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PODCAST

Episode 9: Time to Review the Company's Hedging Policy

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Audio Transcript:

Joe Adams: Welcome to Winston's Benefits Blast Podcast. My name is Joseph Adams, and I am joined today by my partner, Mike Melbinger. During today's episode, we're going to be talking about new hedging rules that were recently promulgated by the SEC.

Michael Melbinger: Okay, Joe, a lot of clients are thinking: "We already have a hedging policy, and I have a *lot* of things to do on my desk right now." Is there really anything new here?

Joe Adams: That's a great question, Mike, and I think that we have found that it's hard for clients to focus on this because we know everyone's busy and as you alluded to, most of our clients already have a hedging policy. There is an existing requirement under the CD&A rules that lists 15 items that a company might want to describe in the CD&A if they would be relevant to investors' understanding of the company's compensation philosophy. Included in that list of 15 items was a requirement to disclose if you had a policy prohibiting hedging by officers and directors.

And, so you're right, Mike many of our clients have a policy already.

The ***new*** rule is pursuant to the Dodd-Frank Act, which was added and finalized by the SEC last December, so it added some new rules to Reg S-K and a new section 407(i).

The new rules don't require, much like the way SEC frequently governs in this space, you to actually have a policy. A company just has to *disclose* any policy that it has. The thinking that from the SEC's perspective, this will give investors, when it comes time for the annual meeting, knowledge as to whether officers and directors have anything that prohibits them from hedging their equity interests in the company that might break their alignment with shareholders. So again, the SEC doesn't require companies to have a hedging policy. But certainly we know that proxy advisory firms like ISS and Glass Lewis will consider it a poor pay practice if you *don't* do those things.

So, everyone needs to have something. We had the old CD&A rule, and now we have this new Dodd-Frank rule. There are a couple of reasons that this merits attention even though we know that everyone is busy:

1. First, the new rule is just *slightly* different than the existing rule in terms of who's covered. Obviously the prior CD&A rule would've only covered the named executive officers, and this rule is broader so you have to think about, "*Are we going to have different rules for different folks, and if we do, then we will need to disclose that we have different rules*," and so we'll talk about that later in the podcast. Also, the new rule has slightly different coverage about stocks owned indirectly, another thing that may not be covered in your existing policy. So, there are these little gaps and you might inadvertently be creating a gap if you don't go back and revise your existing policy to make sure it squares up with the new SEC rule.
2. And, then the other reason this merits focus now is that there is an interesting timeline for this; specifically, this rule goes into effect for anyone that files a proxy after July 1st of this year.

So people are just coming online with this requirement, and it might sneak up on you depending on when your proxy is required to be filed. So, we have some steps towards the end of the podcast with how clients should think about, "*How do we reconcile our existing policy with this new requirement?*"

Michael Melbinger: Interesting.

Joe Adams: So, if we have to draft a new policy, the next question is what would be covered by this, Mike? How did the SEC wind up defining a hedging transaction when they came up with the Dodd-Frank rules requiring disclosure of hedging policies?

Michael Melbinger: Well, Joe, the rules make it clear that the SEC intends the disclosure requirement to apply very broadly and I'll just read a quick quote. "*Establishing downside price protection is the essence of the transactions contemplated by Section 14(j),*" which is the Exchange Act section. However, the SEC did not define the term "hedge" because, as the SEC states in the release, *the SEC intended to "avoid adopting a definition that could prove either over- or under-inclusive and allows for flexibility to address new downside price protection techniques as they develop*."

And that probably makes sense as certainly all the lawyers and most others in the audience will know whenever you specify something, clever lawyers, and clever business folks often find a way around it.

But, by resisting all requests to provide a definition of hedging, the SEC instead has placed the burden entirely on the company and its counsel to develop the policy. In fact, the SEC declined even to state that the purchase and sale of mutual funds, index funds, or other diversified investment vehicles were excluded from the definition of hedging.

So, what's a company to do? Who can tell what's prohibited? Should companies attempt to define hedging or provide examples of the sorts of transactions that are prohibited? These are the types of questions that we are hearing.

Our current thinking is that companies should *not* provide examples of what types of transactions are expressly permitted or prohibited, and the rules do not require that. The rules require you to disclose whatever policy you have. That's it.

But, just for example, a policy could state that covered employees may purchase or invest in mutual funds such as an S&P 500 index funds, and that's okay. The problem is a broad permission to invest in index funds may not be appropriate for certain companies where industry-specific mutual funds are available, which could conceivably be a hedge. So, this might be a good time to sit back and follow the development of best practices.

However, despite its disinclination to provide a definition of hedging, the language of the SEC release provides some specific references to transactions that it regards as hedging. I'm not going to read out the list on a podcast but there is a list of these specific types of hedging transactions on our website and on my blog. [*Editor's note: See here*.]

Joe Adams: Terrific.

Michael Melbinger: All right, now it's my turn to ask you one. Once we have considered what hedging transactions might be covered, then our next question is who should the hedging policy cover?

Joe Adams: The idea here is, again the SEC doesn't require you to have a policy at all on hedging; you're simply supposed to disclose whatever is the company's policy. And, the way the SEC rule is written, it is different than the CD&A which is focused only on the named executive officers. So, you can have a policy that covers whomever you want, and it's up to each company to define what the policy is and define who is covered by it.

And like Mike was saying earlier, our clients are thinking about this now and they're trying to figure out who should be covered by their policies. On the one hand, it is tempting to say that, "*Well, we're just going to make this policy apply to everyone; ALL of our employees and directors are prohibited from entering into hedging transactions*." While that sounds nice and kind of a simple rule, I think we've been having some internal discussions about how enforceable something like that is.

And, given how aggressive litigation in this area can be, do you raise a risk that if you have a policy and you *didn't* enforce it against an employee—particularly if you don't have a way of tracking compliance – that you could be buying yourself a lawsuit?

So, I think our current thinking is that a lot of our clients will limit their hedging policy to some cadre of their executive officers, however, that's defined. And, maybe some alignment with the stock ownership policy: the people that are required to hold their shares. We want to make sure that those people aren't trying to hedge away that liability because we wanted you to own those shares – we wanted you to be "aligned" with the company—and if you hedge, then that takes away that alignment.

And the other employees, those not subject to the share ownership requirement, they're probably less likely to enter into a hedging transaction anyway. If they need liquidity, they'll like just sell the shares.

So, still to come out exactly how companies will ultimately define the individuals covered by their hedging policy. But I think we're thinking something a little narrower than all employees are probably the way to go.

So, Mike, if we considered what types of hedging transactions might be picked up by this rule, and which individuals should be subject to a company's hedging policy, I think the next question people are thinking about is what holdings are subject to this policy? And again, one question revolves around whether these new requirements apply to just the equity compensation that people have received or is it *all* holdings?

Michael Melbinger: The answer is that it is *not* just compensatory awards. So there's really two points to think about here:

Number one is the rules make clear that the policies should apply to the company's stock and other equity securities that are either compensatory or held directly or indirectly by the employees of the directors. So that includes stock acquired on the market, which of course many folks have in order to reach their stock ownership guidelines.

The other point is that the rules also make it clear that equity securities for which disclosure is required, including any parent of the company, any subsidiary of the company, any subsidiary of the parent of the company. So almost anyone you can think of. And there are of course situations where they're multiple public companies in a single controlled group where this occurs.

So, your turn Joe, what should discussion of a company's hedging policies go in their proxy statement? This is after all proxy statement disclosure.

Joe Adams: Exactly. The SEC gave us a bunch of flexibility here. So I think we are talking with clients about both *what* should go in the proxy, and *where* does it best go.

In terms of "what", the SEC rules make clear that you can either provide a summary of your hedging policy or you can disclose the policy in full. Our current thinking is that it's best to just disclose the hedging policy in full unless it's inordinately long, because providing the full policy minimizes any risks that you will have misstated the policy.

One exception to that might be for companies that have their hedging policies baked into their insider trading policies. And so companies like that may have to excerpt the hedging portion from the insider trading policy in order to describe the hedging policy in the proxy. But otherwise, probably best just to include the whole policy if it's not overly burdensome.

And then as to "where" it goes in the proxy, again, the SEC gave us flexibility because we have this existing requirement on hedging that's in the CD&A and we have this new requirement that's pursuant to Dodd-Frank. So, the SEC rules say that the hedging policy can be set out separately and it can then be incorporated in the CD&A or it can be included in both places. Lots of flexibility. I think there's one thing that executive compensation lawyers focus on that if it's incorporated by reference into the CD&A, then that technically makes the hedging policy subject to the company's "Say on Pay" vote, which may not be a huge issue, but nevertheless, our current thinking is that it may be best to keep your new Dodd-Frank disclosure separate from what goes into the CD&A currently.

Michael Melbinger: Right. Good point.

Joe Adams: One issue that we've just started to think about, Mike, and I don't know if you've seen this with any clients is what best to do if there's a violation of our hedging policy? Should we spell that out in the policy? Should we spell it out somewhere else?

Michael Melbinger: Well, Joe, what we're telling clients now is if you have a policy and you specify the consequences of a violation, think about it, but more or less leave it "as is." We are not suggesting any specific consequences set forth in a document. And the reason for that is, there may be a foot fault. We may want discretion. We do want discretion. So, we're suggesting, for example, that if your hedging policy is in your Code of Conduct, Insider Trading Policy, or just generally a separate policy, you add a sentence at the end of the policy that says "*All remedies available under the company's Code of Conduct or the company's insider trading policy shall be available to the Board*." Something simple like that.

Joe Adams: Excellent. And I should make clear that under these new rules, if there is a violation, there is nothing in these SEC rules that require disclosure of the violation. So, it largely a matter of internal corporate governance. Of course, it might trigger some SEC filings if there actually is a trade that affects the shares, but there is nothing in these SEC rules that require disclosure, at least right now.

Michael Melbinger: Right. Well, we've covered a lot of ground. What should companies do now? That's what they really want to know.

Joe Adams: Yes, maybe we can tag team on this one, Mike.

Again, I think a lot of companies already have a hedging policy, so unless they have *no* hedging policy at all, there's no need to take dramatic action at this point. And again, the new rules really focus on *disclosure* of the company's policy. There's no substantive requirements that states what a company has to do. So, given that most companies already prohibit some hedging, and disclose in the proxy their current policy on prohibiting hedging by directors and officers, I think what most companies will want to do is re-examine their existing hedging policy to see how it squares up with the new rules.

What are you seeing, Mike, in terms of what more people might want to do in terms of reviewing their existing policies?

Michael Melbinger: Well, oddly enough, the first thing we are suggesting – because it's a practical consideration – is to get something on the Committee agenda ASAP, if you haven't already discussed it. When I say Committee, I say that advisedly because, in our experience, generally Compensation Committees handle hedging because they are the ones that deal with compensatory company stock awards. But that's certainly not always the case. So find out which committee is responsible. Maybe it's the full board.

Once you've got that, you need to talk to them, explain to them the rules, and explain to them what might have to change. We'd suggest go in there with some ideas about how to change it.

So, at a minimum, you want to dig out your policy. If you haven't looked at it for a while, and many haven't ("*It's been in place for 10 years since I started with the company. . . . " "It worked so far, so. . . ."*) well, take it out, look at it, consider clarifying changes such as "*Should all employees be covered*?" (No, not if you can help it.)

And then sit and wait. That's what we're telling some companies.

Now, some clients, of course, like to get out in front of things and be in the vanguard and that's fine, and we'll help them draft state-of-the-art policies as they exist today. Others want to follow the "wildebeest approach," to just stay in the pack and wait until the institutional investors and ISS and everybody else comes out with what they expect to see in a policy and then we'll change our policy to comply with that. Take the "best practices" approach.

Joe Adams: Exactly. Terrific, Mike, that was very helpful.

Mike and I both want to thank everyone for listening to another edition of Winston's Benefit Blast Podcast. Please stay tuned for future episodes where we'll have insights on additional legislative regulatory and practical developments regarding employee benefits and executive compensation. Please also remember to subscribe to the blog on our website for additional updates on legal developments in this area. Thank you very much.

Speaker

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