SEC Issues Proposed Rule Implementing Dodd-Frank Hedging Disclosure Requirement

Principles-Based Disclosure Aims to "Provide Transparency to Shareholders" as to whether Employees are Permitted to Hedge Company stock.

In a surprise announcement on February 9, 2015 the Securities and Exchange Commission introduced proposed rules implementing the oft-forgotten hedging disclosure requirement from Dodd-Frank Section 955. As proposed, the hedging disclosure rule will require companies to disclose whether or not employees or members of the board of directors are permitted to engage in transactions to "hedge or offset any decrease in the market value of equity securities granted to the employee or board member as compensation, or held directly or indirectly by the employee or board member." The lack of controversy surrounding the hedging disclosure was reflected in the manner in which the SEC chose to introduce the proposed rule, eschewing the typical 'open meeting' manner of introducing rules for a process called *seriatim*. Adoption by *seriatim* involves the circulation of the terms of an item among the SEC's Commissioners for vote and signature, negating the procedural requirements for an open meeting and underscoring the lack of controversy surrounding the vote. Through this process, the proposed hedging disclosure rule received unanimous support of the SEC's five Commissioners, though the Republican Commissioners qualified their support due to the breadth of the proposal and the fact that the Chair chose to make this rule a priority before other Dodd-Frank and non-Dodd-Frank rulemakings. Although on its face this rule does not appear to be controversial or onerous, the public comment period will be important for analyzing the rule to ensure the absence of any unintended consequences.

Implementation of Section 955 Aimed at Improving Transparency with Regard to Company Hedging Practices According to the proposed release, the goal of Section 955 is to "provide transparency to shareholders" as to whether companies permit employees to engage in hedging transactions or other types of transactions which have the same effect as hedging company stock. The need for the increase in transparency is sourced in a Senate report on Dodd-Frank Section 955 which expresses concern as to the ability of company employees and directors to "effectively avoid compensation restrictions…so that they will receive their compensation even in the case that their firm does not perform" by utilizing hedging transactions. Interestingly, despite the overt concern with executives hedging company stock in a runaround of their company's pay for performance program, a report by law firm Shearman & Sterling LLP found that over 90 percent of large companies already prohibit hedging practices. The survey results indicate that for the vast majority of large companies, the hedging disclosure requirement will be a simple exercise.

"Principles-Based" Disclosure Aimed to Efficiently Capture All Hedging-Related Activities of Company Employees The proposed release requires companies to disclose whether or not company employees, directors, officers or their designees are permitted to engage in financial transactions which hedge company stock or have a similar financial effect to hedging. The proposed rule is structured in a way which addresses four key areas in order to formulate the disclosure – (1) Who is subject to the disclosure; (2) What financial transactions are subject to the disclosure; (3) What equity is subject to the disclosure; and (4) Where is the disclosure required.

- Determining Which Financial Transactions Are Considered Hedging and Subject to the Disclosure: In establishing which financial transactions are considered hedging practices, the SEC's proposed rule adopts a principles-based approach rather than providing an exhaustive list of prohibited transactions or a bright-line test for determining what constitutes hedging and what does not. The SEC states the purpose of the principles-based approach is to ensure that the disclosure is complete with regard to the scope of hedging transactions. As a result, the proposed

rule contemplates that hedging transactions consist of the list provided in the text of Dodd-Frank Section 955 (prepaid variable forward contracts, equity swaps, collars, and exchange funds designed to hedge company stock). In addition, the proposed rule continues, any other type of transaction that is "designed to or have the effect of hedging or offsetting any decrease in the market value of equity securities" will also trigger the disclosure. The overall goal, according to the proposed rule, is to cover all financial transactions which result in "downside price protection".

- Determining the Employees Subject to the Disclosure Requirement: According to the proposed rule, the term "employee" will include everyone employed by an issuer, including members of its board of directors as well as the company's officers. Furthermore, the disclosure will also include any "designee" of any of the above individuals to in effect prevent an employee from having someone make hedging transactions on his behalf.
- Determining Which Equity is Subject to the Disclosure Requirement: The proposed rule specifies that the disclosure is required of hedging practices of equity issued by: (a) the company; (b) any parent of the company; (c) any subsidiary of the company; and (d) any registered and reporting subsidiary of any parent company. The covered equity includes both compensatory equity grants as well as any other equity securities holdings of any of the above companies.
- Hedging Disclosure Required in Proxy Statements with Director Elections: The proposed rule states that the hedging disclosure will be required in any proxy statement or consent solicitation materials associated with the election of company directors. The proposed rule further places the location of the disclosure in the director election section of the proxy. Notably, current SEC disclosure requirements in Item 402(b) require companies to disclose company policies regarding hedging practices by executives to the extent it is material. The proposed rule states that by including the new hedging disclosure the requirements of Item 402(b) are satisfied, thus avoiding any chance for a duplicative disclosure.

With regard to the structure of the disclosure itself, the SEC adopts a practical and principles-based approach which starts with a requirement that companies disclose transactions in separate categories of transactions it both permits and prohibits. The SEC, however, recognized that it is impractical to require a potentially limitless list of disclosure in each category. Accordingly, if a company specifically prohibits certain transactions, it may list just those transactions along with a statement indicating that all other transactions are prohibited. Conversely, if a specific transaction is permitted, then the company may list that single transaction while disclosing it prohibits all other hedging transactions. If a company permits or prohibits all transactions, it may say so in lieu of describing them by category. With regard to any permitted transaction, the proposed rule will only require companies to disclose sufficient detail to explain the scope of the permitted transaction (*e.g.* amount of time securities must be held prior to being permitted to be hedged). The same concept applies to the disclosure of which employees are permitted to participate in hedging transactions. For example, a company can disclose that it prohibits hedging by executive officers and board members but does not place restrictions on hedging on other employees.

Conclusion The proposed hedging disclosure is a fairly straightforward disclosure which for the vast majority of companies will not result in any serious compliance burdens. Furthermore, because hedging can be abused by employees to evade the pay for performance consequences of a company's compensation plan, a hedging policy disclosure provides an effective form of corporate governance. Even so, the notice and comment period for the proposed rule will be important for identifying any legitimate uses for hedging, if any, and making the SEC aware of any unintended consequences.

www.ExecComp.org
1100 Thirteenth Street, NW
Suite 850
Washington, DC 20005
info@ExecComp.org
202.408.8181
202.449.5648