SEC Issues Final Hedging Disclosure Rule

On December 18, 2018, the Securities and Exchange Commission moved one step closer to completing its compensation-related rulemaking under the Dodd-Frank Wall Street Reform and Consumer Protection Act by adopting a final rule requiring public companies to disclose whether they maintain practices or policies regarding their employees' (including officers) and directors' ability to hedge the economic risk of owning the company's equity securities.

New Item 407(i) of Regulation S-K, which implements Section 14(j) of the Securities Exchange Act of 1943 (as added by Section 955 of the Dodd-Frank Act), requires most public companies to disclose in their proxy and information statements relating to the election of directors any practices or policies they have adopted with respect to the ability of their employees (including officers) and directors to purchase financial instruments, or otherwise engage in transactions, that hedge or offset, or are designed to hedge or offset, any decrease in the market value of company equity securities.

While the new rule is intended to enable shareholders to understand whether employees and directors are permitted to participate in transactions that minimize the risks of long-term stock ownership, it does not require public companies to have policies or practices regarding hedging, nor does it specify what the content of any such policies or practices should be. Instead, it simply requires that they disclose any such policies and practices, or whether they permit or prohibit hedging activities.

Generally, the new disclosure requirement is effective for proxy and information statements relating to the election of directors during fiscal years beginning on or after July 1, 2019.

Background

Since the adoption of the executive compensation disclosure rules in 2006, public companies have been required to disclose in their Compensation Discussion and Analysis, if material, any policies that they maintain involving the hedging of company equity securities by their named executive officers. In addition, over the years the major proxy advisory firms, particularly Institutional Shareholder Services ("ISS") and Glass Lewis & Co., have adopted policies disfavoring the hedging of shares in the companies they serve by executive officers and directors because such transactions either are considered poor governance or as severing the alignment of executive and shareholder interests.

In response to this disclosure requirement and these policy positions, many public companies have undertaken to adopt anti-hedging policies and disclose the existence of such policies in their CD&As.

In February 2015, the SEC proposed implementing Section 14(j) by amending Item 407 of Regulation S-K to add new paragraph (i), which would require companies to disclose in their proxy and information statements whether they permit their employees and directors to hedge their company's equity securities.

Hedging Disclosure Requirement

Scope of Disclosure

The new rule requires public companies to describe any practices or policies they have adopted (whether written or not) regarding the ability of employees (including officers) and directors or their designees to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds), or otherwise engage in transactions that hedge or offset, or are designed to hedge or offset, any decrease in the market value of the company's equity securities either (i) granted to the employee or director by the company as part of their compensation or (ii) held, directly or indirectly, by the employee or director.

Specifically, a company will be required either to:

- provide a fair and accurate summary of any practices or policies that apply (whether written or not), including the categories of persons covered and any categories of hedging transactions that are specifically permitted or disallowed; or
- disclose the practices or policies in full.

If a company does not have any practices or policies regarding hedging, it must disclose that fact or state that hedging transactions are generally permitted. For example, if a company does not have any practices or policies involving hedging, it could simply state: "Our company does not have any practices or policies regarding hedging or offsetting any decrease in the market value of registrant equity securities."

© 2019 Compensia, Inc. All rights reserved.

Covered Transactions

The new rule does not define the term “hedge.” Rather, as stated in the Adopting Release, the SEC believes the language of Section 14(j), which refers to financial instruments “that are designed to hedge or offset any decrease in the market value” of registrant equity securities, is clear and indicates that “hedge” should be applied as a broad principle. Thus, the disclosure isn’t limited to specific types of transactions. A company will have to evaluate any practices and policies that it has in place in the context of the activities, if any, that it intends to be covered by such practices and policies to determine whether – and how – disclosure is required.

Companies Subject to Disclosure

The new disclosure requirement applies to all companies with securities registered under Section 12 of the Exchange Act, including smaller reporting companies and emerging growth companies. It does not apply to foreign private issuers or listed closed-end investment companies. As discussed below, while subject to the disclosure requirement, the SEC has provided a delayed implementation schedule for smaller reporting companies and emerging growth companies, giving them an extra year to comply.

Individuals Subject to Disclosure

The new disclosure must describe a company’s hedging practicies and policies as they apply to its employees (including officers) and the members of its Board of Directors, or any of their designees. Thus, the disclosure requirement is broader than the current disclosure requirement in the CD&A, which only applies to named executive officers. Further, in spite of requests to do so, the SEC did not define the term “designee.” Instead, under the new rule, whether someone is a “designee” is to be determined based on the particular facts and circumstances.

Covered Equity Securities

The new disclosure requirement applies to “registrant equity securities.” This includes equity securities issued by a public company and its parents, subsidiaries, or subsidiaries of the company’s parents. This includes both equity securities issued in compensatory transactions and other equity securities holdings, whether held directly or indirectly.

Location of Disclosure

The new disclosure is required in any proxy statement under Schedule 14A or information statement under Schedule 14C if action is to be taken with respect to the election of directors. The disclosure is not required in registration statements filed under either the Securities Act of 1933 or the Exchange Act. Further, the disclosure is not required in Part III of annual reports on Form 10-K even if that disclosure is incorporated by reference from a company’s definitive proxy or information statement.

Coordination with CD&A Disclosure Requirement

Currently, companies may need to address their policies with respect to the hedging of the economic risk of owning company securities by their named executive officers in their CD&A if such information is material to an understanding of their executive compensation program. As a result, this is typically where this topic is covered in the proxy statement for an annual meeting of shareholders.

In adopting the new rule, the SEC has added an instruction to Item 402(b) of Regulation S-K, the provision governing the contents of the CD&A, to provide that a company may satisfy its CD&A obligation to disclose material policies on hedging by its named executive officers by cross-referencing the information disclosed pursuant to new Item 407(i) to the extent that this information satisfies the CD&A disclosure requirement.

By providing this instruction, the SEC is enabling companies that are subject to both Item 407(i) and Item 402(b) a degree of flexibility in how to handle these two independent disclosure obligations that allows them to avoid potentially duplicative disclosure. On the one hand, a company may choose to include its Item 407(i) disclosure outside the CD&A and provide a separate Item 402(b) disclosure as part of the CD&A without a cross-reference. Alternatively, it may incorporate the Item 407(i) disclosure into the CD&A, either by directly setting out the information or by providing the Item 407(i) disclosure outside the CD&A and adding a cross-reference within the CD&A. Thus, the new disclosure may be either within or outside the CD&A.

Compliance Dates

For companies that are neither smaller reporting companies nor emerging growth companies, the disclosure required by new Item 407(i) is effective for proxy and information statements relating to the election of directors during fiscal years beginning on or after July 1, 2019. Thus, in the case of a company with a calendar year fiscal year-end, the disclosure will need to be provided in its proxy or information statement filed during the 2020 proxy season. In the case of a company with a fiscal year-end during the second half of 2019 (such as September 30th), the disclosure will need to be

© 2019 Compensia, Inc. All rights reserved.

provided in its first proxy or information statement filed after fiscal year-end, even if filed in late 2019.

In the case of smaller reporting companies and emerging growth companies, the new disclosure requirement is effective for fiscal years beginning on or after July 1, 2020.

Observations. Although new Item 407(i) has a delayed effective date, companies may want to begin reviewing their hedging practices and policies now in view of the new disclosure requirement. To date, the disclosures that have been included in the CD&A about hedging policies have largely been very general and haven't delved into the specifics of who is precisely covered by the policy and what categories of hedging transactions, if any, are specifically permitted or prohibited. Companies may want to see whether any revisions are warranted or ensure that their policy tracks the language of the rule, as well as see that their current disclosures provide a "fair and accurate" summary of the policy. In addition, companies that do not have a hedging policy may wish to consider putting one in place, or face the prospect of having to disclose this fact in their proxy or information statement.

Need Assistance?

Compensia has extensive experience in helping companies prepare the executive compensation disclosure in the proxy materials for their Annual Meeting of Shareholders, as well as analyze the potential impact of the various SEC disclosure requirements on their executive compensation programs. If you would like assistance in preparing your disclosure, or if you have any questions on the subjects addressed in this Thoughtful Disclosure Alert, please contact Mark A. Borges.

About Compensia:

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.■

© 2019 Compensia, Inc. All rights reserved.

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

Silicon Valley

125 S. Market Street
Suite 1000
San Jose, California 95113
408.876.4025

Thomas G. Brown, Chairman & Managing Principal
tbrown@compensia.com
408.876.4023

Susan Gellen
sgellen@compensia.com
408.907.4302

Tom LaWer, Managing Principal
tlawer@compensia.com
408.907.4309

Timothy Sparks
tsparks@compensia.com
408.876.4024

Greg Loehmann
gloehmann@compensia.com
408.907.4319

San Francisco

One Embarcadero Center
Suite 2830
San Francisco, California 94111
415.462.2990

Mark A. Borges
mborges@compensia.com
415.462.2995

Erik Beucler
ebeucler@compensia.com
408.907.4314

Amanda Feyerabend
afeyerabend@compensia.com
415.462.2988

Southern California

Ralph Barry
rbarry@compensia.com
858.603.2288

Pacific Northwest

Jason Borrevik
jborrevik@compensia.com
408.876.4035

© 2019 Compensia, Inc. All rights reserved.