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April 22, 2015

Via email to: **rule-comments@sec.gov**

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. S7-01-15
Release Nos. 33-9723; 34-74232 (the "Release")

Dear Mr. Fields:

McDermott Will & Emery LLP is providing this comment letter with respect to the proposed rules (the "Proposed Rules") set forth in the Release that implement the hedging disclosure requirement under Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). We appreciate the opportunity to comment on the Proposed Rules.

Our firm represents many public companies, financial services companies and financial planning firms that would be impacted by the Proposed Rules. We recognize the importance of the hedging disclosure rules so that shareholders "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] We also appreciate the difficulty facing the Commission in drafting rules to implement Section 955 given the wide range of available financial instruments and the possibility that there will be new financial instruments in the future that might be used to hedge issuer securities held by an executive. We believe, however, that the Proposed Rules are unnecessarily broad, and that our suggested changes to the Proposed Rules will focus issuer hedging disclosures on the types of financial instruments that were intended to be covered by Section 955 while still addressing the Commission's concern about the possibility of other financial instruments that are not expressly listed under Section 955 that might have the same economic effect. We also believe that our suggested changes will avoid undue complexity for

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

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issuers, reduce the risk of inaccurate disclosures and, perhaps most importantly, avoid the unintended consequence of creating a greater incentive to sell an issuer's equity securities.

A. Recommendations

We respectfully recommend that the following changes be made to the scope of transactions covered under Section 14(j) of the Securities and Exchange Act of 1934, as amended (the "Exchange Act") as part of the final rules: [2]

1. Objective criteria should be provided for determining what is, and is not, a financial instrument subject to disclosure under proposed Item 407(i), and be limited to financial instruments that are substantially similar to those listed in Section 14(j).

2. A financial instrument should be exempt from proposed Item 407(i) if it is not a "derivative security" with respect to the issuer's equity securities, as defined in Rule 16a-1(c) under the Exchange Act, that is designed to hedge or offset decreases in the market value of an issuer's equity securities.

3. The following types of equity positions should be exempt from proposed Item 407(i) regardless of how hedging transactions are defined:

(i) all long and short positions (including derivatives) relating to equity securities other than the issuer's own equity securities (thereby excluding both positions with respect to individual equity securities, as well as positions in any equity basket, index or other financial instrument that do not, in each case, include or otherwise reference the issuer's equity securities), and

(ii) positions in any equity basket, index or other financial instrument that includes or otherwise references the issuer's own equity securities as a component of the equity basket, index or other financial instrument if (A) the equity basket, index or other financial instrument is comprised of or references ten or more component securities and (B) the issuer's equity securities upon the date on which the equity basket, index or other financial instrument is created represent less than thirty percent (30%) of the referenced portfolio's weighting.

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[2] We do not address in this letter the other questions raised in the preamble to the Proposed Rules. We note in passing our support for limiting the scope of who will be considered an "employee" for purposes of new Item 407(i). As discussed below, it is not unreasonable to expect that many public companies will be pressured to adopt or modify anti-hedging policies that mirror the scope of new Item 407(i). We question the value of expanding these disclosures with respect to employees who are not "making or shaping key operating or strategic decisions that influence the company's stock price."

B. Background

Section 955, which added Section 14(j) to the Exchange Act, directs the Commission to require, by rule, 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 of the issuer, or any designee of such employee or director (each, a "Named Person"), 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 issuer 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) does not just implement Section 14(j) – it also significantly expands the types of activities subject to the disclosure requirement under Section 14(j). In addition to the financial instruments listed and described in Section 14(j), proposed Item 407(i) would also require disclosure if the issuer allows a Named Person to "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 outer bounds of what "transactions" will be subject to the disclosure requirement under proposed Item 407(i) are unclear. The Proposed Rules do not define the term "hedge" based on the belief that this term is "generally understood." Instead, the Proposed Rules require a "principles-based" approach in order to avoid "incomplete disclosure."

Instruction 3 to proposed Item 407(i) would require an issuer to disclose "categories of hedging transactions" it permits as well as those it prohibits. The Proposed Rules do not define these "categories of hedging." In lieu of identifying and labelling each category of hedging as permitted or prohibited, the Proposed Rules provide that an issuer which specifically prohibits certain hedging categories to disclose those categories of transactions and, if true, disclose that it permits all other hedging transactions. Conversely, an issuer that only allows certain categories of hedging transactions could disclose those permitted categories and, if true, disclose that it prohibits all other hedging categories. The preamble to the Proposed Rules states that "disclosure of both the categories prohibited and those permitted conveys a complete understanding of the scope of hedging at the company."

C. The Breadth and Scope of the Proposed Rules

Contrary to the statement in the Proposed Rules, we do not believe that the meaning of the term hedge is "generally understood" by all interested parties in the same manner. The lack of a clear definition will make it difficult for issuers to apply proposed Item 407(i). Typical definitions of a hedge in the investment world focus on arrangements or strategies that either safeguard oneself from loss on an investment or otherwise reduce the risk associated with an investment. The scope of these potential arrangements or strategies is extremely broad. For example, a Named Person's purchase of equity securities of one or more unrelated issuers as an investment strategy could be considered a hedge "transaction" subject to disclosure under the Proposed Rules if such

securities are negatively correlated *at any level* as compared to the issuer's equity securities.[3] In other words, if a long position in the securities of an unrelated issuer can be anticipated to increase in value at the same time the relevant issuer's equity securities decrease in value, a long position in such other securities can be considered a hedge. It is highly unlikely that Congress intended listed companies to disclose whether their Named Persons are permitted to purchase equity securities *in other companies* as part of an investment strategy to reduce their risk from a concentrated equity position in the issuer.[4] Not all investment transactions that reduce risk in holding a concentrated equity position in an issuer also result in a potential misalignment of interests between a Named Person and shareholders.

It is unduly vague to have a disclosure requirement based on identifying *any transaction* entered into by a Named Person that happens to have the effect of offsetting any decrease in the market value of an issuer's equity security[5]. Except for a limited number of transactions involving short positions in an issuer's own equity securities, such as a prepaid variable forward, a short equity swap, a purchased put option, a collar including a purchased put option, a short sale, or a short securities futures contract, the scope of what is encompassed by the term "hedge" is subjective and is likely to have a significantly different meaning for issuers, their employees and directors, as well as for shareholders. We believe that the definition of a hedge for purposes of Section 14(j) and its intended purpose requires objective criteria that issuers and shareholders alike can apply in a reasonably uniform manner.[6] The usefulness of the disclosure rules under Section 955 will be significantly diminished if they are not readily understood and consistently applied by all interested parties.

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[3] We note in this regard the Commission's statement in the preamble to the Proposed Rules that Section 955 is broad enough to cover "transactions involving dispositions or sales of securities." Footnote 21 to the Proposed Rules.

[4] While there is a paucity of legislative history with respect to Section 955, we note that the Senate Report cites potential abuses with respect to derivative instruments that "provide a mechanism 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." Senate Report at page 136.

[5] We note that proposed Item 407(i) would cover transactions that "have the effect" of hedging even if they are not "designed" to do so.

[6] We note that Congress has developed rules to address hedging of single stock positions. Whether the tax straddle (i.e., hedge) rules apply depends upon whether the investor holds an offsetting position with respect to his or her stock position, which occurs if there is a "substantial diminution" of the investor's risk of loss on his or her stock position resulting from holding "offsetting positions." In the case of stock, however, an investor can generally hold an offsetting position potentially subject to the straddle rules only if the investor holds or enters into a position "with respect to such stock," which is limited for these purposes to positions in the same issuer. *See* Internal Revenue Code Section 1092(d)(3). Special rules are also provided for positions in stock that are offset by "substantially similar or related property", which can apply in certain instances to stock offset by a basket or index of stocks. However, Treasury Regulation §1.246-5(c)(1) generally provides that a position reflecting the value of a portfolio of stock is "substantially similar or related property" to the stock(s) held by the investor only if the position and the investor's stock holding(s) substantially overlap. There is "substantial overlap" only if the investor owns at least seventy percent (70%), by market weight, of the stocks included in the basket or index.

D. Likely Impact on Issuers

Not having an objective hedging definition will likely result in significant difficulties for issuers. The prevalence of anti-hedging policies at public companies is ubiquitous.[7] Not surprisingly, these policies tend to be fairly short and typically provide a general prohibition against executives hedging ownership of the issuer's equity securities using derivative securities such as prepaid variable forward contracts, equity swaps and collars which are listed in Section 955. It is reasonable to anticipate that issuers will be pressured into modifying their hedging policies as necessary to prohibit whatever transactions the Commission determines in final rules to be a hedge.[8] In order to implement this type of policy, an issuer must know with relative certainty what is (and is not) a hedging activity as defined under proposed Item 407(i) and then effectively communicate this information (and the various prohibited and permitted transactions) to Named Persons.[9] It is doubtful that an issuer could develop and effectively communicate such a policy to Named Persons and shareholders given the uncertain scope of Item 407(i) as it is currently drafted. Further, issuers will need to be able to determine whether a financial instrument that a Named Person proposes to use would be prohibited or not. It is reasonable to expect that issuers will need to expend significant time and expense to implement anti-hedging policies to track the scope of the Proposed Rules. As a practical matter, issuers with anti-hedging policies would be faced with choosing between (i) potentially being at odds with shareholders and proxy advisory firms due to having a policy permitting some forms of hedging, and (ii) taking a risk that the proxy disclosure about its policy allowing no forms of hedging may or may not be accurate based on its own subjective determination of hedging, as well as the subjective views of its employees and directors and their advisors. In our view, issuers should be given clear guidelines so that the interpretations are predictable and uniform from one issuer to the next. We submit that, by adopting our recommendations, the dilemma described above can be avoided without diluting the value of the intended disclosure under Section 955 that is relevant to the alignment of the interests of shareholders and Named Persons.

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[7] Approximately fifty-four percent (54.3%) of Russell 3000 companies and eighty-four percent (84%) of large capital S&P 500 companies have policies that prohibit executives from hedging company shares based on an analysis of Institutional Shareholder Services ("ISS") Governance QuickScore data. Romanek, Broc (February 18, 2015, The CorporateCounsel.net.

[8] We respectfully submit that the Commission's statement in the preamble about there being no requirement to "prohibit hedging transactions or to otherwise adopt practices or a policy addressing hedging by any category of individuals" will not alleviate this pressure. Proxy advisory services such as ISS and Glass Lewis object to any type of hedging without defining what is, and is not, hedging. *See* U.S. Corporate Governance Policy, 2013 Updates, page 4 (Nov. 16, 2012) (stating that "[a]ny amount of hedging will be considered a problematic practice warranting a negative voting recommendation") and Proxy Paper Guidelines, 2015 Proxy Season (pages 30-31), "An Overview of the Glass Lewis Approach to Proxy Advice" (Glass Lewis 2015)(stating that "companies should adopt strict policies to prohibit executives from hedging").

[9] Failure to communicate the scope of transactions covered by new hedging policies and to oversee compliance with them may expose public companies to complaints by plaintiff-strike suit law firms alleging violations of the Exchange Act due to misleading proxy disclosures.

E. Defining the Scope of Financial Instruments under Proposed Item 407(i) by Reference to Derivative Securities under Rule 16a-1(c)

Defining the scope of financial instruments under proposed Item 407(i) by reference to "derivative securities" (as defined under Rule 16a-1(c)) that are designed to hedge or offset decreases in the market value of an issuer's equity securities would provide greater certainty to issuers when interpreting the scope of proposed Item 407(i) and developing or amending anti-hedging policies that are intended to eliminate any form of hedging within the scope of Section 955. Section 16 of the Exchange Act requires executive officers to report the purchase or sale of derivative securities as defined in Rule 16a-1(c), and the Commission and issuers have had over two decades of experience applying this rule. We believe that it would be an appropriate exercise of rulemaking authority for the Commission to modify proposed Item 407(i) in this manner. Section 955 lists prepaid variable forward contracts, equity swaps and collars, which have all been determined to be derivative securities under Rule 16a-1(c) because their value is derived from the value of a specific equity security.[10] Rule 16a-1(c) is also flexible enough to cover "similar" financial instruments that may be developed in the future.[11] We agree that whether participation in an exchange fund[12] results in a hedging transaction depends upon "the terms of the fund." If any part of the return paid to the Named Person under an exchange fund is calculated solely based on the performance of an issuer's equity securities contributed by that person with a fixed exercise price, then such Named Person would have a derivative security under Rule 16a-1(c) with respect to that portion of the investment,[13] and our recommended change would include disclosure of any such derivative security under proposed Item 407(i). If, however, the return to the Named Person was calculated based on the performance of all of the securities in the exchange fund's portfolio and payments are made pro rata to all holders, the Named Person would not have a reportable derivative security, either because there is no fixed price and thus excluded from the definition by Rule 16a-1(c)(6) or because the exchange fund qualifies for the market basket exception in Rule 16a-1(c)(4).[14] If an issuer were to allow for hedging involving a derivative security, an additional benefit of this approach is that there would be an established mechanism (i.e., Form 4 reporting) for investors to track when executive officers are hedging the issuer's equity securities.

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[10] Release 33-8230 (May 7, 2003 at text accompanying n.42. See discussion of the resulting reporting of equity swaps, in particular in Release No. 34-34514 (Aug. 10, 1994) at Part III.G and Release No. 34-37260 (May 31, 1996) at part IV.H.

[11] The term "derivative securities" in Rule 16a-1(c) extends to "similar securities with a value derived from the value of an equity security."

[12] We use the term "exchange fund" in this letter to generally refer to a stock fund that allows a Named Period to exchange an issuer's equity securities for units in a portfolio while retaining no voting or investment power over the shares.

[13] The derivative security would be akin to the contingent value right discussed in the Commission's No-Action letter to Marion Merrell Dow, Inc. (January 24, 1992).

[14] If the Commission determines that Section 955 requires disclosure with respect to all exchange funds, the derivative concept could still be applied under proposed Item 407(i). For example, the "otherwise engage" clause could be modified to state "otherwise engage in transactions *involving derivatives as defined in rule 16a-1(c)* that are designed . . . "(new language highlighted in italics).

F. Financial Instruments Based on a Broad Range of Securities

We agree with the observation in the preamble to the Proposed Rules that there is a meaningful distinction between an index that includes a broad range of equity securities, one component of which may be an issuer's equity securities, and a financial instrument designed to or having the effect of specifically offsetting the economic exposure to a specific issuer's equity securities. The Senate Report does not suggest that there was any intention to cover investments made by a Named Person with his or her own funds (other than the financial instruments listed in Section 955) to reduce the risk from a concentrated stock position in the issuer's equity securities. Indeed, it is difficult to understand how information regarding strategies not involving (or only partially involving) the issuer's equity securities is relevant to the alignment of a Named Person's interests with the stockholders' interests. An issuer should be able to disclose that it prohibits all hedging transactions if it prohibits hedging strategies that specifically offset the economic exposure to the issuer's equity securities but permits the entering into of positions with respect to securities other than the issuer's own equity securities or a broad-based equity basket or index. Positions in any equity basket, index or other instrument that includes the issuer's own equity securities as a component of the equity basket, index or other instrument should be considered to be "broad-based" and outside the scope of Item 407(i) to the extent that (a) the equity basket, index or other financial instrument is comprised of ten or more component securities and (b) the market value of the issuer's equity securities on the date on which the equity basket, index or other instrument is created represent less than thirty percent (30%) of the referenced portfolio's weighting. This approach would be relatively easy to implement and is based on the current definition of what is not a "narrow-based security index" in Section 3(a)(55)(C) of the Exchange Act.

G. Impact on Executives and Key Employees

It is widely believed that significant ownership in an issuer's equity securities by executives and key employees provide meaningful incentives that produce alignment with stockholders' interests. At the same time, holding a large portion of an individual's wealth in a single asset may encourage executives and key employees to become risk averse in a manner that is contrary to the stockholders' interests. In accordance with modern portfolio theory, executives and key employees understandably will often want to limit exposure to a concentrated position in a single financial asset. It is very common for executives and key employees, based upon the advice of their professional financial advisors, to invest other liquid assets in ways to mitigate the risks associated with large positions in their employer's stock.[15] Circumstances when there have been alleged misalignments between the interests of shareholders and executives of an issuer typically involve a derivative security that wholly derives its value from stock price movement in that

[15] It is widely recognized that there is a need for executives and employees to mitigate the risks associated with concentrated stock positions. *See* "Concentrate on Concentration Risk," Financial Industry Regulatory Authority (2014) http://www.finra.org/investors/concentrate-concentration-risk.

issuer's equity securities. Establishing clear boundaries consistent with our recommendations on what transactions are covered will not negatively impact investor protection. On the other hand, the Proposed Rules without clear boundaries could result in more selling of an issuer's equity securities by Named Persons if investment strategies not involving derivatives of the issuer's equity securities are labelled as "hedging" by the Commission and are thereafter prohibited by issuers.

We would be pleased to discuss our comments or any questions the Commission may have with respect to this letter. Any questions about this letter may be directed to Andrew C. Liazos at [redacted] or William R. Pomierski at [redacted]

Very truly yours,

McDermott Will & Emery LLP

McDermott Will & Emery LLP