 407(i) just requires disclosures of practices and policies. This new item does not require the annual meeting proxy statement to disclose hedging transactions that have occurred, although other existing disclosure requirements (such as the requirement of Rule 403(b) to disclose beneficial ownership of equity securities by executive officers, directors and nominees for directors and Form 4 reporting of transactions in derivative securities) may reveal that company equity securities have been hedged.

Hedging disclosure is required under the new rule whether or not the relevant practices or policies are written. For example, a company without a written hedging policy might have a practice of reviewing, and perhaps restricting, hedging transactions when it monitors employee trading in company securities or might have a practice of including anti-hedging provisions in employment agreements or equity award documents.

Companies have flexibility in deciding where in the proxy statement to present the new disclosure. A company could place the new hedging disclosure outside of the CD&A with separate Item 402(b) disclosure for the CD&A without any cross reference. Or a company could incorporate the new Item 407(i) disclosure into the CD&A, either by directly including the information in the CD&A or by providing the Item 407(i) information outside of the CD&A and cross-referencing that disclosure within the CD&A.

As part of the hedging disclosure amendments, the SEC added new instruction 6 to Item 402(b) to specify that if information disclosed pursuant to Item 407(i) satisfies the CD&A's requirement with respect to hedging, the Item 407(i) disclosure may be referenced in the CD&A. The SEC also amended the Schedule 14A proxy information requirements set forth in Rule 14a-101 to reflect the new hedging disclosure requirement.

Practical Considerations

The hedging disclosure rule does not require companies to adopt hedging policies. However, the *absence* of a policy, which would have to be disclosed under the new rule, may be viewed negatively in light of corporate governance concerns that have been raised by certain shareholders, proxy advisory firms and corporate governance rating organizations. Therefore, public companies may want to review their existing approaches to hedging to consider whether any new or amended policies would be appropriate.

If a company is contemplating revising an existing hedging policy or adopting a new hedging policy, one thing for it to consider is whether the policy should apply to all employees (including officers) and directors equally or whether different policies are appropriate for different categories of employees or different categories of hedging activities.

To the extent that a company has already been disclosing in its proxy statement that it has a policy covering only executive officers and directors and describing that policy in sufficient detail to satisfy the new rule, it may be sufficient for the company to continue to use that disclosure in future proxy statements. The SEC's adopting release stated: "A company that has disclosed a policy that covers only a subset of employees or directors would not be required to further disclose that it did not have a policy with regard to the company's other employees or directors."

Although hedging disclosure is not needed in 2019 proxy statements, companies that have adopted hedging policies may want to consider adding to or expanding existing hedging disclosure in their 2019 proxy statements.

Exhibit A

Item 407(i) of Regulation S-K

(i) Employee, officer and director hedging. In proxy or information statements with respect to the election of directors:

(1) Describe any practices or policies that the registrant has adopted regarding the ability of employees (including officers) or directors of the registrant, or any of their designees, 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—

(i) Granted to the employee or director by the registrant as part of the compensation of the employee or director; or

(ii) Held, directly or indirectly, by the employee or director.

(2) A description provided pursuant to paragraph (1) shall provide a fair and accurate summary of the practices or policies that apply, including the categories of persons covered, or disclose the practices or policies in full.

(3) A description provided pursuant to paragraph (1) shall also describe any categories of hedging transactions that are specifically permitted and any categories of such transactions specifically disallowed.

(4) If the registrant does not have any such practices or policies regarding hedging, the registrant shall disclose that fact or state that the transactions described in paragraph (1) above are generally permitted.

Instructions to Item 407(i).

1. For purposes of this Item 407(i), "registrant equity securities" means those equity securities as defined in section 3(a)(11) of the Exchange Act (15 U.S.C. 78c(a)(11)) and § 240.3a11-1 of this chapter) that are issued by the registrant or by any parent or subsidiary of the registrant or any subsidiary of any parent of the registrant.

2. The information required by this Item 407(i) will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.

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Endnotes

[1]Available at https://www.sec.gov/rules/final/2018/33-10593.pdf.