SEC Adopts Final Rules for Disclosure of Hedging Policies

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Overview

The U.S. Securities and Exchange Commission (the "SEC") approved a final rule[1] on December 18, 2018 implementing Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The new rule will require a public company to disclose whether, and to what extent, it has adopted practices or policies regarding the ability of employees, officers, and directors to engage in certain hedging transactions with respect to the company's equity securities. Below is a summary of the new rule, a discussion regarding its interplay with existing Compensation Discussion and Analysis ("CD&A") disclosure requirements, and an analysis of the potential situations where hedge funds or other investors who have a designee sitting on a public company Board could be impacted.

Summary of the Final Rule for Disclosure of Hedging Policies

The new rule adds a new paragraph, Item 407(i), to the existing corporate governance requirements in Item 407 of Reg S-K. Pursuant to the new rule, the company must, in any proxy statement or information statement related to the election of directors, disclose any practices or policies it has adopted regarding the ability of its employees, 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. A company may disclose any hedging practices or policies in full, or provide a fair and accurate summary of those practices and policies, including the categories of persons covered and any particular types of hedging transactions the company explicitly permits or prohibits. The rule does not require companies to adopt any such hedging policies, or require any particular content in such policies. If a company has not adopted any hedging practices or policies, it must affirmatively disclose that fact or state that hedging transactions are generally permitted.

1 At: https://www.sec.gov/rules/final/2018/33-10593.pdf.

Issuers Covered. All U.S. public companies, including emerging growth companies ("EGCs"), smaller reporting companies ("SRCs") and business development companies, are subject to the new rule, although EGCs and SRCs have additional time to comply (as described below under "*Timing of Implementation*"). Foreign private issuers, mutual funds, closed-end funds and exchange-traded funds are not subject to the new rule.

Categories of Persons Covered. The rule requires a company to describe the hedging policies and practices applicable to its employees, officers or directors, or any of their "designees." The SEC did not provide a definition of "designee" or guidance on whom would be considered a designee beyond noting that it depends on the particular facts and circumstances involved. Some commentators on the proposed hedging rules release suggested that the SEC define the term "designee." For example, one comment letter recommended defining "designee" to include immediate family members and family or affiliated investment vehicles. Another comment letter recommended defining "designee" as someone specifically appointed to make decisions that the authorizing person would reasonably believe could result in the hedging of equity securities the person beneficially owned. However, the SEC declined to adopt any definition or offer any specific guidance on this topic and explained that each company would determine the scope of who is covered in its own hedging practices and policies.

Hedging Transactions Covered. The rule applies to the purchase of financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) or other transactions that hedge or offset, or are designed to hedge or offset, any decrease in market value of the covered equity security. Covered equity securities include equity securities issued by the company, any parent or subsidiary of the company, or any subsidiary of the parent of the company. The SEC did not define the term "hedge," but the SEC's release indicates that such term should be viewed broadly.

Location of Disclosure. The new disclosure is required in any proxy statement or information statement if action is to be taken with respect to the election of directors, but is not required in registration statements. The new hedging disclosures will not be deemed incorporated by reference into any Securities Act or Exchange Act filings, unless the company specifically incorporates it by reference.

Timing of Implementation. The rule goes into effect for proxy statements and information statements related to the election of directors during the fiscal year beginning on or after July 1, 2019. For example, for calendar-year end companies, this means the new hedging disclosure should be included in the annual proxy statement or information statement filed in 2020. EGCs and SRCs have an additional year before compliance is required (*i.e.*, for calendar-year end companies, the new disclosure should be included in the proxy statement or information statement filed in 2021).

Expansion of Existing Compensation Disclosure & Analysis Disclosure

Currently, Item 402(b) of Reg S-K requires disclosure in the CD&A of any policies on hedging by named executive officers ("NEOs"), if material. The rule amends Item 402(b) by adding an instruction that would allow companies to eliminate potentially duplicative disclosure. For example, a company may satisfy its Item 402(b) CD&A disclosure requirements by cross-referencing the new Item 407(i) disclosure if the new disclosure meets the Item 402(b) requirements.

Furthermore, the new Item 407(i) disclosure is broader than the existing Item 402(b) because Item 407(i) covers the policies that apply to all employees, directors and officers, rather than just NEOs. Additionally, EGCs and SRCs are not subject to the Item 402(b) CD&A hedging disclosure but will be subject to the new hedging disclosure rule.

Implications for Companies with an Investor-Designated Director on Its Board

The main intention of the new rule is to provide disclosure on whether employees, officers and directors are allowed to engage in hedging transactions that are designed to mitigate or offset the risks inherent with equity ownership of a company's securities. Indeed, it does not require companies to have practices or policies regarding hedging, or dictate the content of any such practice or policy. Moreover, if a company does not have any practice or policy in place, it must state that fact or state that it generally permits hedging transactions. Therefore, it is likely that the new disclosure requirement will encourage companies to adopt a hedging policy that is applicable to directors in order to avoid making a disclosure that they lack such a policy or generally permit hedging. This is particularly true for EGCs and SRCs given that they are not subject to Item 402(b) and thus, may be less likely to currently have hedging policies in place.

Companies who decide to adopt or amend anti-hedging or anti-pledging policies should carefully consider the full implications of these policies and give careful consideration to whom these policies apply. If policies are drafted broadly, they could potentially cover transactions made by hedge funds or other investors that have appointed a director to the Board. These types of large financial investors often engage in ordinary course trading activities or customary margin transactions that could inadvertently become subject to the anti-hedging or anti-pledging policies. If a company's anti-hedging or anti-pledging policy does apply to a designating investor, such investor may seek a waiver to the application of these policies as they relate to such ordinary course transactions. For example, if a director is appointed to a Board pursuant to a settlement agreement with an investor, the designating investor may seek to include a provision in the settlement agreement exempting the designating investor from certain anti-hedging or anti-pledging restrictions. Furthermore, if an investor-nominated director is elected to the Board at a shareholder meeting, the nominating investor could seek to negotiate an adequate waiver from the anti-hedging or anti-pledging policy concurrently with commencement of the designee's Board service. The new rule does not specifically require the company to disclose any waivers of the hedging policy though companies may elect to interpret the new rule broadly to require such disclosure.

The new rule does not impact the Section 16 requirements (on Forms 3, 4, and 5) and Section 13 requirements (on Schedules 13G and 13D) that continue to apply to investor-designated designees and the designating investors. The SEC noted in the adopting release that some commenters supported disclosure of any hedging transactions that have occurred. The SEC declined to make the disclosure of actual hedges as a part of the final rule because it believed such disclosure would be largely duplicative of the existing Section 16 reporting requirements.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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