February 11, 2015

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Alert
SEC Disclosure and Corporate Governance

SEC Takes a Step Forward under Dodd-Frank: Proposes Far-Reaching Disclosure Rules on Hedging Policies

Yesterday, the Securities and Exchange Commission took a step forward to complete its unfinished business under the Dodd-Frank Wall Street Reform and Consumer Protection Act by proposing rules that would require disclosure of policies permitting or prohibiting hedging by employees (including officers) and directors of their company's equity securities. The proposed rules, voted on by the Commission seriatim without an open meeting, would implement new Section 14(j) of the Securities Exchange Act of 1934 mandated by Section 955 of the Dodd-Frank Act. The purpose of the proposed rules is to provide transparency to shareholders about whether employees and directors are permitted by the company to engage in transactions that mitigate or avoid the incentive alignment associated with ownership of company equity securities, whether these securities are acquired through company compensatory arrangements, in the open market or otherwise. Because the SEC views Section 14(j) as raising governance issues that transcend the risks associated with executive compensation, it has proposed to amend Item 407 of Regulation S-K (corporate governance disclosures) rather than Item 402 of Regulation S-K (compensation of named executive officers and directors) to require the new principles-based disclosures.

Without waiting for these rules -- whether in response to institutional shareholders, proxy advisory firms and/or insider trading liability concerns -- many companies have, over the last few years, adopted and disclosed policies prohibiting hedging by officers, directors and/or employees more generally.

The deadline for public comment on the SEC's proposal is 60 days from publication of the proposing release in the Federal Register, which has not yet occurred. We expect extensive and divided commentary, given the important issues raised both in the release itself and in separate statements of Commissioners Piwowar and Gallagher, and Commissioner Aguilar, discussed below.

It is important to note that the rules would *not* prohibit hedging transactions and would not require disclosure of such transactions unless required by existing SEC rules. Moreover, the rules would *not* require companies to adopt a policy, but only to describe whether or *not* they have a policy and, if so, what it provides.

Discussion of the Proposed Rules

Transactions Subject to Disclosure. New Item 407(i) of Regulation S-K would cover all transactions that establish "downside price protection." Disclosure would be required of any policy that permits the purchase of 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. Although not expressly contemplated by Section 14(j), the proposed rules would establish a principles-based analytical approach designed to result in disclosure of transactions with economic consequences comparable to the purchase of the specified financial instruments (*e.g.*, short sales, futures sales). However, as the SEC noted in footnote 23 to the proposing release, the proposed rules do not provide clarity as to what is meant by the term "hedge," since the term is believed by the SEC to be "generally understood and should be applied as a broad principle." We anticipate considerable debate over what transactions should or should not be treated as "hedging," and perhaps even some calls for an SEC definition of the term.

The proposed rules would require disclosure of whether hedging was permitted or prohibited. Permitted hedging transactions must be described in sufficient detail "to explain the scope of such permitted transactions" (*e.g.*, only if pre-approved or only after the company's stock ownership guidelines have been met).

Covered Individuals. SEC rules currently require disclosure in the Compensation Discussion and Analysis section of the proxy statement of policies regarding hedging, if material to shareholders' understanding of the company's compensation policies and decisions. The proposed rules expand required disclosure beyond named executive officers and directors to mandate disclosure of the company's hedging policies as they relate to any employee (including officers) or director, or any of their respective designees, *irrespective of materiality to the company or the person, or how such securities were acquired (e.g., as compensation, purchases in the open market or otherwise)*. With respect to "designees" of employees or directors, the proposed rules only provide that whether someone is a "designee" would be determined by the company based on the particular facts and circumstances.

Location of Disclosure; Applicability. Because Section 14(j) would be implemented by adding a new paragraph (i) to Item 407 of Regulation S-K, the new hedging disclosures technically would not be among the compensation disclosures subject to the management "say-on-pay" (SOP) advisory vote. As now occurs, however, we expect proxy advisory firms to take the additional hedging disclosures into account in formulating voting policies relating not only to SOP votes, but also to votes on the election of directors and the adoption or amendment of an executive compensation plan for which shareholder approval is sought. Disclosure would be required in proxy and information statements for the election of directors and apply to companies subject to the federal proxy rules, including smaller reporting companies, emerging growth companies (EGCs), business development companies, and registered closed-end investment companies with shares listed and registered on a national securities exchange. Foreign private issuers would be exempt as under the current regulatory regime.

Covered Securities. The proposed rules specify that disclosure would apply to equity securities of the company, its parent, subsidiary, or any subsidiary of any parent of the company that is registered under Section 12 of the Exchange Act. The proposed rules cover equity securities (1) granted pursuant to compensatory equity grants and (2) other equity securities held by the covered person acquired from any other source, including but not limited to open market purchases.

Statements of SEC Commissioners

Although they voted in favor of issuing the proposed rules, Commissioners Daniel M. Gallagher and Michael S. Piwowar issued a joint statement available here expressing concern about several aspects of the scope and applicability of the proposed rules and urging robust public comment. Among other things, Commissioners Gallagher and Piwowar take issue with the applicability of the proposed rules to EGCs, smaller reporting companies and certain investment companies. In addition, the two Commissioners expressed skepticism about the usefulness of disclosure regarding employees that cannot affect the company's stock price and about the application of the proposed rules to securities of the issuer's affiliates, parents and subsidiaries. Separately, Commissioner Luis A. Aguilar issued a statement available here in support of the proposed rules and also encouraging the SEC to move forward with remaining Dodd-Frank rule making.

The proposing release is available here and includes requests for comments on practically every element of the proposed rules, including whether the term "hedge" should be defined. As noted above, comments are due in 60 days after publication of the proposed rules in the Federal Register.

What To Do Now:

- Review current disclosure requirements around hedging and consider the need to enhance your company's disclosure in light of the additional spotlight on hedging policies that the rule proposal may create this proxy season.
  - The Compensation Discussion and Analysis section of the proxy statement requires disclosure of hedging policies in circumstances where such information is material and necessary to an understanding of the compensation policies and decisions involving named executive officers. Companies should consider whether the 2015 proxy statement should include disclosure of the company's hedging policies – particularly where hedging by executive officers and directors (or in some cases employees) is prohibited – as an important compensation risk mitigation measure.
  - Note that certain SEC rules already require disclosure of hedging transactions. For example, Item 403(b) of Regulation S-K requires footnote disclosure of pledges associated with some hedging transactions, such as pre-paid variable forward contracts in the table on beneficial ownership. In addition, Section 16 of the Exchange Act requires officers and directors to report transactions in derivative securities (such as puts, calls, warrants, convertible securities or other rights or obligations to buy or sell securities) on a Form 4.
- Consider how the company's disclosure would appear if the proposed rules were adopted.
  - Take a fresh look at any existing company policies on hedging, including the insider trading policy, to understand what they permit and what they prohibit. If hedging is permitted by the company, consider whether to require pre-clearance of hedging transactions by officers and directors, to the extent not already required.
  - Review transactions in which employees (including officers) and directors currently engage that could be deemed to have the economic consequence of hedging under the proposed principles-based approach.
- Understand how proxy advisory firms view hedging.
  - Institutional Shareholder Services (ISS) proxy voting policy provides that "any amount" of hedging of company stock by directors or executive officers is considered a "material failure of risk oversight." ISS will

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What To Do Now (continued):

recommend a vote "against" or "withhold" from directors individually, governance committee members, or the entire board, if there exists material failures of risk oversight.

- ISS' QuickScore 3.0 will also produce a "red flag" in the Board Structure pillar if the company lacks an anti-hedging policy. Companies should review their QuickScore to understand whether ISS has issued a "red flag" indicating that the company lacks an anti-hedging policy.
- Glass Lewis' proxy voting policy is that hedging of shares by executives in the shares of the companies where they are employed severs the alignment of interest of the executive with shareholders and that companies should adopt strict policies to prohibit executives from hedging the economic risk associated with their share ownership in the company.

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If you have any questions on these matters, please do not hesitate to speak to your regular contact at Weil, Gotshal & Manges LLP or to any member of Weil's Public Company Advisory Group:

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