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CLIENT MEMORANDUM

SEC Proposes Hedging Disclosure Rule

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AUTHORS

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The SEC recently proposed amending its rules to require disclosure of hedging policies for officers, directors and other employees,[1] to implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. These disclosure obligations under proposed new Item 407(i) of Regulation S-K would require issuers to disclose in any proxy or information statement relating to the election of directors whether any employee (including any officer) or director, or any of their designees, is permitted to engage in transactions to hedge any decrease in the market value of equity securities. Given the timing of the release and the 60 day comment period, a final rule is unlikely to be adopted in time for this upcoming proxy season.

In the release, the SEC expressly notes that nothing in the proposal would require a company to prohibit hedging transactions or otherwise adopt any specific policies. However, like the SEC's other corporate governance disclosure mandates, this disclosure puts pressure on companies to adopt shareholder-friendly policies. We note that proxy advisory firms ISS and Glass, Lewis & Co. strongly disfavor the hedging and significant pledging of company stock. ISS regards such transactions as "failures of risk oversight," stating that hedging by a company insider will be considered a problematic practice warranting a negative vote recommendation against appropriate board members. Glass Lewis similarly believes that companies should adopt strict policies to prohibit executives from hedging the economic risk associated with their ownership of company stock.

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[1] *See* SEC Release Nos. 33-9723 and 34-74232, *Disclosure of Hedging by Employees, Officers and Directors*, February 9, 2015.

Reportable Transactions

The proposed rule takes a principles-based approach and is intended to cover policies regarding all transactions that establish downside price protection – whether by purchasing or selling a security or derivative security or otherwise. An issuer would therefore be required to disclose whether any employee or director of the issuer, 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 or have the effect of hedging or offsetting any decrease in the market value of equity securities. Policies regarding transactions with economic consequences comparable to the purchase of the specified financial instruments would also be covered by the rule.

To convey a complete understanding of the scope of permitted hedging at the company, the rule would require an issuer to disclose permitted and prohibited categories of hedging transactions. If the company's policy distinguished between different persons, that would also be required to be disclosed.

Securities and Issuers Covered

As proposed, the rule would apply to any 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. It would apply to equity securities granted to the employee or director as compensation, or otherwise held directly or indirectly by them.

The proposed rule would cover most issuers with equity securities registered under the Securities Exchange Act, including emerging growth companies, smaller reporting companies and listed closed-end funds. Investment companies registered under the Investment Company Act of 1940 that are not listed closed-end funds and foreign private issuers, which are exempt from most proxy requirements, would not be subject to the new disclosure requirements.

Location of Disclosure

The information required under the proposed Item would need to be included in proxy or consent solicitation materials on Schedule 14A, or information statements on Schedule 14C, with respect to the election of directors.[2] The disclosure would not be required in registration statements or in Form 10-Ks, even if other information from the proxy statement is incorporated by reference.

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[2] To minimize duplication of comparable disclosure currently required for many companies in their Compensation Discussion and Analysis ("CD&A") regarding hedging policies for executive officers, the release permits a company's CD&A to cross-reference this new, more expansive disclosure.

Commissioner Statements

Commissioners Daniel M. Gallagher and Michael S. Piwowar in a joint statement, while noting their general support for the proposal, raised concerns about certain aspects. Among other things, they questioned the rule's application to emerging growth companies, smaller growth companies and listed closed-end funds, to employees who cannot affect the company's share price and to equity securities of affiliates of the issuer, all items the proposing release calls for comment. Commissioner Luis A. Aguilar issued a more supportive statement, but similarly noted more important items on the SEC's agenda that he believes should have taken priority over this proposed rule.

If you have any questions regarding this memorandum, please contact Jeffrey S. Hochman (212 728 8592, jhochman@willkie.com), Patrick J. Horan (212 728 8691, phoran@willkie.com) or the Willkie attorney with whom you regularly work.

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