

February 10, 2015

SEC Proposes Disclosure Rules on Hedging Policies

Will Not Affect 2015 Proxy Season; Requires Description of Hedging Policies, Not Specific Transactions

SUMMARY

Yesterday, the SEC proposed rules requiring disclosure of hedging policies for directors, officers and employees of U.S. public companies. These rules would require each public company to disclose, in any proxy or information statement relating to director elections, whether its directors, officers or employees are permitted to engage in transactions to hedge or offset any decrease in the market value of equity securities of the public company or its affiliates. The rules would cover both equity securities granted as part of compensation and those otherwise held directly or indirectly and would require disclosure of the categories of hedging transactions a public company permits and those it prohibits.

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

The proposal was approved unanimously by the SEC in private session, but the two Republican Commissioners issued a separate joint statement expressing concerns over the scope of the proposal. Comments are due 60 days after publication of the proposal in the Federal Register.

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 equity securities granted as compensation to, or held directly or

SULLIVAN & CROMWELL LLP

indirectly by, the employee or director. The proposed rules would implement Section 14(j). There is no deadline under the Dodd-Frank Act for adopting these rules.

Currently, proxy disclosure regarding hedging policies is limited to named executive officers and arises as an example of a potential material consideration to be discussed in the Compensation Discussion and Analysis (“CD&A”). In addition, to the extent a hedging transaction qualifies as a derivative security under Section 16 of the Exchange Act, specific transactions by executive officers and directors would be subject to disclosure on Form 4.

Hedging policies have received some attention from proxy advisory firms in recent years. In particular, Institutional Shareholder Services announced in its 2013 policy updates that it would recommend votes against incumbent directors if executives are permitted to engage in any hedging activities whatsoever.¹ Glass-Lewis’s policies regarding say-on-pay recommendations specify that companies should adopt strict policies to prohibit executives from hedging company stock.

DISCUSSION OF PROPOSED RULES

The proposed rules would add a new paragraph (i) to Item 407 of Regulation S-K requiring that a company disclose, in its proxy or information statement, whether it permits employees (including officers) or directors to hedge the company’s equity securities.²

Covered Hedging Transactions. The proposal does not provide a comprehensive list of hedging transactions for which the company would need to disclose its policy. Rather, the proposal takes a principles-based approach by covering all transactions with economic consequences comparable to the purchase of specified financial instruments, in effect covering all transactions that establish downside price protection.

A company would be required to disclose the categories of hedging transactions it permits and those it prohibits. The company could accomplish this by disclosing that it prohibits or permits particular categories and permits or prohibits, respectively, all other hedging transactions. A registrant that permits any form of hedging transaction must disclose sufficient detail to explain the scope of permitted transactions (e.g., only after pre-approval or satisfaction of stock ownership guidelines).

Covered Securities. The proposed disclosure requirements would apply to equity securities issued by the company and its parents, subsidiaries or subsidiaries of the company’s parents that are listed on a national securities exchange or registered under Exchange Act Section 12(g) regardless of whether the securities are compensatory grants or other holdings. The proposed rule, like the statute, references both

¹ For a discussion of ISS’s policy updates in this regard, see our publication, dated November 20, 2012, entitled “[ISS Finalizes 2013 Proxy Voting Updates](#)”.

² The proposing release, Release No. 33-9723; 34-74232; IC-31450, is available at <https://www.sec.gov/rules/proposed/2015/33-9723.pdf>.

SULLIVAN & CROMWELL LLP

securities granted to the employee or director as compensation and securities otherwise held, directly or indirectly, by the employee or director.

Covered Individuals. Proposed Item 407(i) would apply to employees, officers and directors and any of their designees. If hedging policies apply differently to different categories of individuals, the company would need to disclose this as well.

Covered Companies. The proposal would be effected through proxy disclosure, and therefore would not apply to foreign private issuers, which are exempt from the U.S. proxy rules. The proposed rules would apply to closed-end investment companies with shares that are listed on a national securities exchange but not to any other investment companies registered under the Investment Company Act of 1940. The proposal does not provide any exemption or delayed implementation for smaller reporting companies or emerging growth companies (and the absence of such relief was among the concerns raised by the two Republican Commissioners, as noted below).

Disclosure Location and Timing. The proposed disclosure would be 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. To avoid duplicative disclosure, the proposal would amend the CD&A rules to specify that the required CD&A disclosure regarding named executive officer hedging policies could be satisfied by cross-reference to compliant disclosure under proposed Item 407(i). There is currently no proposed effective date for the rule, but, given the timing of publication and request for comment, the proposed rules will not affect the 2015 proxy season.

CONCERNS RAISED BY COMMISSIONERS

Although the SEC voted unanimously for the proposed rules, Commissioners Gallagher and Piwowar issued a separate public statement voicing concern over certain aspects of the proposed rules.³ These Commissioners' concerns are:

- The reporting burden on smaller reporting companies and emerging growth companies, noting that it is uncertain whether there is a meaningful benefit to requiring these companies to disclose and that the proposed rules may potentially provide an unintended incentive for these companies to adopt policies on hedging
- The utility of requiring listed, closed-end funds to disclose, noting that hedging activity by employees and directors of these companies is believed to be uncommon
- The utility of requiring disclosure of hedging policies applied to employees that cannot affect share price, noting the risk of "disclosure overload" for investors

³ This statement, along with a separate supportive statement by Commissioner Aguilar, is available at <https://www.sec.gov/news/statements>.

SULLIVAN & CROMWELL LLP

- The cost associated with determining which parent, subsidiary or sister company securities are covered under the proposed rules, noting the particular challenges that complex corporate groups may face under the proposed facts-and-circumstances control analysis
- More generally, the use of limited SEC and staff resources on this rule-making initiative, given the other more pressing matters that remain uncompleted

* * *

SULLIVAN & CROMWELL LLP

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 800 lawyers on four continents, with four offices in the United States, including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Stefanie S. Trilling (+1-212-558-4752; trillings@sullcrom.com) in our New York office.

CONTACTS

New York

Robert E. Buckholz	+1-212-558-3876	buckholzr@sullcrom.com
Catherine M. Clarkin	+1-212-558-4175	clarkinc@sullcrom.com
Jay Clayton	+1-212-558-3445	claytonwj@sullcrom.com
Audra D. Cohen	+1-212-558-3275	cohen@nullcrom.com
H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Heather L. Coleman	+1-212-558-4600	colemanh@sullcrom.com
Donald R. Crawshaw	+1-212-558-4016	crawshawd@sullcrom.com
Robert W. Downes	+1-212-558-4312	downesr@sullcrom.com
William G. Farrar	+1-212-558-4940	farrarw@sullcrom.com
Matthew M. Friestedt	+1-212-558-3370	friestedtm@sullcrom.com
Joseph B. Frumkin	+1-212-558-4101	frumkinj@sullcrom.com
David B. Harms	+1-212-558-3882	harmsd@sullcrom.com
Alexandra D. Korry	+1-212-558-4370	korrya@sullcrom.com
Stephen M. Kotran	+1-212-558-4963	kotrans@sullcrom.com
John P. Mead	+1-212-558-3764	meadj@sullcrom.com
Scott D. Miller	+1-212-558-3109	millersc@sullcrom.com
James C. Morphy	+1-212-558-3988	morphyi@sullcrom.com
Robert W. Reeder III	+1-212-558-3755	reederr@sullcrom.com
Glen T. Schleyer	+1-212-558-7284	schleyerg@sullcrom.com
Marc Trevino	+1-212-558-4239	trevinom@sullcrom.com

SULLIVAN & CROMWELL LLP

Washington, D.C.

Janet T. Geldzahler	+1-202-956-7515	geldzahlerj@sullcrom.com
Eric J. Kadel Jr.	+1-202-956-7640	kadelej@sullcrom.com
Robert S. Risoleo	+1-202-956-7510	risoleor@sullcrom.com

Los Angeles

Patrick S. Brown	+1-310-712-6603	brownp@sullcrom.com
Eric M. Krautheimer	+1-310-712-6678	krautheimere@sullcrom.com
Alison S. Ressler	+1-310-712-6630	resslera@sullcrom.com

Palo Alto

Sarah P. Payne	+1-650-461-5669	paynesa@sullcrom.com
John L. Savva	+1-650-461-5610	savvaj@sullcrom.com

London

Nikolaos G. Andronikos	+44-20-7959-8470	andronikosn@sullcrom.com
Kathryn A. Campbell	+44-20-7959-8580	campbellk@sullcrom.com
Richard C. Morrissey	+44-20-7959-8520	morriseyr@sullcrom.com
John O'Connor	+44-20-7959-8515	oconnorj@sullcrom.com
David Rockwell	+44-20-7959-8575	rockwelld@sullcrom.com
George H. White III	+44-20-7959-8570	whiteg@sullcrom.com

Paris

William D. Torchiana	+33-1-7304-5890	torchianaw@sullcrom.com
----------------------	-----------------	--

Frankfurt

David Rockwell	+49-69-4272-5533	rockwelld@sullcrom.com
Krystian Czerniecki	+49-69-4272-5525	czernieckik@sullcrom.com

Melbourne

Robert Chu	+61-3-9635-1506	chur@sullcrom.com
------------	-----------------	--

Sydney

Waldo D. Jones Jr.	+61-2-8227-6702	jonesw@sullcrom.com
--------------------	-----------------	--

Tokyo

Izumi Akai	+81-3-3213-6145	akaii@sullcrom.com
Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com

Hong Kong

William Y. Chua	+852-2826-8632	chuaw@sullcrom.com
Michael G. DeSombre	+852-2826-8696	desombrem@sullcrom.com
Chun Wei	+852-2826-8666	weic@sullcrom.com
John D. Young Jr.	+852-2826-8668	youngj@sullcrom.com

Beijing

Garth W. Bray	+86-10-5923-5958	brayg@sullcrom.com
---------------	------------------	--
