

SEC Proposes Hedging Disclosure Rules

On February 9, the SEC issued proposed rules regarding disclosure of company hedging policies. Adoption of such rules is required by the Dodd-Frank Act. The proposed rule expands and clarifies aspects of the related statutory provision. It would apply to emerging growth companies and smaller reporting companies, but not foreign private issuers. The proposed rule is solely a disclosure requirement, and does not require companies to adopt any particular policy regarding hedging.

The new provision would be added as paragraph 407(i) to Regulation S-K. It would require disclosure of whether the company permits any of its employees, officers, or directors to purchase specified financial instruments "or otherwise engage in transactions that are designed to or have the effect of hedging or offsetting any decrease in the value of equity securities" that are either (i) granted as compensation or (ii) held, directly or indirectly, by the employee, officer, or director.

- The specified financial instruments covered by Item 407(i) are those listed in the Dodd-Frank Act -- prepaid variable forward contracts, equity swaps, collars, and exchange funds. The proposed rule expands this list to cover any transaction that has the same economic effects as the listed transactions -- namely, providing downside price protection -- such as short sales or sales of a security future.
- If the company prohibits hedging by only certain categories of employees it would need to disclose its policies for each category. For example, if its prohibition is limited to officers and directors, the company would need to expressly disclose that prohibition as well as the fact that hedging is permitted for other employees.
- Similarly, if the company permits hedging only in specified circumstances (such as after advance approval or after certain stock ownership levels have been met), the disclosure would need to describe the categories of transactions or circumstances in which hedging was prohibited and those in which it was permitted. However, a company may instead disclose that it permits specified categories of hedging transactions and/or hedging in specified circumstances and prohibits all other hedging transactions, or vice versa. If the company permits certain hedging transactions, it would be required to disclose sufficient detail to explain the scope of the permitted transactions.
- As required by the Dodd-Frank Act, Item 407(i) also calls for disclosure regarding hedging transactions permitted to any "designee" of the company's employees, officers, and directors. But neither the Act nor the proposed rule defines the term "designee." Instead, the SEC Proposing Release states that "whether someone is a 'designee' would be determined by a company based on the particular facts and circumstances."
- The equity securities covered by the required disclosure are those of the company whose directors are being elected, as well as any of its parents, subsidiaries, or subsidiaries of its parent -- but only if such parent or subsidiary is registered under Section 12 of the Exchange

Act.

- For purposes of the hedging disclosure, the term "equity securities" is defined by reference to Exchange Act Section 3(a)(11) and Rule 3a11-1. These definitions are very broad and include securities convertible into the subject security, warrants or rights to purchase the security, security futures on such security, and other derivative securities.
- The new hedging disclosure would be required in any proxy or information statement with respect to the election of directors. It would not be required in registration statements or the Form 10-K.
- The proposed Item 407(i) disclosure would be in addition to the existing requirement in S-K Item 402(b) to disclose in the CD&A the company's hedging policies applicable to the company's named executive officers, to the extent material. In an effort to minimize duplicative disclosure, the proposed rule would expressly permit companies to satisfy the CD&A requirement by a cross reference to the Item 407(i) disclosure.

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