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Re: Disclosure of Hedging by Employees, Officers and Directors;
Rel. No. 33-9723; 34-74232; IC-31450
File No. S7-01-15

April 20, 2015

VIA E-MAIL: rule-comments@sec.gov

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Dear Mr. Fields:

Thank you for the opportunity to comment upon the Securities and Exchange Commission's proposed rule amendments to implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). Section 955 amends Section 14 of the Securities Exchange Act of 1934 (as amended, the "Exchange Act") to add:

> "(j) DISCLOSURE OF HEDGING BY EMPLOYEES AND DIRECTORS.—
>
> "The Commission shall by rule, require each issuer to disclose, in any proxy or consent solicitation material for an annual meeting of shareholders of the issuer, whether any employee or member of the board of directors, or any designee of such employee or director, is permitted to 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 either (a) granted to the employee or director by the issuer as part of the compensation of the employee or director; or (b) held, directly or indirectly, by the employee or director."

Below we respond to several of the questions posed in the proposing release. Parenthetical page references are to the proposing release, available at: http://www.sec.gov/rules/proposed/2015/33-9723.pdf

1. **The final rule amendments should apply to executive officers and directors and not to all individuals employed by a company.**

(a) *Interpreting the term "employee"*

The proposing release asks: "*Section 14(j) is directed to 'any employee' and we interpret that to mean anyone employed by the issuer. Should we limit the definition of 'employee' to the subset of employees that participate in making or shaping key operating or strategic decisions that influence the company's stock price? Why or why not? If so, how would that distinction be defined for practical purposes?*" (p. 22)

We believe the Commission should interpret the term "employee," as used in Section 14(j), to include only an issuer's "executive officers." The final rules could provide for an instruction that "executive officers" for this purpose would be understood to mean "officer" as defined in Rule 16a-1(f) under the Exchange Act. Rule 16a-1(f) defines "officer" as follows:

> "The term 'officer' shall mean an issuer's president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer. Officers of the issuer's parent(s) or subsidiaries shall be deemed officers of the issuer if they perform such policy-making functions for the issuer. In addition, when the issuer is a limited partnership, officers or employees of the general partner(s) who perform policy-making functions for the limited partnership are deemed officers of the limited partnership. When the issuer is a trust, officers or employees of the trustee(s) who perform policy-making functions for the trust are deemed officers of the trust."

Rule 16a-1(f) officers are recognized in longstanding Commission rulemaking as those individuals who are in a position to make or influence the business decisions that affect a company's stock price, and we agree that investors would benefit from understanding whether their company allows or prohibits hedging transactions involving equity securities held by those individuals. Other aspects of the securities laws recognize the importance of providing public information about executive officers' stock ownership, including filings under Section 16 of the Exchange Act to inform the public of their transactions in company securities, and Exchange Act Section 14 proxy statement disclosure requirements concerning their holdings and pledging of company securities. Given the reliance investors place on information about the equity ownership of executive officers, we believe it makes sense for investors also to have information on whether that equity is permitted to be hedged, since hedging can be used to offset an executive officer's economic exposure to the equity.

We believe that the Commission can interpret the term "employee" in this manner consistently with the Congressional mandate embodied in Section 955. As the proposing release indicates (p. 5), a report issued by the Senate Committee on Banking, Housing and Urban Affairs stated that Section 14(j) is intended to "allow shareholders to know if executives are allowed to purchase financial instruments to effectively avoid compensation restrictions that they hold stock long-term, so that they will receive their compensation even in the case that their firm does not perform."[1] This legislative history provides strong evidence that Congress was concerned with providing investors information about the permitted hedging activity of executive officers, not rank-and-file employees.

Alternatively, since Congress inserted Section 14(j) into the Exchange Act, Congress also gave the Commission the authority to exempt non-executive officer employees from Section 14(j)'s use of the term "employee" pursuant to Section 36(a)(1) of the Exchange Act. Indeed, it is noteworthy that the Dodd-Frank Act limited the Commission's general exemptive authority in several meaningful respects, but did not limit it with respect to Section 14(j) of the Exchange Act.

Therefore, whether the Commission elects to use its interpretive authority under Section 14(j) or its general exemptive authority under Section 36(a)(1), we believe the Commission can, and should, limit the term "employee" as used in Section 14(j) and any rules promulgated thereunder to mean executive officers. Doing so would be consistent with the proposing release's acknowledgment that "for employees below the executive level who typically do not make decisions that influence stock price, information about their equity incentives and hedging of their equity holdings may be less relevant for investors." (p. 56)

Limiting the reach of the term "employee" would also result in less of a burden for issuers. Hedging of securities by executive officers and directors has been in the spotlight recently because influential proxy advisory firms' voting guidelines view hedging of company stock by executive officers and directors as a failure of board risk oversight.[2] The views of these proxy advisory services have led many companies to adopt new policies, or publicly disclose existing policies, regarding hedging by executive officers and directors.[3] Limiting the new disclosure requirements so that they align with many companies' existing policies would make implementation of the disclosure requirement less of a burden, as companies would not need to consider whether to extend the prohibition on hedging to all company employees, bear the associated costs of educating all employees about the prohibition, and monitor and enforce it.

Similarly, limiting the reach of the term "employee" to executive officers would also be fairer to non-executive employees. These employees, by and large, do not have the ability to exert influence on their company's stock price, yet out of a sense of loyalty, or otherwise in the course of their careers, these employees may accumulate employer stock and it may become appropriate for them from a personal perspective to diversify. These employees are investors too, and we believe the Commission can sensibly take their interests into account in crafting the new rules.

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[1] Report of the Senate Committee on Banking, Housing and Urban Affairs, S. 3217, Report No 111-176 (Apr. 30, 2010).

[2] E.g., ISS, United States Proxy Voting Guideline Updates: 2015 Benchmark Policy Recommendations, at p. 3 n.1 (Nov. 6, 2014), available at: http://www.issgovernance.com/file/policy/2015USPolicyUpdates.pdf

[3] According to ISS Corporate Services, ISS QuickScore indicates that 49 percent of Russell 3000 companies and 84 percent of S&P 500 companies have hedging policies governing their officers and directors.

(b) *Costs and benefits*

The proposing release asks: "*Are the costs and benefits of disclosing information about whether non-officer employees are permitted or prohibited to hedge different from the costs and benefits of disclosing information about officers and directors? If so, should the rule be modified to take those differences into account?*" (p. 82)

We recognize that the proposed amendments require disclosure of whether or not a policy on hedging exists, and do not mandate the adoption of such a policy. However, there is no question that Commission rules requiring corporate governance disclosure have a tremendous normative impact on corporate policies. A notable example of this is Item 407 of Regulation S-K, which requires companies to disclose whether they have at least one "audit committee financial expert." Although styled as a disclosure rule and not a substantive requirement, most companies have been motivated to retain at least one, if not more than one, audit committee financial expert.[4]

While the proposed amendments permit a company to state that it does not have a hedging policy, or that its hedging policy is limited in scope to executive officers and directors, we suspect a significant number of companies would come to the view that, despite the legislative history cited above, Section 14(j) embodies a judgment that allowing hedging of company securities by any person employed by the company is not good corporate governance. Even companies that do not subscribe to this view initially may eventually find it necessary to act on as a "best practice," or may be concerned about being criticized for appearing to do less than peer companies to rein in what the proposed amendments may suggest is a negative practice.

Corporate policies require compliance and enforcement mechanisms to reinforce their purposes, and there are always costs associated with instituting these mechanisms. The type and amount of the cost of adopting a policy that encompasses all employees would vary with factors such as the size of a company's employee base, the geographic dispersion of employees and the nature of the company's efforts toward ensuring compliance, but undoubtedly there would be costs related to the adoption of any broad corporate policy.

Limiting the proposed amendments to an appropriate subset of employees – executive officers – would lower these costs. As the proposing release notes (p. 29), existing disclosure rules already require that many companies become aware of hedging transactions by officers and directors, and companies have been moving toward adopting these types of policies in response to concerns conveyed through proxy advisory firm voting recommendations, as discussed above. Therefore, limiting the scope of persons covered by disclosable policies would lower reporting costs.

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[4] A 2012 Corporate Board Member survey showed that less than 1% of the audit committees that responded did not have a financial expert on the committee, and the vast majority indicated that they had two or more experts on the committee, available at: http://rss.boardmember.com/uploadedFiles/Home/Audit_Committee/Articles/2012%20Audit%20Committee%20Survey%20Report.pdf

Considering the Commission's explicit acknowledgment (p. 52) that "theories of equity incentives may not apply to employees who do not participate in making and shaping key operating or strategic decisions that influence stock price" and that, as a result, "[e]quity ownership for these employees mainly serves the purpose of recruitment and job retention, and on an individual employee basis, is unlikely to have a notable impact on the company's equity market value," it appears the Commission is well aware that there is very little, if any, benefit to requiring disclosure of hedging policies covering non-executive employees. And indeed, we note that the cost-benefit analysis in the proposing release largely focuses on application of the disclosure requirement to a subset of the employee population. The proposing release indicates that investors would benefit from knowing if officer, director, and "critical employee" equity incentives tend to align their interests with those of the shareholders. (p. 62) Similarly, the Commission noted that a benefit of the proposed disclosure is the reduction of costs for investors who would otherwise analyze Section 16 reports, which do not cover employees generally, to glean information about hedging activities. (pp. 62-63) Finally, the proposing release notes that investors will benefit "if the public nature of the required disclosures results in changes in hedging policies that improve incentive alignment between shareholders and *executive officers or directors*" (emphasis added). (p. 63) Without quantifiable evidence of investor benefit from information on non-executive hedging policies, it is hard to see how any cost at all can be justified to require this type of disclosure.

2. **If the Commission does not limit the term "employee" as we urge above, the final rule amendments should include a materiality qualification.**

The proposing release asks: "*[S]hould we add an express materiality condition to the definition [of employee], as is the case under CD&A, to permit each issuer to determine whether disclosure about all its employees would be material information for its investors? Why or why not?*" (p. 23)

Although we believe the simplest approach is for the Commission to interpret the term "employee" in Section 14(j) in the manner discussed above, in the alternative we support permitting each company to determine whether disclosure about a policy that governs none, some or all of its non-executive employees would be material information for its investors. A central tenet of the Commission's public disclosure regime is that companies should only be required to disclose material information, and consistently with the proposing release's observation that information on non-executive hedging policies is "less relevant for investors" (p. 56), we believe many companies could conclude that disclosure of policies (or lack of policies) concerning hedging activity by some or all of their non-executive employees is simply not material. This would be consistent with the approach taken in Item 402(b)(2)(xiii) of Regulation S-K, which requires, if material, disclosure of any company policies regarding hedging the economic risk of security ownership.

3. **The Commission should clarify the terms "held, directly or indirectly" and "designee."**

(a) "*Held, directly or indirectly*"

The proposing release asks: "*Section 14(j) does not define the circumstances in which equity securities are 'held, directly or indirectly' by an employee or director. Is the concept of 'held, directly or indirectly' unclear, such that we should provide more certainty about what is meant by the phrase? If so, how should we clarify it?*" (p. 22)

We agree that the Commission should provide more clarity around the meaning of "held, directly or indirectly," either by substituting the term "beneficial ownership," as defined in Rule 13d-3(d)(1) under the Exchange Act, instead of "held, directly or indirectly," or by providing an instruction clarifying that describing a hedging policy applicable to securities beneficially owned by directors and executive officers would fulfill the disclosure requirement. There is a well-developed history and understanding of the meaning of the term "beneficial ownership" under Rule 13d-3(d)(1), and use of the term would be consistent with the beneficial ownership table included in proxy statements under Item 403 of Regulation S-K. It would make sense, then, for the disclosure of hedging policies to cover the same security ownership disclosed in the beneficial ownership table.

(b) "*Designee*"

The proposing release asks: "*Section 14(j) also does not define who is a 'designee,' nor is this term otherwise defined in the rules under the Securities Act or the Exchange Act. One commenter has recommended that the Commission define the term 'designee.' Should the proposed amendment include an instruction clarifying who is a 'designee'? If so, please explain how this term should be defined, and the costs and benefits that would result.*" (p. 22)

We believe it would be useful for the Commission to define the term "designee," or to provide guidance in the adopting release. We believe a "designee" for purposes of Section 14(j) should be someone specifically appointed to make decisions that the director or officer authorizing the designee would reasonably believe could result in the hedging of equity securities beneficially owned by them. Otherwise, it is not clear who the term "designee" is intended to reach, which could, for example, extend to trusts over or in which the director or executive officer has no decision-making authority or pecuniary interest.

4. **The Commission should clarify the scope of transactions subject to the disclosure requirement.**

(a) *Mutual funds, index funds and similar financial products*

The proposing release asks: "*Should the scope of transactions covered by proposed Item 407(i) be clarified? We are of the view that there is a meaningful distinction between an index that includes a broad range of equity securities, one component of which is company equity securities, and a financial instrument, even one nominally based on a broad index, designed to or having the effect of hedging the economic exposure to company equity securities. Should we clarify the application of Item 407(i) to account for this situation? If so, how? For* *example, if an issuer prohibited hedging generally, but permitted the purchase of broad-based indices, should we specify that the issuer could nonetheless disclose that it prohibits all hedging transactions? Should the rule explicitly distinguish between instruments that provide exposure to a broad range of issuers or securities and those that are designed to hedge particular securities or have that effect? Would a principles-based or numerical threshold approach be most helpful in this regard? If not, what other clarification should be provided?*" (pp. 18-19)

We agree with the Commission that there is a meaningful distinction between an index that includes a broad range of equity securities, one component of which is company equity securities, and a financial instrument designed to or having the effect of hedging economic exposure to company equity securities. By analogy, during a self-imposed "blackout period," companies often permit employees to invest in mutual funds, index funds and similar types of financial products that combine a range of securities and offer a means of diversification, whether or not a company's own stock may be a component of the fund or index. Because of diversification rules that apply to these financial products, these types of products would be unlikely to serve as an effective hedge against most companies' equity securities. If investing in some of these products is deemed to constitute a hedging transaction, it would difficult for many companies to flatly state that they prohibit hedging transactions. It may also be difficult for companies to permit customary flexibility under their insider-trading policies.

We believe that if a company prohibited hedging generally, but permitted the purchase and sale of mutual funds, index funds and other diversified investment vehicles, the Commission should provide guidance to the effect that the company could nonetheless disclose that it prohibits all hedging transactions. Given the broad range of securities in the marketplace and the broad range of transactions and investment strategies, we believe a principles-based approach provides necessary flexibility to companies in designing and disclosing their anti-hedging policies. Companies should not feel the need to inventory and constantly update a list of prohibited securities and transactions in order to put themselves in a position to disclose that they prohibit hedging of company securities by their executive officers and directors.

(b) *Type of disclosure required*

The proposing release asks: "*If a company prohibits some, but not all, of the categories of transactions described in the proposed amendment, in order to fully describe what hedging transactions are permitted and by whom, is it necessary to require disclosure, as proposed, of both the categories of transactions that are permitted and the categories of transactions that are prohibited? If not, please explain why not. Does proposed Instruction 3 to Item 407(i) provide a way for companies that permit or prohibit only certain covered transactions to disclose this information in a clear and effective manner? Alternatively, should the company simply be required to describe its policy, if any, without further elaboration?*" (p. 19)

Proposed Instruction 3 to Item 407(i) requires companies to disclose the categories of hedging transactions they permit and those they prohibit. A company may disclose that it prohibits or permits particular categories and permits or prohibits, respectively, all other hedging transactions. Proposed Instruction 4 requires companies that permit hedging transactions to disclose "sufficient detail" to explain the scope of the permitted transactions.

Companies with blanket policies (either prohibiting or permitting all hedging transactions) do not need to describe them by category.

As noted above, under the proposal, even companies that believe they have a blanket policy that prohibits all hedging transactions may need to indicate that they allow the purchase or sale of certain diversified securities products even though their purpose is not to act as a hedge. At minimum, companies would be confused about what they can say about their policies.

Rather than a lengthy list of transactions permitted or prohibited, we support an approach, raised in the proposing release (p. 19), that would allow companies to simply describe their policies without further elaboration. This would help the numerous companies that already have insider trading policies prohibiting covered individuals from engaging in any hedging of company securities. The policies tend to speak in general, "plain English" terms that would be consistent with a principles-based approach to Section 14(j) disclosure.

5. **The Commission should eliminate the Item 402(b) hedging disclosure requirement.**

The proposing release asks: "*We propose to amend the CD&A requirement of Item 402(b) of Regulation S-K to add an instruction providing that the obligation under that item requirement to disclose material policies on hedging by named executive officers in a proxy or information statement with respect to the election of directors may be satisfied by a cross reference to the Item 407(i) disclosure in that document to the extent that the information disclosed there satisfies this CD&A disclosure requirement. Is there an alternative way to avoid possibly duplicative hedging disclosure in these proxy and information statements?*" (p. 40)

Item 402(b) of Regulation S-K is proposed to be amended to add an instruction providing that the obligation to disclose material policies on hedging by named executive officers may be satisfied by a cross reference to the Item 407(i) disclosure, to the extent that the disclosure there complies with the CD&A requirement. But, as the proposing release notes, the two rules do not perfectly align since Item 402 requires disclosure of hedging of all securities, not only equity. A requirement to cross-reference is also cumbersome, especially if the Item 402(b) disclosure is otherwise simple.

If companies forego the cross-reference, then the proxy statement would contain two separate disclosures regarding hedging policies, which because of the slight differences in the rules could be confusing to investors. Shareholders may believe that there are differences in the policies that do not exist, or worse, that companies are deliberately trying to obfuscate disclosure. Instead, we recommend that the Commission simply eliminate the Item 402(b) requirement as unnecessary and redundant in light of the new Section 14(j) rules, which were motivated by Congress's particular focus on equity securities, and not other types of company securities which theoretically could be, but rarely are, hedged.

6. **The Commission should not impose a disclosure requirement in other filings.**

The proposing release asks: "*Should proposed Item 407(i) disclosure also be required in Securities Act and Exchange Act registration statements? Should it be required in Exchange*

Act annual reports on Form 10-K? Would such information be material to investors in any of those contexts?" (p. 39)

Proposed Item 407(i) disclosure should not be required in registration statements or annual reports on Form 10-K. The information would not be relevant to investors in the context in which those forms are provided. As the Commission recognizes, the intent of Section 14(j) is to give investors an understanding of a company's governance structure in terms of whether it allows employees and directors to engage in transactions that are not aligned with shareholders (p. 35), and this fits squarely with the purpose of an annual proxy statement that asks shareholders to elect directors.

7. **The Commission should not impose a disclosure requirement on foreign private issuers.**

The proposing release asks: "*Should foreign private issuers be required to provide the disclosure? If so, please explain why and specify the filing(s) in which the disclosure should be required?*" (p. 44)

Consistent with the rule as proposed, foreign private issuers should not be required to comply with the proposed rules since they generally are not required to file proxy statements and do not need to make other governance disclosures under existing Item 407.

* * *

We appreciate the opportunity to participate in this process, and would be pleased to discuss our comments or any questions the Commission or its staff may have, which may be directed to Ning Chiu, Edmond T. FitzGerald, Joseph A. Hall or Kyoko Takahashi Lin of this firm at 212-450-4000.

Very truly yours,

Davis Polk & Wardwell LLP