The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 31570

January 22, 2019

SEC Excludes Closed-End Funds from Final Rule Requiring Disclosure of Hedging Practices and Policies

[31570]

January 22, 2019 TO: ICI Members
Closed-End Investment Company Committee SUBJECTS: Closed-End Funds
Disclosure RE: SEC Excludes Closed-End Funds from Final Rule Requiring Disclosure of Hedging Practices and Policies

In December, the Securities and Exchange Commission adopted a rule requiring certain companies to disclose any practices or policies regarding the ability of employees and directors to hedge the companies' securities.[1] In a change from the proposal and consistent with ICI comments, the final rule now excludes from the disclosure requirement closed-end funds that have shares listed and registered on a national securities exchange.[2] As proposed, the final rule also excludes other registered funds (e.g., exchange-traded funds) from the requirement, but the requirement will apply to business development companies.[3]

General Requirements

The final rule amends Item 407 of Regulation S-K by adding paragraph (i) to require a company to describe any practices or policies regarding the ability of its employees and directors (or their designees) to purchase financial instruments or otherwise engage in transactions to hedge or offset any decrease in the market value of the company's securities. Alternatively, the company must explain that it does not have any such practices or policies. The final rule: (1) includes, within its scope, transactions in specified financial instruments (prepaid variable forward contracts, equity swaps, collars, and exchange funds);[4] (2) specifies that the equity securities for which disclosure is required are only equity securities of the company, any parent of the company, any subsidiary of the company, or any subsidiary of any parent of the company that are registered under Section 12 of the Exchange Act; (3) requires the disclosure in any proxy statement in Schedule 14A or information statement on Schedule 14C with respect to the election of directors; and (4) clarifies that the term "employee" includes officers of the company.

Exclusion of Listed Closed-End Investment Companies

In excluding listed closed-end funds, the SEC agreed with ICI's comments determining that, in the context of compensation and corporate governance, listed closed-end funds are more

akin to open-end funds and exchange-traded funds, which were intentionally excluded from these disclosure requirements.[5] The SEC highlighted that registered investment companies have different management structures, regulatory regimes, and disclosure obligations than operating companies, and noted that "[n]early all funds, unlike other issuers, are externally managed and have few, if any, employees who are compensated by the fund."[6] It found that the unique characteristics of investment companies, as contrasted with operating companies, make the proposed disclosure less useful to investors in registered funds.[7]

The SEC also distinguished fund compensation practices from those of operating companies, noting how uncommon it is, and in some cases, prohibited, for funds to grant shares as a component of incentive-based compensation.[8] The Commission accepted commenters' suggestions that, even if fund directors acquired shares of listed closed-end funds, "it is difficult to hedge such shares by selling short or trading in derivatives."[9] Thus, it stated that the concerns about avoiding restrictions on long-term compensation, which was one of the reasons Congress mandated the required disclosures, are less likely to be raised with registered funds.[10]

Based on these factors, the SEC determined that it is in the public interest and consistent with the protection of investors to exclude listed closed-end funds from the new disclosure requirements.

The final rule will take effect 30 days after publication in the Federal Register.

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endnotes

[1] *See* Disclosure of Hedging by Employees, Officers and Directors, Release No. IC-33333 (Dec. 18, 2018) ("Adopting Release"), *available at* https://www.sec.gov/rules/final/2018/33-10593.pdf. The final rule implements Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 955 added Section 14(j) to the Securities Exchange Act of 1934 ("Exchange Act"), which directs the SEC to require, by rule, each issuer to disclose in any proxy or information statement for an annual meeting of shareholders whether any of its employees or directors (or their designees) is permitted to purchase financial instruments or otherwise engage in transactions that are designed to hedge or offset any decrease in the market value of equity securities.

[2] *See* Letter from Dorothy Donohue, Deputy General Counsel, ICI, to Brent J. Fields, Secretary, SEC, dated April 20, 2015, *available at* https://www.ici.org/pdf/28907.pdf. For a summary of ICI's comment letter, please see ICI Memorandum No. 28907 (April 20, 2015), *available at* https://www.ici.org/my_ici/memorandum/memo28907.

[3] *See* Disclosure of Hedging by Employees, Officers and Directors, Release No. IC-31450 (Feb. 9, 2015) ("Proposing Release"), *available*

at http://www.sec.gov/rules/proposed/2015/33-9723.pdf. For a summary of the Proposing Release, please see ICI Memorandum No. 28733 (Feb. 13, 2015), *available at* https://www.ici.org/my_ici/memorandum/memo28733.

[4] These are instruments with economic consequences comparable to the financial instruments specified in Section 14(j) of the Exchange Act.

[5] *See* Adopting Release, *supra* note 1, at 44.

[6] *Id.* Instead, investment companies generally contract out the operation of the fund and portfolio management duties to the fund's investment adviser. *Id.*

[7] *Id.*

[8] *Id*. at 44 and note 142 (citing the sections of the Investment Company Act of 1940 that prohibit granting fund shares as compensation, except in limited circumstances).

[9] *Id.*

[10] *Id*. at 44-45.

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