ALERT MEMORANDUM

SEC Adopts Final Hedging Disclosure Rule

January 2, 2019

If you have any questions concerning this memorandum, please reach out to your regular firm contacts in the Executive Compensation and ERISA group.

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

In late December 2018, the Securities and Exchange Commission (the "SEC") adopted a final hedging disclosure rule (the "Final Rule"), as required by Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1] The Final Rule generally requires U.S. public companies to disclose any company practices or policies regarding the ability of employees, officers, directors or their respective designees to engage in hedging transactions. The Final Rule is generally consistent with the SEC's 2015 proposal (the "Proposed Rule").[2] A summary of the Final Rule, and a discussion of relevant changes from the Proposed Rule, are set forth below.

Although most companies will be required to comply with the Final Rule for proxy and information statements for fiscal years beginning on or after July 1, 2019, companies may wish to begin reviewing their existing hedging policies and practices in light of the new disclosure requirements.

[1] SEC Release No. 33-10593 (December 20, 2018), available at https://www.sec.gov/rules/final/2018/33-10593.pdf (the "Adopting Release").

[2] SEC Release No. 33-9723 (February 9, 2015), available at https://www.sec.gov/rules/proposed/2015/33-9723.pdf. See also our prior alert memorandum, *SEC Proposes Hedging Disclosure Rules*, available at https://www.clearygottlieb.com/news-and-insights/publication-listing/sec-proposes-hedging-disclosure-rules23.

Required Disclosure

The Final Rule implements Section 14(j) of the Securities Exchange Act of 1934 (the "Exchange Act"), which was enacted by Section 955 of Dodd-Frank, by adding Item 407(i) to Regulation S-K. Item 407(i) requires a covered company to disclose any policies or practices (whether or not written) regarding the ability of its employees (including officers), directors or their respective designees to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) 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 (i) granted to the employee or director by the company as compensation, or (ii) held, directly or indirectly,[3] by the employee or director.

Companies must either disclose their practices or policies in full or provide a fair and accurate summary of the applicable practices or policies, including the categories of persons covered by such practices or policies. Further, the disclosure must include a description of any categories of hedging transactions that are specifically permitted or prohibited, but need not include disclosure regarding actual hedging transactions that may have occurred. If a company does not have any hedging practices or policies, the company must disclose this fact or state that hedging transactions are generally permitted. Nonetheless, if a company has a policy covering only a subset of employees or directors, it would not be required to disclose that it did not have a policy with regard to the company's other employees or directors.

The Final Rule, like the Proposed Rule, is a disclosure-only requirement, and does not mandate that companies maintain practices or policies regarding hedging or dictate the content of any such practice or policy. However, while the Proposed Rule required disclosure of whether any such hedging transactions were "permitted", in accordance with the statutory language of Section 14(j) of the Exchange Act, in adopting the Final Rule, the SEC acknowledged that the use of the term "permitted" is potentially confusing, and could result in uncertainty and/or lengthy disclosures. The Final Rule therefore reflects the SEC's interpretation of the term "permit" as merely requiring disclosure as to whether the company has a practice or policy regarding hedging transactions.

Covered Transactions

Consistent with the Proposed Rule, the Final Rule applies to transactions with the same economic effects (e.g., to hedge or offset any decrease in market value of equity securities) as those specified by the statute.

Other highlights include:

— ***Definition of "Hedge".*** As in the Proposed Rule, the SEC declined to define the term "hedge" in the Final Rule on the basis that the statutory language of Section 14(j) of the Exchange Act is clear. The Adopting Release states that "establishing downside price protection is the essence of the transactions contemplated by Section 14(j)."[4]

— ***Registrant Equity Securities.*** As did the Proposed Rule, the Final Rule applies to equity securities issued by the company and its parents, subsidiaries or subsidiaries of the company's parents. Unlike the Proposed Rule, the Final Rule does not limit coverage to equity securities that are registered under Section 12 of the Exchange Act.

Covered Individuals

Under the Final Rule, covered individuals include employees, officers and directors of the company, as well as their applicable designees. The categories of covered individuals are the same as those in the Proposed Rule, and the SEC declined to limit the definition of "employee" to executive officers in the Final Rule.

Additionally, the SEC determined that it would not clarify the meaning of the word "designee" in the Final

[3] The Final Rule does not define the term "held, directly or indirectly". The SEC indicated that companies can address this issue in describing the scope of their practices or policies, such that further guidance on the topic was unnecessary.

[4] Adopting Release, *supra* note 1, at p. 12.

Rule, stating instead that a person's status as a designee depends on the relevant facts and circumstances, and that the content of a company's hedging policies and practices will ultimately determine the disclosure, if any, that is required with respect to designees.

Covered Companies

Consistent with the Proposed Rule, the Final Rule generally applies to all U.S. public companies, including emerging growth companies ("EGCs"), smaller reporting companies ("SRCs") and business development companies; however, the SEC provided a transition period for compliance with the Final Rule for EGCs and SRCs, as described below.

Foreign private issuers are exempt from the disclosure requirements under the Final Rule. In a departure from the Proposed Rule, the Final Rule also exempts closed-end investment companies with shares listed on a national securities exchange and registered under Section 12 of the Exchange Act.

Location of Disclosure

The Final Rule provides that the relevant disclosure is required in any proxy statement on Schedule 14A or information statement on Schedule 14C with respect to the election of directors.

Though the Final Rule provides companies with flexibility in determining where they will present the new Item 407(i) disclosure, the SEC recognized that companies required to provide a Compensation Discussion and Analysis ("CD&A") in their proxy statements are already required to disclose material policies regarding hedging by named executive officers in such CD&A pursuant to Item 402(b) of Regulation S-K. The Final Rule therefore added an instruction to Item 402(b) which provides that companies may (but are not required to) satisfy the CD&A obligation by including a cross-reference to the new Item 407(i) disclosure. Companies that choose to include a cross-reference should note that doing so would technically make the new hedging disclosure subject to the say-on-pay vote.

Moreover, the new Item 407(i) disclosure will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Exchange Act (including for purposes of Part III of Form 10-K), except to the extent the company specifically incorporates such disclosure by reference.

Compliance Dates

Generally, U.S. public companies must be in compliance with the Final Rule for proxy and information statements with respect to the election of directors for fiscal years beginning on or after July 1, 2019. EGCs and SRCs must be in compliance with the Final Rule for fiscal years beginning on or after July 1, 2020.

Key Takeaways

— Many companies already have hedging policies and practices in place, but those that do not may wish to consider whether to adopt or implement a new policy as a good governance practice in light of the Final Rule.

— Although most companies will not need to disclose information about their hedging policies and practices until their 2020 proxy statements, companies may wish to review their existing policies and practices regarding hedging and consider whether any changes may be warranted.

— The new disclosure requirements under Section 14(j) do not replace or impact Form 4 filing obligations or the requirements applicable to the beneficial ownership table disclosure in annual proxy statements, in Item 403(b) of Regulation S-K.

— As stated in Adopting Release, "the rule does not direct companies to have practices or policies regarding hedging, or dictate the content of any such practice or policy."[5] Nevertheless, the disclosure obligation gives rise to the question of

[5] Adopting Release, *supra* note 1, at p. 18.

what type of policy is appropriate from a governance perspective; inevitably, benchmarking will occur. Specifically, companies should consider whether their hedging policies should extend to all transactions covered by the Final Rule, including "transactions that may not necessarily raise the same concerns as the financial instruments specified by Section 14(j), such as . . . portfolio diversification transactions [or] broad-based index transactions."[6]

— Insider trading policies will apply to hedging transactions involving the company's securities as they do to transactions in the company's securities generally. For example, a company's insider trading policy will prohibit executives from purchasing put options on the company's stock while in possession of material non-public information. Because the prohibition on insider trading is of general applicability – i.e., not limited to hedging transactions specifically – the Final Rule should not be interpreted to require disclosure of a company's insider trading policy irrespective of whether the policy specifically refers, by way of example, to hedging transactions.

— Companies should consider whether they will cross-reference the new disclosure in the CD&A or keep CD&A and new Item 407(i) disclosure separate, bearing in mind that a cross-reference would make the hedging disclosure subject to the say-on-pay vote.

If you have any questions or would like to discuss this further, please do not hesitate to contact your regular contacts in the Executive Compensation and ERISA group.

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[6] Adopting Release, *supra* note 1, at p. 21.