

Meridian Client Update

SEC Issues Proposed Rule on Hedging Disclosure

On February 9, 2015, the Securities and Exchange Commission (SEC) issued a proposed rule that would require the disclosure of employee and director hedging activity as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).

Overview of Proposed Rule

Under the proposed rule, a public company would be required to disclose in its annual meeting proxy whether any employee or member of its board of directors, or any designee of such employee or board member, is permitted to (i) purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities, or (ii) otherwise engage in transactions that are designed to or have the effect of hedging or offsetting any decrease in the market value of equity securities (collectively referred to as “Hedging Transactions”):

- granted to the employee (including officers) or member of the board as compensation; or
- held, directly or indirectly, by the employee (including officers) or member of the board.

Neither Dodd-Frank nor the proposed rule requires a public company to maintain a policy on employee and director hedging activities.

Simple Disclosure Required Under Lengthy Proposed Rule

For those public companies that prohibit or will prohibit all forms of hedging transactions, the following disclosure should be sufficient to comply with the proposed rule:

“The Company prohibits every employee (including officers) and director from (i) purchasing financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities, or (ii) otherwise engage in transactions that are designed to or have the effect of hedging or offsetting any decrease in the market value of equity securities:

- ***granted to an employee or director as compensation (or any designee of such employee or director); or***
- ***held, directly or indirectly by, an employee or director.”***

Additional Requirements of the Proposed Rule

The proposed rule provides the following additional requirements:

- **Disclosure Requirement Solely Applies to Hedging Transactions in Registered Securities.** The proposed rule would solely apply to Hedging Transactions in a company’s equity securities that are registered on a national securities exchange or registered under Section 12(g) of the Securities

Exchange Act of 1934. Subject equity securities also would include registered equity securities issued by a company's parent, subsidiaries or subsidiaries of the company's parent.

- **Placement of Disclosure.** The proposed rule would require the disclosure on hedging to be included in proxy or consent solicitation materials and information statements with respect to the election of directors. The SEC has designated the proposed disclosure as relating to corporate governance (Item 407 disclosure) rather than executive compensation (Item 402 disclosure). Therefore, the required disclosure need not be included in the Compensation Discussion and Analysis (CD&A) section of an annual proxy. However, we anticipate that many companies will, in fact, make the required disclosure in their CD&As.
- **Disclosure Satisfies Obligation to Disclose in CD&A Hedging Policies Applicable to NEOs.** Under current rules, a company is required to disclose in its CD&A any material hedging policies that cover named executive officers. By requiring proxy statement disclosure of whether employees generally are permitted to hedge equity securities that they receive as compensation or otherwise hold, the proposed rule includes within its scope hedging policies applicable to named executive officers. To avoid duplicative disclosures, the proposed rule generally would allow a company to satisfy its CD&A obligation to disclose material policies on hedging by named executive officers by simply cross-referencing the disclosures required under the proposed rule.
- **Disclosures Required Under the Proposed Rule.** Generally, the proposed rule would require a public company to disclose which categories of hedging transactions it permits and which categories of hedging transactions it prohibits. However, the SEC recognized that in certain instances such a disclosure regime could become unwieldy. For example, where a company permits hedging transactions subject to certain specified exceptions, the general rule would require such a company to disclose both the prohibited hedging transactions and a potentially limitless number of permitted hedging transactions. To avoid such an outcome, the proposed rules would permit a company to make the following streamlined disclosures under each of the described circumstances:

Company Policy	Disclosure on Permitted Hedging Transactions	Disclosure On Prohibited Hedging Transactions
Identifies specified forms of hedging transactions that are prohibited Hedging transactions that are not expressly prohibited are permitted	Disclose that all categories of hedging transactions are permitted subject to certain exceptions	Identify each category of hedging transactions that is prohibited
Identifies specified forms of hedging transactions that are permitted Hedging transactions that are not expressly permitted are prohibited	Identify each category of hedging transactions that is permitted	Disclose that all categories of hedging transactions are prohibited subject to certain exceptions
Prohibits all forms of hedging transactions	No disclosure required	Disclose that all forms of hedging transactions are prohibited
Permits all forms of hedging transactions	Disclose that all forms of hedging transactions are permitted	No disclosure required

- **Companies Subject to Disclosure Requirement.** Unless otherwise exempted from the disclosure requirement (see below discussion), the proposed rule would apply to all classes of issuers, including the following classes:
 - Smaller reporting companies
 - Emerging growth companies
 - Closed-end investment companies that have shares that are listed and registered on a national securities exchange

- **Companies Exempt from the Disclosure Requirement.** The proposed rule would exempt from the disclosure requirement the following classes of issuers:
 - Foreign private issuers
 - Investment companies registered under the Investment Company Act of 1940 that are not listed closed-end funds (e.g., open-ended mutual funds, ETFs)

Comment Period and Timing for Adoption of Final Rule

Comments on the proposed rule must be submitted to the SEC no later than April 20, 2015.

The SEC is under no obligation to adopt a final rule within a specified period following the conclusion of the comment period. However, we anticipate that the SEC will adopt a final rule on hedging disclosures sometime this year. If so, then it is likely that the disclosure will be required in 2016 proxy filings.

Meridian comment. Among the four remaining Dodd-Frank executive compensation and governance disclosures awaiting rulemaking by the SEC, the disclosure on hedging transactions is the sole one that is uncontroversial and that does not create a significant compliance burden. Perhaps that is why the SEC decided at this time to issue its proposed rule on hedging transactions, rather than to adopt a final rule on the CEO pay ratio or to release proposed rules on the two other important Dodd-Frank mandates (i.e., disclosure on the relationship between pay and performance and mandatory recoupment or “clawback” policies). The SEC has provided no firm indication as to when we can expect to see action on these open items.

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The *Client Update* is prepared by Meridian Compensation Partners’ Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.

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