HEDGING DISCLOSURE IS HERE: SEC ADOPTS FINAL RULES

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U.S. Benefits, ESOPs, and Executive Compensation / Securities Law Alert

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On December 18, 2018, the Securities and Exchange Commission (the "SEC") adopted final hedging disclosure rules, which were initially proposed more than three years ago, as directed by Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "DFA"). The final rules, which add new paragraph (i) to Item 407 of Regulation S-K, require public companies to disclose their hedging practices and policies (whether or not written) for employees, officers and directors in proxy and information statements relating to the election of directors.

This leaves only three sets of executive compensation-related rulemaking under the DFA that have not been finalized, related to performance-based compensation disclosures, clawback policies and excessive compensation at certain financial institutions. See the chart at the end of this alert for a full summary of the DFA rules related to executive compensation.

WHAT ARE HEDGING POLICIES AND WHY DOES THE DFA REQUIRE DISCLOSURE ABOUT THEM?

"Hedging" in the context of equity ownership normally refers to instruments or transactions that have the effect of protecting the employee or director from the economic risk of stock price going down. Equity compensation programs at public companies, including related stock ownership and retention requirements, are normally intended to align the interests of key employees and directors with the interests of long-term shareholders. Many institutional shareholders consider hedging transactions by key employees and directors as contrary to that alignment of long-term interests. Also, if key employees and directors are protected against downside risks in stock price, they may be encouraged to take excessive risks to create upside value. The DFA, as a product of the 2008/2009 global economic crisis, was focused on these types of risk management issues. As discussed below, although the DFA does not mandate specific hedging policies, it does require disclosure about hedging policies in order to ensure that shareholders can asses the risk-management practices at the companies in which they choose to invest.

REQUIRED DISCLOSURE

The new rules are disclosure rules - they do not require companies to prohibit or limit hedging transactions, or to have or adopt any specific practices or policies relating to hedging. Rather, the rules simply require companies that have adopted hedging practices or policies to provide a fair and accurate summary of those practices or policies, including the categories of persons covered and any categories of hedging transactions that are specifically permitted or specifically disallowed. In lieu of this summary, companies may disclose their practices or policies in full. Alternatively, a company without any hedging practices or policies must state that fact or state that hedging transactions are generally permitted. Although the rules do not require companies to adopt hedging policies, many companies have adopted such policies in recent years as a governance best practice in light of voting policies by institutional investors and proxy advisory firms.

COVERED COMPANIES AND COMPLIANCE DATES

The final rules apply to all domestic companies that file reports pursuant to the Securities Exchange Act of 1934, including smaller reporting companies ("SRCs") and emerging growth companies ("EGCs"). Public companies that are not SRCs or EGCs must comply with the new disclosure requirements in their proxy and information statements relating to the election of directors during fiscal years beginning on or after July 1, 2019. For December 31 fiscal year-end companies, this means required compliance will begin for the spring 2020 proxy statements. SRCs and EGCs are given an extra year to comply with the new disclosure requirements.

COVERED INDIVIDUALS AND HEDGING TRANSACTIONS

The new rules require disclosure of hedging practices or policies that apply to employees, officers or directors or any of their designees. The rules do not delineate the specific types of hedging transactions covered. Instead, they provide a broad framework requiring disclosure of practices and policies relating to the purchase of financial instruments or the engagement in other transactions that hedge or offset, or are designed to hedge or offset, any decrease in the market value of a company's equity securities. Equity securities include those of the company, any parent or subsidiary of the company or any subsidiary of any parent of the company. The manner of acquisition of the equity securities is irrelevant, with the new rules applying to those granted as compensation and those otherwise held, directly or indirectly.

LOCATION OF DISCLOSURE

Item 402(b)(2)(xiii) of Regulation S-K already required a company to disclose in its Compensation Discussion & Analysis ("CD&A") any company policies regarding hedging the economic risk of company securities ownership by the company's named executive officers to the extent material. This requirement is similar to, but narrower than, the new rules, which require disclosure about practices and policies impacting all employees, not just named executive officers, as well as directors. The new rules also apply to SRCs and EGCs, which are not otherwise required to prepare a CD&A. Given the potential disclosure overlap between the disclosure requirements of Item 402(b) and the new rules, the SEC noted that companies have flexibility in where they present the newly required disclosure. A company may include its new Item 407(i) disclosure outside of the CD&A and provide a separate, likely narrower, Item 402(b) disclosure as part of the CD&A. Alternatively, a company may incorporate the newly required disclosure into the CD&A, either by directly including the information in the CD&A or by providing the Item 407(i) information outside of the CD&A and adding a cross-reference within the CD&A.

For companies with hedging policies that apply more broadly than to only named executive officers, the cleanest approach may be to include the new disclosure outside of the CD&A, but to note in the CD&A that the company has adopted a hedging policy, with a cross-reference to the hedging practice disclosure. This approach should avoid the company's hedging policy or practices becoming subject to any "say on pay" vote.

WHAT COMPANIES SHOULD DO NOW

The new rules require a limited amount of straightforward disclosure. For companies that already have hedging policies noted in their CD&A, the new rules likely require no more than a minor expansion of the existing disclosure and a fresh look as to where the disclosure should be located. For calendar-year companies, there will be an extended period before the disclosure is required. Companies with July 1-June 30 fiscal years will be the first that have to comply. In the interim, companies may wish to consider whether any modifications to their existing hedging policies are desirable in light of the new rules and should plan on periodically reassessing those policies based on future developments and new benchmarking information for comparable companies.

Any company that has not previously adopted a hedging policy may wish to consider adopting a policy before the disclosure requirement becomes effective. Hedging policies are widely recognized as a governance best practice, and the new rules may renew attention on these policies by institutional investors and proxy advisory firms. A company without a hedging policy will be required to state that fact or state that hedging transactions are generally permitted and should consider including disclosure explaining why a hedging policy is not appropriate.

DODD-FRANK ACT EXECUTIVE COMPENSATION RULEMAKING STATUS -- JANUARY 1, 2019

Green: Final rules adopted and in effect

Yellow: Initial rules proposed but not yet finalized

Provision	Act §	Brief Description	Rule-Making Status	Location of Rules
Say-on-Pay (Green)	951(a)	Non-binding shareholder vote on executive compensation as disclosed in the annual proxy statement	- Currently in effect - SEC final rules published on Jan. 25, 2011	- Final SEC rules at: http://www.sec.gov/rules/final/2011/33-9178.pdf
Say-on-Frequency (Green)	951(a)	Non-binding shareholder vote on the frequency for the say-on-pay vote; choices are one, two or three year cycles; must provide say-on-frequency vote at least once every six years	- Same as for Say-on-Pay	- Same as for Say-on-Pay

Say-on-Golden Parachutes (Green)	951(b)	Non-binding shareholder vote on compensation to target company executives in certain M&A transactions	- Same as for Say-on-Pay	- Same as for Say-on-Pay
Compensation Committee Independence (Green)	952	Heightened standards for "independence" of compensation committee members	- Currently in effect - SEC final rules published on June 20, 2012; related changes to listing rules implemented by various exchanges in January 2013	- Final SEC rules at: http://www.sec.gov/rules/final/2012/33-9330.pdf
Compensation Consultant and Adviser Independence (Green)	952	Mandates factors to be considered regarding independence of compensation consultants and other advisers to the compensation committee; does not mandate use of independent advisers	- Same as for Compensation Committee Independence	- Same as for Compensation Committee Independence
Executive Compensation Disclosures (Yellow)	953	Requires "clear disclosures" in annual proxy statement of linkage between pay and performance; also requires disclosure	- Not effective until rules finalized - SEC proposed rules regarding CEO pay ratio disclosure in September 2014;	- Proposed CEO Pay Ratio Disclosure Rules at: https://www.sec.gov/rules/proposed/2013/33-9452.pdf - Proposed Pay-for-Performance Disclosure Rules at: https://www.sec.gov/rules/proposed/2015/34-74835.pdf

	954	of ratio of CEO pay to median employee pay	numerous comments received; timing for final rules unclear; to be effective for the fiscal year following the effective date of the final rule - SEC proposed rules regarding pay-for-performance disclosures in May 2015; initial comment period runs through July 6, 2015; timing of final rules unclear	
Compensation Recovery (Clawbacks) (Yellow)	954	Requires companies to adopt, comply with and disclose a compensation recovery policy for certain incentive awards to current and former executive officers that were based on financial information later restated	- Not effective until rules finalized (both SEC and applicable exchanges) - SEC proposed rules on July 1, 2015; initial comment period through September 1, 2015; timing of final rules unclear	- SEC proposed rules at: http://www.sec.gov/rules/proposed/2015/33-9861.pdf
Hedging Policies	955	Requires disclosure as to	- SEC final rules published on	- SEC final rules at: https://www.sec.gov/rules/final/2018/33-

(Green)		whether directors or employees of the company are permitted to hedge against stock price drops with respect to equity compensation awards	December 18, 2018 - Effective for fiscal years beginning on or after July 1, 2019	10593.pdf
Excessive Compensation at Covered Financial Institutions (Yellow)	956	Prohibits "excessive compensation" or other incentive arrangements that could encourage "inappropriate risks" at certain "covered financial institutions"	- Not effective until rules finalized - Proposed rules published jointly by the SEC and various banking agencies on March 30, 2011	- Proposed rules at: http://www.sec.gov/rules/proposed/2011/34-64140.pdf
Broker Non-Votes (Green)	957	Prohibits discretionary voting by brokers on shares they do not beneficially own on (i) election of directors, (ii) executive compensation, and (iii) any other "significant matter" as determined by the SEC	- NYSE listing rules adopted Sept. 9, 2010, including clarification that this applies to shareholder votes under §951 - No current schedule for rules to determine "other significant matters"	- NYSE listing rules at: http://www.sec.gov/rules/sro/nyse/2010/34-62874.pdf

