Articles + Publications | January 2, 2019

SEC's New Rules on Hedging Disclosure

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On December 18, 2018, the Securities and Exchange Commission (the "SEC") adopted final rules requiring companies to disclose in proxy or information statements for the election of directors any practices or policies regarding the ability of directors or employees to engage in certain hedging transactions with respect to company equity securities.[1] New Rule 407(i) of Regulation S-K follows the SEC's proposal[2] with some modifications reflecting commenter suggestions. It will become effective on July 1 in either 2019 or 2020, depending upon the issuer's status, as noted in the table below.

Currently, Item 402(b) of Regulation S-K requires companies, through their Compensation Discussion and Analysis ("CD&A"), to disclose material information necessary to understand a company's compensation policies and decisions regarding its "named executive officers." Such information includes whether or not the company has hedging practices or policies in place for such individuals. However, the CD&A disclosure requirements, unlike new Rule 407(i), do not address the hedging activities of the employee population as a whole.

The new rule does not require companies to adopt hedging policies, but the expanded disclosure may prompt companies to consider doing so or to revisit policies already adopted.

Scope of the New Rule

Under new Rule 407(i), SEC-registered companies will now be required to describe any practices or policies (whether or not written) regarding the ability of directors, employees (including officers) 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 company equity securities granted as compensation, or held directly or indirectly by the director or employee. Further, a company will be required to either provide a fair and accurate summary of any practices or policies that apply, including the categories of persons covered and any categories of hedging transactions that are specifically permitted and any categories that are specifically prohibited, or to disclose the practices or policies in full. The "fair and accurate" standard is uncommon in SEC regulations and thus may raise concerns over its meaning, but it is a concept used elsewhere, including in typical opinions given to underwriters. If a SEC-registered company does not have any such practices or policies, then Rule 407(i) will require it to disclose that fact or state that hedging transactions are generally permitted.

The SEC clarified that the term "equity securities," as proposed, means "registrant equity securities," noting that this is more consistent with the overall intention of Rule 407(i) to focus on the specific company's hedging practices or policies. Thus, Rule 407(i) requires companies to disclose only with respect to equity securities of the company, of any parent or subsidiary of the company or any subsidiary of any parent of the company.

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Who is Subject to the Rule

Current disclosure requirements only call for CD&A disclosure of hedging practices and policies for "named executive officers." Under new Rule 407(i), companies will be required to disclose hedging practices and policies with regard to their "employees." For purposes of Rule 407(i), "employee" means anyone employed by the company, including officers, or someone determined to be a "designee" based upon the particular facts or circumstances. The SEC has noted that the breadth of the persons covered is consistent with Congress' intent. In addition, the SEC has stressed that the focus of Rule 407(i) is on the company's disclosure of its particular practices or policies, and that each company will determine who is covered by its practice or policy.

Manner and Location of Disclosure

Companies will be required to provide this new information in a variety of places once new Rule 407(i) takes effect. First, companies will have to include these disclosures as a part of Item 7 of Schedule 14A. The SEC's rationale for including these disclosures in proxy statements is that they serve informational purposes for use by shareholders for the election of directors. As such, it makes sense that shareholders be able to consider this disclosure at the same time they consider the company's board makeup and other corporate governance policies. Rule 407(i) information will not, however, be required in a company's Form 10-K, Part III disclosure, even if incorporated by reference from the definitive proxy statement or information statement.

Second, companies that file an information statement on Schedule 14C also will need to disclose the information required under Rule 407(i). As such, when action is taken by shareholders without a company soliciting proxies, it will be required to make the Rule 407(i) disclosure. In the SEC's view, this requirement promotes consistent corporate governance disclosure.

Third, companies will have to change how they currently approach CD&A requirements. The new rule amends Rule 402(b) of Regulation S-K, specifically Instruction 6, so as to limit duplicative disclosures. Importantly, it should be noted that the SEC is not eliminating Rule 402(b). Instead, the SEC has decided that companies subject to both Rule 402(b) and new Rule 407(i) will have flexibility to decide how to handle the disclosure in the CD&A and outside of it. For example, a company could choose to include Rule 407(i) information outside of CD&A and then provide a separate Rule 402(b) disclosure as part of CD&A, without a cross reference. On the other hand, a company could elect to incorporate Rule 407(i) information into its CD&A, either by directly including the information or by cross referencing to information outside the CD&A.

Issuers Subject to the Amendments

Despite comments seeking their exclusion, the SEC chose to apply the new disclosure requirement to emerging growth companies ("EGCs")[3] and smaller reporting companies ("SRCs"),[4] as it proposed. However, the effective date for compliance by these companies is deferred a year, as shown in the table below. The SEC noted that it is consistent with its historical approach to corporate governance related disclosures, as well as the objectives of Section 14(j) of the Securities Exchange Act, to apply these disclosure requirements to EGCs and SRCs. In addition, the SEC stated that new Rule 407(i) does not in any way prevent these companies from creating such hedging practices or policies, if any, that they choose. If these companies believe that it would be in their best interests not to have such practices or policies, then they are free not to create any.

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The SEC excluded closed-end funds[5] from the requirements of Rule 407(i). It noted that the special structure, regulatory regime and disclosure obligations of registered closed-end funds makes the new disclosure requirements less useful to fund investors. In addition, the SEC noted that the compensation scheme often associated with closed-end funds is either inapplicable to the new disclosure requirements (as shares are not typically a component of incentive-based compensation), or if compensation does occur in the form of shares, it is often difficult to hedge these shares. Thus, Congress' concern about the undermining of the objectives of long-term compensation through hedging is unlikely to be raised in the case of closed-end funds. However, the SEC did choose to have the new disclosure requirement apply to business development companies, as being consistent with how it has previously treated these entities.

Finally, foreign private issuers ("FPIs")[6] are not subject to the new disclosure requirements because FPIs are not subject to the proxy and information statement requirements of Section 14 of the Exchange Act.

Compliance Date

Reporting Company Type	Date
Companies not qualifying as "smaller reporting companies" or "emerging growth companies"	**July 1, 2019**
Smaller Reporting Companies and Emerging Growth Companies	**July 1, 2020**

Our Insight

New Rule 407(i) expands the disclosure required about hedging policies and brings new focus on that disclosure. Although the new rule does not require companies to have a hedging policy, we believe the new disclosure requirements will likely motivate companies to adopt policies that prohibit hedging transactions. Most larger companies already have adopted such policies. ISS encourages the adoption of policies prohibiting hedging by employees as best practice and considers whether a company has done so in assessing the quality of the company's governance. Because the new disclosure requirements extend beyond directors and officers to policies covering employees generally, we recommend that companies without policies consider both whether or not to adopt one and how broadly a policy should apply. Companies that already have a policy should consider whether its coverage should be expanded, having in mind the disclosure that will be required.

A company is free to decide not to have a policy prohibiting hedging or to limit the scope of any such policy. A company without a policy could simply disclose: "Our company does not have any practices or policies regarding hedging or offsetting any decrease in the market value of registrant equity securities."

The new disclosure under Rule 407(i) will not be required for calendar-year companies until the 2020 proxy statement or, in the case of EGCs and SRCs, the 2021 proxy statement. However, because decisions will need to be made about a company's hedging policy, we recommend that the board of directors give careful consideration to the company's policy well before the disclosure will need to be made.

[1] *See* Rel. No. 33-10593 (Dec. 20, 2018), available at https://www.sec.gov/rules/final/2018/33-10593.pdf.

[2] *See* Rel. No. 33-9723 (Feb. 9, 2015), available at: https://www.sec.gov/rules/proposed/2015/33-9723.pdf.

[3] *See* Rule.405 of Regulation S-K (An issuer is deemed as such if it had total annual gross revenues of less than $1,070,000,000 during its most recently completed fiscal year. Moreover, the issuer shall retain this status until the earliest of: (i) the last day of the fiscal year of the issuer during which it had total annual gross revenues of $1,070,000,000 or more; (ii) the last day of the fiscal year of the issuer following the fifth anniversary of the date of the first sale of common equity security of the issuer pursuant to an effective registration statement under the Securities Act of 1933; (iii) the date of which such issuer has, during the previous three year period, issued more than $1,000,000,000 in non-convertible debt; or (iv) the date on which such issuer is deemed to be a large accelerated filed, as defined in Rule 12b-2 of the Exchange Act.

[4] *See* Rule 10(f)(1) of Regulation S-K (An issuer that is not an investment company, an asset-backed issuer, or a majority owned subsidiary of a parent that is not a smaller reporting company and that: (i) had a public float of less than $250,000,000; or (ii) had annual revenues of less than $100,000,000 and either (a) no public float; or (b) a public float of less than $700,000,000.

[5]*See §202(5)* of Investor Advisor Act of 1940 (a "closed-end fund" is legally known as a "closed-end company" – a corporation, a partnership, an association, a joint-stock company, a trust, or any organized group of persons, whether incorporated or not, or any receiver, trustee in a case under title 11 of the United States Code of similar official, or any liquidating agent for any of the foregoing in his capacity as such).

[6] *See* Rule 3b-4 (any foreign issuer other than a foreign government except for an issuer meeting the following conditions as of the last business day of its most recently completed second fiscal quarter: (i) more than 50 percent of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the United States; and (II) and of the following: (a) the majority of the executive officer or directors are United States citizens or residents; (b) more than 50 percent of the assets of the issuer are located in the United States; or (c) the business of the issuer is administered principally in the United States.

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