SEC Proposes New Rules Requiring Issuer Disclosure of Hedging Policies for Employees and Directors

On February 9, 2015, the Securities and Exchange Commission (the "SEC") proposed rule amendments to implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The proposed rule amendments would require registrants to disclose whether or not employees, officers and directors, or their "designees," are permitted to purchase financial instruments or otherwise engage in transactions that are designed to or have the effect of hedging or offsetting any decrease in the market value of equity securities issued by the registrant, any parent or subsidiary of the registrant or any subsidiary of the registrant's parent that, in each case, are registered under Section 12 of the Exchange Act.[1] The proposed disclosure requirements would apply to virtually all Exchange Act Section 12 registrants other than foreign private issuers.

Background

Section 955 of Dodd-Frank added Section 14(j) to the Exchange Act, which directs the SEC to adopt rules requiring registrants to disclose in any proxy or consent solicitation material for any annual shareholder meeting whether any employee or director of the registrant, or any of their designees, 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 registrant as part of their compensation or (2) held, directly or indirectly, by the employee or director. The SEC views the purpose of Exchange Act Section 14(j) as providing shareholders, in the context of the election of directors, with information about whether employees or directors are permitted to engage in transactions that could mitigate or avoid the incentives associated with equity ownership.[2] The proposed rule amendments implement a disclosure obligation regarding hedging policies but, consistent with Exchange Act Section

[1] See SEC Release No. 34-74232 (February 9, 2015).

[2] The SEC's view of the statutory purpose behind Exchange Act Section 14(j) is buttressed by a report issued by the Senate Committee on Banking, Housing, and Urban Affairs on April 30, 2010, and cited in the proposing Release, which stated that the law is intended to "allow shareholders to know if 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."

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14(j), does not require a registrant to prohibit hedging transactions or to adopt any specific policies addressing hedging activities for a particular group of employees or directors.

Registrants Subject to the Proposed Disclosure Obligations

Consistent with the SEC's view of the purpose of Exchange Act Section 14(j), the proposed amendments would apply to virtually all registrants with securities registered under Section 12 of the Exchange Act, including smaller reporting companies, emerging growth companies ("EGCs") and listed closed-end funds, such as business development companies, all of which generally require the election of directors by shareholders. Other types of funds, such as non-listed closed-end funds, open-end funds and unit investment trusts (e.g., mutual funds and exchange traded funds or ETFs), which have different management structures and regulatory regimes, are not required to hold annual shareholder meetings, whose shares are redeemable at the holder's option and/or where the granting of equity as a form of incentive-based compensation is uncommon or prohibited, are not subject to the proposed disclosure obligations. As foreign private issuers are not subject to the proxy statement rules under the Exchange Act, the proposed disclosure obligations would also not apply to them.

Transactions Required to be Disclosed

The proposed rule amendments reflect a broadening of the requirements of Exchange Act Section 14(j) by requiring the disclosure of not only whether or not any employee, officer or director of the registrant, or any of their designees, may purchase the types of financial instruments expressly identified in Section 14(j) of the Exchange Act (i.e., 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, but also whether or not other transactions are permitted that could have the same economic or hedging effect as purchasing those types of instruments (e.g., short sales and futures). The SEC's stated intention is for the proposed disclosure to be more "principles-based" so that the disclosure obligation covers all transactions that establish downside protection of equity securities,[3] whether by purchasing or selling a security or derivative security or otherwise, in which employees, officers, directors or any of their designees are either prohibited or permitted to execute.

Disclosure Required in Proxy and Other Statements Covering the Election of Directors

Currently, more limited information regarding a registrant's hedging policies or transactions by directors and certain officers must be disclosed in certain circumstances. First, disclosure obligations relating to a registrant's hedging policies are part of the non-exclusive list of items that may be appropriate for disclosure in the registrant's Compensation Discussion and Analysis ("CD&A") under Item 402(b) of Regulation S-K under the Exchange Act. Under the SEC's guidance provided in that Item, a registrant would, to the extent it is considered material, include in the CD&A information about the registrant's equity or other security ownership requirements or guidelines and any policies regarding hedging the economic risk of such ownership, in each case as applied to the registrant's named executive officers. However,

[3] The equity securities covered by the proposed amendments would cover any "equity securities" (as defined in Exchange Act Section 3(a)(11) and Exchange Act Rule 3a11-1) issued by the registrant and its parents, subsidiaries or subsidiaries of the registrant's parents (i.e., affiliates of the registrant whose equity securities may be granted as similar long-term incentive compensation) that are registered on a national securities exchange or registered under Exchange Act Section 12(g) and which reflect the equity securities most likely to be traded and easily hedged.

since they are not subject the CD&A disclosure obligations, smaller reporting companies, emerging growth companies, registered investment companies and foreign private issuers are not currently required to disclose any information on hedging policies. Second, hedging transactions by officers and directors of registrants with a class of equity securities registered pursuant to Exchange Act Section 12 are subject to reporting pursuant to Exchange Act Section 16(a) within two business days on Form 4. Finally, certain hedging transactions by named executive officers, directors and director nominees that require equity securities to be pledged as collateral are required to be disclosed by Item 403(b) of Regulation S-K in proxy statements, annual reports on From 10-K, registration statements under the Securities Act of 1933, as amended (the "Securities Act"), and the Exchange Act on Form 10.

Under the proposed rule amendments, more fulsome disclosure would be required in a registrant's proxy or consent solicitation materials and information statements that specifically address the election of directors as part of the set of rules that requires disclosure of other corporate governance concerns under Item 407 of Regulation S-K. The disclosure would need to be included in Schedule 14A proxy statements with respect to the election of directors and Schedule 14C information statements provided to security holders whose consent is not required for the election of directors (e.g., a non-listed controlled company with securities registered under Section 12 of the Exchange Act). Consistent with how certain other corporate governance disclosure provisions are treated, the proposals do not require the hedging policy disclosure in registration statements under the Exchange Act or the Securities Act or in the Item 407 disclosure required by Part III of Form 10-K (e.g., when no action is to be taken regarding the election of directors), even if that disclosure is incorporated by reference from the registrant's definitive proxy statement or information statement.

For registrants that permit hedging transactions, the proposed rule amendments require that disclosure include, generally, information regarding what groups of people are permitted to engage in, and who is prohibited from engaging in, such transactions, the types of hedging transactions that may be permitted or prohibited and sufficient detail to explain the scope of the permitted transactions. The SEC also proposed to amend Item 402(b) of Regulation S-K to allow (but not require) a registrant to satisfy its CD&A obligation, if any, to disclose material policies on hedging by named executive officers by including in the CD&A a cross reference to the information disclosed elsewhere in its proxy or other information statement, as long as that disclosure would otherwise satisfy this CD&A disclosure requirement.

Some Commissioners Expressed Reservations

The SEC Commissioners approved the proposal of the rule amendments, but with some reservations. Two SEC Commissioners, Daniel M. Gallagher and Michael S. Piwowar, issued a joint statement noting concerns over, among others, (i) imposing the added disclosure obligations on EGCs and smaller reporting companies, (ii) subjecting listed, closed-end funds that are mostly externally managed and have limited employee hedging activities to the disclosure requirements, (iii) the usefulness of the disclosure addressing all employees that would include those with limited or no affect on a registrant's share price, (iv) the broad coverage of the disclosure that would include equity securities of affiliates of the registrant, and (iv) the implementation of parts of Dodd-Frank that are not viewed as relevant to the financial crisis. Commissioner Aguliar issued a separate statement in which he noted the need for increased transparency about registrants' executive compensation decisions, that the proposed rules were Congressionally mandated and expressed the view that the proposal was a "positive step in the direction of providing more information to shareholders as to whether the interests of corporate insiders are truly aligned with their own."

The SEC invites comments on the proposed amendments within 60 days after publication in the Federal Register.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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