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SEC Adopts New Hedging Disclosure Rules

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Capital Markets and Securities

On December 18, 2018, the Securities and Exchange Commission (the "SEC") announced that it had adopted final rules[1] implementing a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") requiring public companies to make certain disclosures regarding their hedging policies and practices.[2] New Item 407(i) of Regulation S-K will require most public companies to disclose this information in proxy and information statements relating to the election of directors during fiscal years beginning on or after July 1, 2019. Smaller reporting companies and emerging growth companies will not be required to comply with the rule until fiscal years beginning on or after July 1, 2020.

The new rule, which was proposed in February 2015[3], will require a company to disclose its practices or policies, whether written or not, regarding the ability of its 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, decreases in the market value of the company's equity securities granted as compensation or held directly or indirectly by the employee or director. The rule covers equity securities of the company, as well as equity securities of its subsidiaries, parents, and any subsidiary of any parent of the company.

The description required by the new rule must either provide a fair and accurate summary of the practices or policies that apply, including the categories of persons covered, or disclose the practices or policies in full. The required disclosure must also describe any categories of hedging transactions that are specifically permitted or disallowed. If the company does not have any practices or policies regarding hedging, the company must either disclose that fact or state that hedging transactions are generally permitted.

As the adopting release notes, the SEC's rules already require certain hedging policy disclosures. For example, companies must include in their Compensation Discussion & Analysis ("CD&A") a description of policies regarding hedging the risk of equity ownership, if such policies are material to an understanding of the company's compensation policies and decisions

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[1] https://www.sec.gov/news/press-release/2018-291

[2] In its adopting release, the SEC said that it inferred the statutory purpose of Section 14(j), added to the Securities Exchange Act of 1934 by Dodd-Frank, "is to provide transparency to shareholders at the time of an annual meeting, which is when directors are elected, about whether a company's employees or directors may engage in transactions that reduce or avoid the incentive alignment associated with equity ownership related to their employment or board service."

[3] For a discussion of the proposed rule, please see our prior article, available at: https://www.insidecompensation.com/2015/02/10/sec-hedging-disclosure-proposal-could-cause-companies-to-review-trading-policies/

related to their named executive officers.[4] The new rules add an instruction to Item 402(b) of Regulation S-K to make clear that if the information disclosed pursuant to new Item 407(i) would satisfy the CD&A disclosure obligation, the company may simply refer to such information in the CD&A.

Although public companies are not required to comply with Item 407(i) of Regulation S-K until fiscal years beginning on or after July 1, 2019 at the earliest, public companies should review their existing policies and practices regarding hedging to determine whether any modifications to such policies should be considered. For example, if a company's hedging policy does not explicitly cover all employees, the company should consider revising the policy to expand its scope of coverage; if it does not do so, Item 407(i) will require the company to describe the categories of employees covered by the policy. Similarly, because the disclosure requirement refers to the hedging of equity securities held "directly or indirectly," companies may wish to ensure that their policies employ similar language, so as to avoid having to disclose a "gap" in the policy's coverage for shares not held directly. Finally, it is important to note that the SEC has made clear that the new rule does not require companies to adopt policies that prohibit or limit hedging. Of course, companies that do not have such policies will now have to disclose such fact, which may encourage some companies to adopt hedging policies.

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[4] Regulation S-K Item 402(b)(2)(xiii)