CLEARY GOTTLIEB Alert Memorandum

February 18, 2015 clearygottlieb.com

SEC Proposes Hedging Disclosure Rules

On February 9, 2015 the Securities and Exchange Commission (the "SEC") announced the issuance of proposed rules (the "Proposed Rules")[1] implementing the mandate of Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[2] Section 955 of the Dodd-Frank Act added Section 14(j) to the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Under Section 14(j), the SEC is directed to promulgate rules requiring issuers to disclose whether any employee or member of the board of directors, or any designee of such employee or director, is permitted to purchase financial instruments 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. The disclosure would be required in any proxy or consent solicitation material for an annual meeting of the shareholders of the issuer.

The Proposed Rules implement Section 14(j) by adding new paragraph (i) to Item 407 of Regulation S-K under the Exchange Act. We note that comments on the Proposed Rules are due on or before April 20, 2015 and that the Proposed Rules will not affect the 2015 proxy season. This memorandum summarizes the requirements of the Proposed Rules.

What Disclosures do the Proposed Rules Require?

Generally—The Proposed Rules require disclosure as to whether issuers permit employees, officers or directors, or any of their designees, to engage in transactions that are designed to or have the effect of hedging or offsetting any decrease in the market value of equity securities that are granted as compensation, or are held directly or indirectly.[3]

To be clear, the Proposed Rules do not require an issuer to prohibit hedging transactions or to otherwise adopt practices or policies addressing hedging by any category of

1 SEC Release No. 33-9723 (February 9, 2015), available at http://www.sec.gov/rules/proposed/2015/33-9723.pdf.

2 Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, Title IX, Subtitle E, § 953(b), 124 Stat. 1904 (2010), available at http://www.gpo.gov/fdsys/pkg/STATUTE-124/pdf/STATUTE-124-Pg1376.pdf.

3 While Section 14(j) provides only for disclosure concerning "financial instruments . . . that are designed to hedge or offset any decrease in the market value," the Proposed Rules provide for disclosure concerning "financial instruments . . . that are designed to *or have the effect of* hedging or offsetting any decrease in the market value" (emphasis added). See "What Transactions are Subject to the Proposed Rules?" below for a further discussion of the transactions encompassed by the Proposed Rules.

individuals.[4] Nor do the Proposed Rules require disclosure of whether hedging has actually occurred (whether or not in violation of any applicable policies).[5]

Categories of Permitted or Prohibited Transactions—The Proposed Rules require issuers to disclose which categories of transactions it permits and which categories of transactions it prohibits. If an issuer specifically prohibits certain categories of hedging transactions, it may disclose such categories and, if true, disclose that it permits all other hedging transactions. Similarly, if an issuer specifically permits certain categories of hedging transactions, it may disclose such categories and, if true, disclose that it prohibits all other hedging transactions. If an issuer simply discloses that it does not permit any hedging transactions or, conversely, that it permits all hedging transactions, it does not need to disclose by category.

In addition, if an issuer permits hedging transactions, it must disclose sufficient detail to explain the scope of such permitted transactions. For example:

- If there is a requirement to hold the securities for a specified amount of time prior to engaging in any permitted transaction, an issuer must disclose the period of time the securities must be held.
- An issuer must disclose whether the permitted transactions must be pre-approved by the issuer, or may only be engaged in after any applicable stock ownership guidelines have been met.

As discussed further below, the Proposed Rules do not define the term "hedge." Given the potential breadth of the transactions that may be subject to the Proposed Rules, we caution issuers to consider carefully whether they are able to make blanket disclosures indicating that they prohibit all hedging transactions (as compared to disclosing the specific categories of transactions they permit or prohibit).[6]

Categories of Persons Permitted to Hedge—If an issuer permits some, but not all, of the categories of persons covered by the Proposed Rules to engage in hedging transactions, the

---

4 Although hedging activities are not prohibited by the Proposed Rules, Institutional Shareholder Services announced in 2013 that it would, when recommending votes on incumbent directors, consider it a risk failure on the part of the board if executives were allowed to engage in any hedging activities whatsoever. ISS considers transactions, including covered call, collar or other derivative transactions, that are "a strategy to offset or reduce the risk of price fluctuations for an asset or equity" as hedging.

5 Note, however, that for issuers with a class of equity securities registered pursuant to Section 12 of the Exchange Act (other than foreign private issuers), transactions by certain officers and directors involving the issuer's stock or derivative securities are subject to reporting pursuant to Section 16 of the Exchange Act.

6 For example, under the Proposed Rules an argument could potentially be made that transactions by employees in sector funds, indices or baskets of stocks, or even in broad-based market indices, might constitute hedging transactions. The SEC has requested comments on whether the Proposed Rules should be clarified in respect of when any such transactions should be considered hedging transactions.

issuer must disclose both the categories of persons who are permitted to hedge and those who are not.

What Issuers are Subject to the Proposed Rules?

Generally, the Proposed Rules apply to issuers with a class of equity securities registered under Section 12 of the Exchange Act.

This includes:

- Smaller reporting companies;
- Emerging growth companies; and
- Listed closed-end funds that have shares that are listed on a national securities exchange (including business development companies).

But excludes:

- Foreign private issuers; and
- All investment companies registered under the Investment Company Act of 1940 (the "Investment Company Act"), that are not listed closed-end funds, including:
    - Non-listed closed-end funds
    - Open-end funds
    - Mutual funds whose shares do not trade on an exchange
    - Exchange traded funds
    - Unit investment trusts

What Transactions are Subject to the Proposed Rules?

Section 14(j) covers transactions where employees, directors or their designees are permitted to purchase financial instruments that are designed to hedge or offset a decrease in the market value of equity securities.

The Proposed Rules implement this requirement, but take a more expansive view of what transactions constitute hedging by covering the ability to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) or otherwise engage in transactions that are designed to or have the effect of hedging or offsetting any decrease in the market value of equity securities.[7]

---

[7] Examples of transactions that that the Proposed Rules pick up include short sales and the sale of a security future that establishes a position that increases in value as the value of the underlying equity security decreases.

In other words, the Proposed Rules cover all transactions that establish downside price protection—whether by purchasing or selling a security or derivative security or otherwise.[8] We note that the SEC declined to define the term "hedge" (though it does specifically request comment as to whether it should) based on its belief that the meaning of the term is generally understood[9] and its desire not to have an overly prescriptive and narrow approach to the disclosure.

Thus, in interpreting and applying the Proposed Rules, in order to determine what transactions may or may not constitute covered hedging transactions, issuers should adopt an expansive principles-based approach rather than merely relying on an enumerated list of specific covered transactions.

Whose Hedging is the Subject of the Proposed Rules?

Section 14(j) requires disclosure of hedging transaction policies in regard to any "employee"[10] or member of the board of directors of the issuer[11] or any of their designees. The proposing release clarifies that the term "employee" encompasses everyone employed by an issuer, including officers of the company.[12] The Proposed Rules do not address when someone

[8] The SEC has interpreted Section 14(j) as covering transactions involving not only the purchase of financial instruments, as is expressly referenced in Section 14(j), but also to cover the disposition or sale of securities. The SEC states that such an interpretation is supported by the explicit reference in Section 14(j) to "exchange funds" and the fact that an employee or director can acquire an interest in an exchange fund only in exchange for a disposition to the exchange fund of equity securities held by the employee or director. The SEC did note, however, that whether or not any such disposition to an exchange fund constituted a hedging transaction depends on the terms of the applicable fund.

[9] Despite its hesitation to define the term "hedge", the SEC did note that a stand-alone pledge or loan of equity securities that does not involve a prepaid variable forward or similar transaction would not constitute a hedging transaction for purposes of the Proposed Rules. Its rationale was that such transactions do not alter the underlying economic risk of ownership of the pledged or loaned securities. Despite this statement, issuers should consider the specific facts and circumstances of any such pledge or loan in determining whether it may constitute a hedging transaction (*e.g.*, a non-recourse loan of equity securities might constitute a hedging transaction by limiting the lender's downside risk).

[10] Although the Proposed Rules interpret the term "employee" to mean anyone employed by the issuer, the SEC has requested comments as to whether this definition should be limited to those employees that "participate in making or shaping key operating or strategic decisions that influence the company's stock price." Alternatively, the SEC requests comments as to whether there should be an express materiality condition to the definition, which would permit individual issuers to determine whether disclosure about all its employees would be material information for its investors.

[11] The SEC does make clear that, with respect to funds, the Proposed Rules will generally only affect the funds' employees and directors and not the employees and directors of the fund's investment advisers (*e.g.*, portfolio managers).

[12] Interestingly, the Proposed Rules do not appear to include officers of an issuer who are not also employees of that issuer. For example, in the case of an externally managed business development company, an officer of the company may be employed by the external manager and not by the business development company itself.

is acting as a "designee", leaving it to be determined by the issuer, based on the particular facts and circumstances. Also, unlike other regulations, such as those under Section 16 of the Exchange Act, the Proposed Rules do not clarify what it means for securities to be held "indirectly."

What are "Equity Securities" for purposes of the Proposed Rules?

Under the Proposed Rules, the term "equity securities" means any equity security[13] (as defined in Exchange Act Section 3(a)(11)[14] and Exchange Act Rule 3a11-1)[15] issued by the company, any parent of the company, any subsidiary of the company or any subsidiary of any parent of the company, in each case, that are registered on a national securities exchange or registered under Section 12(g) of the Exchange Act.[16]

Since the Exchange Act and Exchange Act rule definitions of "equity securities" do not specify an issuer, the SEC felt it necessary to make explicit that the Proposed Rules are not intended to cover the equity securities of any company held by the employee or director, but rather equity securities of the issuer to whom the employee or director provides services and any equity securities issued by a member of the issuer's company group (as discussed in the foregoing sentence). Finally, the Proposed Rules cover all equity securities either granted to the employee or director as compensation or otherwise held, directly or indirectly, by the employee or director.

13 In defining "equity securities", it is not clear whether the SEC intended to cover compensatory instruments that may be settled in cash (*e.g.*, a cash settled stock appreciation right).

14 Exchange Act Section 3(a)(11) defines "equity security" as any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the SEC shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

15 Exchange Act Rule 3a11-1 defines "equity security" to include any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; any security future on any such security; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so.

16 The Proposed Rules do not define "parent" or "subsidiary". Under the Exchange Act, however, the definition of "parent" is an affiliate controlling such person directly, or indirectly through one or more intermediaries, whereas the definition of "subsidiary" is an affiliate controlled by such person directly, or indirectly through one or more intermediaries.

What Filings Must Contain the Proposed Hedging Disclosure?

Under the Proposed Rules, an issuer will be required to make the proposed disclosures when it files any proxy or consent solicitation materials or information statements with respect to the election of directors. This includes information statements filed on Schedule 14C.

Disclosure would not be required for:

- Proxy solicitations not involving a solicitation for the election of directors;
- Registration statements under the Securities Act of 1933, as amended (the "Securities Act") or Exchange Act; or
- Annual Reports on Form 10-K in Part III's Item 407 disclosure.

Disclosure under the Proposed Rules will not be deemed to be incorporated by reference into any filing under the Securities Act, the Exchange Act or the Investment Company Act, unless an issuer specifically incorporates it by reference. Further, disclosure is not required for completing the Form 10-K even if that disclosure is incorporated by reference from the company's definitive proxy statement or information statement filed with the SEC no later than 120 days after the end of the fiscal year covered by the Form 10-K.

How Do the Proposed Rules Interact with Existing CD&A Disclosure Requirements?

Under Item 402 of Regulation S-K, the current Compensation Discussion and Analysis ("CD&A") disclosure requirements call for disclosure of any policies regarding named executive officers hedging the economic risk of equity or other security ownership in the issuer. If a company does not have a hedging policy for named executive officers, there is no obligation to make any disclosure in the CD&A.[17] The Proposed Rules do not eliminate the CD&A requirements. They do, however, allow an issuer to satisfy its obligation to disclose its policies on hedging by named executive officers in the CD&A by cross-referencing the disclosure required by the Proposed Rules (so long as the disclosure under the Proposed Rules satisfies the CD&A disclosure requirement).

Issuers should be aware that although disclosure under both the Proposed Rules and the CD&A is required, cross-referencing is optional. When deciding whether to cross-reference for these purposes, issuers should note that shareholder advisory say-on-pay votes apply to disclosures made in the CD&A, but generally do not apply to disclosures made under the Proposed Rules. As a result, broad incorporation by reference could result in inadvertently subjecting the new disclosure to the advisory say-on-pay vote. In addition, unlike the disclosure called for by the Proposed Rules, the CD&A is incorporated by reference into other Exchange

[17] We note that the language of Item 402(b) is both narrower and broader than Item 407(i) under the Proposed Rules. Item 402(b) is narrower insofar as it is limited to only the issuer's securities (as opposed to also capturing securities of all of its affiliates) and only to such registrant's named executive officers. Item 402(b) is broader in that it includes equity securities and any other security the SEC *deems to be of similar nature.*

Act filings so a general cross-reference could have the effect of incorporating by reference the new disclosure into such other filings where not otherwise required.

How Will the Rules Be Implemented?

The Proposed Rules implement Section 14(j) by amending the following:

- Item 402 of Regulation S-K—The Proposed Rules amend Item 402 of Regulation S-K by revising paragraph (b) to add Instruction 6, which provides 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 the CD&A disclosure requirement.

- Item 407 of Regulation S-K—The Proposed Rules add new paragraph (i) to Item 407 of Regulation S-K under the Exchange Act to require companies to disclose whether they permit employees, officers, or directors, or any of their designees, to engage in transactions that are designed to or have the effect of hedging or offsetting any decrease in the market value of equity securities.

- Schedule 14A—The Proposed Rules amend Items 7 and 22 of Schedule 14A to call for new Item 407(i) information to be provided if action is to be taken with respect to the election of directors. In addition, the proposal amends Item 7 of Schedule 14A to streamline its current provisions by more succinctly cross-referencing disclosure Items.

* * * * *

Please call any of your regular contacts at the firm or any of the partners and counsel listed under Executive Compensation and ERISA or Corporate Governance in the Practices section of our website (www.cgsh.com) if you have any questions.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

Office Locations

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

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Cleary Gottlieb Steen & Hamilton (Hong Kong)
Bank of China Tower, 39th Floor
One Garden Road
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI
Al Sila Tower, 27th Floor
Sowwah Square, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

SEOUL
Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T:+82 2 6353 8000
F:+82 2 6353 8099