SULLIVAN & CROMWELL LLP

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SEC Adopts Disclosure Rules on Hedging Policies

Requires Description of any Hedging Policies or Practices Adopted, Not Specified Transactions; Will Apply to Most Companies Beginning in 2020

SUMMARY

On December 18, 2018, the SEC adopted rules requiring disclosure of policies and practices regarding hedging for directors, officers and employees of U.S. public companies. These rules require public companies to describe, in any proxy or information statement relating to director elections, any practices or policies they have adopted regarding the ability of its directors, officers or employees to engage in transactions that hedge or offset, or are designed to hedge or offset, any decrease in the market value of equity securities of the public company or its affiliates. The rules cover both equity securities granted as part of compensation and those otherwise held directly or indirectly.

The final rules do not require any company to prohibit hedging transactions or to otherwise adopt hedging policies and do not require disclosure of any particular hedging transactions.

These rules will generally apply to proxy and information statements with respect to the election of directors during fiscal years beginning on or after July 1, 2019, although there is a one-year transition period for emerging growth companies and smaller reporting companies.

BACKGROUND

Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act added a new Section 14(j) to the Securities Exchange Act of 1934 that requires annual meeting proxy statement disclosure of whether employees or directors are permitted to engage in transactions to hedge or offset any decrease in the

market value of the equity securities granted as compensation to, or held directly or indirectly by, the employee or director.

In February 2015, the SEC proposed rules to implement Section 14(j).[1] Although the SEC voted unanimously for the proposed rules, two then-sitting Commissioners, Commissioners Gallagher and Piwowar, issued a separate public statement voicing concern over certain aspects of the proposed rules, including the reporting burden on emerging growth companies and smaller reporting companies, the utility of requiring disclosure of policies applied to employees that cannot affect share price, the utility of requiring disclosure from listed closed-end funds and the cost of determining which securities are covered. On December 18, 2018, the SEC adopted final rules to implement Section 14(j).[2] The SEC published the text of the final rules on December 20, 2018, two days after they were adopted.

In addition to the hedging disclosure rules, proxy disclosure regarding hedging policies may also be required (1) with respect to named executive officers as a potential material consideration to be discussed in the Compensation Discussion and Analysis ("CD&A") pursuant to Item 402(b) of Regulation S-K and (2) for specific transactions by executive officers and directors on Form 4, to the extent that a hedging transaction qualifies as a derivative security under Section 16 of the Exchange Act.

DISCUSSION OF FINAL RULES

The final rules add a new paragraph (i) to Item 407 of Regulation S-K requiring that a company provide hedging disclosure in a proxy statement or consent solicitation, or an information statement under Schedule 14C, when action is to be taken with respect to the election of directors.

Required Disclosure. The final rules require the company to describe any practices or policies, whether or not in writing, that it has adopted regarding the ability of its directors, officers or employees to hedge or offset a decrease in the market value of the company's equity securities. Such description must either disclose the practices and policies in full or provide a "fair and accurate summary" of the practices and policies, including the categories of people covered and any categories of hedging transactions that are specifically permitted or disallowed. Companies that do not have any such practices or policies are required to disclose either that they do not have any hedging practices or policies or that they generally permit hedging transactions. The proposed rules would have required each company to disclose which categories

[1] The proposing release, Release No. 33-9723; 34-74232; IC-31450 is available at https://www.sec.gov/rules/proposed/2015/33-9723.pdf. *See* our publication, dated February 10, 2015, entitled "SEC Proposes Disclosure Rules on Hedging Policies" for a discussion of the proposing release.

[2] The adopting release, Release No. 33-10593; 34-84883; IC-33333 is available at https://www.sec.gov/rules/final/2018/33-10593.pdf.

of hedging transactions were permitted and which were prohibited, and the categories of persons permitted to engage in hedging transactions and those who are not.

Covered Hedging Transactions. Like the proposed rules, the final rules do not define the term "hedge" or provide a comprehensive list of hedging transactions for which the company would need to provide disclosure. Rather, the rules take a principles-based approach and in effect cover all transactions that establish downside price protection. Namely, the final rules cover the purchase of financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) and other transactions that hedge or offset any decrease in the market value of equity securities. The SEC noted that this ensures that the rules are sufficiently flexible to address new downside price protection techniques that may develop. In response to comments that the language could be far reaching and pick up portfolio diversification, broad-based index or similar transactions, the SEC noted these concerns are alleviated by requiring disclosure of any practice or policy the company has adopted regarding these types of transactions. For example, a company would only need to describe portfolio diversification or broad-based index transactions if its hedging policy or practice addresses them.

Covered Securities. Disclosure is required with respect to equity securities issued by the company, any of its parents, any of its subsidiaries or any subsidiary of any of its parents, regardless of whether the securities are compensatory grants or other holdings. The final rules, like the proposed rules and the statute, reference both securities granted to the director, officer or employee as compensation and securities otherwise held, directly or indirectly, by the director, officer or employee.

Covered Individuals. The final rules apply to employees, officers and directors and any of their designees. If the company's disclosure takes the form of a "fair and accurate summary" of the hedging policies and practices, the summary must include the categories of people covered. The final rules, like the proposed rules, state that whether someone is a "designee" depends on the particular facts and circumstances involved. In response to comments requesting guidance on who constitutes a designee, the SEC noted that no further guidance is necessary since Item 407(i) requires disclosure of a company's practices and policies and the company determines who is covered by the scope of its practices and policies.

Covered Companies. Because the final rules are effected through proxy disclosure, they do not apply to foreign private issuers, which are exempt from the U.S. proxy rules. In addition, unlike the proposed rules, the final rules do not apply to any investment companies registered under the Investment Company Act of 1940 (including closed-end investment companies). The final rules do apply to business development companies, as well as emerging growth companies and smaller reporting companies. However, as noted below, there is a transition period for emerging growth companies and smaller reporting companies.

Disclosure Location. Under the final rules, hedging disclosure is required in a proxy statement or consent solicitation, or an information statement under Schedule 14C, when action is to be taken with respect to the election of directors. This disclosure may be included within or separate from the CD&A. To avoid duplicative disclosure, the hedging disclosure rules amend the CD&A rules to specify that any CD&A disclosure regarding named executive officer hedging policies required by Item 402(b) of Regulation S-K could be satisfied by cross-reference to compliant disclosure under Item 407(i). Companies should note that incorporating the new 407(i) disclosure into the CD&A either directly or through a cross-reference would subject it to the company's advisory say-on-pay vote.

Timing. Companies will generally be required to provide Item 407(i) hedging disclosure in proxy and information statements with respect to the election of directors during fiscal years beginning on or after July 1, 2019 (meaning it will apply in 2020 for calendar year-end companies). However, emerging growth companies and smaller reporting companies have a one-year transition period and are required to comply with respect to fiscal years beginning on or after July 1, 2020 (meaning it will apply in 2021 for such calendar year-end companies).

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