MARCH 5, 2019

# New SEC Rule Mandates Disclosure of Hedging Policies of SEC Registrants

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A new rule of the U.S. Securities and Exchange Commission (SEC) will become effective on March 8, 2019, which will require SEC registrants (other than foreign private issuers) to disclose in their proxy or information statements any practices and policies regarding the ability of their employees, officers and directors (or their designees) to purchase financial instruments or otherwise engage in transactions that hedge or offset (or are designed to hedge or offset) any decrease in the market value of registrant equity securities. This new disclosure requirement, which is primarily corporate governance–related, is set out in new Item 407(i) of Regulation S-K.

Foreign private issuers, including Canadian issuers that file reports with the SEC under the multijurisdictional disclosure system, are not subject to the proxy statement requirements of the U.S. *Securities Exchange Act of 1934* (Exchange Act) and, therefore, are not subject to Item 407(i).

## Background

Item 407(i) was adopted to implement new section 14(j) of the Exchange Act, a provision added by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* in July 2010. Section 14(j) directs the SEC to adopt a rule that requires each issuer to disclose whether employees or directors are permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of the issuer's equity securities they hold. The intention behind this legislation is to inform shareholders if companies permit their executives to purchase financial instruments to hedge against any decrease in the value of company equity securities that they hold even if their company does not perform.

## New Item 407(i)

As adopted, Item 407(i) requires a registrant to disclose the following in its proxy statement or information statement with respect to the election of directors:

- any practices or policies adopted by the registrant, whether in writing or not,[1] regarding the ability of its employees (including officers) or directors (or their 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 "registrant equity securities" granted to such individual as part of his or her compensation or otherwise held, directly or indirectly, by such individual;[2]
- a fair and accurate summary of any practices or policies that apply, including the categories of persons covered, any categories of hedging transactions that are specifically permitted and any categories that are specifically disallowed, or to disclose the practices or policies in full; and
- if the registrant does not have any such practices or policies, to disclose that fact or state that hedging transactions are generally permitted.

Item 407(i) does not require registrants to have a practice or policy regarding hedging, or a particular type of practice or policy; rather it requires only the disclosure of hedging practices or policies. Information disclosed under Item 407(i) is not deemed incorporated by

reference into any filing made under the U.S. *Securities Act of 1933* or the Exchange Act, except to the extent that the registrant specifically incorporates that information by reference.

## Other Disclosure Rules That May Be Triggered by Hedging Transactions or Policies

Item 407(i) does not affect other SEC disclosure requirements that could be triggered when equity securities (other than those of foreign private issuers) are hedged. For example, under section 16(a) of Exchange Act, officers and directors are required to report on Form 4 hedging transactions involving one or more derivative securities within two business days of entering into such transaction. Some hedging transactions, such as prepaid variable forward contracts, may involve pledges of the underlying company equity securities as collateral. Item 403(b) of Regulation S-K requires registrants to disclose the amount of equity securities beneficially owned by directors, director nominees and named executive officers, and also requires disclosure of the amount of shares that are pledged as security in such transactions.

Item 402(b) of Regulation S-K requires domestic registrants to provide a compensation discussion and analysis (CD&A)[3] that discloses material information necessary to understand their compensation policies and decisions regarding the "named executive officers,"[4] including, if material, a description of the registrants' equity or other security ownership requirements or guidelines and any policies regarding hedging the economic risk of such ownership. Although CD&A disclosure addresses only hedging by the named executive officers, some registrants – in providing their CD&A disclosure – describe the policies that address hedging by all employees and directors, not just the named executive officers. To avoid duplicative disclosure for those registrants that are also subject to Item 402(b), the SEC amended Item 402(b) to permit registrants to satisfy their Item 402(b) disclosure obligations on material hedging policies by cross-referencing to the information disclosed under new Item 407(i) (to the extent that the information disclosed satisfies the 402(b) disclosure requirement).

## Compliance Dates

Registrants that do not qualify as smaller reporting companies or emerging growth companies[5] must comply with Item 407(i) for proxy and information statements with respect to the election of directors during fiscal years beginning on or after July 1, 2019. Smaller reporting companies and emerging growth companies must comply with Item 407(i) for proxy and information statements with respect to the election of directors during fiscal years beginning on or after July 1, 2020.[6]

[1] The SEC offered the following examples of non-written policies or practices that a company may have: (i) a practice of reviewing, and perhaps restricting, hedging transactions as part of its program for reviewing employee trading in company securities; or (ii) a practice of including anti-hedging provisions in employment agreements or equity award documentation.

[2] The term "registrant equity securities" for which disclosure is required covers equity securities issued by the registrant or by any parent or subsidiary of the registrant or by any subsidiary of any parent of the registrant.

[3] CD&A does not apply to smaller reporting companies, emerging growth companies, registered investment companies or foreign private issuers.

[4] Under SEC rules, "named executive officers" are all individuals serving as the company's principal executive officer during the last completed fiscal year; all individuals serving as the company's principal financial officer during that fiscal year; the company's three other most highly compensated executive officers who were serving as executive officers at the end of that year; and up to two additional individuals who would have been among the three most highly compensated but for not serving as executive officers at the end of that year.

[5] As defined in Rule 12b-2 under the Exchange Act.

[6] The one-year delay in implementation was intended to allow these smaller companies to observe how larger and more established companies implement Item 407(i), and give these smaller companies adequate time to implement the new disclosure requirements.

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