Simpson Thacher

Memorandum

SEC Proposes Rules Regarding Disclosure of Corporate Hedging Policies

February 13, 2015

On February 9, 2015, the Securities and Exchange Commission ("SEC") issued proposed rule amendments to implement the Dodd-Frank Act requirement that each issuer disclose in any proxy or consent solicitation material for an annual meeting whether any employee or director, or any designee thereof, "is permitted to purchase 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 either (1) granted to the employee or director by the issuer as part of the compensation of the employee or director; or (2) held, directly or indirectly, by the employee or director."[1] This disclosure requirement, which the Dodd-Frank Act added as Section 14(j) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), is intended "to provide transparency to shareholders, if action is to be taken with respect to the election of directors, about whether employees or directors are permitted to engage in transactions that mitigate or avoid the incentive alignment associated with equity ownership."

Viewing the statutory purpose of Section 14(j) as "primarily corporate governance-related," the SEC proposes to add the hedging disclosure requirement to Item 407 of Regulation S-K in order to "keep disclosure requirements relating to corporate governance matters together." Proposed new Item 407(i) and the instructions thereto would codify the details regarding the scope and application of the disclosure requirement.

[1] *Disclosure of Hedging by Employees, Officers and Directors*, Release No. 33-9723; 34-74232; File No. S7-01-15 (Feb. 9, 2015), at 5 (quoting §14(j) of the Securities Exchange Act of 1934). Neither the Dodd-Frank Act requirement nor the SEC's proposed rule amendments "would require a company to prohibit hedging transactions or to otherwise adopt practices or a policy addressing hedging by any category of individuals." *Id.* at 6.

- **Transactions Subject to the Disclosure Requirement.** In addition to disclosure of the financial instruments explicitly enumerated in Section 14(j), proposed Item 407(i) would require "disclosure of transactions with economic consequences comparable to the purchase of the specified financial instruments." The SEC explains that "[i]n order for the disclosure to be complete and to avoid discouraging or promoting the use of particular hedging transactions, [the SEC's] proposed amendment would require disclosure of whether an issuer permits other types of transactions" that, like the instruments specifically identified in Section 14(j), "are designed to or have the effect of hedging or offsetting any decrease in the market value of equity securities."
- **Content of the Required Disclosure.** The SEC proposes several instructions to Item 407(i) to provide substantive guidance regarding the required hedging disclosure.
    - In order for the disclosure to convey "a complete understanding of the scope of hedging at the company," a proposed instruction would direct companies to disclose those categories of hedging transactions it permits, as well as those categories of transactions it prohibits. The proposed instruction, however, would allow a company to disclose the categories of transactions it specifically prohibits and disclose that it permits all other hedging transactions, or vice versa. In addition, under the proposed instruction, "[i]f a company does not permit any hedging transactions, or permits all hedging transactions," it can so state, without having to describe the transactions by category.
    - The SEC proposes to instruct companies permitting hedging transactions "to disclose sufficient detail to explain the scope of such permitted transactions."
    - Under the proposed instructions, "[i]f a company permits some, but not all, of the categories of persons covered by the proposed amendment to engage in hedging transactions, the company would disclose both the categories of persons who are permitted to hedge and those who are not."
- **Definition of "Equity Securities".** The SEC proposes an instruction to clarify that, as used in proposed Item 407(i), the term "equity securities" means "any equity securities (as defined in Exchange Act Section 3(a)(11) and Exchange Act Rule 3a11-1) issued by the company, any parent of the company, any subsidiary of the company or any subsidiary of any parent of the company that are registered under Section 12 of the Exchange Act." The SEC reasons that equity securities registered under Section 12 "are more likely to be readily traded, and more easily hedged." Additionally, since the broad language of Section 14(j) could imply that the disclosure requirement applies with respect to equity securities of *any* company that are held by an employee or director, the SEC's proposed definition purposely limits the term "equity securities" to those "issued by the company, its parents, subsidiaries or subsidiaries of the company's parents that are registered under Exchange Act Section 12"; according to the SEC, this narrower reading of "equity securities" would provide shareholders with relevant information about corporate policies affecting the alignment of interests between the companies' employees/directors and its shareholders.

- **Persons Covered by the Disclosure Requirement.** Under Section 14(j), disclosure of company policies on hedging transactions is required with regard to any employee or member of the board of directors or any of their designees. The SEC believes that the term "employee" should "include everyone employed by an issuer, including its officers" and proposes to specify this in Item 407(i).
- **Location of the Disclosure.**
    - **Proxy or Consent Solicitation Material Pertaining to Election of Directors.** The SEC proposes to require disclosure of hedging transactions – like other corporate governance-related disclosures required by Item 407 – in proxy solicitation material with respect to the election of directors, "without regard to whether at an annual or special meeting of shareholders or in connection with an action authorized by written consent." The SEC reasons that the information required under proposed Item 407(i) is "most relevant to shareholders if action is to be taken with respect to the election of directors."[2]
    - **Schedule 14C Filings.** The SEC believes that proposed Item 407(i)'s hedging disclosures should also be included in information statements filed on Schedule 14C. Item 1 of Schedule 14C provides that with limited exceptions, the information statement "must include the information called for by all of the items of Schedule 14A to the extent each item would be applicable to any matter to be acted upon at a meeting if proxies were to be solicited." The SEC believes that applying the proposed disclosure obligation to Schedule 14C filings "would retain consistency in the corporate governance disclosure provided in proxy statements and information statements with respect to the election of directors." Accordingly, the SEC is not proposing to exclude proposed Item 407(i) disclosure from Schedule 14C.
    - **Cross-References in Compensation Discussion & Analysis ("CD&A").** Under Item 402(b) of Regulation S-K, CD&A calls for disclosure of material policies of the registrant regarding named executive officers' hedging of economic risk of their company securities ownership. In the interest of avoiding duplicative disclosure, the SEC proposes "to amend Item 402(b) of Regulation S-K to add an instruction providing that a company may satisfy its CD&A obligation to disclose material policies on hedging by named executive officers by cross referencing the information disclosed pursuant to proposed Item 407(i) to the extent that the information disclosed there satisfies this CD&A disclosure requirement."
- **Issuers Subject to the Disclosure Requirement.** The SEC proposes to require Item 407(i) disclosure to apply to:

[2] For the same reason, the SEC does not propose to require Item 407(i) disclosure in Securities Act or Exchange Act registration statements or in Forms 10-K.

- closed-end investment companies that have shares listed and registered on a national securities exchange[3];
- smaller reporting companies; and
- emerging growth companies.

However, under the SEC's proposed rule release, foreign private issuers would not be subject to Item 407(i)'s disclosure obligations.

The SEC set a 60-day period for public comment on its proposed rule amendments.

Joint Statement of SEC Commissioners Gallagher and Piwowar on the Proposed Rule

On the same day the SEC's proposed rule was released, SEC Commissioners Daniel M. Gallagher and Michael S. Piwowar issued a joint statement, indicating that while they "ultimately voted to support" the proposal, they "remain quite concerned by several aspects of the proposal," on which they hope to receive "robust public comment."[4]

- **Application to Emerging Growth Companies ("EGCs") and Smaller Reporting Companies ("SRCs").** Commissioners Gallagher and Piwowar questioned the SEC's conclusion – which they stated was "based on little empirical data" – that the cost of disclosure to EGCs and SRCs "is likely to be minimal, and that investors in EGCs and SRCs may receive benefits from the rule." The two Commissioners highlighted that "the release does not analyze whether the incremental cost of this disclosure, when added to the already-substantial cumulative burdens of disclosure, may have negative effects on capital formation." In addition, Commissioners Gallagher and Piwowar posited whether "investors in these smaller companies, who may care more deeply about the company's ideas or growth prospects, would experience the same benefits as investors in larger companies." Because it is uncertain whether the benefits of the disclosure requirement justify the costs imposed on EGCs and SRCs, the two Commissioners opined that the SEC "should have proposed exempting them."
- **Application to Investment Companies.** Commissioners Gallagher and Piwowar noted that they would not have included listed closed-end funds within the scope of the rule. According to these Commissioners: (1) it is uncommon for fund directors to hold shares of their listed closed-end funds; (2) since "investment companies are overwhelmingly externally managed, there is very little employee hedging that would be subject to the rule"; and (3) directors have "limited control" over the investment advisers that manage these funds. Therefore, Commissioners Gallagher and Piwowar concluded that the utility of the disclosure rule as it pertains to investment companies is "questionable."

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[3] Item 407(i)'s disclosure requirements would not apply to investment companies registered under the Investment Company Act of 1940 that are not listed closed-end funds.

[4] Commissioners Daniel M. Gallagher and Michael S. Piwowar, "Joint Statement on the Commission's Proposed Rule on Hedging Disclosures" (Feb. 9, 2015).

- **Application to Employees Who Cannot Affect the Company's Share Price.** Commissioners Gallagher and Piwowar believe that the SEC "should have exercised its statutorily-granted exemptive authority to exempt from the rule disclosures relating to employees that cannot affect the company's share price." The two Commissioners explained that legislative history and their own economic analysis indicate that disclosures regarding hedging policies with respect to such employees "fall below the level of information that investors would find useful" and thus "risk harming investors through disclosure overload."
- **Application to Securities of An Issuer's Affiliates.** Commissioners Gallagher and Piwowar opined that the proposed release's coverage of securities of subsidiaries, parents and brother-sister companies of the issuer is "overbroad." The two Commissioners expressed concern that the release's definition of "equity securities" would "require registrants to engage in a complex, facts-and-circumstances control analysis to determine who is covered by the proposed disclosure requirement," which would raise the cost of disclosure.
- **The SEC's Priorities.** Aside from commenting on the scope of the proposed rule, Commissioners Gallagher and Piwowar expressed their view that the SEC's release "reflects a prioritization of the Commission's work that [they] do not share." With regard to implementing Dodd-Frank Act requirements, Commissioners Gallagher and Piwowar opined that the SEC should concentrate its efforts on "those rules actually germane to the financial crisis – e.g., credit ratings reference removal, or Title VII [Wall Street Transparency and Accountability]." The two Commissioners further noted that a singular focus on Dodd-Frank implementation "also neglects other important priorities stemming from the rest of the federal securities laws," such as the Division of Corporation Finance's comprehensive disclosure review.

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