McDermott Will & Emery

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SEC Proposes Disclosure Rule for Hedging Transactions by Directors, Officers and Employees

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On February 9, 2015, the U.S. Securities and Exchange Commission (SEC) issued a proposed rule that, if adopted, would require public companies to disclose in annual proxy statements whether their employees and board members may hedge or otherwise offset any decrease in the market value of such companies' equity securities. The proposed rule implements Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and covers a much broader range of transactions than hedging policies adopted at most public companies. The proposed rule would not require a public company to prohibit hedging type transactions.

It is appropriate for issuers at this time to consider the extent to which the scope of their existing hedging policies differs from the proposed rule. The SEC has solicited comments on the proposed rule prior to April 14, 2015. Specific areas that are requested for comment may be found in an appendix at the end of this *On the Subject*.

Hedging Disclosure as "Principles Based" Corporate Governance Disclosure

The proposed rule would add the hedging disclosure rule as part of a public company's required corporate governance disclosure under Item 407. The SEC proposes this approach, as opposed to requiring the hedging disclosure as part of the executive compensation disclosure under Item 402, because "it requires a company to provide . . . shareholders [with] insight into whether the company has policies affecting how the equity holdings and equity compensation of *all* of a company's employees and directors may or may not align with shareholders' interests" (emphasis added). Consistent with viewing hedging type transactions as a form of misalignment with shareholder interests, ensuring complete disclosure and favoring any particular type of hedging activity, the proposed rule provides a "principles-based" disclosure requirement. Specifically, disclosure is required for any transactions that have or are designed to have "economic consequences comparable" to prepaid variable forward contracts, equity swaps, collars and exchange funds that have or are designed to have the effect of hedging or offsetting. One of the more significant areas identified for comment is the scope of transactions that may be considered comparable to hedging. For now, it is clear that a pledge or loan of equity securities that does not involve a prepaid variable forward contract will not be considered a disclosable hedging transaction.

Covered Equity Securities

The securities covered by the proposed rule are not limited to just the issuer's publicly traded stock that is listed on an exchange. Covered securities include any equity security issued by a public company, any parent or subsidiary of the public company, and any subsidiary of any parent of a public company with registered equity securities. It is not uncommon to see hedging policies that focus on just the shares of stock that the public company has listed on a national stock exchange. The proposed rule also clarifies that the disclosure requirement extends to equity securities either earned as

compensation or otherwise held from whatever source acquired.

Covered Persons

As noted above, the proposed rule would extend to all employees (including officers) and directors. In addition, the rule extends to "designees," which would appear to include fiduciaries of trusts or family limited partnerships that may be established for gift tax planning purposes. Many, if not most, hedging policies only extend to executive officers. If a public company intends to change its hedging policies in light of whatever final rule is adopted under Section 955, it is appropriate to consider what steps should be taken in order for the policy to be enforceable. Actions that may be appropriate include adding provisions in new equity awards requiring compliance with hedging policy, as may be amended from time to time, and obtaining a written acknowledgment from any designee that it will comply with the hedging policy.

Matters to Be Addressed in Disclosure

The proposed rule would not require public companies to identify in the proxy each possible type of hedging or other transaction. A public company that only prohibits certain types of hedging transactions would be able to disclose just the categories of transactions it specifically prohibits and state that it permits all other hedging transactions. On the other hand, a public company that only allows certain types of hedging transactions would be able to disclose just the categories of such permitted transactions, and state that all other hedging type transactions are prohibited. Any distinctions among different classes of persons covered by Section 955 would also need to be disclosed under the proposed rule. For example, the preamble to the proposed note provides that a company might disclose that it prohibits all hedging transactions by executive officers and directors, but does not restrict hedging transactions by other employees.

Coordination with Other Rules

Item 402 provides as an example of the kind of information that should be provided in the Compensation Discussion & Analysis (CD&A), if material, a public company's equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership) and any policies regarding hedging the economic risk of such ownership. Issuers subject to this requirement (*i.e.*, public companies other than smaller reporting companies, emerging growth companies, registered investment companies and foreign private issuers) often address their hedging policies in their CD&A disclosure. To reduce potentially duplicative disclosure, the proposed rule would allow public companies to satisfy this CD&A obligation by cross referencing to the information disclosed under Section 955 (provided that such information is presented in a manner that also satisfies this CD&A disclosure requirement). The proposed rule would be in addition to other existing proxy disclosure rules that address hedging transactions. The purchase and sale of derivative securities by officers and directors would continue to be subject to reporting under Section 16(a) of the Exchange Act within two business days on SEC Form 4. Pledges of the underlying company equity securities as collateral would also be subject to disclosure in the beneficial ownership table under Item 403.

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Appendix: The SEC's Request for Comment

1. Should the disclosure required by Section 14(j) be implemented by amending the corporate governance disclosures required by Item 407, as proposed? Alternatively, should it be implemented by amending the Item 402 executive compensation disclosure requirements? Are there advantages or disadvantages to requiring these disclosures under Item 402? If so, please explain why.

2. Should the scope of the proposed Item 407(i) disclosure requirement cover transactions that are not expressly listed in Exchange Act Section 14(j) but have economic consequences comparable to the purchase of the financial instruments specifically identified in Section 14(j), as proposed? If not, why not?

3. Should the scope of transactions covered by proposed Item 407(i) be clarified? We are of the view that there is a meaningful distinction between an index that includes a broad range of equity securities, one component of which is company equity securities, and a financial instrument, even one nominally based on a broad index, designed to or having the effect of hedging the economic exposure to company equity securities. Should we clarify the application of Item 407(i) to account for this situation? If so, how? For example, if an issuer prohibited hedging generally, but permitted the purchase of broad-based indices, should we specify that the issuer could nonetheless disclose that it prohibits all hedging transactions? Should the rule explicitly distinguish between instruments that provide exposure to a broad range of issuers or securities and those that are designed to hedge particular securities or have that effect? Would a principles-based or numerical threshold approach be most helpful in this regard? If not, what other clarification should be provided?

4. If a company prohibits some, but not all, of the categories of transactions described in the proposed amendment, in order to fully describe what hedging transactions are permitted and by whom, is it necessary to require disclosure, as proposed, of both the categories of transactions that are permitted and the categories of transactions that are prohibited? If not, please explain why not. Does proposed Instruction 3 to Item 407(i) provide a way for companies that permit or prohibit only certain covered transactions to disclose this information in a clear and effective manner? Alternatively, should the company simply be required to describe its policy, if any, without further elaboration?

5. A company that permits hedging transactions would be required to disclose sufficient detail to explain the scope of such permitted transactions. For example, a company may permit hedging transactions only if pre-approved, or only after the company's stock ownership guidelines have been met. Should proposed Instruction 4 be more specific about the types of details, such as a pre-approval requirement, that the company must disclose?

6. Does our proposal to define the term "equity securities" as equity securities of the company or any of its parents, subsidiaries or subsidiaries of its parents that are registered under Exchange Act Section 12 appropriately capture the disclosure that shareholders would find useful? Should the Commission limit the term "equity securities" to only equity securities of the company? If so, please explain why and the costs and benefits that would result. How often are directors and employees compensated through equity securities of an affiliated company that are not registered under Section 12(b) of the Exchange Act? If the definition of equity securities includes only equity securities registered under Section 12(b) of the Exchange Act, would that affect either compensation structure or corporate structure? Do companies typically have policies addressing hedging of equity securities of their parents, subsidiaries or subsidiaries of their parents? What would be the costs and benefits of disclosing whether hedging the equity securities of these affiliates is permitted or prohibited? Would any ongoing compliance efforts be different? If so, please explain why and the costs and benefits that would result.

7. Should the proposed definition be broadened to include equity securities that are not registered under Exchange Act Section 12 or narrowed to only include equity securities registered under Section 12(b) of the Exchange Act? If so, explain why and the costs and benefits that would result. Alternatively, should the proposed definition be revised to exclude equity securities that do not trade in an established public market? If so, how would

"established public market" be defined? To the extent the amendment applies to equity securities that do not trade on an established public market, should we provide guidance about how to interpret "market value" for purposes of the proposed amendment? In either case, please explain why, and what costs and benefits would result from the recommended change.

8. Should we define "parent" and "subsidiary" specifically for purposes of this disclosure requirement? The definition of "parent" of a person in the Exchange Act Rules is an affiliate controlling such person directly, or indirectly through one or more intermediaries. Similarly, the Exchange Act Rules definition of "subsidiary" of a person is an affiliate controlled by such person directly, or indirectly through one or more intermediaries. Will these definitions, in the context of hedging disclosure, present any implementation challenges in determining what needs to be disclosed? Should we consider an alternative term, or alternative definition of "parent" for this disclosure requirement, such as an affiliate that owns a majority of the voting securities in the company? Similarly, with respect to subsidiaries, should we consider an alternative term, or alternative definition of "subsidiary" for this disclosure requirement, such as a majority-owned subsidiary, wholly owned subsidiary, consolidated subsidiary or significant subsidiary? In each case, please explain why, and what costs and benefits would result from the recommended change.

9. Section 14(j) does not define the circumstances in which equity securities are "held, directly or indirectly" by an employee or director. Is the concept of "held, directly or indirectly" unclear, such that we should provide more certainty about what is meant by the phrase? If so, how should we clarify it? Section 14(j) also does not define who is a "designee," nor is this term otherwise defined in the rules under the Securities Act or the Exchange Act. One commenter has recommended that the Commission define the term "designee." Should the proposed amendment include an instruction clarifying who is a "designee"? If so, please explain how this term should be defined, and the costs and benefits that would result.

10. Section 14(j) is directed to "any employee," and we interpret that to mean anyone employed by the issuer. Should we limit the definition of "employee" to the subset of employees that participate in making or shaping key operating or strategic decisions that influence the company's stock price? Why or why not? If so, how would that distinction be defined for practical purposes? Alternatively, should we add an express materiality condition to the definition, as is the case under CD&A, to permit each issuer to determine whether disclosure about all its employees would be material information for its investors? Why or why not?

11. Should the amendment define "hedge"? If so, what concepts other than the statutory reference to "offset[ting] any decrease in the market value of equity securities" would be necessary to define this term?

12. One commenter has recommended that the Commission "should not only require disclosure of whether hedging is permitted, but should also require disclosure of any hedging that has occurred—both in promptly filed Form 4 filings and in the annual proxy statement." Should the Commission require such disclosure in the final rule for those already subject to Form 4 reporting requirements?

13. Should Item 407(i) disclosure be required whenever action is taken with respect to the election of directors, as proposed? Instead, should we require disclosure in any proxy or information statement relating to an annual meeting of shareholders, irrespective of whether directors are to be elected at that meeting? Should the disclosure be limited only to annual meetings, and not special meetings, even if directors are to be elected at a special meeting?

14. Should proposed Item 407(i) disclosure also be required in Securities Act and Exchange Act registration statements? Should it be required in Exchange Act annual reports on Form 10-K? Would such information be material to investors in any of those contexts?

15. To retain consistency in the corporate governance disclosure provided in proxy statements and information statements with respect to the election of directors, Item 407(i) disclosure as proposed would apply to Schedule 14C as well as Schedule 14A. Is there any reason that the proposed Item 407(i) disclosure should be limited to issuers that are soliciting proxies? Why or why not?

16. In addition to including the new disclosure requirement, the proposed amendment to Item 7 of Schedule 14A would amend this Item to more succinctly organize its current provisions without changing the substance. As so revised, would the requirements of Item 7 be easier to understand? Alternatively, should we retain the current structure of Item 7, with the addition of the Item 407(i) disclosure?
17. We propose to amend the CD&A requirement of Item 402(b) of Regulation S-K to add an instruction providing that the obligation under that item requirement to disclose material policies on hedging by named executive officers in a proxy or information statement with respect to the election of directors may be satisfied by a cross reference to the Item 407(i) disclosure in that document to the extent that the information disclosed there satisfies this CD&A disclosure requirement. Is there an alternative way to avoid possibly duplicative hedging disclosure in these proxy and information statements?
18. Is there a better way to align the requirements of Item 402(b) of Regulation S-K and proposed Item 407(i) of Regulation S-K? Are there circumstances in which the current CD&A requirement in Item 402(b) of Regulation S-K would result in more complete disclosure about the company's hedging policies than what would be required under proposed Item 407(i)? For example, although Section 14(j) addresses only hedging of equity securities, would disclosure of employees' and directors' ability to hedge other securities further the statutory purpose? In this regard, should we expand the proposed disclosure in Item 407(i) to include debt securities?
19. We request comment on all aspects of the proposed disclosure requirements as applied to funds, including whether all funds or additional types of funds other than listed closed-end funds should be required to provide the proposed disclosure. Should we require all funds, including mutual funds and ETFs, to provide the proposed disclosure? Should we, instead, require different specific types of funds to provide the proposed disclosure? For example, should we require ETFs to provide the proposed disclosure? Would shareholders in mutual funds, ETFs or other types of funds benefit from the information provided by the proposed disclosure?
20. If we were to require additional types of funds to provide the proposed disclosure, why and how, if at all, should we modify the disclosure requirements for such funds? As noted above, some ETFs are organized as UITs, which do not have boards of directors, and ETFs generally do not hold annual meetings of shareholders. How should any disclosure under Section 14(j) accommodate these or other characteristics of ETFs if we were to require ETFs to provide the proposed disclosure?
21. Are there additional characteristics of funds that we should consider in determining which funds should be required to provide the proposed disclosure or whether the disclosure requirements should be modified for funds or particular types of funds? If we were to require some or all funds to provide the proposed disclosure, including listed closed-end funds as proposed, what are the benefits and costs expected to result?
22. Should we modify the Item 407(i) disclosure requirements for listed closed-end funds? Would this information be material to an investor in contexts other than those relating to voting decisions, such as an investment decision? Should we also require the disclosure in listed closed-end funds' other disclosure documents, such as an annual report or shareholder report next following a meeting of shareholders, for example? If we were to require all funds or a broader group of funds to provide Item 407(i) disclosure, should we also require the disclosure in other disclosure documents, such as the funds' Statements of Additional Information?
23. As proposed, listed closed-end funds would be required to provide proposed Item 407(i) disclosure. Should we not require listed closed-end funds to provide this disclosure? If so, please explain why, and the benefits and costs that would result.
24. Do funds generally have policies concerning their employees and directors engaging in hedging transactions of securities issued by their respective funds, or policies that prohibit such hedging transactions? To what extent do employees or directors of listed closed-end funds receive shares of such funds as a form of compensation? Do employees or directors of listed closed-end funds currently effect hedging transactions with respect to the

shares of those funds and, if so, what kinds of transactions do they effect?

25. How could employees or directors effect hedging transactions with respect to shares of funds other than listed closed-end funds, in particular mutual funds? How prevalent are these hedging transactions?

26. As proposed, listed closed-end funds, like the other issuers covered by the proposed amendments, would be required to provide disclosure concerning hedging of the equity securities issued by the fund or any of the fund's parents, subsidiaries or subsidiaries of the fund's parents that are registered under Section 12 of the Exchange Act. Should we instead require listed closed-end funds to provide disclosure only about hedging transactions concerning the funds' shares? Would investors in listed closed-end funds benefit from receiving information about the funds' directors' and employees' holdings of the funds' parents, subsidiaries or subsidiaries of the fund's parents?

27. As proposed, business development companies would be required to provide proposed Item 407(i) disclosure. Should we modify the disclosure requirements for business development companies? Should we not require business development companies to provide this disclosure? If so, please explain why, and the benefits and costs that would result. Should we only require a business development company to provide the proposed disclosure if the business development company's shares are listed on a national securities exchange?

28. Should smaller reporting companies or emerging growth companies be exempted from proposed Item 407(i) or subject to a delayed implementation schedule? If so, please explain why and the benefits and costs that would result. As discussed below, a component of the disclosure costs (especially initial costs) may be fixed, which may have a greater impact on smaller reporting companies and emerging growth companies. Do the proposed disclosure requirements also impose other potential costs on smaller reporting companies or emerging growth companies that are different in kind or degree from those imposed on other companies? Would the proposed disclosure requirements be as meaningful for investors in smaller reporting companies and emerging growth companies as for those in other companies? Do investors in smaller reporting companies and emerging growth companies place more, less or the same value on corporate governance disclosures of the type proposed here than do investors in larger, more established companies, either alone or in relation to other disclosures?

29. Should foreign private issuers be required to provide the disclosure? If so, please explain why and specify the filing(s) in which the disclosure should be required.

30. Are there any other categories of issuers that should be exempt from the requirement to provide Item 407(i) disclosure? If so, please explain why, and the benefits and costs that would result.

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