SOCIETY
of Corporate Secretaries
& Governance Professionals

VIA EMAIL

April 20, 2015

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

Re: Disclosure of Hedging By Employees, Officers and Directors (Release Nos. 33-9723; 34-74232; File No. S7-01-15

Dear Mr. Fields:

The Society of Corporate Secretaries and Governance Professionals appreciates the opportunity to provide comments on the U.S. Securities and Exchange Commission's (the "SEC") proposed rule amendments to implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), which adds new Section 14(j) to the Securities Exchange Act of 1934 (the "Exchange Act"). Section 14(j) directs the SEC to require, by rule, each issuer to disclose in any proxy or consent solicitation material for an annual meeting of the shareholders of the issuer whether any employee or member of the board of directors of the issuer, 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 (1) granted to the employee or director by the issuer as part of the compensation of the employee or director; or (2) held, directly or indirectly, by the employee or director. Proposed Item 407(i) of Regulation S-K would implement the provisions of Section 14(j) ("Item 407(i)" or the "Proposed Rules").

Founded in 1946, the Society is a professional membership association of more than 3,200 corporate secretaries, in-house counsel, and other governance professionals who serve approximately 1,600 entities, including 1,000 public companies of almost every size and industry. Society members are responsible for supporting the work of corporate boards of directors and their committees and the executive managements of their companies regarding corporate governance and disclosure. Our members generally are responsible for their companies' compliance with the securities laws and regulations, corporate law, and stock exchange listing requirements.

Summary

For the reasons described in detail below, we recommend that proposed Item 407(i):

1. be modified and a clarifying comment added to differentiate between hedging and portfolio diversification;

2. be modified so that it (i) distinguishes between instruments that provide exposure to a broad range of issuers or securities (e.g., broad-based indices, exchange traded funds, indexes, baskets, etc.) and those that are principally designed to hedge particular securities or have that effect (e.g., prepaid variable forward contracts, equity swaps, collars, covered calls and puts, etc.); and (ii) permits an issuer to disclose that it prohibits all hedging transactions if it prohibits hedging generally but permits the purchase of broad-based indices;

3. be narrowed to cover equity securities of only the registrant, or reporting, company, and not any publicly traded parent, subsidiary, or other affiliate of the reporting company;

4. be limited to the cover those individuals who participate in making or shaping key operating or strategic decisions that influence the company's stock price – specifically, to directors and executive officers; and

5. should NOT apply to smaller reporting companies or emerging growth companies.

The Proposed Rules Should Distinguish Between Hedging and Portfolio Diversification [1]

Proposed Item 407(i) requires disclosure of whether any covered persons are permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) or 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. The Proposed Rules would implement this requirement by also requiring disclosure of transactions with economic consequences comparable to the purchase of the specified financial instruments.

We recommend that proposed Item 407(i) be modified and that a clarifying comment be added to differentiate between hedging and portfolio diversification. The Report of the Senate Committee on Banking, Housing and Urban Affairs accompanying the Dodd Frank Act explains:

> This will 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. Dr. Carr Bettis has written that derivatives instruments "provide a mechanism

[1] See Disclosure of Hedging by Employees, Officers and Directors (Release Nos. 33-9723; 34-74232) ("Proposing Release") at 10 – 14, 17 - 23.

> that insiders can use to trade on inside information prior to adverse corporate events without the level of transparency typically associated with open market sales." [2]

This shows that the intent of the legislation is focused on derivatives and other instruments that are designed to increase in value when the issuer's securities decrease in value. Congress did not intend to reach broader investment diversification strategies that include a range of investments in addition to the issuer's securities. All major investment advisors and scholars recognize the importance of portfolio diversification. The SEC acknowledges the importance of portfolio diversification on its website *www.investor.gov*. Most if not all executives will have a significant portion of their portfolio invested in the employer's securities. Therefore it is prudent that an executive direct his or her other investments into other areas. A diversified portfolio likely will include investments in business sectors that tend to perform opposite the employer's business sector. This is not what Congress was concerned with and should not be inadvertently caught up in 407(i).

To make it clear that portfolio diversification is not hedging under proposed Item 407(i) we suggest modifying proposed Item 407(i) as follows:

> (i) Employee, officer and director hedging. In proxy or information statements with respect to the election of directors, disclose whether the registrant permits any employees (including officers) or directors of the registrant, 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 are designed to ~~or~~ and have the direct effect of hedging or offsetting any decrease in the market value of equity securities….

In addition, we suggest that a new instruction be added as follows:

> The disclosure mandated here is limited to instruments that are tied to and principally designed to perform opposite of the issuer's equity securities. It does not include investments that provide general portfolio diversification.

We also recommend that proposed Item 407(i) be clarified to distinguish between instruments designed for hedging and other instruments that may have characteristics of hedging but are principally designed for diversification. We agree with the SEC 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."[3] We therefore recommend that the SEC clarify Proposed Item 407(i) to:

i. distinguish between instruments that provide exposure to a broad range of issuers or securities (e.g., broad-based indices, exchange traded funds, indexes, baskets, etc.) and those that are principally designed to hedge particular securities and have that direct

[2] Senate Report 111-176 at 136.
[3] Proposing Release at 18.

effect (e.g., prepaid variable forward contracts, equity swaps, collars, covered calls and puts, etc.); and

ii. permit an issuer to disclose that it prohibits all hedging transactions if it prohibits hedging generally but permits the purchase of broad-based indices, exchange traded funds, indexes, baskets, etc.

The Proposed Rules Should be Limited to Disclosure of Hedging in the Registrant, or Reporting, Company's Equity Securities [4]

A proposed instruction to proposed Item 407(i) specifies that "equity securities" means "only those equity securities issued by the registrant or any parent of the registrant, any subsidiary of the registrant or any subsidiary of any parent of the registrant that are registered under Section 12 of the Exchange Act." The disclosure requirement would thus apply to the equity securities issued by the company and its parents, subsidiaries or subsidiaries of the company's parents that are registered on a national securities exchange or registered under Section 12 of the Exchange Act.

We agree with the SEC's proposal to clarify that "equity securities" does not include any equity security of any issuer. We recommend, however, that the proposed instruction be narrowed to cover equity securities of only the reporting company, and not any publicly traded parent, subsidiary or other affiliate of the reporting company, as currently proposed. This would fulfill the clear statutory intent to require disclosure about whether executives can "effectively avoid compensation restrictions that they hold stock long-term" without including securities that are not advancing this purpose and unnecessarily increasing the burden on companies to implement processes and controls to effectively create, monitor and enforce hedging policies regarding the securities of other publicly traded entities.

As an initial matter, we do not believe it is necessary to include affiliated entities in the scope of the proposed instruction, since it would be unusual for a publicly traded company to grant equity securities of a different publicly traded entity as compensation or count shares held in an affiliate towards their equity retention requirements. We are not aware that this is a widespread practice and note that it would require a compensation committee comprised of outside independent directors to approve granting equity securities to employees of a different publicly traded entity. To the extent the SEC is concerned with capturing legacy securities after a controlled subsidiary of a publicly traded parent completes an initial public offering, this situation could be covered with a further clarification to the instruction to include any other equity securities that are reported as compensation under Item 402 of Regulation S-K.

In addition, including parents, subsidiaries and affiliates within the scope of "equity securities" is overly broad and captures equity investments that are not related to compensation or equity retention requirements. For example, employees may purchase equity in an affiliated public company as an investment like any other outside investment in a non-affiliated company. Under the current proposal, these equity securities would fall within the scope of Item 407(i)(2) even though they are no different from any other unaffiliated investment. To the extent the SEC is

[4] See Proposing Release at 14 – 23.

concerned that companies might allow parent or subsidiary securities to count towards an executive's equity retention requirements, the SEC could tailor the instruction to cover that potential scenario rather than broadly including securities that have no impact on an executive's compensation or equity retention requirements.

The SEC could also consider aligning the scope of "equity securities" to those required to be reported on Section 16 filings. This would provide transparency to investors about whether executives can hedge the securities that the executives report they own, directly or indirectly, without covering securities that are not currently monitored or disclosed by companies.

We do not believe that there is sufficient incremental benefit of including parent, subsidiary or affiliate companies into the scope of "equity securities" to outweigh the burden on companies and their employees to implement, monitor and enforce a hedging policy that covers securities beyond the intended statutory purpose of the rule. Alternatively, if the SEC determines it is important to include certain affiliated issuers, we recommend that the scope be limited to any parent or majority-owned subsidiary so that there is a controlling or controlled relationship with the issuer.

Only Directors and Executive Officers Should Be Subject to the Proposed Disclosure Requirement [5]

Proposed Item 407(i) would require disclosure for "any employees (including officers) or directors of the registrant, or any of their designees."

The Society believes this is too broad and recommends that the SEC limit the scope of proposed Item 407(i) to the subset of individuals that participate in making or shaping key operating or strategic decisions that influence the company's stock price – specifically, to directors and executive officers.

The term "executive officer," as defined in Rule 3b-7 under the Exchange Act, was designed to apply to all of the persons who have major operational responsibilities for an issuer and therefore the ability to make strategic decisions that may influence the company's stock price. Determining whether an employee is an executive officer is not strictly formulaic and often requires an analysis of the person's duties and a subjective determination of the significance of those duties to the registrant's policy-making function. We believe that applying this type of principles-based disclosure to the proposed rule is most likely to produce information that is material to shareholders in evaluating a company's executive compensation practices.

Further, the SEC notes 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 case their firm does not perform." As a practical matter, many, if not most, issuers do not offer equity-based incentive compensation as part of a broad-based compensation program for all employees, but limit equity grants to a subset of senior executives with the ability to substantially influence company performance. In most instances, only those directors and employees who receive

[5] See Proposing Release at 17 – 23.

equity-based compensation are subject to the issuer's stock ownership guidelines and holding requirements, and in many instances, only directors and executive officers are subject to such requirements. On the other hand, many non-executive employees choose to invest in the issuer's equity securities through a company-sponsored savings plan. These employee investments are covered by proposed Item 407(i) even though they were purchased, not granted as compensation, and are not related to the statutory intent. The Society therefore believes that adopting an expansive definition of "employee" that covers all employees of the issuer will provide little additional meaningful information to shareholders.

Moreover, requiring disclosure for the entire employee population will likely result in issuers being compelled to adopt a companywide hedging policy, which will then have to be monitored and enforced. It will be difficult and impracticable for an issuer to monitor the use of hedging transactions by its entire employee population, particularly for non-executive employees who do not regularly receive performance-based equity compensation and are not otherwise subject to reporting requirements for securities trading and hedging. This imposes a significant burden on issuers as a result of the complexities and cost of monitoring and enforcing such company-wide policies. This increased cost to issuers is seemingly without any added benefit to shareholders. The benefit analysis of the Proposing Release, for example, does not mention benefits related to covering the entire employee population. Instead, the cited benefits refer to a limited population, primarily focusing on executive officers and directors.[6] Limiting the disclosure requirement to this population would lower the costs of compliance for companies and still meet the intended benefits.

Finally, we believe that limiting the scope of proposed Item 407(i) to directors and executive officers is consistent with and analogous to the approach to and purposes of disclosure under Item 403(b) of Regulation S-K, which requires tabular disclosure of registrant security ownership of directors and executive officers. The purpose of Item 403(b) disclosure is to help shareholders understand and evaluate a director's and officer's level of ownership and economic interest in the company. Appropriately, Item 403(b) disclosure is limited to disclosure for directors and executive officers because it is this population that is most likely to own significant portions of the company's securities and is, accordingly, the population whose ownership is material to shareholders. We believe that the same principles should be applied to proposed Item 407(i), which is to say that we believe information about a company's hedging policies relative to directors and executive officers rather than the entire employee population is most useful to shareholders. With this modification, proposed Item 407(i) would, like Item 403(b), accomplish the desired transparency and disclosure without imposing unnecessary reporting and monitoring burdens on companies.

The Proposed Rules Should Not Apply to Emerging Growth Companies or Smaller Reporting Companies [7]

Proposed Item 407(i) would apply to smaller reporting companies ("SRCs") or emerging growth companies ("EGCs"). In the Proposing Release, the SEC states that it is not aware of "any reason why [the proposed disclosure] would be less relevant to shareholders of [these

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[6] See Proposing Release at 62 – 66.
[7] See Proposing Release at 36 – 45.

companies] than to shareholders of any other company" and that "given its narrow focus, the proposed disclosure is not expected to impose a significant compliance burden on companies."[8]

We do not believe that proposed Item 407(i) should apply to EGCs or SRCs. The Jumpstart Our Business Startups Act (the "JOBS Act") was enacted to "increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies," which the statute defines generally as an issuer with total annual gross revenues of less than $1 billion during its most recently completed fiscal year.[9] Recognizing that EGCs may not have the cash flow to be able to comply with all of the regulation and disclosure requirements applicable to multi-billion dollar corporations, Congress eased the registration and reporting requirements for EGCs, in an effort to encourage capital formation and stimulate the economy.

The SEC's proposal to extend the hedging disclosure requirement to EGCs and SRCs threatens to undermine the critical purposes of the JOBS Act. As the SEC notes in its proposed release, EGCs and SRCs are not required to provide Compensation Discussion & Analysis ("CD&A") disclosure, including disclosure of material policies regarding named executive officers' hedging of economic risk of their company securities ownership. These companies are, therefore, less likely to have hedging policies in place. Accordingly, as the SEC acknowledges in its proposed release, "these companies may have a greater initial cost than companies that already have a policy or already disclose one."[10] Yet, EGCs and SRCs are less likely to be in the financial position to bear the cost of compliance with the disclosure requirement. Imposing such cost and regulatory burden on EGCs and SRCs is at direct odds with the legislative purposes of the JOBS Act.

Additionally, if EGCs and SRCs are subject to the hedging disclosure rule, they may feel compelled to adopt hedging policies – a process that often involves the retention of counsel and/or compensation consultants – thus further augmenting their financial burden. Moreover, this behavioral change among EGCs and SRCs could trigger some potentially significant unintended consequences. Executives of EGCs and SRCs are more likely than those of larger companies to be heavily (and disproportionately) invested in the company, and thus undiversified; as much of the wealth of these executives is often tied to the company's equity, these executives may become more risk averse, refraining from undertaking risks that could be in the best interests of the company's well-diversified shareholders. Thus, as applied to EGCs and SRCs, policies prohibiting hedging may not be in the best interests of shareholders; in direct contrast to the proposed rule's stated purpose, they could misalign the incentives of employees/directors on the one hand and shareholders on the other. Alternatively, anti-hedging policies could drive the less diversified employees and directors to sell any stock holdings beyond the minimum required by the company's stock ownership guidelines, also defeating the objective of the proposed hedging rule – *i.e.*, to better align employees/directors with shareholders.

[8] Proposing Release at 36 – 37.
[9] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).
[10] Proposed Release at 38.

Given the potentially negative effects on capital formation of burdening EGCs and SRCs with disclosure of corporate hedging policies, thus diluting the impact of the JOBS Act, as well as the real possibility that including EGCs and SRCs within the scope of the rule could have the unintended consequence of misaligning employees and directors of EGCs and SRCs with their shareholders, the SEC should exempt EGCs and SRCs from the rule.

Conclusion

We appreciate the opportunity to provide comments on this important rulemaking and would be happy to provide you with further information to the extent you would find it useful.

Respectfully submitted,

Rick E. Hansen
Chair, Securities Law Committee

cc: Mary Jo White, Chair
Luis A. Aguilar, Commissioner
Daniel M. Gallagher, Commissioner
Michael S. Piwowar, Commissioner
Kara M. Stein, Commissioner
Keith F. Higgins, Director, Division of Corporation Finance
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