

MEMO# 28733

February 13, 2015

SEC Proposal to Require Disclosure of Hedging by Employees and Directors

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 3-15
ETF ADVISORY COMMITTEE No. 2-15
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 2-15
INVESTMENT COMPANY DIRECTORS No. 5-15
SEC RULES MEMBERS No. 9-15 RE: SEC PROPOSAL TO REQUIRE DISCLOSURE OF HEDGING BY EMPLOYEES AND DIRECTORS

Recently, to implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Securities and Exchange Commission ("SEC") proposed rule amendments to require certain companies to disclose whether they permit employees and directors to hedge their companies' securities. [\[1\]](#) The SEC is proposing to require closed-end funds that have shares listed and registered on a national securities exchange to provide the proposed disclosure. The SEC is not proposing to impose the requirement on other types of funds (i.e., mutual funds and exchange-traded funds). [\[2\]](#) The Proposing Release, however, specifically requests comment on whether the requirements should apply to additional types of funds and seeks input and data on the prevalence of hedging by employees and directors for all registered funds. Comments are due by April 20.

General Requirements

The SEC proposes to add new paragraph (i) to Item 407 of Regulation S-K to require disclosure of whether an employee, officer or director, or any of their designees, is permitted to hedge or offset any decrease in the market value of equity securities granted to the employee or director as part of the compensation of the employee or director or held, directly or indirectly, by the employee or director. The proposal would: (1) include within the scope of the proposed disclosure requirement transactions with economic consequences comparable to the financial instruments specified in Section 14(j) of the Exchange Act (prepaid variable forward contracts, equity swaps, collars, and exchange funds); [\[3\]](#) (2) specify 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) require the disclosure in any proxy statement in Schedule 14A

or information statement on Schedule 14C with respect to the election of directors; and (4) clarify that the term “employee” includes officers of the company.

Application to Registered Funds

The SEC is proposing to require closed-end funds that have shares that are listed and registered on a national exchange to provide the proposed disclosure. [4] Registered funds that are not listed closed-end funds would be excluded from these requirements. The Proposing Release discusses various considerations for not proposing to impose the disclosure requirements on funds other than listed closed-end funds. For example, the Proposing Release states that funds generally have a management structure and regulatory regime that differ in various respects from operating companies and make the proposed disclosure less useful for investors in funds that are not listed closed-end funds. The SEC also notes that nearly all funds are externally managed and have few, if any, employees who are compensated by the fund. In addition, the SEC acknowledges that the granting of shares as a component of incentive-based compensation is uncommon (and in some cases prohibited) for funds. The Proposing Release also notes that open-end funds differ from operating companies in the way their shares are purchased and sold. For funds that do not trade on an exchange, the SEC states that it may be less efficient or not possible to engage in certain hedging transactions with respect to the fund’s shares.

The SEC states, however, that there are several features of listed closed-end funds that may make requiring the proposed disclosure appropriate. For instance, shares of listed closed-end funds trade at negotiated market prices on a national securities exchange and are not redeemable from the funds. The shares may trade at a “discount,” or a price below the net asset value per share. The SEC believes that requiring listed closed-end funds to provide the proposed disclosure would allow shareholders to know if a listed closed-end fund permits its directors and employees (if any) to hedge the value of the fund’s securities held by these persons and whether they, like the fund’s other shareholders, would receive the discounted price upon a sale of the shares without an offset from any hedging transaction.

The SEC also states that it may be more efficient to engage in certain hedging transactions with respect to shares of a listed closed-end fund as compared to certain other types of funds. For example, the SEC notes that market participants can and do sell listed closed-end funds short. In addition, unlike other types of funds, listed closed-end funds generally are required to hold annual meetings of shareholders. Finally, the SEC states that officers and directors of listed closed-end funds are subject to the requirements in Section 16(a) of the Exchange Act to report hedging transactions similar to officers and directors of emerging growth companies and smaller reporting companies.

Jennifer S. Choi
Associate General Counsel

endnotes

[1] Disclosure of Hedging by Employees, Officers and Directors, Release No. IC-31450 (Feb. 9, 2015), available at <http://www.sec.gov/rules/proposed/2015/33-9723.pdf> (“Proposing Release”). Section 955 added new 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 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.

[2] Commissioners Piowar and Gallagher in a joint statement on the proposal stated that they would not have included listed closed-end funds within the scope of the rule. They also expressed concern that the release expressly seeks comment on whether to extend the disclosure requirement to all funds, including open-end funds. They noted that it will be important to receive comment from these other types of funds (e.g., mutual funds and ETFs) explaining what the impact of this rule would be on them. See Commissioners Daniel M. Gallagher and Michael S. Piowar, Joint Statement on the Commission's Proposed Rule on Hedging Disclosures (Feb. 9, 2015), available at <http://www.sec.gov/news/statement/020912ps-cdmg-cmsp.html#.VN0PaChnCg0>.

[3] As an example, the SEC notes that a short sale can hedge the economic risk of ownership and selling a security future can establish a position that increases in value as the value of the underlying equity security decreases.

[4] As proposed, business development companies would be required to provide proposed Item 407(i) disclosure.