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How the SEC's Hedging Rule Will Impact Public Companies

In December 2018, the SEC was able to close the books on a pending provision from the Dodd-Frank Act by finalizing a long-awaited hedging disclosure rule. What does this mean for public firms?

The new disclosure requires most public companies to disclose any practices or policies regarding the ability of employees and corporate directors to hedge their company's equity securities by adding a new paragraph to the corporate governance disclosure requirements in Item 407 of Regulation S-K. The final rule is generally consistent with the rule the SEC proposed back in February 2015.

Scope of the disclosure requirement

The hedging rule requires companies to disclose in full or provide a summary of their practices and policies for employees, officers, and directors to engage in hedging transactions. The final rule did not define the term "hedge," and the disclosure requirement is not limited to any particular type of hedging transaction. Instead, the SEC adopted a broad framework, requiring the disclosure of all company practices and policies relating to the purchase of financial instruments. This also includes engaging 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 consist of securities issued by the registrant and any parent or subsidiary of the registrant.

If the company does not have any such hedging practices or policies, it must disclose that fact or state that hedging transactions are generally permitted. Notably, the rule does not require a description of hedging transactions because the SEC viewed that disclosure as duplicative of existing Section 16 reporting requirements.

Who is covered under the rule

The final rule covers any company with securities registered pursuant to Section 12 of the Securities Exchange Act, including business development companies, small reporting companies (SRCs), and emerging growth companies (EGCs). Foreign private issuers and listed closed-end funds are exempt from the new disclosure requirement.

Companies will need to disclose their hedging practices or policies that apply to employees and directors, as well as any of their designees. The final rule does not define "designee," instead specifying that "whether someone is a 'designee' depends on the particular facts and circumstances involved."

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Compliance dates

Large accelerated and accelerated filers 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 calendar year companies, the required disclosure should be included in proxy or information statements filed in the year 2020. SRCs and EGCs must comply with the new disclosure requirements in proxy and information statements for the election of directors during fiscal years beginning on or after July 1, 2020 (i.e. the 2021 proxy season for calendar year companies).

Relationship to existing CD&A obligations

The rules governing the Compensation Discussion & Analysis (CD&A) section of the proxy statement already require disclosure of any hedging policies covering named executive officers if they are deemed material. The new rule permits companies to avoid disclosure that could be duplicative. In addition, it allows companies to locate the required disclosure in the location that best accomplishes their communication goals. Existing hedging disclosure will likely need some modification to comply with the new rule, but companies might consider consolidated disclosure and an appropriate cross-reference to satisfy the rule.

Proxy advisory firm angle

ISS and Glass Lewis generally view hedging as a problematic practice. Hedging constitutes, in ISS' view, a type of governance failure in risk oversight that could lead to a recommendation "against" a director, committee, or the full board, if material. Glass Lewis' view is that hedging de-links the alignment of executives' interests with that of shareholders, and the firm favors strict anti-hedging policies.

Next steps

The new disclosure rule does not appear to present a significant compliance burden. Many public companies are already required to disclose policies on hedging by executive officers in the CD&A. However, because the new disclosure requirement extends to policies covering all employees, companies will likely need to consider expanding the coverage of their existing anti-hedging policies. Any issuer that has not previously adopted an anti-hedging policy should consider adopting a policy before the applicable compliance date.

If you have any questions about this disclosure rule or other corporate governance and executive compensation related topics, and want to speak with one of our experts, please write to info@mclagan.com.

Author Contact Information

Gayle Appelbaum
Partner, McLagan
Aon
1.952.886.8242
gayle.appelbaum@mclagan.com

Katrina Gerenz
Associate Partner, McLagan
Aon
1.952.886.8247
katrina.gerenz@mclagan.com

Todd Leone
Partner, McLagan
Aon
1.952.886.8254
todd.leone@mclagan.com

Mark Behnke
Partner, McLagan
Aon
1.203.602.1203
mark.behnke@mclagan.com

Bryan Lemke
Principal, McLagan
Aon
1.952.886.8272
bryan.lemke@mclagan.com

Dan Pliskin
Associate Partner, Rewards
Aon
1.215.255.2028
dan.pliskin@aon.com

Greg Camarco
Associate Partner, McLagan
Aon
1.203.517.3804
gregory.camarco@mclagan.com

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