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The SEC's Proposed Disclosure Rules for Hedging Transactions by Directors, Officers, and Employees

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On February 9, 2015, the Securities and Exchange Commission ("SEC") made progress in its Dodd-Frank rulemaking by proposing regulations that Commissioner Aguilar described as being necessary because:

- "hedging transactions could permit individuals to receive incentive compensation, even where the company fails to perform and the stock value drops"; and
- "[j]ust as problematic, hedging transactions can be structured so that executives or directors monetize their shareholdings while they still technically own the stock, which makes the fact that the hedging took place less transparent to investors."[1]

Companies are not required to prohibit hedging transactions or to adopt policies or practices that address hedging by any category of individuals. Rather, in summary the proposed rules require disclosure in proxy statements as to whether employees or directors are permitted to engage in hedging transactions. Interestingly, the SEC proposes to extend the disclosure requirement beyond officers and directors to cover all employees, many of whom are likely to own very small portions of the company. Specifically, the SEC proposes to amend Item 407 of Regulation S-K to require companies to disclose whether an employee, officer, or director, or any of their designees, is permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) or otherwise engage in transactions (such as short sales) that are designed to, or have the effect of, hedging or offsetting any decrease in the market value of equity securities.

Many public companies have long required that such arrangements be reported and approved as part of their insider trading policies to the extent they are permitted. These policies should be reviewed given that the S-K Item 407 requires detailed disclosure of the scope of such permitted transactions. Companies will be required to disclose which categories of persons are permitted to engage in hedging transactions and which categories of persons are not. Companies must also disclose the types of hedging transactions permitted and those which it prohibits. However, the rules do not require disclosure of individual hedging transactions undertaken by executive officers and directors.

The SEC's governance approach to the proposed disclosure requirement reflects the views of influential proxy advisor ISS, which since 2013 has considered any hedging or significant pledging of company stock to be "failures of risk oversight" that warrant negative voting recommendations against those directors who are responsible.[2] Similarly, Glass Lewis has stated in its guidelines for the 2015 proxy season that:

> "the hedging of shares by executives in the shares of the companies where they are employed severs the alignment of interests of the executive with shareholders. We believe companies should adopt strict policies to prohibit executives from hedging the economic risk associated with their share ownership in the company."

With respect to pledging, Glass Lewis' 2015 guidelines reflect a general preference for stock ownership by executives and (like ISS) set forth a multi-factor facts and circumstances approach for evaluating whether the pledging of employer securities presents a governance concern. Since 2006, the SEC has required proxy statement disclosure of pledges of stock as collateral by executive officers and directors.[3] Despite the required transparency, an ISS survey in 2012 found that:

- at least one executive or director pledged shares as collateral in fifteen percent (15%) of the Russell 3000 Index companies;
- $57,000,000 was the average amount of company stock pledged, with the median being just over $5,000,000; and
- executive and director pledging of company shares occurred at approximately sixteen percent (15.8%) of S&P500 companies.

The extensive use and the dollar values involved as reflected in the survey may explain why the SEC proposed that the new disclosure rules apply to all companies subject to the Securities Exchange Act, including smaller reporting companies, emerging growth companies, business development companies, and registered closed-end investment companies with shares listed and registered on a national securities exchange.

Overall, because the hedging and pledging of company stock are widely considered to reflect poor corporate governance practices, the boards of public companies should take thoughtful action in 2015. In doing so, they should carefully analyze and update their insider trading policies. ISS recently reported that the policies of approximately fifty-four percent (54.3%) of Russell 3000 Companies and eighty-four percent (84%) of large capital S&P500 companies prohibit employees from hedging company shares. There are alternatives to outright prohibitions worth considering such as programs that are carefully designed with an eye towards compliance with Internal Revenue Code §409A—to allow the conversion of equity awards into deferred compensation that has a self-directed rate of return.

If hedging is permitted, boards should make sure that they have developed a clear message as to the reasons supporting their policies and that they explain the procedures in place fully to assure that the boards are informed of hedging transactions when undertaken by executive officers and directors. In this way, all will be prepared when the SEC's final hedging disclosure rules take effect (likely for, or before, the 2016 proxy season).

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[1] "Aligning the Interests of Company Executives and Directors with Shareholders," SEC Public Statement by Commissioner Luis Aquilar, Feb. 9. 2015.

[2] U.S. Corporate Governance Policy, 2013 Updates, page 4 (Nov. 16, 2012), by ISS, an MSCI Brand.

[3] Proxy Paper Guidelines, 2015 Proxy Season (page 30-31), "An Overview of the Glass Lewis Approach to Proxy Advice" (Glass Lewis 2015).