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SEC Proposes Proxy Disclosure Rules for Hedging by Directors, Officers and Employees

Posted by Steven Rosenblum, Wachtell, Lipton, Rosen & Katz, on Thursday February 12, 2015

Editor's Note: Steven Rosenblum is a partner in the Corporate Department of Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell, Lipton, Rosen & Katz client memorandum by Mr. Rosenblum, Andrew R. Brownstein, and Sabastian V. Niles.

Pursuant to Section 955 of the Dodd-Frank Act, the SEC on February 9, 2015 proposed hedging disclosure rules for public comment and review. These rules, if adopted, would require proxy statements involving the election of directors to disclose whether the company permits employees (including officers), members of the board of directors or their designees to engage in transactions to hedge or offset any decrease in the market value of equity securities that are granted to the employee or board member as compensation or otherwise held, directly or indirectly, by the employee or board member, regardless of source.

The proposed rules treat hedging as a corporate governance matter relevant to shareholders making voting decisions about directors. They also contemplate a principles-based approach to required disclosures and accordingly would not be strictly limited to the use of financial instruments (such as prepaid variable forward contracts, equity swaps, collars and exchange funds) but would also reach other transactions with comparable economic consequences that "establish downside price protection."

In disclosing hedging policies, companies would be required to describe (i) which categories of hedging transactions are permitted and which are prohibited (or include blanket statements that all hedging transactions are permitted or prohibited, as applicable); (ii) which categories of persons are permitted to engage in hedging transactions and which are not (if treatment differs); and (iii) the scope of permitted transactions in sufficient detail to provide adequate explanation. The proposed rules would only cover hedging involving equity securities that are registered under Section 12 of the Exchange Act and issued by the company, any parent of the company or any parent or company subsidiary.

Existing executive compensation-related proxy rules require companies to disclose, within the context of discussing compensation of named executive officers, stock ownership guidelines and company policies regarding hedging the economic risk of such ownership, if material. The proposed rules would apply beyond NEOs to directors, officers and employees generally, eliminate the materiality overlay and apply broadly to company securities, whether or not granted for compensatory purposes. The proposing release also requests comment in several areas relating to the appropriate scope and coverage of the proposed rules, including potential exemptions.

Since at least 2010, companies have been actively reviewing their policies regarding hedging (and pledging) of company securities, deploying diverse approaches and engaging with shareholders and proxy advisory firms on this topic. Companies should review the SEC's proposing release closely and take the additional required disclosures into account in determining whether updates to policies and internal controls are appropriate.