New Scrutiny for Hedging Policies

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New SEC disclosure rules regarding hedging are now in effect. As a technical matter, these rules do not require a publicly traded company to implement a hedging policy. They merely require a company to disclose information regarding its hedging policy or state that it does not have one.

Nonetheless, companies that lack a hedging policy should strongly consider implementing one now.

The prevailing practice among S&P 500 companies is to have a hedging policy, according to an SEC survey cited in the rules, with a high percentage of S&P SmallCap 600 companies disclosing a policy as well. A motivating factor for companies to adopt these policies is that Institutional Shareholder Services (ISS) views the existence of a robust hedging

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policy as important from a company risk oversight perspective. With increased focus on hedging policies in light of the new disclosure rules, those companies lacking a policy can expect increased shareholder scrutiny in the upcoming proxy season. Now is the time for these companies to prioritize the adoption of a policy. In addition, companies with hedging policies already in place should now review their policies and consider how they compare to current market practices.

Lastly, while the rules do not mandate the disclosure of pledging policies, we encourage companies to consider their hedging and pledging policies hand in hand. Keep reading for the "Five Ws" of the hedging disclosure rules.

Who? During proxy season 2020, most public companies will be required to disclose information regarding their hedging policies and practices.

What? Under final rules promulgated in 2018 by the SEC (available at: https://www.sec.gov/news/press-release/2018-291) under the Dodd-Frank Act, companies must disclose practices or policies regarding the ability of employees (including officers) and directors to engage in hedging transactions. Hedging transactions are designed to allow an individual to hedge or offset any decrease in the market value of the individual's equity securities. The SEC intentionally did not define the word "hedge," preferring to keep the concept principles-based. However, prototypical examples of hedging transactions, as referenced in the statute and the rules, include the purchase of prepaid variable forward contracts, equity swaps, collars and exchange funds. Companies may provide their hedging policies in full or summarize the policies. A summary should address who is subject to the policy and the types of hedging transactions that are permitted and prohibited. If a company does not have a hedging policy in place, it must disclose that fact or state that hedging transactions are generally permitted.

Where? The disclosure must be included in proxy and information statements for the election of directors. The location within the proxy is not mandated. Many companies already describe hedging policies applicable to named executive officers, if material, in their Compensation Discussion & Analysis (CD&A) to comply with preexisting requirements under Item 402(b) of Regulation S-K. Some of these companies may opt to simply make the existing disclosure more robust to comply with the final hedging rules. Other companies may prefer to keep the newly required disclosure outside of the CD&A, so that it does not become incorporated into the company's Say on Pay vote. Another possibility is to utilize cross-referencing to avoid duplicative disclosures.

When? During fiscal years beginning on or after July 1, 2019, public companies filing proxy and information statements for the election of directors must comply with the new disclosure requirements. Calendar-year companies will be required to include the new disclosure in their annual meeting proxy statements filed with the SEC on or after January 1, 2020. However, smaller reporting companies and emerging-growth companies need only comply when making these filings during fiscal years beginning on or after July 1, 2020.

Why? The disclosure rules are intended to enhance the market's understanding about whether employees or directors can engage in transactions that mitigate the incentive alignment associated with equity ownership.

How about pledging? While the rules do not mandate the disclosure of pledging policies or practices, hedging and pledging policies often go hand in hand. ISS may recommend a vote against directors who oversee risks related to pledging, or the full board of directors, when a significant level of pledged company stock by executives or directors raises concerns. We encourage companies to consider their hedging and pledging policies in tandem.

To discuss hedging and pledging policies at your company, please contact Sheri Adler, David Kaplan, or any other member of the Employee Benefits and Executive Compensation Practice Group at Pepper Hamilton.