December 21, 2018

SEC Adopts Final Hedging Disclosure Rule

On December 18, 2018, the SEC adopted the long-awaited hedging disclosure rule, as required by Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1] The final rule requires a description of any practices or policies a public company has adopted regarding the ability of its employees (including officers) and directors to engage in certain hedging transactions. Under the final rule, most companies must include this disclosure in their proxy and information statements relating to the election of directors during fiscal years beginning on or after July 1, 2019.

In this Alert, we describe the scope and application of the final rule and offer some practical guidance for public companies.

Covered Issuers

All U.S. operating companies that file Exchange Act reports are subject to the new disclosure requirement, and the Commission chose not to provide exemptions for smaller reporting companies (SRCs) or emerging growth companies (EGCs), although they have an additional year to comply. Foreign private issuers and listed closed-end funds are exempt from the new disclosure requirement. Business development companies are subject to the requirement.

Covered Employees and Directors

The final rule requires a company to describe any practices or policies it has adopted regarding the ability of its employees, officers, and directors[2] to engage in certain hedging transactions.

Because the definition of employee in the Exchange Act rules expressly exempts officers, new Item 407(i) adds the parenthetical "(including officers)" after the term "employees" to clarify that the new requirement applies to officers.

Covered Equity Securities

The new disclosure requirement applies to equity securities issued by the company and its parents, subsidiaries or subsidiaries of the company's parents. An instruction specifies that the scope of the disclosure requirement captures equity securities acquired as compensation and other equity securities holdings.

Covered Hedging Transactions

Similar to the proposal, the final rule does not define the term "hedge." Instead, the final rule uses the term as a broad principle for transactions that hedge or offset, or are designed to hedge or offset, any decrease in the market value of covered equity securities. The new disclosure requirement, therefore, is not limited to specific transaction types and, instead, requires the disclosure of practices and policies related to any hedging transactions that a company views as relevant in light of its specific circumstances and incentive structures.

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[1] Section 955 of the Dodd-Frank Act added new Section 14(j) to the Securities Exchange Act of 1934 and directed the SEC to require each issuer to disclose in any proxy or consent solicitation material for an annual meeting of the shareholders of the issuer whether any employee or member of the board of directors of the issuer, or any designee of such employee or member, is permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities either (1) granted to the employee or director by the issuer as part of the compensation of the employee or director, or (2) held, directly or indirectly, by the employee or director.

[2] Consistent with the statutory language, the disclosure also applies to "designees" of these individuals, but the Commission declined to provide any guidance on who might constitute a designee.

Content of Disclosure

In contrast to the proposal, which, consistent with the language in the statute, would have required companies to disclose what hedging transactions the company permitted, the final rule simply requires a company to provide a fair and accurate summary of the practices or policies that apply, including the categories of persons covered and any categories of hedging transactions that are specifically permitted and any categories that are specifically disallowed. Alternatively, a company may disclose the practices or policies in full. If a company does not have any such practices or policies, the company must disclose that fact or state that hedging transactions are generally permitted.

The final rule's focus on the disclosure of a company's practices and policies allows each company to make its own judgments in determining what activities, if any, should be covered by a practice or policy, and does not direct companies to have practices or policies regarding hedging, or dictate the content of any such practice or policy.

Manner and Location of Disclosure

New Item 407(i) requires disclosure in a proxy statement on Schedule 14A or information statement on Schedule 14C if action is to be taken with respect to the election of directors. Hedging disclosure is not required in Securities Act or Exchange Act registration statements or in the Part III disclosure of Form 10-K (even if that disclosure is incorporated by reference from the company's definitive proxy statement or information statement).

Relationship to Existing CD&A Obligations

Item 402(b) of Regulation S-K requires, if material, disclosure in the Compensation Discussion & Analysis (CD&A) of any policies on hedging by named executive officers. The final rule amends Item 402(b) by adding an instruction that would allow companies to avoid potentially duplicative disclosure. The final rule gives companies the flexibility to place the disclosure where it best fulfills their communication objectives. For example, a company may choose to include its Item 407(i) disclosure outside of its CD&A and provide a separate Item 402(b) disclosure as part of its CD&A without a cross reference. Alternatively, it could incorporate the Item 407(i) disclosure into its CD&A, either by directly including the information or by providing the Item 407(i) information outside of the CD&A and adding a cross-reference within the CD&A. It is unlikely that the current CD&A disclosures – which focus only on the applicability of hedging policies to named executive officers – will be sufficient to satisfy the Item 407(i) requirement. However, companies will want to consider consolidating hedging disclosure in one place outside of the CD&A and adding a cross-reference to it within the CD&A.

Implementation Dates

The SEC adopted a phased implementation schedule, such that companies that do not qualify as SRCs or EGCs must comply with the new disclosure requirement in proxy and information statements for the election of directors during fiscal years beginning on or after July 1, 2019. For calendar year-end reporting companies, this means that the required hedging disclosures should be included in annual proxy or information statements that are filed in 2020. In a change from the proposal, the SEC adopted a delayed implementation schedule for SRCs and EGCs, which have an additional year to comply.

Practical Considerations

Given that the new rule does not appear to present a significant compliance burden as well as the fact that many public companies already disclose their hedging policies on a voluntary basis, all companies should consider whether to include the required hedging disclosures (or, if applicable, revise any existing hedging disclosures in light of the new rule) in their upcoming annual proxy or information statements.

Proxy advisory firms generally view hedging by a company's insiders as a problematic practice. Glass Lewis believes that hedging by executives of company shares "severs the alignment of interests of the executive with shareholders." Glass Lewis supports "strict policies" that prohibit executives from hedging the economic risk associated with their share ownership in their companies. In addition, ISS's proxy voting policies list the hedging of company stock as an example of a governance failure in risk oversight, which, if material, could result in a voting recommendation by ISS against an individual director, committee members, or the full board. ISS will also generally recommend voting in favor of shareholder proposals seeking a policy that prohibits named executive officers from engaging in derivative or speculative transactions involving company stock, including hedging, holding stock in a margin account, or pledging stock as collateral for a loan.

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