

Capital Markets & Securities

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SEC Adopts Compensation Hedging Disclosure Rule

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What You Need To Know:

- **Item 407, Item 402, and Schedule 14A are amended to require companies to disclose information regarding any practices or policies adopted allowing their employees or directors to engage in transactions that hedge or offset any decrease in the market value of equity securities given as compensation or held directly or indirectly by the employees or directors.**
- **These new disclosure requirements will apply to all companies with a class of securities registered under Section 12 of the Exchange Act, including emerging growth companies, smaller reporting companies, and business development companies.**
- **Smaller reporting companies and emerging growth companies must comply with the newly adopted rules during fiscal years beginning on or after July 1, 2020, while companies that do not qualify as smaller reporting companies or emerging growth companies must comply with the newly adopted rules during fiscal years beginning on or after July 1, 2019.**

On December 20, 2018, the Securities and Exchange Commission (the “SEC” or the “Commission”) issued Release No. 33-10593/34-84883 (the “Release”) (full Release can be found [here](#)), announcing the Commission’s adoption of amendments to Item 407 of Regulation S-K (Corporate Governance).

The new Item 407(i) will require a company to “describe any practices or policies it has adopted (whether written or not) regarding the ability of employees (including officers) or directors of the company, or any of 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 to the employee or director by the company as part of the compensation of the employee or director, or held, directly or indirectly, by the employee or director.” The SEC makes it clear that nothing in the Release should be construed as the SEC suggesting that companies need to adopt policies or practices regarding hedging

activity. If a company has no such policy or practice, it should disclose that fact or state that hedging activities are generally permitted. The new Item 407(i) disclosure requirement will apply to equity securities issued by the company, its parents, subsidiaries, or subsidiaries of the company’s parents.

Item 407(i) does not define “hedge” (a deliberate omission), as the Release states that the term should be interpreted broadly, so as to capture “transactions with the same economic effects—to hedge or offset any decrease in the market value of company equity securities.” This broad interpretation aligns with the legislative intent behind Section 14(j), which is to allow shareholders to know whether executives are permitted to purchase financial instruments that reduce the incentivizing effects associated with equity compensation related to an executive’s employment.

The new rule amendments will require additional disclosures but do not alter existing requirements regarding hedging policies and practices under existing SEC rules and regulations, such as in

Compensation Discussion and Analysis (CD&A), Item 403(b) of Regulation S-K, and Form 4 under Section 16(a) of the Exchange Act.

The amendments will require disclosure in any proxy statement on Schedule 14A (or information statement on Schedule 14C) with respect to the election of directors. Item 7 of Schedule 14A will be amended to require the disclosure to appear in proxy statements, thereby allowing shareholders to consider additional information on whether the company has practices or policies affecting the alignment of incentives for employees and directors of the company whose securities they hold. The disclosure is not required in Securities Act or Exchange Act registration statements or in a proxy solicitation not involving the election of directors.

To avoid duplicative disclosures, the amendments will add an instruction to Item 402(b) that states that a company may satisfy its CD&A obligations by cross-referencing the information disclosed pursuant to the new Item 407(i), if that information also satisfies its CD&A disclosure requirements.

All companies with a class of securities registered under Section 12 of the Exchange Act will be subject to the new disclosure requirements, including emerging growth companies, smaller reporting companies, and business development companies. Smaller reporting companies and emerging growth companies must comply with the new disclosure item for proxy and information statements with

respect to the election of directors during fiscal years beginning on or after July 1, 2020. Companies that do not qualify as smaller reporting companies or emerging growth companies must comply with the adopted rules for proxy and information statements with respect to the election of directors during fiscal years beginning on or after July 1, 2019. The new disclosure requirements will not apply to foreign private issuers, investment companies registered under the Investment Company Act, or closed-end investment companies with shares listed on a national securities exchange and registered under Section 12(b) of the Exchange Act.

Taking Action in Advance

Companies are advised to prepare in advance for the new disclosure rules and consider what changes, if any, they will want to make before the rules are in effect. Companies that are considering adopting policies or practices regarding hedging activity, despite the SEC not requiring such adoption, should look ahead to what their disclosure would include. Companies that currently have hedging and anti-hedging practices and policies in place should review such practices and policies, consider any changes they would like to make, and anticipate what they will be required to disclose under the new rules.

If you have any questions or would like further information about the final SEC amendments, please contact any member of the Lowenstein Sandler Capital Markets & Securities Practice.

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