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Part IV

Securities and Exchange Commission

17 CFR Parts 229 and 240
Disclosure of Hedging by Employees, Officers and Directors; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 229 and 240

[Release No. 33–9723; 34–74232; IC–31450; File No. S7–01–15]

RIN 3235–AL49

Disclosure of Hedging by Employees, Officers and Directors

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: We are proposing amendments to our rules to implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires annual meeting proxy statement disclosure of whether employees or members of the board of directors are permitted to engage in transactions to hedge or offset any decrease in the market value of equity securities granted to the employee or board member as compensation, or held directly or indirectly by the employee or board member. The proposed disclosure would be required in a proxy statement or information statement relating to an election of directors, whether by vote of security holders at a meeting or an action authorized by written consent.

DATES: Comments should be received on or before April 20, 2015.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*);
- Send an email to *rule-comments@sec.gov.* Please include File Number S7–01–15 on the subject line; or
- Use the Federal Rulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Brent J. Fields, Secretary, U. S. Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549–1090.

All submissions should refer to File Number S7–01–15. This file number should be included on the subject line if email is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

Studies, memoranda or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the SEC's Web site. To ensure direct electronic receipt of such notifications, sign up through the ''Stay Connected'' option at *www.sec.gov* to receive notifications by email.

FOR FURTHER INFORMATION CONTACT: Carolyn Sherman, Special Counsel, or Anne Krauskopf, Senior Special Counsel, at (202) 551–3500, in the Office of Chief Counsel, Division of Corporation Finance, and Nicholas Panos, Senior Special Counsel, at (202) 551–3440, in the Office of Mergers and Acquisitions, Division of Corporation Finance; or, with respect to investment companies, Michael Pawluk, Branch Chief, at (202) 551–6792, Division of Investment Management, U.S. Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We propose to amend Item 402 [1] of Regulation S–K [2] by revising paragraph (b) to add Instruction 6; to amend Item 407 [3] of Regulation S–K to add new paragraph (i); and to amend Schedule 14A [4] to revise Items 7 and 22.

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I. Introduction

We are proposing rule amendments to implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the ''Act''),[5] which adds new Section 14(j) to the Securities Exchange Act of 1934 (the ''Exchange Act'').[6] Section 14(j) directs the Commission 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.

A report issued by the Senate Committee on Banking, Housing, and

[1] 17 CFR 229.402.

[2] 17 CFR 229.10 *et seq.*

[3] 17 CFR 229.407.

[4] 17 CFR 14a–101.

[5] Public Law 111–203, 124 Stat. 1900 (July 21, 2010).

[6] 15 U.S.C. 78a *et seq.*

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.'' [7] In this regard, we infer that the statutory purpose of Section 14(j) is to provide transparency to shareholders, if action is to be taken with respect to the election of directors, about whether employees or directors are permitted to engage in transactions that mitigate or avoid the incentive alignment associated with equity ownership.

We propose to implement Section 14(j) as described in detail below. Neither Section 14(j) nor the proposed amendments would require a company to prohibit hedging transactions or to otherwise adopt practices or a policy addressing hedging by any category of individuals.

II. Background

The current disclosure obligations relating to company hedging policies are provided by Item 402(b) of Regulation S–K, which sets forth the disclosure required in the company's Compensation Discussion and Analysis (''CD&A''). CD&A requires disclosure of material information necessary to an understanding of a company's compensation policies and decisions regarding the named executive officers.[8] Item 402(b)(2)(xiii) includes, as an example of the kind of information that should be provided, if material, the company's equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership) and any company policies regarding hedging the economic risk of such ownership. This CD&A disclosure item requirement, which does not apply to smaller reporting companies,[9] emerging growth companies,[10] registered investment companies [11] or foreign private issuers,[12] by its terms addresses only hedging by the named executive officers. In providing their CD&A disclosure, however, some companies describe policies that address hedging by employees and directors, as well as the named executive officers.

In addition, disclosures pursuant to other requirements may reveal when company equity securities have been hedged:

- For companies with a class of equity securities registered pursuant to Section 12 of the Exchange Act,[13] hedging transactions by officers and directors in transactions involving one or more derivative securities—such as options, warrants, convertible securities, security futures products, equity swaps, stock appreciation rights and other securities that have an exercise or conversion price related to a company equity security or derive their value from a company equity security—are subject to reporting within two business days on Form 4, pursuant to Exchange Act Section 16(a).[14]
- Some hedging transactions, such as prepaid variable forward contracts,[15] may involve pledges of the underlying company equity securities as collateral. Item 403(b) of Regulation S–K requires disclosure of the amount of company equity securities beneficially owned by directors, director nominees and named executive officers,[16] including the amount of shares that are pledged as security.[17]

III. Discussion of the Proposed Amendments

We propose to implement Section 14(j) by adding new paragraph (i) to Item 407 of Regulation S–K to require companies to disclose whether they permit employees and directors to hedge their company's securities. We believe that the disclosure called for by Section 14(j) is primarily corporate governance-related because it requires a company to provide in its proxy statement information giving shareholders insight into whether the company has policies affecting how the equity holdings and equity compensation of all of a company's employees and directors may or may not align with shareholders' interests. Because Section 14(j) calls for disclosure about employees and directors, we believe that this information raises broader issues with respect to the alignment of shareholders' interests with those of employees' and directors', and is more closely related to the Item 407 corporate governance disclosure requirements than to Item 402 of Regulation S–K, which focuses only on the compensation of named

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[7] *See* Report of the Senate Committee on Banking, Housing, and Urban Affairs, S. 3217, Report No. 111–176 (Apr. 30, 2010) (''Senate Report 111–176'').

[8] As defined in Item 402(a)(3) of Regulation S–K, ''named executive officers'' are all individuals serving as the company's principal executive officer during the last completed fiscal year, all individuals serving as the company's principal financial officer during that fiscal year, the company's three other most highly compensated executive officers who were serving as executive officers at the end of that year, and up to two additional individuals who would have been among the three most highly compensated but for not serving as executive officers at the end of that year.

[9] As defined in Exchange Act Rule 12b–2 [17 CFR 240.12b–2].

[10] Section 101 of the Jumpstart Our Business Start-Ups Act (the ''JOBS Act'') [Pub. L. 112–106, 126 Stat. 306 (2012)] codified the definition of ''emerging growth company'' in Section 3(a)(80) of the Exchange Act and Section 2(a)(19) of the Securities Act.

[11] Registered investment companies are investment companies registered under Section 8 of the Investment Company Act of 1940 (''Investment Company Act''). 15 U.S.C. 80a *et seq.*

[12] As defined in Rule 3b–4 [17 CFR 240.3b–4].

[13] 15 U.S.C. 78*l.*

[14] 15 U.S.C. 78p(a). For Section 16 purposes, the term ''derivative securities'' is defined in Exchange Act Rule 16a–1(c), which excludes rights with an exercise or conversion privilege at a price that is not fixed. Exchange Act Rule 16a–1(d) defines ''equity security of the issuer'' as any equity security or derivative security relating to the issuer, whether or not issued by that issuer. See also Exchange Act Rule 16a–4, which provides that for Section 16 purposes, both derivative securities and the underlying securities to which they relate shall be deemed to be the same class of equity securities.

The Commission has clarified that Section 16 applies to equity swap and similar transactions that a Section 16 insider may use to hedge, and has addressed how these derivative securities transactions should be reported, including specifically identifying them through the use of transaction code K. *See Ownership Reports and Trading by Officers, Directors and Principal Security Holders,* Release No. 34–34514 (Aug. 10, 1994) [59 FR 42449] at Section III.G; and *Ownership Reports and Trading by Officers, Directors and Principal Security Holders,* Release No. 34–37260 (May 31, 1996) [61 FR 30376] at Sections III.H and III.I. The Commission also has clarified how transactions in securities futures should be reported. *Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and Rules thereunder to Trading in Security Futures Products,* Release No. 33–8107 (June 21, 2002) [67 FR 43234] at Q. 13.

[15] A prepaid variable forward contract obligates the seller to sell, and the counterparty to purchase, a variable number of shares at a specified future maturity date. The number of shares deliverable will depend on the per share market price of the shares close to the maturity date. The contract specifies maximum and minimum numbers of shares subject to delivery, and at the time the contract is entered into, the seller will pledge to the counterparty the maximum number of shares. The Commission has indicated that forward sales contracts are derivative securities transactions subject to Section 16(a) reporting. *Mandated Electronic Filing and Web site Posting for Forms 3, 4 and 5,* Release No. 33–8230 (May 7, 2003) [68 FR 25788], text at n. 42.

[16] Item 403(b) of Regulation S–K [17 CFR 229.403(b)]. Disclosure is required on an individual basis as to each director, nominee, and named executive officer, and on an aggregate basis as to executive officers of the issuer as a group and must be provided in proxy statements, annual reports on Form 10–K [referenced in 17 CFR 240.310], and registration statements under the Securities Act and under the Exchange Act on Form 10.

[17] The Commission's rationale for requiring the disclosure of the amount of shares pledged as security was as follows: ''To the extent that shares owned by named executive officers, directors and director nominees are used as collateral, these shares may be subject to material risk or contingencies that do not apply to other shares beneficially owned by these persons.'' *Executive Compensation and Related Person Disclosure,* Release No. 33–8732A (Aug. 29, 2006) [71 FR 53158] (the ''2006 Executive Compensation Disclosure Release'') at Section IV.

executive officers and directors. We propose to amend Item 407 in this manner to keep disclosure requirements relating to corporate governance matters together in a single item in Regulation S–K.[18]

The proposed amendments implement Section 14(j) in the following ways:

- Include within the scope of the proposed disclosure requirement other transactions with economic consequences comparable to the financial instruments specified in Section 14(j);
- 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; [19]
- require the disclosure in any proxy statement on Schedule 14A or information statement on Schedule 14C [20] with respect to the election of directors because the information seems most relevant for shareholders voting or receiving information about the election of directors; and
- clarify that the term ''employee'' includes officers of the company.

A. Transactions Subject to the Disclosure Requirement

Section 14(j) requires disclosure of whether any employee or director 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 [21]) that are designed to hedge or offset any decrease in the market value of equity securities. Our proposal would implement this requirement and would also require disclosure of transactions with economic consequences comparable to the purchase of the specified financial instruments.

As noted above, a Senate report indicated that Section 14(j) was added so that shareholders would know whether executive officers are able ''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.'' [22] Although Section 14(j) expressly refers only to the purchase of financial instruments designed to hedge or offset any decrease in the market value of equity securities, there are other transactions that could have the same economic effects, the disclosure of which would be consistent with the purpose of Section 14(j).[23] For example, a short sale can hedge the economic risk of ownership. Similarly, selling a security future establishes a position that increases in value as the value of the underlying equity security decreases, thereby establishing the downside price protection that is the essence of the transactions contemplated by Section 14(j).

We are concerned that if the proposed disclosure requirement is not sufficiently principles-based, the result would be incomplete disclosure as to the scope of hedging transactions that an issuer permits. If, for example, a company discloses that it prohibits the purchase of the types of financial instruments specifically listed in the statute, and does not otherwise disclose whether it permits other types of hedging transactions that may have the same economic effects as the purchase of the listed financial instruments, a shareholder might assume that the company does not permit any hedging transactions at all, even though that may not be the case. Similarly, failing to cover transactions with the same economic effects as purchase of the listed financial instruments might cause employees and directors to use those transactions that are not covered by the disclosure requirement. In order for the disclosure to be complete and to avoid discouraging or promoting the use of particular hedging transactions, our proposed amendment would require disclosure of whether an issuer permits other types of transactions that have the same hedging effect as the purchase of those instruments specifically identified in Section 14(j). Proposed Item 407(i) would require disclosure of whether an employee, officer or director, or any of their designees, is 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 amendment would therefore cover all transactions that establish downside price protection—whether by purchasing or selling a security or derivative security or otherwise,[24] consistent with the statutory purpose and providing more complete disclosure. Like the existing CD&A disclosure item, which applies to company policies regarding hedging the economic risk of named executive officers' ownership of the company's securities,[25] the scope of the proposed amendment is not limited to any particular types of hedging transactions.

A proposed instruction would clarify that the company must disclose which categories of transactions it permits and which categories of transactions it prohibits.[26] Disclosure of both the categories prohibited and those permitted conveys a complete understanding of the scope of hedging at the company. However, we recognize that where, for example, a company only prohibits specified hedging transactions, potentially limitless disclosure of each specific category otherwise permitted may not be meaningful. Accordingly, if a company specifically prohibits certain hedging transactions, it would disclose the categories of transactions it specifically prohibits, and could, if true, disclose that it permits all other hedging transactions in lieu of listing all of the specific categories that are permitted. For example, a company could disclose that it prohibits prepaid variable forward contracts, but permits all other hedging transactions. Conversely, where a company specifies only the hedging transactions that it permits, in addition to disclosing the particular categories of transactions permitted, it may, if true, disclose that it prohibits all other

[18] As a result, the proposed disclosure would not be subject to shareholder advisory votes to approve the compensation of named executive officers, as disclosed pursuant to Item 402, that are required pursuant to Section 14A(a)(1) of the Exchange Act and Rule 14a–21(a) [17 CFR 240.14a–21(a)]. We recognize, however, that there is an executive compensation component of the proposed disclosure as it relates to existing CD&A obligations. See Section III.D.3, below.

[19] 15 U.S.C. 78*l*.

[20] 17 CFR 240.14c–101.

[21] By covering ''exchange funds,'' we believe that Section 14(j) can be interpreted to cover transactions involving dispositions or sales of securities. This is because an employee or director can acquire an interest in an exchange fund only in exchange for a disposition to the exchange fund of equity securities held by the employee or director. Whether the disposition to the exchange fund is a hedging transaction will depend on the terms of the fund.

[22] *See* Senate Report 111–176.

[23] Section 14(j) refers to financial instruments that are designed to hedge or offset any decrease in market value. The proposed amendments do not define the term ''hedge,'' as we believe the meaning of hedge is generally understood and should be applied as a broad principle.

[24] A pledge or loan of equity securities that does not involve a prepaid variable forward or similar transaction, would not be considered a hedging transaction covered by the proposed disclosure rule even though such a pledge or loan may be viewed as an ''offer or sale'' of a security under Securities Act Section 17(a) [15 U.S.C. 77q(a)]. *See Rubin* v. *United States,* 449 U.S. 424 (1981). This is because such stand-alone pledges and loans generally contemplate the return of the pledged or borrowed securities to the employee, with no consequent change in the employee's economic risk in ownership of the securities.

[25] Item 402(b)(2)(xiii) of Regulation S–K, discussed in Section II.D, below.

[26] Proposed Instruction 3 to Item 407(i).

hedging transactions in lieu of listing all of the specific categories that are prohibited. For example, a company could disclose that it permits exchange fund transactions, but prohibits all other hedging transactions. If a company does not permit any hedging transactions, or permits all hedging transactions, it should so state and would not need to describe them by category. An additional instruction would require a company that permits hedging transactions to disclose sufficient detail to explain the scope of such permitted transactions.[27] For example, a company that permits hedging of equity securities that have been held for a specified period of time would need to disclose the period of time the securities must have been held.

If a company permits some, but not all, of the categories of persons covered by the proposed amendment to engage in hedging transactions, the company would disclose both the categories of persons who are permitted to hedge and those who are not.[28] For example, a company might disclose that it prohibits all hedging transactions by executive officers and directors, but does not restrict hedging transactions by other employees. Disclosing both categories of transactions and persons would provide investors a more complete understanding of the persons permitted to engage in hedging transactions, if any, and the types of hedging transactions permitted by the company.

B. Specifying the Term ''Equity Securities''

We are proposing an instruction to specify that the term ''equity securities,'' as used in proposed Item 407(i), would mean any equity securities (as defined in Exchange Act Section 3(a)(11)[29] and Exchange Act Rule 3a11–1)[30] issued by 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.[31] As proposed, the disclosure requirement would 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[32] or registered under Exchange Act Section 12(g).[33] We believe that the equity securities registered under Exchange Act Section 12 encompass the securities that are more likely to be readily traded, and more easily hedged. Because the Exchange Act and Exchanges Act Rules definitions of ''equity security'' do not specify the issuer, and Section 14(j) does not itself do so, without an instruction that narrows the scope, the term ''equity securities'' could be interpreted to include the equity securities of any company that are held directly or indirectly by an employee or director.

The proposed instruction would specify the scope of covered equity securities for both paragraphs (1) (compensatory equity securities grants) and (2) (other equity securities holdings) of proposed Item 407(i). Disclosure of whether a director or employee is permitted to hedge equity securities granted as compensation or otherwise held from whatever source acquired will more fully inform shareholders whether employees and directors are able to engage in transactions that reduce the alignment of their interests with the economic interests of other shareholders of the company and any affiliated company in which the employees or directors might have an interest. Shareholders would receive the Item 407(i) disclosure because they hold equity securities of the company and action is to be taken with respect to the election of directors for that company. The disclosure would provide additional information on whether the company has policies affecting the alignment of incentives for employees and directors of the company whose securities they hold. We therefore believe that disclosure about whether employees and directors are permitted to hedge equity securities issued by the company, its parents, subsidiaries or subsidiaries of the company's parents that are registered under Exchange Act Section 12 would be most relevant when providing information about the election of directors. We believe that, in certain instances,[34] companies may grant equity securities of affiliated companies to their employees or directors that are intended to achieve similar incentive alignment as grants in the company's equity securities. In these instances, we believe it would be relevant for shareholders to know whether such persons are permitted to mitigate or avoid the risks associated with long-term ownership of these securities.

C. Employees and Directors Subject to the Proposed Disclosure Requirement

Section 14(j) covers hedging transactions conducted by any employee or member of the board of directors or any of their designees. Consistent with that mandate, we believe the term ''employee'' should be interpreted to include everyone employed by an issuer, including its officers. We believe it is just as relevant for shareholders to know if officers are allowed to effectively avoid restrictions on long-term compensation as it is for directors and other employees of the company.[35] Accordingly, we propose to implement Section 14(j) by adding the parenthetical ''(including officers)'' after the term ''employees'' in the language of the proposed disclosure requirement.[36] In sum, the proposed amendment uses the language ''any employees (including officers) or directors of the registrant, or any of their designees'' in describing the persons covered by the disclosure requirement.[37]

Request for Comment

1. Should the disclosure required by Section 14(j) be implemented by amending the corporate governance disclosures required by Item 407, as proposed? Alternatively, should it be implemented by amending the Item 402

[27] Proposed Instruction 4 to Item 407(i).

[28] Proposed Instruction 2 to Item 407(i).

[29] 15 U.S.C. 78c(a)(11). Exchange Act Section 3(a)(11) defines ''equity security'' as any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

[30] 17 CFR 240.3a11–1. Exchange Act Rule 3a11–1 defines ''equity security'' to include any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; any security future on any such security; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so.

[31] 15 U.S.C. 78*l;* Proposed Instruction 1 to Item 407(i).

[32] 15 U.S.C. 78*l(b).*

[33] 15 U.S.C. 78*l(g).*

[34] Examples may include, but are not limited to, where a company reorganizes to create a publicly-traded subsidiary.

[35] *See Senate Report 111–176.*

[36] The parenthetical ''(including officers)'' in proposed Item 407(i) is intended to include officers employed by an issuer and avoid possible confusion with Exchange Act Rule 12b–2 [17 CFR 240.12b–2], which states that the term ''employee'' does not include a director, trustee, or officer.

[37] Section 14(j) refers to ''designee[s]'' of employees and directors. Under the proposed disclosure requirement, whether someone is a ''designee'' would be determined by a company based on the particular facts and circumstances.

executive compensation disclosure requirements? Are there advantages or disadvantages to requiring these disclosures under Item 402? If so, please explain why.

2. Should the scope of the proposed Item 407(i) disclosure requirement cover transactions that are not expressly listed in Exchange Act Section 14(j) but have economic consequences comparable to the purchase of the financial instruments specifically identified in Section 14(j), as proposed? If not, why not?

3. 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?

4. 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?

5. A company that permits hedging transactions would be required to disclose sufficient detail to explain the scope of such permitted transactions. For example, a company may permit hedging transactions only if pre-approved, or only after the company's stock ownership guidelines have been met. Should proposed Instruction 4 be more specific about the types of details, such as a pre-approval requirement, that the company must disclose?

6. Does our proposal to define the term ''equity securities'' as equity securities of the company or any of its parents, subsidiaries or subsidiaries of its parents that are registered under Exchange Act Section 12 appropriately capture the disclosure that shareholders would find useful? Should the Commission limit the term ''equity securities'' to only equity securities of the company? If so, please explain why and the costs and benefits that would result. How often are directors and employees compensated through equity securities of an affiliated company that are not registered under Section 12(b) of the Exchange Act? If the definition of equity securities includes only equity securities registered under Section 12(b) of the Exchange Act, would that affect either compensation structure or corporate structure? Do companies typically have policies addressing hedging of equity securities of their parents, subsidiaries or subsidiaries of their parents? What would be the costs and benefits of disclosing whether hedging the equity securities of these affiliates is permitted or prohibited? Would any on-going compliance efforts be different? If so, please explain why and the costs and benefits that would result.

7. Should the proposed definition be broadened to include equity securities that are not registered under Exchange Act Section 12 or narrowed to only include equity securities registered under Section 12(b) of the Exchange Act? If so, explain why and the costs and benefits that would result. Alternatively, should the proposed definition be revised to exclude equity securities that do not trade in an established public market? If so, how would ''established public market'' be defined? To the extent the amendment applies to equity securities that do not trade on an established public market, should we provide guidance about how to interpret ''market value'' for purposes of the proposed amendment? In either case, please explain why, and what costs and benefits would result from the recommended change.

8. Should we define ''parent'' and ''subsidiary'' specifically for purposes of this disclosure requirement? The definition of ''parent'' of a person in the Exchange Act Rules is an affiliate controlling such person directly, or indirectly through one or more intermediaries.[38] Similarly, the Exchange Act Rules definition of ''subsidiary'' of a person is an affiliate controlled by such person directly, or indirectly through one or more intermediaries.[39] Will these definitions, in the context of hedging disclosure, present any implementation challenges in determining what needs to be disclosed? Should we consider an alternative term, or alternative definition of ''parent'' for this disclosure requirement, such as an affiliate that owns a majority of the voting securities in the company? Similarly, with respect to subsidiaries, should we consider an alternative term, or alternative definition of ''subsidiary'' for this disclosure requirement, such as a majority-owned subsidiary, wholly-owned subsidiary, consolidated subsidiary or significant subsidiary? In each case, please explain why, and what costs and benefits would result from the recommended change.

9. 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? 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.''[40] 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.

10. 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?[41] Why or why not? If so, how would that distinction be defined for practical purposes? Alternatively, should we add an express materiality condition to the definition, as is the case under CD&A,

[38] Exchange Act Rule 12b-2 [17 CFR 240.12b–2].

[39] Exchange Act Rule 12b-2 [17 CFR 240.12b–2].

[40] See Letter from Compensia, Inc. (Oct. 4, 2010). To facilitate public input on the Act, the Commission has provided a series of email links, organized by topic, on its Web site at *http://www.sec.gov/spotlight/regreformcomments.shtml.* The public comments we have received on Section 955 of the Act are available on our Web site at *http://www.sec.gov/comments/df-title-ix/executive-compensation/executive-compensation.shtml.*

[41] *See Section IV.C.1.*

to permit each issuer to determine whether disclosure about all its employees would be material information for its investors? Why or why not?

11. Should the amendment define ''hedge''? If so, what concepts other than the statutory reference to ''offset[ting] any decrease in the market value of equity securities'' would be necessary to define this term?

12. One commenter has recommended that the Commission ''should not only require disclosure of whether hedging is permitted, but should also require disclosure of any hedging that has occurred—both in promptly filed Form 4 filings and in the annual proxy statement.'' [42] Should the Commission require such disclosure in the final rule for those already subject to Form 4 reporting requirements?

D. Implementation

1. Manner and Location of Disclosure

Section 14(j) calls for disclosure in any proxy or consent solicitation material for an annual meeting of the shareholders. Shareholder annual meetings are typically the venue in which directors are elected.[43] Although the language of Section 14(j) refers to disclosure in any proxy or consent solicitation material for an annual meeting of the shareholders, this language, construed strictly, would result in the disclosure appearing in different instances than we currently require other corporate governance related disclosure. In particular, under our current rules, if a company solicits proxies [44] with respect to the election of directors, its proxy statement must include specified corporate governance information required by Item 407 of Regulation S–K, whether or not the election takes place at an annual meeting.[45] We believe that Item 407(i) disclosure would be relevant information for shareholders evaluating the governance practices of the company and the election of directors. By providing the disclosure in a proxy statement if action is to be taken with respect to the election of directors, shareholders will be able to consider the proposed disclosure at the same time as they are considering the company's other corporate governance disclosures and voting for the election of directors, without regard to whether at an annual or special meeting of shareholders or in connection with an action authorized by written consent.[46] We therefore propose to implement Section 14(j) by amending Items 7 and 22 of Schedule 14A to call for new Item 407(i) information to be provided if action is to be taken with respect to the election of directors. In addition to including the new disclosure requirement, the proposal would amend Item 7 of Schedule 14A to streamline its current provisions by more succinctly cross-referencing disclosure Items.[47]

The information required under proposed Item 407(i) would need to be included in proxy or consent solicitation materials and information statements with respect to the election of directors. Section 14(j) specifically calls for the disclosure to be made in the proxy solicitation materials, and we believe the information would be most relevant to shareholders if action is to be taken with respect to the election of directors. We therefore do not propose to require Item 407(i) disclosure in Securities Act or Exchange Act registration statements or in the Form 10–K Part III Item 407 disclosure,[48] even if that disclosure is incorporated by reference from the company's definitive proxy statement or information statement filed with the Commission not later than 120 days after the end of the fiscal year covered by the Form 10–K.[49]

2. Disclosure on Schedule 14C

The statutory language of Section 14(j) expressly calls for proxy or consent solicitation materials for an annual meeting of the shareholders of the issuer to include the disclosure contemplated by the proposed amendments. These solicitation materials are required by our proxy rules to be filed under cover of Schedule 14A.[50] As provided in Item 1 of Schedule 14C, however, an information statement filed on Schedule 14C must include the information called for by all of the items of Schedule 14A to the extent each item would be applicable to any matter to be acted upon at a meeting if proxies were to be solicited, with only limited exceptions.[51] An information statement

[42] *See* letter from Brian Foley & Company, Inc. (Sept. 22, 2010).

[43] The Commission has previously recognized that directors ordinarily are elected at annual meetings. See, *e.g.,* Rule 14a–6(a) [17 CFR 240.14a–6(a)], which acknowledges that registrants soliciting proxies in the context of an election of directors at an annual meeting may be eligible to rely on the exclusion from the requirement to file a proxy statement in preliminary form. Rule 14a–3(b) [17 CFR 240.14a–3(b)] requires proxy statements used in connection with the election of directors at an annual meeting to be preceded or accompanied by an annual report containing audited financial statements. The requirement for registrants to hold an annual meeting at which directors are to be elected, however, is imposed by a source of legal authority other than the federal securities laws. In Delaware, for example, where more than 50% of the publicly traded issuers are incorporated according to the State of Delaware's official Web site, Delaware General Corporation Law, Section 211(b) is viewed as requiring an annual meeting for the election of directors. See Delaware Law of Corporations & Business Organizations, Third Edition by R. Franklin Balotti, Jesse A. Finkelstein at § 7.1, Folk on the Delaware General Corporate Law, 2013 Edition by Edward P. Welch, Andrew J. Turezyn, and Robert S. Saunders at § 211.2, and the text of DGCL Section 211(b), which reads in relevant part, ''unless directors are elected by written consent in lieu of an annual meeting as permitted by this subsection, an annual meeting of stockholders shall be held for the election of directors on a date and at a time designated by or in the manner provided in the bylaws.'' See also Corporations and Other Business Associations, Seventh Edition by Charles R.T. O'Kelley and Robert B. Thompson at page 167 (explaining that the ''paramount shareholder function is the election of directors'' and that ''[m]ost corporation codes protect this right by specifying immutably that directors shall be elected at an annually held meeting of shareholders.''), California Corporations Code, Section 600(b), and 1984 Model Business Corporation Act (as amended through 2006), Section 7.01(a) (each requiring an annual meeting of shareholders for the election of directors).

[44] Rule 14a–1(f) [17 CFR 240.14a–1(f)] defines the term ''proxy'' to include every proxy, consent or authorization within the meaning of Section 14(a) of the Exchange Act. A solicitation of consents therefore constitutes a solicitation of proxies subject to Section 14(a) and Regulation 14A.

[45] *See* Items 7(b)–(d) and 8(a) of Schedule 14A.

[46] We note that an annual meeting, the meeting at which companies generally provide for the election of directors, could theoretically not include an election of directors. For reasons explained above, an annual meeting ordinarily involves an election of directors. In the unlikely event that a company is not conducting a solicitation for the election of directors but is otherwise soliciting proxies at an annual meeting, the proposed amendment would not require the proposed disclosure in the proxy statement.

[47] Proposed amended Item 7(b) and Instruction to Item 7 of Schedule 14A.

[48] This approach is consistent with the disclosure requirements for registration statements under the Securities Act and for annual reports on Form 10–K, which include only selected provisions of Item 407. See Item 11(l) and 11(o) on Form S–1 and Items 10, 11 and 13 of Form 10–K.

[49] As permitted by General Instruction G to Form 10–K. Proposed Instruction 5 to Item 407(i) would provide that information disclosed pursuant to Item 407(i) would not be deemed incorporated by reference into any filing under the Securities Act, the Exchange Act or the Investment Company Act. As proposed, the disclosure also would not be subject to forward incorporation by reference under Item 12(b) of Securities Act Form S–3 [17 CFR 239.13].

[50] As stated above, Exchange Act Rule 14a–1(f) [17 CFR 240.14a–1(f)] defines the term ''proxy'' to include every proxy, consent or authorization within the meaning of section 14(a) of the [Exchange] Act. Exchange Act Rule 14a–3(a) [17 CFR 240.14a–3(a)] prohibits any proxy solicitation unless each person solicited is currently or has been previously furnished with a publicly-filed preliminary or definitive proxy statement containing the information specified in Schedule 14A [17 CFR 240.14a–101], and Exchange Act Rule 14a–6(m) [17 CFR 240.14a–6(m) requires proxy materials to be filed under cover of Schedule 14A.

[51] Specifically, Item 1 of Schedule 14C permits the exclusion of information called for by Schedule 14A Items 1(c) (Rule 14a–5(e) information re shareholder proposals), 2 (revocability of proxy), 4 (persons making the solicitation), and 5 (interest of certain persons in matters to be acted upon). Other Items of Schedule 14C prescribe the information to

Continued

filed on Schedule 14C in connection with an election of directors therefore already is required to include the information required by Item 7 of Schedule 14A. Absent an amendment to Schedule 14C to exclude proposed Item 407(i) from the requirements for the information statement, the disclosure contemplated by the amendments would be required in Schedule 14C pursuant to existing Item 1 of Schedule 14C.

We are not proposing to exclude Item 407(i) disclosure from Schedule 14C.[52] Applying the proposed disclosure obligation to Schedule 14C filings would have the effect of expanding the requirement to comply with Item 407(i) to companies that do not solicit proxies from any or all security holders but are otherwise authorized by security holders to take an action with respect to the election of directors.

We believe that doing so would retain consistency in the corporate governance disclosure provided in proxy statements and information statements with respect to the election of directors. Exchange Act Section 14(c) was enacted to apply to companies not soliciting proxies or consents from some or all holders of a class of securities registered under Section 12 of the Exchange Act entitled to vote at a meeting or authorize a corporate action by execution of a written consent.[53] It creates disclosure obligations for a company that chooses not to, or otherwise does not, solicit proxies, consents, or other authorizations from some or all of its security holders entitled to vote. An example of when such a situation could occur is in the case of a controlled company [54] not listed on the New York Stock Exchange, NYSE Market or NASDAQ. In instances where management and/or a shareholder affiliate may control sufficient shares to assure a quorum and a favorable voting outcome, as in the case of a majority-owned subsidiary, or where a solicitation of proxies, consents or authorization is made of only certain security holders in connection with an election of directors, Section 14(c) would operate to ensure that security holders not solicited would receive disclosure substantially equivalent to that which would have been included in a proxy statement had a solicitation of all security holders been made.[55] In light of this purpose, we believe requiring Item 407(i) disclosure in information statements filed pursuant to Section 14(c) furthers the regulatory objective of Section 14(j) of the Exchange Act and would mitigate the regulatory disparity that otherwise might result.[56]

3. Relationship to Existing CD&A Obligations

One of the non-exclusive examples currently listed in the Item 402(b) requirement for CD&A calls, in part, for disclosure of any registrant policies regarding hedging the economic risk of company securities ownership,[57] to the extent material. CD&A applies only to named executive officers and is part of the Item 402 executive compensation disclosure that is required in Securities Act and Exchange Act registration statements, and Exchange Act annual reports on Form 10–K, as well as proxy and information statements relating to the election of directors.[58] Smaller reporting companies, emerging growth companies, registered investment companies and foreign private issuers, however, are not required to provide CD&A disclosure.

By requiring proxy statement disclosure of whether employees generally are permitted to hedge equity securities that they receive as compensation or otherwise hold, the disclosure mandated by Section 14(j) includes within its scope hedging policies applicable to named executive officers.[59] To reduce potentially duplicative disclosure in proxy and information statements, we propose to amend Item 402(b) of Regulation S–K to add an instruction providing that a company may satisfy its CD&A obligation to disclose material policies on hedging by named executive officers by cross referencing the information disclosed pursuant to proposed Item 407(i) to the extent that the information disclosed there satisfies this CD&A disclosure requirement.[60] This instruction, like the Item 407(i) disclosure requirement, would apply to a company's proxy statement or information statement with respect to the election of directors. We believe that

be provided with regard to such of these topics that are relevant to information statements. Specifically, Item 3 addresses the interest of certain persons in or opposition to matters to be acted upon, and Item 4 addresses proposals by security holders. In addition, Notes A, C, D and E to Schedule 14A are applicable to Schedule 14C [17 CFR 240.14c–101].

[52] Because our proposal would not add a new exclusion for information called for by the proposed amendment to Item 7 of Schedule 14A, the effect of the proposal will be to require Item 407(i) disclosure in Schedule 14C.

[53] Section 14(c) of the Exchange Act was enacted to ''reinforce [ ] fundamental disclosure principles [for companies] subject to the proxy rules which did not solicit proxies . . .'' By enacting Section 14(c), Congress was advised that these companies ''would be required to furnish shareholders with information equivalent to that contained in a proxy statement . . . [and that such legislation was needed] [b]ecause evasion of the disclosures required by the proxy rules is made possible by the simple device of not soliciting proxies . . .'' Statement of William L. Cary, Chairman, Securities and Exchange Commission, Part I. K. Other Amendments Proposed by S. 1642, Hearings before a Subcommittee of the Committee on Banking and Currency for the U.S. Senate, Eighty-Eighth Congress, First Session on S. 1642, June 18–21 and 24–25, 1963.

[54] A controlled company is generally understood to be a company in which more than 50% of the voting power is held by an individual, a group or another issuer. *See e.g.,* Exchange Act Section 10C(g)(2) [15 U.S.C. 78jC(g)(2)].

[55] At the time Section 14(c) was being considered by Congress as an amendment to the Exchange Act, the Securities and Exchange Commission provided an official statement that reported findings associated with a study that examined the proxy solicitation practices of 556 industrial and other companies. ''Twenty-nine percent of these companies did not solicit proxies and 24 percent did not even send shareholders a notice of meeting.'' Statement of the Securities and Exchange Commission with respect to Proposed Amendments to Sections 12, 13, 14, 15, 16, 20(c), and 32(b) of the Securities Exchange Act of 1934 and Section 4(1) of the Securities Act of 1933, at 2. Existing Disclosures by Over-the-Counter Companies, Hearings before a Subcommittee of the Committee on Banking and Currency for the U.S. Senate, Eighty-Eighth Congress, First Session on S. 1642, June 18–21 and 24–25, 1963. Simply extending the coverage of the proxy rules to reach over-the-counter issuers was not viewed as a solution, and was believed to have been a decision that would have accentuated the problem of non-solicitation ''because of management's relatively larger holdings.'' Statement of William L. Cary, Chairman, U.S. Securities and Exchange Commission, cited in n. [51] above.

[56] Of the approximately 6845 operating companies with at least one class of securities registered under Section 12 of the Exchange Act, 4018 have a class of securities listed on an exchange. Based on our review of and experience with NASDAQ, the New York Stock Exchange or NYSE Market, collectively referred to here as primary market exchanges, companies with a class of common or voting preferred stock (or their equivalents) listed on these exchanges are generally required to solicit proxies from shareholders for all meetings of shareholders, including those to elect directors. See, *e.g.,* NYSE Listed Company Manual Section 402.04, and NASDAQ Rule IM–5620—Meetings of Shareholders or Partners. Operating companies with a class of voting stock listed on a primary exchange that comply with the listing exchange's requirements, therefore, will be providing the proposed disclosure in proposed amended Item 7 of Schedule 14A and proposed Item 407(i) of Regulation S–K for each election of directors. By contrast, the approximately 2827 non-exchange listed companies with a class of securities registered under Section 12 may not be subject to compulsory requirements analogous to the primary market exchange rules that impose an affirmative obligation to solicit shareholders. Consequently, these non-exchange listed companies, if not subject to a compulsory requirement to solicit proxies, could avoid the proposed disclosures if the new requirement were limited to only companies soliciting proxies or consents pursuant to Section 14(a), especially given that companies with a class of securities registered only under Exchange Act Section 12(g) may be able to effectuate a corporate action (as referenced in Exchange Act Rule 14c–2) without soliciting security holder approval and thus would need only comply with Section 14(c) and Regulation 14C.

[57] Item 402(b)(2)(xiii) of Regulation S–K.

[58] As required by Item 8 of Schedule 14A.

[59] See Section III, above.

[60] Proposed Instruction 6 to Item 402(b).

amending Item 402(b) to add this instruction will, in certain circumstances, make it easier for companies that are subject to both Item 407(i) and Item 402(b) to prepare their proxy and information statements by avoiding the potential for duplicative disclosure.[61] In addition, we believe that locating all the responsive disclosure in one place in the proxy or information statement will make it easier for investors to find.

4. Issuers Subject to the Proposed Amendments

In proposing amendments to implement Section 14(j), we have considered whether certain categories of issuers should be exempted from the proposed Item 407(i) disclosure requirements, or, alternatively, whether they should be subject to a delayed implementation schedule.[62] In making these determinations, we have been guided by what we understand to be the statutory purpose behind Section 14(j), namely, to provide transparency to shareholders, if action is to be taken with respect to the election of directors, about whether employees or directors are permitted to engage in transactions that mitigate or avoid the incentive alignment associated with equity ownership.

a. Registered Investment Companies

We are proposing to require closed-end investment companies that have shares that are listed and registered on a national securities exchange (''listed closed-end funds'') to provide the proposed disclosure. Investment companies registered under the Investment Company Act of 1940 (''funds'' or ''registered investment companies'') that are not listed closed-end funds would be excluded from these requirements, as discussed in more detail below.[63]

Funds generally have a management structure and regulatory regime that differs in various respects from issuers that are operating companies, which we believe makes the proposed disclosure less useful for investors in funds that are not listed closed-end funds. Nearly all funds, unlike other issuers, are externally managed and have few, if any, employees who are compensated by the fund.[64] Rather, personnel who operate the fund and manage its portfolio generally are employed and compensated by the fund's investment adviser.[65] Although fund directors may hold shares of the funds they serve,[66] fund compensation practices can be distinguished from those of operating companies. We believe that the granting of shares as a component of incentive-based compensation is uncommon (and in some cases is prohibited) [67] for funds. Concerns about avoiding restrictions on long-term compensation, which we understand to be one of the reasons Congress mandated this disclosure, may therefore be less likely to be raised with respect to funds.

In addition, most funds, other than listed closed-end funds as discussed below, also are generally not required to hold annual meetings of shareholders.[68] Exchange-traded funds (''ETFs''), although traded on an exchange, also do not generally hold annual meetings of shareholders, and some ETFs do not have boards of directors.[69]

Open-end funds differ from operating companies in the way that their shares are purchased and sold. For example, mutual funds sell shares that are redeemable, meaning generally that shareholders are able to present the shares to the fund at the shareholder's discretion and receive the net asset value (''NAV'') per share determined at the end of each day.[70] For funds like mutual funds whose shares do not trade on an exchange, it may be less efficient or not possible to engage in certain hedging transactions with respect to the fund's shares. And although ETF shares

[61] Exchange Act Rule 14a–21(a) [17 CFR 240.14a–21(a)] provides that shareholder advisory say-on-pay votes apply to executive compensation disclosure pursuant to Item 402 of Regulation S–K, which includes CD&A. Because Item 407(i) disclosure will not be subject to these votes except to the extent made part of CD&A pursuant to the proposed cross-reference instruction, the proposal will not effect any change in the scope of disclosure currently subject to say-on-pay votes. We also note that the cross-reference is optional and issuers may, if they prefer, avoid making the Item 407(i) disclosure part of CD&A by not cross-referencing the disclosure.

[62] Section 36(a) of the Exchange Act permits the Commission, by rule, regulation, or order, to conditionally or unconditionally exempt any person security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

[63] Business development companies are a category of closed-end investment company that are not registered under the Investment Company Act [15 U.S.C. 80a–2(a)(48) and 80a–53–64]. As proposed, business development companies would be treated in the same manner as all issuers (other than certain funds as discussed in this section) and therefore would be subject to the requirements of proposed Item 407(i). We believe that this would be consistent with the Commission's treatment of business development companies regarding other disclosure requirements. *See* the 2006 Executive Compensation Disclosure Release, at Section II.D.3.

[64] Some funds do have employees, who might also hold fund shares. *See also* footnote 36 and accompanying text (explaining that the parenthetical ''(including officers)'' in proposed Item 407(i) is intended to include officers employed by an issuer).

[65] Funds also typically will contract with other service providers in addition to the investment adviser.

[66] *See* Saitz, Greg, ''Here Are Two Choices: Buy Fund Shares or Buy Fund Shares,'' July 30, 2013, *available at http://www.boardiq.com/c/556021/60971/here_choices_fund_shares_fund_shares.*

[67] Registered open-end and closed-end investment companies are generally prohibited from issuing their securities for services. *See* Sections 22(g) (open-end funds) and 23(a) (closed-end funds) of the Investment Company Act. Recognizing that ''effective fund governance can be enhanced when funds align the interests of their directors with the interests of their shareholders,'' our staff has provided guidance concerning the circumstances under which funds may compensate fund directors with fund shares consistent with sections 22(g) and 23(a). *See* Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24083 (Oct. 14, 1999). With respect to registered closed-end funds, some of which would be subject to the proposed amendments, our staff stated that ''[c]losed-end funds also may wish to institute policies that encourage or require their directors to use the compensation that they receive from the funds to purchase fund shares in the secondary market on the same basis as other fund shareholders.'' *See id.* at n.73. The staff also stated that it ''would not recommend enforcement action to the Commission under Section 23(a) if closed-end funds directly compensate their directors with fund shares, provided that the directors' services are assigned a fixed dollar value prior to the time that the compensation is payable,'' while noting that ''any closed-end fund that compensates its directors by issuing fund shares would generally be required to issue those shares at net asset value, even if the shares are trading at a discount to their net asset value.'' *See id.* at n.74.

[68] The requirement to hold an annual meeting of shareholders at which directors are to be elected generally is imposed by a source of authority other than the federal securities laws. *See* footnote 43 above. Funds are typically organized under state law as a form of trust or corporation that is not required to hold an annual meeting. See Robert A. Robertson, Fund Governance: Legal Duties of Investment Company Directors § 2.–6[5]. Funds may, however, hold shareholder meetings from time to time under certain circumstances, including where less than a majority of the directors of the fund were elected by the holders of the fund's outstanding voting securities. *See* Section 16(a) of the Investment Company Act. *See also* footnote 73 and accompanying text.

[69] ETFs are organized either as open-end funds or unit investment trusts (''UITs''). A UIT does not have a board of directors, corporate officers, or an investment adviser to render advice during the life of the trust, and does not actively trade its investment portfolio. *See* Section 4(2) of the Investment Company Act (''Unit investment trust'' means an investment company which (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities, but does not include a voting trust.'').

[70] The term ''redeemable,'' as used with respect to fund shares, refers to shares that are redeemable at the discretion of the investor holding the shares. *See* Section 2(a)(32) of the Investment Company Act (defining the term ''redeemable security''). Closed-end fund shares, in contrast, generally are not redeemable, and these shares trade at negotiated market prices, including on national securities exchanges.

trade on exchanges, they often trade on the secondary market at prices close to the NAV of the shares, rather than at discounts or premiums to NAV.

Based on these considerations, the proposed amendments would not require funds, other than listed closed-end funds, to provide the proposed disclosure.

We are, however, proposing to require listed closed-end funds to provide Item 407(i) disclosure. Although listed closed-end funds are similar to other funds in certain respects, including with respect to their management structure and regulatory regime, there are several features of listed closed-end funds that may make requiring the Item 407(i) disclosure appropriate. Shares of listed closed-end funds, unlike mutual fund shares, trade at negotiated market prices on a national securities exchange and are not redeemable from the funds. The shares thus may, and often do, trade at a ''discount,'' or a price below the NAV per share.[71] 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 thus whether they, like the fund's other shareholders, would receive that discounted price upon a sale of the shares without an offset from any hedging transactions. This information may be important to the voting decision of an investor when evaluating the extent to which a fund director or employee's interest is aligned with that of the fund's other shareholders, including in considering whether the director or employee may be more or less incentivized as a result of holding shares in the fund to seek to decrease the discount. It also 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. Market participants can and do sell these types of fund shares short, for example.[72] Hedging transactions might thus be more likely with respect to shares of listed closed-end funds, and thus potentially of greater interest to those funds' shareholders.

Finally, unlike other types of funds as discussed above, listed closed-end funds generally are required to hold annual meetings of shareholders.[73] Listed closed-end funds thus more closely resemble operating companies that would be subject to the proposed disclosure requirements in this respect.[74] We also note that officers and directors of listed closed-end funds, like officers and directors of emerging growth companies and smaller reporting companies which would be subject to the proposed disclosure requirements as discussed below, are subject to the requirement in Section 16(a) of the Exchange Act to report hedging transactions.[75]

For all of these reasons and those discussed in Section IV below, we propose to require listed closed-end funds to provide Item 407(i) disclosure and to exclude all other registered investment companies from these requirements. We request comment below on this proposed approach and, more generally, on the application of the proposed disclosure requirements to funds, including whether these requirements should apply to additional specific types of funds, such as ETFs. We seek input and data on the prevalence of hedging by employees and directors for all registered investment companies.

b. Emerging Growth Companies and Smaller Reporting Companies

We do not propose to exempt smaller reporting companies or emerging growth companies from Item 407(i) disclosure. We are not aware of any reason why information about whether a company has policies affecting the alignment of shareholder interests with those of employees and directors would be less relevant to shareholders of an emerging growth company or a smaller reporting company than to shareholders of any other company. In this regard, we believe it is consistent with the statutory purpose of Section 14(j) to require these companies to provide disclosure about their hedging policies. Moreover, given its narrow focus, the proposed disclosure is not expected to impose a significant compliance burden on companies. For these reasons, the proposed disclosure would apply to smaller reporting companies and emerging growth companies to the same extent as other companies subject to the federal proxy rules.

We acknowledge that the JOBS Act excludes emerging growth companies from some, but not all, of the provisions of Title IX of the Act, of which Section 955 is a part,[76] and that emerging growth companies and smaller reporting companies are in many instances subject to scaled disclosure requirements, including with respect to executive compensation.[77] We believe that it would be more consistent with our historical approach to corporate governance related disclosures,[78] as well as the statutory objectives of Section 14(j), not to exempt these companies from the proposed disclosure requirement. We recognize that, since emerging growth companies and smaller reporting companies are not required to provide CD&A disclosure required by Item 402(b) and therefore may not have had the occasion to consider a hedging policy, these companies may have a greater initial cost than companies that already have a policy or already disclose one. Further, these companies would also have on-going costs implementing and administering their policies. On balance, however, we believe the proposed rule would not constitute a substantial, incremental burden for smaller reporting companies or emerging growth companies.

[71] Based on staff review of information available from Morningstar Direct and filings with the Commission.

[72] Based on staff review of market data available from the Bloomberg Professional service.

[73] *See, e.g.,* Section 302.00 of the New York Stock Exchange's Corporate Governance Standards (''Listed companies are required to hold an annual shareholders' meeting during each fiscal year.'').

[74] Listed closed-end funds also are similar to operating company issuers in other respects. For example, listed closed-end funds, like operating companies, do not issue redeemable securities (*i.e.,* at the option of the holder); rather, they issue securities in traditional underwritings, which are subsequently listed on an exchange or traded in the over-the-counter markets. In addition, listed closed-end funds and operating companies each may be able to issue preferred shares and are not restricted in the amount of illiquid assets they may hold, although the assets of an operating company are generally more illiquid than the securities held by a listed closed-end fund.

[75] *See* Section 30(h) of the Investment Company Act (''Every person who is . . . an officer, director, member of an advisory board, investment adviser, or affiliated person of an investment adviser of [a registered closed-end fund] shall in respect of his transactions in any securities of such company (other than short-term paper) be subject to the same duties and liabilities as those imposed by section 16 of the Securities Exchange Act of 1934 upon certain beneficial owners, directors, and officers in respect of their transactions in certain equity securities.'').

[76] Section 102 of the JOBS Act exempts emerging growth companies from: the say-on-pay, say-on-frequency, and say-on-golden parachutes advisory votes required by Exchange Act Sections 14A(a) and (b), enacted in Section 951 of the Act; the ''pay versus performance'' proxy disclosure requirements of Exchange Act Section 14(i), enacted in Section 953(a) of the Act; and the pay ratio disclosure requirements of Section 953(b) of the Act.

[77] *See* Section 102(c) of the JOBS Act and Item 402(*l*) of Regulation S–K.

[78] *See* Item 407(a), (b), (c), (d), (e)(1)–(3), (f) and (h) of Regulation S–K; *but see* Item 407(g) of Regulation S–K that provides a phase-in period for smaller reporting companies from the disclosure required by Item 407(d)(5) of Regulation S–K and does not require smaller reporting companies to provide the disclosures required by Item 407(e)(4) and (5) of Regulation S–K. In addition, as noted above, officers and directors at smaller reporting companies and emerging growth companies are subject to the obligation under Exchange Act Section 16(a) to report transactions involving derivative securities.

In light of what we believe to be the minimal burden imposed by proposed Item 407(i) in terms of additional disclosure and the time necessary to prepare it, we are not proposing a delayed implementation schedule for smaller reporting companies and emerging growth companies. We are requesting comment, however, on the need for either an exemption for smaller reporting companies or emerging growth companies or a delayed implementation schedule for these companies.

c. Foreign Private Issuers

As noted above, Section 14(j) calls for disclosure in any proxy or consent solicitation material for an annual meeting of the shareholders of the issuer. Because securities registered by a foreign private issuer are not subject to the proxy statement requirements of Exchange Act Section 14,[79] foreign private issuers would not be required to provide Item 407(i) disclosure.

Request for Comment

13. Should Item 407(i) disclosure be required whenever action is taken with respect to the election of directors, as proposed? Instead, should we require disclosure in any proxy or information statement relating to an annual meeting of shareholders, irrespective of whether directors are to be elected at that meeting? Should the disclosure be limited only to annual meetings, and not special meetings, even if directors are to be elected at a special meeting?

14. 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?

15. To retain consistency in the corporate governance disclosure provided in proxy statements and information statements with respect to the election of directors, Item 407(i) disclosure as proposed would apply to Schedule 14C as well as Schedule 14A. Is there any reason that the proposed Item 407(i) disclosure should be limited to issuers that are soliciting proxies? Why or why not?

16. In addition to including the new disclosure requirement, the proposed amendment to Item 7 of Schedule 14A would amend this Item to more succinctly organize its current provisions without changing the substance. As so revised, would the requirements of Item 7 be easier to understand? Alternatively, should we retain the current structure of Item 7, with the addition of the Item 407(i) disclosure?

17. 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?

18. Is there a better way to align the requirements of Item 402(b) of Regulation S–K and proposed Item 407(i) of Regulation S–K? Are there circumstances in which the current CD&A requirement in Item 402(b) of Regulation S–K would result in more complete disclosure about the company's hedging policies than what would be required under proposed Item 407(i)? For example, although Section 14(j) addresses only hedging of equity securities, would disclosure of employees' and directors' ability to hedge other securities further the statutory purpose? In this regard, should we expand the proposed disclosure in Item 407(i) to include debt securities?

19. We request comment on all aspects of the proposed disclosure requirements as applied to funds, including whether all funds or additional types of funds other than listed closed-end funds should be required to provide the proposed disclosure. Should we require all funds, including mutual funds and ETFs, to provide the proposed disclosure? Should we, instead, require different specific types of funds to provide the proposed disclosure? For example, should we require ETFs to provide the proposed disclosure? Would shareholders in mutual funds, ETFs, or other types of funds benefit from the information provided by the proposed disclosure?

20. If we were to require additional types of funds to provide the proposed disclosure, why and how, if at all, should we modify the disclosure requirements for such funds? As noted above, some ETFs are organized as UITs, which do not have boards of directors, and ETFs generally do not hold annual meetings of shareholders. How should any disclosure under Section 14(j) accommodate these or other characteristics of ETFs if we were to require ETFs to provide the proposed disclosure?

21. Are there additional characteristics of funds that we should consider in determining which funds should be required to provide the proposed disclosure or whether the disclosure requirements should be modified for funds or particular types of funds? If we were to require some or all funds to provide the proposed disclosure, including listed closed-end funds as proposed, what are the benefits and costs expected to result?

22. Should we modify the Item 407(i) disclosure requirements for listed closed-end funds? Would this information be material to an investor in contexts other than those relating to voting decisions, such as an investment decision? Should we also require the disclosure in listed closed-end funds' other disclosure documents, such as an annual report or shareholder report next following a meeting of shareholders, for example? If we were to require all funds or a broader group of funds to provide Item 407(i) disclosure, should we also require the disclosure in other disclosure documents, such as the funds' Statements of Additional Information?

23. As proposed, listed closed-end funds would be required to provide proposed Item 407(i) disclosure. Should we not require listed closed-end funds to provide this disclosure? If so, please explain why, and the benefits and costs that would result.

24. Do funds generally have policies concerning their employees and directors engaging in hedging transactions of securities issued by their respective funds, or policies that prohibit such hedging transactions? To what extent do employees or directors of listed closed-end funds receive shares of such funds as a form of compensation? Do employees or directors of listed closed-end funds currently effect hedging transactions with respect to the shares of those funds and, if so, what kinds of transactions do they effect?

25. How could employees or directors effect hedging transactions with respect to shares of funds other than listed-closed end funds, in particular mutual funds? How prevalent are these hedging transactions?

26. As proposed, listed closed-end funds, like the other issuers covered by the proposed amendments, would be required to provide disclosure concerning hedging of the equity securities issued by the fund or any of the fund's parents, subsidiaries or subsidiaries of the fund's parents that

[79] Exchange Act Rule 3a12–3(b) [17 CFR 240.3a12–3(b)] specifically exempts securities registered by a foreign private issuer from Exchange Act Sections 14(a) and 14(c).

are registered under Section 12 of the Exchange Act.[80] Should we instead require listed closed-end funds to provide disclosure only about hedging transactions concerning the funds' shares? Would investors in listed closed-end funds benefit from receiving information about the funds' directors' and employees' holdings of the funds' parents, subsidiaries or subsidiaries of the fund's parents?

27. As proposed, business development companies would be required to provide proposed Item 407(i) disclosure. Should we modify the disclosure requirements for business development companies? Should we not require business development companies to provide this disclosure? If so, please explain why, and the benefits and costs that would result. Should we only require a business development company to provide the proposed disclosure if the business development company's shares are listed on a national securities exchange?

28. Should smaller reporting companies or emerging growth companies be exempted from proposed Item 407(i) or subject to a delayed implementation schedule? If so, please explain why and the benefits and costs that would result. As discussed below, a component of the disclosure costs (especially initial costs) may be fixed, which may have a greater impact on smaller reporting companies and emerging growth companies. Do the proposed disclosure requirements also impose other potential costs on smaller reporting companies or emerging growth companies that are different in kind or degree from those imposed on other companies?) Would the proposed disclosure requirements be as meaningful for investors in smaller reporting companies and emerging growth companies as for those in other companies? Do investors in smaller reporting companies and emerging growth companies place more, less, or the same value on corporate governance disclosures of the type proposed here than do investors in larger, more established companies, either alone or in relation to other disclosures?

29. 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?

30. Are there any other categories of issuers that should be exempt from the requirement to provide Item 407(i) disclosure? If so, please explain why, and the benefits and costs that would result.

General Request for Comment

We request and encourage any interested person to submit comments on any aspect of our proposals, other matters that might have an impact on the proposed amendments, and any suggestion for additional changes. With respect to any comments, we note that they are of greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments and by alternatives to our proposals where appropriate.

IV. Economic Analysis

A. Background

Section 955 of the Act added Section 14(j) to the Exchange Act, which directs the Commission to adopt rules requiring an issuer to disclose in any proxy or consent solicitation material for an annual meeting of its shareholders whether any employee or director of the issuer, or any designee of an employee or director, is permitted to engage in transactions to hedge or offset any decrease in the market value of equity securities granted to the employee or director as compensation, or held directly or indirectly by the employee or director.

To implement the mandate of Section 14(j), we are proposing new paragraph (i) of Item 407 of Regulation S–K and amendments to Schedule 14A under the Exchange Act. Further, to reduce potentially duplicative disclosure, we propose to allow a company to satisfy its obligation to disclose material policies on hedging by named executive officers in the CD&A by cross reference to the information disclosed under proposed Item 407(i) to the extent that the information disclosed there satisfies this CD&A disclosure requirement.

We are mindful that our proposed amendments can both impose costs and confer benefits. Exchange Act Section 3(f) requires us, when engaging in rulemaking that requires us to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation. Exchange Act Section 23(a)(2) requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition and not to adopt any rule that would impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The discussion below addresses the economic effects of the proposed amendments, including likely benefits and costs, as well as the likely effect of the proposal on efficiency, competition and capital formation. We request comment throughout this release on alternative means of meeting the statutory mandate of Section 14(j) and on all aspects of the costs and benefits of our proposals and possible alternatives. We also request comment on any effect the proposed disclosure requirements may have on efficiency, competition and capital formation. We appreciate comments on costs and benefits that are attributed to the statute itself and, to the extent that they are separable, the costs and benefits that are a result of policy choices made by the Commission in implementing the statutory requirements, as well as any data or analysis that helps quantify the potential costs and the benefits identified.

B. Baseline

The proposed amendments affect all issuers registered under Section 12 of the Exchange Act, including smaller reporting companies (''SRCs''), emerging growth companies (''EGCs''), and listed closed-end funds, but excluding foreign private issuers (''FPIs''), and other types of registered investment companies, including non-listed closed-end funds, open-end funds, and unit investment trusts. We estimate that approximately 7,447 companies would be subject to the proposed amendments, including 4,620 listed Exchange Act Section 12(b) registrants and 2,827 non-listed Exchange Act Section 12(g) registrants. Among the Section 12(b) registrants subject to the proposed amendments, we estimate that 602 are listed closed-end funds, 916 are SRCs or EGCs, and the remaining 3,102 are other operating companies. Among the Section 12(g) registrants subject to the proposed amendments, 2,220 are SRCs or EGCs, and the remaining 607 are operating companies that are not SRCs or EGCs.[81]

[80] Item 22 of Schedule 14A defines terms used in that Item, including the terms parent and subsidiary. Item 22(a)(1)(ix) defines the term ''parent'' to mean ''the affiliated person of a specified person who controls the specified person directly or indirectly through one or more intermediaries.'' Item 22(a)(1)(xii) defines the term ''subsidiary'' to mean ''an affiliated person of a specified person who is controlled by the specified person directly, or indirectly through one or more intermediaries.''

[81] We estimate the number of operating companies subject to the proposed amendments by analyzing companies that filed annual reports on Form 10–K in calendar year 2012 with the Commission. This set excludes ABS issuers (SIC 6189), registered investment companies, issuers that have filed registration statements but have yet to file Forms 10–K with the Commission, and foreign issuers filing on Forms 20–F and 40–F. We identify

Other affected parties include these issuers' employees (including officers) and directors who hold equity securities of these issuers, and investors in general. Because almost all listed closed-end funds are externally managed by investment advisers and only a small number of listed closed-end funds are internally managed where the portfolio managers are employees of the closed-end funds, the proposed amendments will generally affect the funds' employees and directors; employees of the funds' investment advisers (*e.g.,* portfolio managers) will not be affected by the amendments.[82] Equity securities covered by the proposed amendments include equity securities issued by 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.[83]

To assess the economic impact of the proposed amendments, we use as our baseline the state of the market as it exists at the time of this release. For Section 12 registrants (other than SRCs, EGCs, and listed closed-end funds) that are subject to the proposed amendments, the regulatory baseline is the current CD&A disclosure requirement in Item 402(b)(2)(xiii) of Regulation S–K. Item 402(b)(2)(xiii) calls for disclosure of ''any registrant policies regarding hedging the economic risk'' of security ownership by named executive officers as one of the ''non-exclusive'' examples of information includable in CD&A, if material. To the extent that a registrant does not have a policy regarding hedging by named executive officers, there is no obligation to disclose. For SRCs, EGCs, and listed closed-end funds, CD&A disclosure pursuant to Item 402(b)(2)(xiii) is not currently required.

Additionally, officers and directors of companies with a class of equity securities registered under Section 12, including SRCs and EGCs, are currently required to report their hedging transactions involving the company's equity securities pursuant to Exchange Act Section 16(a). Further, Section 30(h) of Investment Company Act specifies that officers and directors of closed-end funds are subject to the same duties and liabilities as those imposed by Section 16 of the Exchange Act.

Table 1 below draws a comparison between the current requirements for CD&A disclosure and Section 16 reporting, where applicable, and the proposed disclosure requirement for the registrants that would be affected by the proposed amendments.

TABLE 1—COMPARISON OF DISCLOSURE REQUIREMENTS

Covered company	Covered persons	Current company reporting requirement	Current officer & director reporting requirement	Company reporting requirement under the proposed amendments
(1)	(2)	(3)	(4)	(5)
12(b) companies other than SRCs, EGCs, and listed closed-end funds [Number = 3,102].	NEOs	Item 402(b)	Section 16(a).	
	Other employees	None	Section 16(a), if an officer.	
	Directors	None	Section 16(a).	
12(g) companies other than SRCs and EGCs [Number = 607].	NEOs	Item 402(b)	Section 16(a).	
	Other employees	None	Section 16(a), if an officer	Item 407(i).[84]
	Directors	None	Section 16(a).	
SRCs & EGCs under 12(b) [Number = 916].	Employees (including NEOs) & Directors.	None	Section 16(a), if an officer or director.	
SRCs & EGCs under 12(g) [Number = 2,220].	Employees (including NEOs) & Directors.	None	Section 16(a), if an officer or director.	
Listed closed-end funds [Number = 602].	Employees & Directors	None	Section 30(h) of the Investment Company Act.	

the companies that have securities registered under Section 12(b) or Section 12(g) from Form 10–K. We also determine from Form 10–K whether a company is a SRC. We determine whether a company is an EGC by reviewing both its Form 10–K and any registration statement. We estimate the number of listed closed-end funds based upon data from the 2014 Investment Company Fact Book, page 170 (available at *http://www.ici.org/pdf/2014_factbook.pdf*).

[82] Among the approximately 602 listed closed-end funds in 2012, Commission staff has identified only 4 internally-managed closed-end funds from a review of filings with the Commission.

[83] In some instances, equity of a company's subsidiary may be granted as compensation for that company's officers (He *et al.* 2009). Stock holdings in a company's subsidiary provide officers with an incentive to make decisions to improve the subsidiary's performance, which in turn may positively affect the economic prospects of the parent company. As discussed later, it is important for shareholders (of both the company and its subsidiary) to better understand whether incentives can be reduced by hedging. See He W., M. K. Tarun, and P. Wei, 2009, ''Agency Problems in Tracking Stock and Minority Carve-out Decisions: Explaining the Discrepancy in Short- and Long-term Performances'' Journal of Economics and Finance 33(1): 27–42.

[84] As proposed, companies would be required to make disclosure under proposed Item 407(i) when they file proxy or information statements with respect to the election of directors. Proxy statement disclosure obligations only arise under Section 14(a), however, when an issuer with a class of securities registered under Section 12 chooses to solicit proxies (including consents). Since the federal securities laws do not require the solicitation of proxies, the application of Section 14(a) is not automatic. Whether or not an issuer has to solicit therefore depends upon any requirement under its charter and/or bylaws, or otherwise imposed by law in the state of incorporation and/or by the relevant stock exchange (if listed). For example, NYSE, NYSE Market, and NASDAQ generally require solicitation of proxies for all meetings of shareholders. If a listed company then chooses to hold a meeting at which directors are to be elected and solicit proxies, Section 14(a) would then apply and compel the disclosure identified in Item 407(i). Section 12(g)-registered companies also can make the decision to solicit proxies and thus similarly will have to comply with Section 14(a), to the same extent Section 12(b)-registered companies. When Section 12 registrants that do not solicit proxies from any or all security holders are nevertheless authorized by security holders to take an action with respect to the election of directors, disclosure obligations also arise under proposed Item 407(i) due to the requirement to file and disseminate an information statement under Section 14(c).

As illustrated in Table 1, disclosure requirements will increase for all companies subject to the proposed amendments, although the extent of the increase may vary for different categories of registrants.

To establish the baseline practices for Section 12 companies subject to Item 402(b)(2)(xiii), we reviewed the disclosures of ''policies regarding hedging'' by named executive officers from two samples of exchange-listed companies. The first sample included all S&P 500 companies that filed proxy statements during the calendar year 2012, totaling 484 companies.[85] Our analysis revealed that disclosures are not uniform across companies. Out of the 484 proxy statements, 158 companies (33%) did not disclose hedging policies for named executive officers, six companies (1%) disclosed that the company did not have a policy regarding hedging by named executive officers, 284 companies (59%) disclosed that named executive officers were prohibited from hedging, and 36 companies (7%) disclosed that they permitted hedging by named executive officers under certain circumstances.

The second sample included 100 randomly selected companies from the 494 S&P Smallcap 600 index companies that filed proxy statements during the calendar year 2012. These companies are significantly smaller and less widely followed than S&P 500 companies, and, as a result, may have significantly different disclosure practices. These companies are all exchange-listed, and none are SRCs or EGCs. We found that 71 companies (71%) did not disclose hedging policies for named executive officers, four companies (4%) disclosed that the company did not have a policy regarding hedging by named executive officers, 23 companies (23%) disclosed that named executive officers were prohibited from hedging, and two companies (2%) disclosed that they permitted hedging by named executive officers under certain circumstances.

Our analysis of the two samples revealed that a significant percentage (34%) of S&P 500 companies, and an even larger percentage of the subset of S&P Smallcap 600 companies (75%) either did not make a disclosure or reported that they did not have a policy for named executive officers. This baseline analysis suggests that smaller companies will likely have a greater initial disclosure burden under the proposed amendments than larger companies.

As mentioned above, SRCs, EGCs, and listed closed-end funds are not required to make Item 402(b) disclosure and, consequently, are not currently required to disclose any policies regarding hedging by named executive officers. However, officers and directors at SRCs and EGCs with a class of equity securities registered under Section 12 are currently required to report their hedging transactions involving the companies' equity securities pursuant to Section 16(a), and officers and directors of registered closed-end funds are required to make similar reports by Section 30(h) of the Investment Company Act. Notwithstanding these reports, investors' ability to use reported insider hedging transactions, if any, to infer these companies' policies regarding hedging by officers and directors is imperfect at best. First, an investor must track all the accumulated insider trades reported to assess whether there is hedging. Disclosures of particular hedging transactions by officers and directors could indicate that the company permits that particular type of transaction, that the company has no hedging policy, or that a company policy was violated but the transaction was reported in accordance with current rules. The absence of reported hedging transactions could indicate that the company prohibits hedging, that the company permits hedging but the officers and directors do not engage in hedging transactions, or that officers and directors engage in hedging transactions but are not complying with Section 16(a) reporting requirements.

C. Discussion of Benefits and Costs, and Anticipated Effects on Efficiency, Competition and Capital Formation

1. Introduction

From an economic theory perspective, an executive officer's ownership in the employer company ties his or her financial wealth to shareholder wealth, and hence can provide the executive officer with an incentive to improve the company's performance, as measured by stock price.[86] Permitting executive officers to hedge can be perceived by shareholders as a problematic practice[87] because hedging can have the economic effect of taking a short position on the employer's stock, which is counter to the interests of other shareholders.

Alternatively, permitting executive officers to hedge, under certain circumstances, could align officers' and shareholders' preferences more closely and thereby promote more efficient corporate investment. Compared with well-diversified shareholders, executive officers are likely to be disproportionately invested in their company and thus inherently undiversified.[88] The concentrated financial exposure, together with executive officers' concerns about job security in the event of a stock price decline, could lead them to take on fewer risky projects (*i.e.,* projects with uncertain future cash flows) that are potentially value enhancing than would be in the interest of well-diversified shareholders, resulting in underinvestment.[89] This

[85] To be included in the S&P 500 index, the companies must be publicly listed on either the NYSE (NYSE Arca or NYSE MKT) or NASDAQ (NASDAQ Global Select Market, NASDAQ Select Market or the NASDAQ Capital Market). Because this index includes foreign companies, there were fewer than 500 proxy statements filed.

[86] The literature in economics and finance typically refers to a principal-agent model to describe the employment relationship between shareholders and executive officers (managers) at a company. The principal (shareholders) hires an agent (manager) to operate the company. However, because shareholders cannot perfectly observe managerial actions, this information asymmetry gives rise to a moral hazard problem: managers may act in their own self-interest and not always in the interest of shareholders. This potential misalignment of incentives is ameliorated when managers are also owners of the company, and thus must internalize the cost of any actions that harm shareholders or do not otherwise maximize the value of the company. See, *e.g.,* Jensen, M. C. and W. H. Meckling, 1976. ''Theory of The Firm: Managerial Behavior, Agency Costs and Ownership Structure'' Journal of Financial Economics 3: 305–360; Holmstrom, B., 1979. ''Moral Hazard and Observability'' Bell Journal of Economics 10: 324–340; Holmstrom, B. and Ricart I Costa, J., 1986 ''Managerial Incentives and Capital Management'', Quarterly Journal of Economics 101, 835–860.

[87] See, *e.g.,* Institutional Shareholder Services Inc., ''2013 Corporate Governance Policy Updates and Process: Executive Summary'', Nov. 16, 2012 at *http://www.issgovernance.com/file/files/2013ExecutiveSummary.pdf.*

[88] Meulbroek (2005) points out that employees may be even more undiversified than their equity holdings suggest: ''their continued employment and its relation to the fortunes of the firm, outstanding deferred compensation owed to the employee, and any firm specific human capital exacerbate employees' firm-specific risk exposure.'' See Meulbroek, L. 2005, ''Company Stock in Pension Plans: How Costly Is It?'' Journal of Law and Economics, vol. XLVIII: 443–474; Hall, B., and K. Murphy. 2002. ''Stock options for undiversified executives'' Journal of Accounting and Economics 33: 3–42. Moral hazard and adverse selection issues cause boards of directors to compel executive officers to maintain large personal investment in their companies. Executive officers may not be able to diversify this exposure because of explicit stock ownership guidelines for executives and directors, contractual restrictions on trading equity grants within the vesting periods, and retention plans that prohibit the sale of unrestricted stock for some time after vesting.

[89] This underinvestment concern has been studied in a long strand of academic literature. See *e.g.,* Rappaport, A. 1978, ''Executive Incentives vs. Corporate Growth'' Harvard Business Review 57: 81–88; Smith, C., and R. Stulz. 1985. ''The Determinants of Firms' Hedging Policies'', Journal of Financial and Quantitative Analysis 20: 391–405; Kaplan, R., 1982, ''Advanced Management Accounting'' Englewood Cliffs, N. J.: Prentice-Hall; and Lambert, R., 1986, ''Executive Effort and the

underinvestment concern can be addressed by providing downside price protection to executive officers' equity holdings, in case high-risk projects—that are in the interest of shareholders at the time of the investment decision—do not turn out to be successful and thereby cause a decline in the stock price.[90] One way to do so is to permit executive officers to seek downside price protection by hedging their equity holdings. However, the value of hedging to address potential underinvestment depends on the availability and cost-effectiveness of other solutions to the underinvestment concern.[91]

The theories of equity incentives described above for executive officers may also apply to critical employees (*e.g.,* key research scientists), because these individuals' actions and decisions can also impact company stock price. These theories can also apply to directors, who typically receive equity-based compensation to align their interests with those of the shareholders they represent. However, directors may have less incentive to hedge because their financial wealth is typically better diversified than executive officers', and is therefore less sensitive to company stock price. Nevertheless, directors' compensation, particularly in the form of equity compensation, grew significantly during the 2000s, contributing to a significant increase in directors' equity incentives.[92] The increased level of directors' equity incentives suggests that equity incentives could be playing an increasingly important role in influencing directors' actions on corporate decisions.

These 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. While some of these employees may also receive equity grants as part of the companies' broad-based equity plans, their equity ownership on average is much lower than that of executive officers. Equity 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.[93] In other words, 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.

Like operating companies, listed closed-end funds also confront a principal-agent relationship between shareholders and the fund's directors and employees, if any. The connection between managerial incentives and firm performance is, however, less direct in listed closed-end funds than it is in operating companies because almost all of these funds are externally managed by investment advisers.

Fund directors oversee the many service providers that will typically serve a listed closed-end fund, including the investment adviser. Holding equity shares in the fund can align directors' interests with those of the shareholders.[94] Some listed closed-end funds do require or encourage directors to hold fund shares.[95] The proposed disclosure thus would allow the shareholders of a listed closed-end fund whose shares, for example, are trading at a discount to know if the listed closed-end fund permits its directors to hedge the value of the fund's equity securities. The proposed disclosure would thereby show whether the fund's directors, like the fund's other shareholders, would receive that discounted price upon a sale of the shares without an offset from any hedging transactions.

In an operating company, shareholdings also affect the incentives of employees, including managers who are making the company's decisions. In contrast, almost all listed closed-end funds have few (if any) employees. Fund portfolios are almost always managed by portfolio managers who are employed by external investment advisers. Because listed closed-end fund shares are not redeemable and often trade at a discount to NAV, shareholders of those funds may place importance on the degree of incentive alignment between funds' key decision makers and shareholders when making voting decisions.[96]

Selection of Risky Projects'' Rand Journal of Economics 17, 77–88.

[90] See Hemmer, T., O., Kim, and R. Verrecchia, 1999, ''Introducing Convexity into Optimal Compensation Contracts'' Journal of Accounting and Economics 28: 307–327.

[91] For example, requiring executive officers to hold stock options can also provide them with incentives to take on risky but value-enhancing investment projects. Such risk-taking incentives depend on option moneyness: the incentives are the strongest when options are near the money, but quickly diminish when options go deep in the money. If a company experiences a sharp stock price increase, which causes executive officers' option holdings to become deep in-the-money, such holdings likely would not provide effective risk-taking incentives. In this situation, permitting executives to hedge may be a better solution to the underinvestment concern than for the company to grant new at-the-money options, because the latter may cause the company to overpay the executives. Hedging of corporate operations, as opposed to personal hedging by executive officers, could also increase the executives' incentives to take higher risk but value-enhancing corporate projects, but corporate hedging can be costly. *See* Smith C. and R. Stulz, 1985, ''The Determinants of Firms' Hedging Policies'' Journal of Financial and Quantitative Analysis 20(4): 392–405).

[92] For S&P 1500 companies, median total compensation per outside director rose from $57,514 in 1998 to $112,745 in 2004 (a 51% increase), far greater than the rate of increase of 24% in CEO compensation over the same period. The proportion of director pay provided by equity increased from around 45% in 1998 to over 60% in 2004. Yermack (2004) show that, in Fortune 500 companies, some directors near the top of the distribution receive very significant equity awards that can provide ex-post performance rewards exceeding those of some CEOs. Altogether, equity holdings, turnover, and opportunities to obtain new board seats provide outside directors serving in their fifth year with wealth increases of approximately 11 cents per $1,000 rise in firm value. Although typically smaller than incentives for CEOs, director incentives can be significant given that many directors serve on multiple boards. See Yermack, D. 2004, ''Remuneration, Retention, and Reputation Incentives for Outside Directors'', The Journal of Finance LIX: 2281–2308; Farrell K., G. Friesen, and P. Hersch, 2008, ''How Do Firms Adjust Director Compensation?'', Journal of Corporate Finance 14: 153–162; J. Linck, J. Netter, and T. Yang, 2009, ''The Effects and Unintended Consequences of the Sarbanes-Oxley Act on the Supply and Demand for Directors'', The Review of Financial Studies 22: 3287–3328; and Fedaseyeu V., J. Linck, and H. Wagner, 2014, ''The Determinants of Director Compensation'' Bocconi University and Southern Methodist University working paper (available at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id*= 2335584). Note that these studies used samples prior to 2011; however, we have no reason to believe that director incentives and compensation have declined significantly in more recent years.

[93] See Oyer, P. 2002, ''Stock Options—It's Not Just About Motivation'', Stanford Institute for Economic Policy Research (available at *http://web.stanford.edu/group/siepr/cgi-bin/siepr/?q=system/files/shared/pubs/papers/briefs/policybrief_oct02.pdf*); Oyer, P. and S. Schaefer, 2005, ''Why Do Some Firms Give Stock Options to All Employees?: An Empirical Examination of Alternative Theories'', Journal of Financial Economics 76 (1): 99–133.

[94] We have previously published the Commission staff's view that ''[f]und directors who own shares in the funds that they oversee have a clear economic incentive to protect the interests of fund shareholders,'' and that fund policies that encourage or require independent directors to invest the compensation that they receive from the funds in shares of the funds ''gives the independent directors a direct and tangible stake in the financial performance of the funds that they oversee, and can help more closely align the interests of independent directors and fund shareholders.'' *See* Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24083 (Oct. 14, 1999).

[95] Zhao (2007) studies 316 closed-end funds in 2002. She finds that 200, or 62.3%, report positive director ownership. The average (median) director ownership is at $105,493 ($30,001). See Zhao, L., 2007, ''Director Ownership and Fund Value: Evidence from Open-End and Closed-End Funds'', Columbia University working paper (available at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=963047*).

[96] See Wu, Y., R. Wermers, and J. Zechner, 2013, ''Managerial Rents vs. Shareholder Value in Delegated Portfolio Management: The Case of Closed-End Funds'' working paper. Available at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2179125&download=yes.*

The proposed amendments apply only to employees and directors of the fund itself, however. As a result, these amendments would not directly affect outside portfolio managers' asset choices. However, fund directors may influence the investment adviser's management of the fund's portfolio indirectly, through the directors' oversight of the investment adviser, which is responsible for managing the fund's portfolio consistent with the fund's disclosed strategy and investment objectives.

In summary, information on the company's policies regarding hedging by employees and directors may help investors better understand the employees' and directors' incentives in creating shareholder wealth. For example, in operating companies, because executive officers' and directors' reported equity holdings in proxy statements may not reflect their actual economic exposure to the company's performance, there may in certain cases exist an information asymmetry between insiders and other investors regarding the executive officers' and directors' equity incentives. The mandated disclosures can help mitigate this information asymmetry.

2. New Disclosure Requirements Across Covered Companies

Before considering the economic effects from proposed Item 407(i), we first discuss the new disclosures that would be required for different covered companies, and the new information from these disclosures. The potential economic effects would likely vary across companies depending on the nature and amount of new information from the disclosures, the degree of investment opportunities available to the company, and the likelihood that employees and directors engage in hedging transactions (discussed in detail later).

Section 12 registrants, with the exception of SRCs, EGCs, and registered investment companies (which include listed closed-end funds), are currently required under Item 402(b) to disclose their hedging policies for named executive officers, if material. Companies are not otherwise currently required to provide information about whether they have a policy on hedging. They may not be providing such disclosures, possibly because their hedging policies are not material, or because they do not have a policy. Table 2 divides covered companies, which includes both operating companies and listed closed-end funds, into four categories. The first three categories include operating companies. The last category includes listed closed-end funds.

TABLE 2—FOUR CATEGORIES OF COVERED COMPANIES

Section 12 Companies Subject to the Proposed Amendments
(1) Companies that are subject to Item 402(b) and make disclosures for named executive officers.
(2) Companies that are subject to Item 402(b) but make no disclosures.
(3) SRCs and EGCs that are not currently required to make Item 402(b) disclosures but must disclose under Item 407(i).
(4) Listed closed-end funds that are not currently required to make Item 402(b) disclosures but must disclose under Item 407(i).

Category 1 refers to the subset of companies subject to Item 402(b) that currently provide disclosure about hedging policies for named executive officers. These companies may be unlikely to change such policies as a result of the proposed amendments. For these companies, the new disclosures required under proposed Item 407(i) are whether employees (other than named executive officers) and directors are permitted to hedge.

Category 2 refers to companies subject to Item 402(b) that do not currently disclose information about whether hedging by their named executive officers is permitted.[97] New disclosures under the proposed amendments would confirm for shareholders whether hedging is permitted. Given that shareholders are likely to view a policy prohibiting hedging by named executive officers as shareholder friendly,[98] the requirement to disclose may prompt some of these companies to adopt new policies or change their current policies or practices. In light of the required say-on-pay vote on executive compensation, we believe that companies prohibiting hedging by named executive officers would already have an incentive to disclose such a policy. Some shareholders may believe it is reasonable to infer that a company that is subject to Item 402(b) but does not disclose a hedging policy in effect may permit named executive officers to hedge. As a result, because shareholders either know through affirmative disclosure under Item 402(b)(2)(xiii) or may believe it is reasonable to infer from the absence of disclosure that named executive officers are permitted to hedge, the proposed amendments may not have much effect in reducing uncertainty as it relates to named executive officers. For Section 12 registrants other than SRCs, EGCs and listed closed-end funds, the new information provided by disclosures under the proposed amendments relates primarily to whether employees (other than named executive officers) and directors are permitted to hedge.

Category 3 refers to SRCs and EGCs, which are currently exempt from Item 402(b). The new information available to investors under proposed Item 407(i) would require disclosure, for the first time, about whether employees (including named executive officers) and directors are permitted to hedge.

Category 4 refers to listed closed-end funds. Since these funds are not currently subject to Item 402(b), the new information that would be available to shareholders is comparable in type to that of SRCs and EGCs. However, the new information about listed closed-end funds may in fact be less substantial than that of SRCs and EGCs for most funds because almost all listed closed-end funds are externally managed, as discussed above. Only a small number of internally-managed listed closed-end funds have employees, which include funds' portfolio managers.

[97] For example, as discussed above, we collected data on the baseline practice of some Section 12(b) registrants other than SRCs and EGCs. The proxy statements filed during calendar year 2012 indicated that most of the S&P 500 companies disclosed their hedging policies for named executive officers: 59% of companies prohibited hedging, while 7% permitted hedging. The rest either made no disclosure of hedging policy (33% of companies) or disclosed that they did not have a policy regarding hedging by named executive officers (1% of companies); we include such companies in category 2. The incidence of no disclosure tended to be higher among smaller companies.

[98] See, *e.g.,* Institutional Shareholder Services Inc., ''2013 Corporate Governance Policy Updates and Process: Executive Summary'', Nov. 16, 2012 at *http://www.issgovernance.com/file/files/2013ExecutiveSummary.pdf* (''Stock-based compensation or open market purchases of company stock are intended to align executives' or directors' interests with those of shareholders. Therefore, hedging of company stock through covered call, collar, or other derivative transactions severs the ultimate alignment with shareholders' interests. Any amount hedged will be considered a problematic practice warranting a negative voting recommendation on the election of directors.'').

3. Benefits and Costs

Investors can benefit from the disclosures under the proposed amendments in the following ways.[99] First, as discussed above, officers', directors', and non-officer critical employees' equity incentives tend to align their interests with those of the shareholders. Under the proposed amendments, investors would benefit from new disclosures that provide more clarity and transparency about these incentives, thereby reducing the information asymmetry between corporate insiders and shareholders regarding such incentives. Better information about equity incentives could be useful for investors' evaluation of companies, enabling investors to make more informed investment and voting decisions, thereby encouraging more efficient capital allocation decisions.

Second, the proposed amendments may reduce the costs for investors in researching and analyzing equity-based incentives. Knowledge that employees and directors are not permitted to hedge could confirm for investors that the reported equity holdings of officers and directors in proxy statements and annual reports on Form 10–K represent their actual incentives.[100] While Section 16(a) reports provide transaction-level information on officer and director hedging activity, Forms 3, 4, and 5 may be costly to search; investors also may incur costs in analyzing whether a reported transaction is indeed a hedge. Moreover, hedging activity disclosed on a Form 3, 4, or 5 does not indicate whether a transaction was conducted in accordance with the company's hedging policy, and therefore may lead to improper inferences about the company's hedging policy.

Third, the proposed amendments could also benefit investors 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.[101] Companies that currently already disclose whether named executive officers are permitted to hedge may be unlikely to substantially change their policies as a result of the proposed amendments. However, this could be different for companies that do not currently make disclosures on hedging policies for all employees or directors.[102] Without disclosed hedging policies, these companies may in fact implicitly permit hedging. However, permitting hedging may not necessarily promote efficient investment decisions. Employees and directors often demand a premium for receiving equity compensation in lieu of cash. However, through hedging they may be able to convert the value of that premium into cash. This causes the company to overpay relative to its opportunity cost.[103] If, in light of the disclosure requirement under Item 407(i), the company later chooses to prohibit hedging, this change could increase shareholder wealth to the extent that the change better aligns incentives and hence induces officers and directors to make corporate decisions that are more beneficial to all shareholders. However, to the extent that changes in hedging policies reduce incentive alignment between shareholders and officers or directors, and results in underinvesting in potentially value-enhancing projects, the opposite effect could result.

The benefits discussed above are relevant for investors of all companies affected by proposed Item 407(i), including listed closed-end funds.[104] Among operating companies (the first three categories in Table 2), the new information elicited from the required disclosures increases, so we expect the benefits from the new disclosures also to increase similarly. Further, we expect the potential benefits to be higher for EGCs and SRCs (category 3) than for non-EGCs and non-SRCs (categories 1 and 2), because EGCs and SRCs potentially face greater risk of a stock price decline than non-EGCs and non-SRCs. EGCs are typically younger firms with high growth options but fewer financial resources and are more likely to face financial distress since firm age is among the most important determinants of probability of failure.[105] Because employees and directors of EGCs and SRCs potentially face greater downside price risk than those of non-EGCs and non-SRCs, the former have likely stronger incentives to hedge, thus making information about permissible hedging activities more relevant for shareholders of these companies.[106]

The benefits to investors also depend on the likelihood that officers and directors engage in hedging transactions. Officers and directors can hedge by, for example, entering into exchange-traded or over-the-counter derivative contracts. In either case, however, when the underlying stock is illiquid, the price of the derivatives contracts likely reflects the higher risk and cost that would be required to dynamically replicate the exposure of the derivatives contracts by trading in the underlying stock. As a result, it is likely more costly to hedge the risk of more illiquid stock. Though undiversified officers and directors have strong incentives to diversify (*e.g.,* through hedging), they may not engage in hedging transactions if the cost is too high. In companies whose officers and directors are less likely to hedge due to high hedging cost, the potential benefits to investors from the required disclosures under the proposed amendments might be more limited. In the first three categories of companies, each category includes both exchange-listed and non-exchange-listed

[99] Our discussion focuses on officers and non-officer critical employees, not on employees who do not participate in making and shaping key operating or strategic decisions that influence stock price. As discussed earlier, information about these other employees' equity incentives and hedging of their equity holdings is less relevant for investors.

[100] Between 1996 and 2006, in firms where insiders hedged their equity ownership, insiders on average used collars, forwards or swaps to cover about 30% of their ownership and placed about 9% of their ownership into the exchange funds. See Bettis, C., J. Bizjak, and S. Kalpathy, 2013, ''Why Do Insiders Hedge Their Ownership? An Empirical Examination'' working paper (available at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1364810*). There is limited research on hedging transactions by corporate insiders. Hedging transactions studied in this paper included those by 10% owners. In addition, the sample period was 1996–2006, and thus the findings may not reflect the current situation.

[101] Alternatively, as discussed later, if the change in hedging policies reduces incentive alignment, such change can reduce shareholder wealth.

[102] Such companies include any company that currently does not disclose a hedging policy for any category of employees (including named executive officers) and directors, so could fall under any of the last three categories of companies in Table 2.

[103] See Larcker D. and B. Tayan, 2010,''Pledge (and Hedge) Allegiance to the Company'', Stanford Closer Look Series, available at *http://ssrn.com/abstract=1690746.*

[104] Because listed closed-end funds exhibit salient differences in organizational structure, and hence incentive compensation mechanisms, from operating companies, we do not compare the economic effects of the proposed amendments between listed closed-end funds and operating companies.

[105] See Lane, S., Schary, M.,1991,''Understanding the Business Failure Rate'', Contemporary Economic Policy 9: 93–105; Kapadia, N. 2011. ''Tracking Down Distress Risk,'' Journal of Financial Economics 102: 167–182

[106] Though no study to our knowledge directly examines whether insiders of smaller firms tend to hedge more, indirect evidence suggests that this is likely the case. For example, Bettis et al. (2001) find a total of 87 zero-cost collar transactions by searching Forms 3, 4 and 5 filed between January 1996 and December 1998. Firms in this sample have total assets with a mean (median) value of $3.4 billion ($401 million). These firms are much smaller than S&P 500 companies over the same time period, whose total assets have mean (median) of $16.15 billion ($3.84 billion) based on our calculation. This comparison indicates that hedging by zero-cost collars is disproportionally more frequent in smaller firms. See Bettis, J., J. Bizjak, and M. Lemmon. 2001. ''Managerial Ownership, Incentive Contracting, and the Use of Zero-cost Collars and Equity Swaps by Corporate Insiders'' Journal of Financial and Quantitative Analysis 36 (3): 345–370.

companies. Since stocks of exchange-listed companies are typically more liquid than stocks of non-exchange-listed companies, the potential benefits of the new disclosure to investors of non-exchange-listed companies may be lower than for exchange-listed ones. It is possible that stocks of smaller companies are less liquid, and hence these companies may be subject to the same effect.

The expected potential benefits from proposed Item 407(i) would not be achieved without costs. All covered companies would incur costs to comply with the proposed amendments. Such costs include both disclosure costs, which stem directly from complying with the proposed amendments, and potential costs incurred to implement, administer, or revise a hedging policy.

We first focus on disclosure costs, which should increase with the amount of new disclosures required under proposed Item 407(i). As discussed above, for operating companies (*i.e.,* the three first categories in Table 2), the new required disclosures are higher in categories 2 and 3 than in category 1, so disclosure costs should also be higher in categories 2 and 3. Specifically, category 1 companies would incur costs to determine whether employees (other than named executive officers) and directors are permitted to engage in hedging transactions, and incur costs to provide the required disclosure.

Category 2 companies are subject to Item 402(b) but do not currently disclose any information about whether hedging by their named executive officers is permitted. To the extent that these companies permit hedging and that required disclosures under the proposed amendments do not change this practice, this category of companies would incur small additional costs to disclose their hedging policies for named executive officers. If these companies instead decide to prohibit hedging by named executive officers, they would incur a small additional cost to disclose the revised hedging policies, but they could incur other costs that could be more significant, which we discuss separately below. Similar to category 1, these companies would also incur costs to determine and disclose whether directors and employees other than named executive officers are permitted to hedge.

Category 3 companies, *i.e.,* SRCs and EGCs, are not currently subject to Item 402(b). They may be less likely than companies subject to Item 402(b) to have policies, or to have articulated their practices, on whether hedging is permitted for employees (including named executive officers) and directors. Some SRCs and EGCs may incur costs in formulating policies for the first time, which will likely involve obtaining the advice of legal counsel and may also involve retaining compensation consultants. These companies would also incur costs in presenting the required disclosures in proxy or information statements.

In Category 4, listed closed-end funds, similar to SRCs and EGCs, would incur costs to disclose, and possibly to formulate, policies regarding hedging by employees and directors. As noted above, the vast majority of listed closed-end funds is externally-managed and thus would incur costs to disclose whether hedging by employees (if any) and directors is permitted. The limited number of listed closed-end funds that are internally managed also would incur costs to disclose if employees and directors are permitted to hedge with the difference, relative to externally-managed listed closed-end funds, that these funds will have portfolio managers and others as employees.

We expect the above disclosure costs to be minimal for these four categories of companies. A component of these costs (especially initial costs) may be fixed, which may have a greater impact on the smaller companies in category 3. While we cannot quantify these disclosure costs with precision, many of the costs reflect the burden associated with collection and reporting of information that we estimate for purposes of the Paperwork Reduction Act (''PRA''). For purposes of the PRA, we estimate the total annual increase in paperwork burden for all covered companies to be approximately 19,283 hours of in-house personnel time and approximately $2,571,200 for the services of outside professionals.[107]

These disclosure costs, however, do not include costs incurred to implement, administer, or revise a hedging policy. For example, under the proposed amendments, a company that prohibits hedging by directors may incur additional costs to implement this policy, *e.g.,* by analyzing whether transactions by a director have the effect of hedging.[108] If a company revises its hedging policy as a result of the proposed amendments, additional costs may also arise. Such costs could involve obtaining the advice of compensation consultants and legal counsel.

Perhaps most importantly, disclosing whether employees and directors are permitted to hedge might lead to changes in hedging policies that reduce incentive alignment between shareholders and officers or directors, if the current compensation arrangement is already in shareholders' interest. Specifically, a company may currently permit hedging by executive officers to promote efficient investments in risky projects. As discussed above, companies in category 1 currently disclose hedging policy for named executive officers, and may be unlikely to substantially change their policies under proposed Item 407(i). However, companies in categories 2 and 3, which do not disclose their hedging policies for named executive officers, may currently permit hedging by named executive officers but could switch to prohibiting hedging as a result of public disclosure under proposed Item 407(i). Such a change in policy, in certain instances, could limit executives' ability to arrive at optimal levels of economic exposure to the company—*i.e.,* one that leads executives to undertake the optimal level of risk in corporate investment decisions for the company's shareholders.[109] To the extent that compensation incentives materially affect a firm's value, such changes could result in a reduction in shareholder wealth.

We expect this cost from distorted investment incentives to be greater for companies in categories 2 and 3 than those in 1, as the latter may be unlikely to substantially change their hedging policies. However, between categories 2 and 3, it is not clear whether category 3 (EGCs and SRCs) would incur a higher cost than category 2. On one hand, EGCs and SRCs likely have higher growth options than non-EGCs and non-SRCs. Since the use of equity incentives to induce officers and directors to make proper corporate investment decisions is more important for companies with higher growth options, the cost from distorting investment incentives could be higher for EGCs and SRCs. On the other hand, as discussed above, such cost is limited by the availability of other cost-effective solutions to the underinvestment concern, *e.g.,* requiring an officer to hold stock options. Without adequate data, it is difficult to determine whether and when hedging would be more prevalent than stock options in providing incentives for officers at EGCs and SRCs as compared to non-EGCs and non-SRCs. Evidence

[107] See Section V of the release.

[108] Such costs are only incremental to the extent that the company does not already have procedures in place to administer and make such determination for named executive officers.

[109] As discussed above, hedging by officers and directors is one of the solutions to the underinvestment concern, and the significance of such a problem depends on the availability and cost-effectiveness of other solutions.

from academic studies shows that reported hedging transactions by officers and directors are infrequent; however, officers' option holdings are much more prevalent, and the magnitude of CEO options holdings is greater in higher-growth firms to provide risk-taking incentives.[110] Taken together, it is not clear whether costs to EGCs and SRCs are higher than to companies in category 2.

The extent of the cost resulting from distorted investment incentives not only depends on a company' growth opportunities, but also depends on the likelihood that officers and directors engage in hedging transactions. As discussed above, we expect officers and directors are less likely to hedge when the equity security is more illiquid, because hedging cost is higher. As a result, in these companies, hedging by officers and directors is less likely to be used as a way to address the underinvestment concern in the first place. Thus, the cost to these companies from prohibiting hedging when it would otherwise be economically beneficial would also likely to be more limited. In company categories 1, 2, and 3, each category includes both exchange-listed and non-exchange-listed companies; we expect such cost to be lower for non-exchange-listed companies than exchange-listed companies, because equity securities of the former typically are more liquid than equity securities of non-exchange-listed companies. Finally, to the extent that equity securities of smaller companies are less liquid, these companies may be subject to the same effect.

The effects resulting from distorted incentives are likely to be different between externally-managed listed closed-end funds and internally-managed listed closed-end funds. As discussed above, portfolio managers for these externally managed funds are employees of the funds' investment advisers and thus are not covered by proposed Item 407(i). Policies on whether portfolio managers are permitted to hedge, if any, therefore are unlikely to change as a result of listed closed-end funds complying with proposed Item 407(i). Since these portfolio managers directly make investment decisions, their incentives to make portfolio selections are unlikely to be changed by the proposed amendments. Directors of listed closed-end funds are covered by proposed 407(i), however, and so directors' equity incentives could be affected. To the extent that directors do not influence portfolio managers' investment decisions, we do not expect listed closed-end funds to incur any cost from possible distortion of director incentives by the required disclosure under Item 407(i). However, directors oversee the fund's investment adviser (and other service providers), which employs the portfolio managers for the funds. If directors exert some influence over portfolio managers' investment decisions through their oversight of the investment adviser, closed-end funds may incur cost from distorted director incentives. Out of all listed closed-end funds, we estimate only 4 are internally managed, so their portfolio managers are covered by proposed 407(i). These four closed-end funds may incur cost resulting from distortion to both portfolio managers' and directors' incentives by the required disclosure under Item 407(i).

A revision in hedging policy also could impose costs on employees and directors. For example, if the company currently allows hedging for named executive officers but decides to prohibit all hedging transactions as a result of the new proposed disclosure requirements, named executive officers may incur costs stemming from the loss of their ability to hedge their current and future equity compensation awards or holdings.[111]

These costs incurred to implement a hedging policy or to revise a hedging policy are difficult to quantify. For example, in the absence of data on a company's investment opportunities, the magnitude of the inefficiency in choosing investment projects as a result of a change in hedging policy is difficult to estimate.

The proposed amendments would also require Item 407(i) disclosure in Schedule 14C, in addition to Schedule 14A. This would extend the disclosure requirements and potential benefits described above to the Section 12(g) companies that do not file proxy statements with respect to the election of directors, thereby facilitating better understanding of companies' corporate governance policies and practices, without regard to whether proxies or consents are solicited or otherwise obtained for such an action. At the same time, requiring the disclosure specified in proposed Item 407(i) to be included in information statements on Schedule 14C would impose costs on companies that file Schedule 14C. However, consistency of the disclosure requirements applicable to both Schedules 14A and 14C in the context of an action with respect to the election of directors would facilitate better understanding of how companies address hedging, without regard to whether proxies or consents are solicited or otherwise obtained in connection with such action.

The proposed amendment to Item 402(b) would add an instruction providing that a company may satisfy its CD&A obligation to disclose any material policies on hedging by named executive officers under that requirement by cross referencing to the information disclosed pursuant to proposed Item 407(i) to the extent that the information disclosed there would satisfy this CD&A disclosure requirement. This approach would reduce potentially duplicative disclosure in complying with the existing CD&A requirements under Item 402(b) and the proposed requirements of Item 407(i), thereby reducing issuers' cost of compliance. Locating all the responsive disclosure in one place also would make it easier for investors to find it.

4. Anticipated Effects on Efficiency, Competition, and Capital Formation

As discussed above, the proposed amendments may improve capital

[110] See Guay, W., 1999, ''The Sensitivity of CEO Wealth to Equity Risk: An Analysis of the Magnitude and Determinants'', Journal of Financial Economics 53, 43–71.

[111] Such loss does not necessarily need to be compensated through other forms of compensation. Consider the following three alternative scenarios. First, under efficient contracting where hedging by officers promotes efficient investment decisions, officers are paid their opportunity wage to the extent that their labor market is competitive. If hedging is later prohibited as a result of public disclosure under the proposed amendments, these companies would resort to other, possibly more costly, compensation mechanisms to promote efficient investment decisions. While this change represents a cost to the company, officers still would receive their opportunity wage, so they are not better or worse off than before. Note that the dollar amount of the compensation may vary due to a potential change in riskiness of compensation. Prohibiting hedging may affect the riskiness of officers' compensation, but the riskiness also depends on the use of new types of compensation mechanism to promote efficient investments decisions, so the direction of the net change is not clear. The change in the dollar amount of compensation, if any, reflects the change in the riskiness of the compensation, and is not a compensation for a loss in hedging opportunity. Second, if the labor market is not competitive, officers may be paid above their opportunity wage. If hedging is used to promote efficient investment decisions, prohibiting it as a result of public disclosure under the proposed amendments may shift the balance of power between the board and officers. While the loss of hedging opportunity is a cost to the officers, they may not be compensated for it as long as their compensation is still above their opportunity wage. Third, if hedging by officers is not in shareholders' interests, a change from permitting to prohibiting hedging better aligns incentives. Officers may incur a cost from the loss of ability to hedge, but such cost merely represents the loss in the rents extracted by officers, and the officers should not be compensated for it.

allocation efficiency by enabling investors to make more informed voting decisions. The disclosure costs incurred by Section 12 registrants to comply with the proposed amendments would be minimal, and hence unlikely to put any company at a competitive disadvantage. However, as discussed above, additional costs could arise if companies revise their hedging policies from permitting hedging to prohibiting hedging by officers and directors. Such a change could aggravate the underinvestment concern and result in shareholder wealth reduction. However, such costs would be limited by the availability and cost-effectiveness of other means to promote investments in high risk but value-enhancing projects.[112] The proposed amendments are unlikely to have a notable impact on the competition either among U.S. companies or between U.S. companies and FPIs. We also do not expect the proposed amendments to affect the attractiveness of employment opportunities at the company to employees and directors, and hence impact the competitiveness of the labor market of employees and directors. The proposed amendments would impose new costs on companies seeking to become public, but such costs, taken alone, are unlikely to be a significant hurdle to companies seeking to become public.

D. Alternatives

1. Changing the Scope of Disclosure Obligations

The proposed amendments would extend reporting requirements to information statements on Schedule 14C. This extension primarily affects those Section 12(g) registrants that do not file proxy statements given that Section 12(b) registrants are generally required to solicit proxies. We have considered alternatives to this extension. One alternative would be to require proposed Item 407(i) disclosure in proxy statements only, *i.e.,* not in information statements. This would reduce the disclosure burden on companies that do not solicit proxies from any or all security holders but are otherwise authorized by security holders to take an action with respect to the election of directors. However, providing Item 407(i) disclosure in information statements provides consistency in disclosures in proxy statements and information statements, so that the disclosure could be made to all shareholders when a company does not solicit proxies from any or all security holders but are otherwise authorized by security holders to take a corporate action with respect to the election of directors. Excluding the Item 407(i) disclosure from information statements, as under this alternative, would reduce such benefits.

We also considered extending the proposed disclosure requirement to Form 10–K filings of Section 12 companies in order to impose consistent disclosure obligations upon all registrants with a class of securities registered under Section 12. This extension would have increased the proposed disclosure obligations especially for Section 12(g) companies that did not solicit proxies as they then would be required to provide the required disclosure in annual Form 10–K filings. Moreover, extending the disclosure requirement to all Section 12(g) companies may provide limited benefits to shareholders, as non-exchange listed companies can have infrequently traded stock, making it more costly and thus less likely that employees and directors would pursue hedging opportunities.

2. Issuers Subject to the Proposed Amendments

The proposed amendments apply to all Section 12 registrants, including EGCs, SRCs, and listed closed-end funds. We have considered the following alternatives about the scope of the proposed amendments.

The first alternative would be to either exempt or delay the application of the proposed amendments to EGCs and SRCs. Doing so would reduce costs for these entities, but the potential benefits would be eliminated or delayed as well. As discussed above, we expect the potential benefits from the required disclosures under proposed Item 407(i) to be higher for shareholders of EGCs and SRCs (*i.e.,* category 3 in Table 2) than for shareholders of other operating companies (*i.e.,* categories 1 and 2). While EGCs and SRCs likely also incur a higher cost from distorted incentives than companies in category 1, it is not clear whether such cost is higher than that for companies in category 2.

Not exempting EGCs and SRCs from the proposed amendment is also consistent with officers and directors at these companies not being exempt from the obligation under Exchange Act Section 16(a) to disclose hedging transactions involving derivative securities.

The second alternative is to include all funds, including mutual funds and ETFs, or a broader group of funds than listed closed-end funds, as proposed. Requiring all funds to provide the proposed disclosure would impose costs on the funds. The disclosure also could provide benefits, however, although the benefits to investors in funds other than listed closed-end funds may not be as significant where fund shares do not trade on an exchange. As discussed above, exchange-listed fund shares likely are more liquid than non-exchange-listed fund shares. Due to increased cost to hedge less liquid shares, directors and employees of non-exchange-listed funds may be less likely to engage in hedging transactions than those at exchange-listed funds.[113]

Further, the benefits that would result from applying the proposed amendments to ETFs are likely lower than the benefits from applying the proposed amendments to listed closed-end funds as proposed. Employees (if any) and directors of ETFs may not have as strong an incentive to hedge their personal fund shareholdings as those at listed closed-end funds. First, listed closed-end funds likely are more volatile than ETFs. While the shares of many ETFs often trade on the secondary market at prices close to NAV of the shares, one study finds that closed-end funds' monthly return on average is 64% more volatile than that of the underlying NAV.[114] The difference in volatility between ETF and closed-end fund returns is not driven by the difference in NAV between the two types of funds, and the listed closed-end funds' ''excess'' volatility is largely idiosyncratic, and cannot be explained by market risk or risks that affect other closed-end funds.[115] Employees and directors of listed closed-end funds may therefore have more incentive to hedge their fund shareholdings due to the ''excess'' volatility. Second, the non-redeemability of listed closed-end fund shares allows the funds to take more illiquid positions, or positions that may not be possible to sell quickly and at short notice without incurring a substantial loss in value. Due to the potentially heightened liquidity risk in the funds' portfolios, fund directors and employees may prefer not to expose their personal portfolios to the volatility resulting from liquidity risk and thus may hedge their personal fund share holdings. To the extent that listed

[112] See footnote 91.

[113] The scope for hedging may be even more limited for mutual funds, as investors purchase mutual fund shares from or sell them to the fund daily at NAV.

[114] See Pontiff, J., 1997, ''Excess Volatility and Closed-End Funds'' American Economic Review 87 (1): 155–169. Day et al. (2011) find similar evidence in a much more recent sample. See Day T., G. Li, and Y. Xu, 2011, ''Dividend Distributions and Closed-end Fund Discounts'' Journal of Financial Economics 100: 579–593.

[115] Id.

closed-end funds have greater ability than ETFs to invest in illiquid assets, it is possible that employees and directors of listed closed-end funds would have more incentives to hedge their personal holdings.

Another alternative is not to require any funds to provide the proposed disclosure. Doing so would not impose costs related to the proposed rule on the funds. However, fund investors, including investors in listed closed-end funds, also would not derive any benefits, including a better understanding of policies that may affect incentives provided by fund shareholdings of employees and directors.

E. Request for Comments

1. We request information including data that would help quantify the costs and the value of the benefits of the proposed amendments described above. We seek estimates of these costs and benefits, as well as any costs and benefits not already defined, that may result from the adoption of the proposed amendment. We also request qualitative feedback on the nature of the benefits and costs described above and any benefits and costs we may have overlooked.

2. We are interested in any studies or analysis on the number and characteristics of companies that have made disclosures of their ''policies regarding hedging'' under the existing requirement of Item 402(b)(2)(xiii) or otherwise. In particular, among the companies subject to the reporting requirement of Item 402(b)(2)(xiii), how many have hedging policies that they do not disclose because they do not deem them material? Among companies that disclose hedging policies, what are the types of the ''policies'' disclosed?

3. Among companies currently subject to Item 402(b), some make no disclosure of a hedging policy for named executive officers. We believe that it may be reasonable to construe the absence of a disclosure of hedging policy to mean that the company does not prevent named executive officers from hedging. Is there evidence to the contrary? Are we correct in thinking that investors may draw the same inference?

4. To our knowledge, hedging transactions typically involve derivative contracts, and fixed price derivative contracts are subject to reporting under Section 16(a). Are there any types of hedging transactions that are not currently subject to reporting by officers and directors under Section 16(a)? If yes, please provide details.

5. Would the proposed disclosure increase the transparency to investors about the incentives provided by employees' and directors' equity holdings? Are there alternative ways to make the disclosures that would be more useful to investors in evaluating employees' and directors' incentive alignment with shareholders while still satisfying the mandate of Section 14(j)?

6. What impact would the proposed amendments have on the incentives of employees and directors? Would the proposed amendments likely change the behavior of issuers, investors, or other market participants?

7. Would the proposed disclosure requirements be likely to cause companies to change their policies on whether hedging is permitted for employees and directors? Why and how? If so, what costs would be incurred? What effect, if any, may the proxy voting policies of institutional investors and proxy advisory firms have on a company's decision to change its policy? Have institutional investors and proxy advisory firms already established hedging policy positions that have been guiding voting decisions and vote recommendations? Have institutional investors and proxy advisory firm recommendations regarding such policies encouraged companies to provide transparency into hedging transactions that are permitted at the companies? How would the transparency into hedging transactions as a result of this disclosure impact investor communication with companies about such policies? What effect will this proposed disclosure requirement have on voting decisions? Would the proposed disclosure requirements be likely to cause companies to change their compensation policies for employees (including officers) or directors? Why or why not, and if so, how?

8. If a company revises its hedging policy, would this revision influence other corporate decisions, for example, by encouraging or discouraging more risky but value-enhancing corporate investments? Please explain and provide data.

9. Relative to other operating companies, would the proposed amendments have differential economic effects on EGCs and SRCs that we do not currently discuss in the release? If so, what are these differential economic effects? Would the impact of the proxy voting policies of institutional investors and proxy advisory firms, if any, be different for EGCs and SRCs than for other operating companies? In the absence of disclosure of hedging policies by EGCs and SRCs, to what extent have hedging policy positions of institutional investors and proxy advisory firms already been guiding voting decisions and vote recommendations for EGCs and SRCs?

10. 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?

11. What impact would the proposed amendments have on competition? Would the proposed amendments put registrants subject to the new disclosure requirements, or particular types of registrants subject to the new disclosure requirements, at a competitive advantage or disadvantage?

12. What impact would the proposed amendments have on efficiency? Have we overlooked any positive or negative effects on efficiency?

13. What impact would the proposed amendments have on capital formation? Would there be any positive or negative effects on capital formation that we may have overlooked?

14. Are listed closed-end funds subject to an incentive alignment concern due to shareholders' inability to redeem their shares from the fund (or often to sell them in secondary transactions at or close to the funds' NAV per share) that would relate to hedging considerations? What are the characteristics of listed closed-end funds' incentive structure with respect to employees and directors that would inform this consideration?

15. We note above that shares of listed closed-end funds are not redeemable, and they may trade at a discount to NAV. Will this create heightened incentives for these funds' employees and directors to hedge personal holdings in listed closed-end funds as compared to employees and directors of other types of funds? Are there features of ETFs that would make the disclosures under the proposed amendments particularly useful for their investors even though ETF shares often trade on the secondary market at prices close to NAV of the shares? Are there features of mutual funds or other types of funds that would make the disclosures under the proposed amendments particularly useful for their investors?

16. The potential cost to companies from distorting investment incentives as a result of required disclosures under proposed Item 407(i) is lower for companies with fewer investment choices. How, if at all, does the range of available investment choices for listed closed-end funds differ from that for operating companies?

V. Paperwork Reduction Act

A. Background

The proposed amendments contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA''). We are submitting the proposed amendments to the Office of Management and Budget (''OMB'') for review in accordance with the PRA.[116] The titles for the collection of information are:

(1) ''Regulation 14A and Schedule 14A'' (OMB Control No. 3235–0059);

(2) ''Regulation 14C and Schedule 14C'' (OMB Control No. 3235–0057);

(3) ''Regulation S–K'' (OMB Control No. 3235–0071);[117] and

(4) ''Rule 20a–1 under the Investment Company Act of 1940, Solicitation of Proxies, Consents, and Authorizations'' (OMB Control No. 3235–0158).

Regulation S–K was adopted under the Securities Act and Exchange Act; Regulations 14A and 14C and the related schedules were adopted under the Exchange Act; and Rule 20a–1 was adopted under the Investment Company Act. The regulations and schedule set forth the disclosure requirements for proxy and information statements filed by companies to help investors make informed investment and voting decisions. The hours and costs associated with preparing, filing and sending the schedule constitute reporting and cost burdens imposed by each collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. Compliance with the proposed amendment would be mandatory. Responses to the information collection would not be kept confidential, and there would be no mandatory retention period for the information disclosed.

B. Summary of the Proposed Amendments

We are proposing to add new paragraph (i) to Item 407 of Regulation S–K that would implement Section 14(j) of the Exchange Act, as added by Section 955 of the Act. As discussed in more detail above, proposed Item 407(i) would require disclosure of whether employees and directors of the company, or their designees, are permitted to hedge or offset any decrease in the market value of equity securities that are granted to them by the company as part of their compensation, or that are held, directly or indirectly, by them. Pursuant to the proposed amendment to Item 7 of Schedule 14A, and for listed closed-end funds, the proposed amendment to Item 22 of Schedule 14A, this new disclosure would be required in proxy or consent solicitation materials with respect to the election of directors, or an information statement in the case of such corporate action authorized by the written consent of security holders.

In addition, to reduce potentially duplicative disclosure between proposed Item 407(i) and the existing requirement for CD&A under Item 402(b) of Regulation S–K, we propose to amend Item 402(b) to add an instruction providing that a company may satisfy its obligation to disclose material policies on hedging by named executive officers in the CD&A by cross referencing the information disclosed pursuant to proposed Item 407(i) to the extent that the information disclosed there satisfies this CD&A disclosure requirement.[118] This instruction, like the Item 407(i) disclosure requirement, would apply to the company's proxy or information statement with respect to the election of directors.

C. Burden and Cost Estimates Related to the Proposed Amendments

If adopted, proposed Item 407(i) would require additional disclosure in proxy statements filed on Schedule 14A with respect to the election of directors and information statements filed on Schedule 14C where such corporate action is taken by the written consents or authorizations of security holders, and would thus increase the burden hour and cost estimates for each of those forms. For purposes of the PRA, we estimate the total annual increase in the paperwork burden for all affected issuers to comply with our proposed collection of information requirements, averaged over the first three years, to be approximately 19,238 hours of in-house personnel time and approximately $2,565,200 for the services of outside professionals (see Table 3).[119] These estimates include the time and cost of collecting and analyzing the information, preparing and reviewing disclosure, and filing the documents.

In deriving our estimates, we assumed that the information that proposed Item 407(i) would require to be disclosed would be readily available to the management of a company because it only requires disclosure of policies they already have but does not direct them to have a policy or dictate the content of the policy. Nevertheless, we used burden estimates similar to those used in the 2006 Executive Compensation Disclosure Release for updating Schedules 14A and 14C, which we believe were more extensive.[120] Since the first year of compliance with the proposed amendment is likely to be the most burdensome because companies are not likely to have compiled this information in this manner previously, we assumed it would take five total hours per form the first year and two total hours per form in all subsequent years.

Based on our assumptions, we estimated that the proposed amendments would increase the burden hour and cost estimates per company by an average of three total hours per year over the first three years the amendments are in effect for each Schedule 14A or Schedule 14C with respect to the election of directors.

We recognize that the burdens may vary among individual companies based on a number of factors, including the size and complexity of their organizations, and whether or not they prohibit or restrict hedging transactions by employees, directors and their designees and if they do, the specificity and complexity of such restrictions.

The table below shows the three-year average annual compliance burden, in hours and in costs, of the collection of information pursuant to proposed Item 407(i) of Regulation S–K.[121] The burden estimates were calculated by multiplying the estimated number of responses by the estimated average amount of time it would take a company to prepare and review the proposed disclosure requirements. The portion of the burden carried by outside professionals is reflected as a cost, while the portion of the burden carried by the company internally is reflected in hours. For purposes of the PRA, we estimate that 75% of the burden of preparation of Schedules 14A and 14C is carried by the company internally and that 25% of the burden of preparation is carried by outside professionals retained by the company at an average cost of $400 per hour. There is no change to the estimated burden of the

[116] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

[117] The paperwork burden from Regulation S–K is imposed through the forms that are subject to the disclosure requirements in Regulation S–K and is reflected in the analysis of these forms. To avoid a Paperwork Reduction Act inventory reflecting duplicative burdens, for administrative convenience we estimate the burden imposed by Regulation S–K to be a total of one hour.

[118] Proposed Instruction 6 to Item 402(b).

[119] Our estimates represent the average burden for all companies, both large and small.

[120] See the 2006 Executive Compensation Disclosure Release.

[121] For convenience, the estimated hour and cost burdens in the table have been rounded to the nearest whole number.

collections of information under Regulation S–K because the burdens that this regulation imposes are reflected in our burden estimates for Schedule 14A and 14C.

TABLE 3—INCREMENTAL PAPERWORK BURDEN UNDER THE PROPOSED AMENDMENTS AFFECTING SCHEDULES 14A AND 14C—THREE-YEAR AVERAGE COSTS

	Number of responses (A) [122]	Incremental burden hours/ form (B)	Total incremental burden hours (C)=(A)*(B)	Internal company time (D)=(C)*0.75	External professional time (E)=(C)*0.25	External professional costs (F)=(E)*$400
Sch. 14A	7,300	3	21,900	16,425	5,475	$2,190,000
Sch. 14C	680	3	2,040	1,530	510	204,000
Rule 20a–1	590	3	1,770	1,328	443	177,200
Total	8,570		25,710	19,283	6,428	2,571,200

The proposed amendment to the CD&A requirement under Item 402(b) would not be applicable to smaller reporting companies or emerging growth companies because under current CD&A reporting requirements these companies are not required to provide CD&A in their Commission filings. For all other issuers, we do not expect this amendment would materially affect the disclosure burden associated with their Commission filings.

D. Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), we request comment in order to:

- Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility;
- Evaluate the accuracy of our assumptions and estimates of the burden of the proposed collection of information;
- Determine whether there are ways to enhance the quality, utility and clarity of the information to be collected;
- Evaluate whether there are ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection techniques or other forms of information technology; and
- Evaluate whether the proposed amendments will have any effects on any other collection of information not previously identified in this section.

Any member of the public may direct to us any comments concerning the accuracy of these burden estimates and any suggestions for reducing these burdens. Persons submitting comments on the collection of information requirements should direct their comments to the Office of Management and Budget, Attention: Desk Officer for the U.S. Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and send a copy to, Brent J. Fields, Secretary, U.S. Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549–1090, with reference to File No. S7–01–15. Requests for materials submitted to OMB by the Commission with regard to the collection of information should be in writing, refer to File No. S7–01–15 and be submitted to the U.S. Securities and Exchange Commission, Office of FOIA Services, 100 F Street NE., Washington DC 20549–2736. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is best assured of having its full effect if the OMB receives it within 30 days of publication.

VI. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or ''SBREFA,'' [123] we solicit data to determine whether the rule proposals constitute a ''major'' rule. Under SBREFA, a rule is considered ''major'' where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment or innovation.

Commentators should provide empirical data on: (1) The potential annual effect on the economy; (2) any increase in costs or prices for consumers or individual industries; and (3) any potential effect on competition, investment or innovation.

VII. Initial Regulatory Flexibility Act Analysis

This Initial Regulatory Flexibility Analysis has been prepared in accordance with the Regulatory Flexibility Act.[124] This analysis involves a proposal to require, in proxy or consent solicitation materials, or in an information statement, with respect to the election of directors disclosure of whether employees (including officers), directors or their designees are permitted to engage in transactions to hedge or offset any decrease in the market value of equity securities granted to them as compensation, or directly or indirectly held by them.

A. Reasons for, and Objectives of, the Proposed Action

The proposed amendments are designed to implement Section 14(j), which was added to the Exchange Act by Section 955 of the Act. Specifically, the proposed amendments would require disclosure, in any proxy or information statement with respect to the election of directors, of whether any employee or director of the company or any designee of such employee or director, is permitted to purchase any financial instruments (including but not limited to prepaid variable forward contracts, equity swaps, collars, and

[122] For Schedules 14A and 14C, the number of responses reflected in the table equals the three-year average of the number of schedules filed with the Commission and currently reported by the Commission to OMB. For Rule 20a–1, the number of responses reflected in the table is based on an average of three years of data from 2012–2014 in the 2014 ICI Fact book.

[123] Public Law 104–121, Title II, 110 Stat. 857 (1996).

[124] 5 U.S.C. 603.

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, that are granted to the employee or director by the company as compensation, or held, directly or indirectly, by the employee or director. The covered equity securities would be equity securities issued by 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 Exchange Act Section 12.

B. Legal Basis

We are proposing the amendments pursuant to Section 955 of the Act, Sections 14, 23(a) and 36(a) of the Exchange Act, as amended, and Sections 6, 20(a) and 38 of the Investment Company Act, as amended.

C. Small Entities Subject to the Proposed Amendments

The proposed amendments would affect some companies that are small entities. The Regulatory Flexibility Act defines ''small entity'' to mean ''small business,'' ''small organization,'' or ''small governmental jurisdiction.'' [125] The Commission's rules define ''small business'' and ''small organization'' for purposes of the Regulatory Flexibility Act for each of the types of entities regulated by the Commission. Exchange Act Rule 0–10(a) [126] defines a company, other than an investment company, to be a ''small business'' or ''small organization'' if it had total assets of $5 million or less on the last day of its most recent fiscal year. We estimate that there are approximately 428 issuers that may be considered small entities. The proposed amendments would affect small entities that have a class of securities that are registered under Section 12 of the Exchange Act. An investment company, including a business development company, is considered to be a ''small business'' if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year.[127] We believe that the proposal would affect some small entities that are investment companies. We estimate that there are approximately 29 investment companies that would be subject to the proposed rule that may be considered small entities.

D. Reporting, Recordkeeping and Other Compliance Requirements

The proposed amendments would add to the proxy disclosure requirements of companies, including small entities, that file proxy or information statements with respect to the election of directors, by requiring them to provide the disclosure called for by the proposed amendment. Specifically, proposed Item 407(i) would require disclosure of whether any employee or director of the company or any designee of such employee or director, is permitted to purchase any financial instruments (including but not limited to 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, that are granted to the employee or director by the company as compensation, or held, directly or indirectly, by the employee or director.

E. Duplicative, Overlapping or Conflicting Federal Rules

We believe that the proposed amendments would not duplicate, overlap or conflict with other federal rules. The proposal would reduce potentially duplicative disclosure by adding an instruction permitting a company to satisfy any obligation under Item 402(b) of Regulation S–K to disclose in the CD&A material policies on hedging by named executive officers by cross referencing to the new disclosure required by proposed Item 407(i) to the extent that the information disclosed there satisfies this CD&A disclosure requirement.[128] However, as described above, the CD&A disclosure obligation does not apply to small entities that are emerging growth companies, smaller reporting companies or registered investment companies.

F. Significant Alternatives

The Regulatory Flexibility Act directs us to consider alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. In connection with the proposed amendments, we considered the following alternatives:

- Establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- clarifying, consolidating, or simplifying compliance and reporting requirements under the rules for small entities;
- use of performance rather than design standards; and
- exempting small entities from all or part of the proposed requirements.

We believe that the proposed amendments would require clear and straightforward disclosure of whether employees or directors are permitted to engage in transactions to hedge or offset any decrease in the market value of equity securities granted to them as compensation, or directly or indirectly held by them. Given the straightforward nature of the proposed disclosure, we do not believe that it is necessary to simplify or consolidate the disclosure requirement for small entities. We have used performance standards in connection with the proposed amendments by proposing to use a principles-based approach to identify transactions that would hedge or offset any decrease in the market value of equity securities. Additionally, the amendments do not specify any specific procedures or arrangements a company must develop to comply with the standards, or require a company to have or develop a policy regarding employee and director hedging activities.

We considered, but have not proposed, different compliance requirements or an exemption for small entities. We believe that mandating uniform and comparable disclosures across all issuers subject to our proxy rules will promote informed shareholder voting. The proposed rule amendments are intended to provide transparency regarding whether employees, directors, or their designees are allowed to engage in hedging transactions that will permit them to receive compensation without regard to company performance, or will permit them to mitigate or avoid the risks associated with long-term equity security ownership.[129] We believe this transparency would be just as beneficial to shareholders of small companies as to shareholders of larger companies. By increasing transparency regarding these matters, the proposed amendments are designed to improve the quality of information available to all shareholders, thereby promoting informed voting decisions. Different compliance requirements or an exemption for small entities may interfere with the goal of enhancing the information provided by all issuers. We also note that the disclosure is expected to result in minimal additional compliance costs for issuers although there could be indirect costs for some small entities, depending on their current hedging policies. Thus, we

[125] 5 U.S.C. 601(6).

[126] 17 CFR 240.0–10(a).

[127] 17 CFR 270.0–10(a).

[128] Proposed Instruction 6 to Item 402(b).

[129] See Senate Report 111–176.

believe that our proposed amendments will promote consistent disclosure among all issuers, without creating a significant new burden for small entities.

Although we preliminarily believe that an exemption for small entities from coverage of the proposed amendments would not be appropriate, we solicit comment on whether we should exempt small entities. At this time, we do not believe that different compliance methods or timetables for small entities would be necessary given the relatively straightforward nature of the disclosure involved. Nevertheless, we solicit comment on whether different compliance requirements or timetables for small entities would be appropriate and consistent with the purposes of Section 14(j).

G. Solicitation of Comments

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, we request comments regarding:

- How the proposed amendments can achieve their objective while lowering the burden on small entities;
- The number of small entities that may be affected by the proposed amendments;
- Whether small entities should be exempt from the proposed amendments;
- The existence or nature of the potential impact of the proposed amendments on small entities discussed in the analysis; and
- How to quantify the impact of the proposed amendments.

Respondents are asked to describe the nature of any impact of the proposed amendments on small entities and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments are adopted, and will be placed in the same public file as comments on the proposed amendments themselves.

VIII. Statutory Authority and Text of the Proposed Amendments

The amendments contained in this release are being proposed under the authority set forth in Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Sections 14, 23(a) and 36(a) of the Securities Exchange Act of 1934, as amended, and Sections 6, 20(a) and 38 of the Investment Company Act, as amended.

List of Subjects in 17 CFR Parts 229 and 240

Reporting and recordkeeping requirements, Securities.

Text of the Proposed Amendments

For the reasons set out in the preamble, the Commission proposes to amend title 17, chapter II, of the Code of Federal Regulations as follows:

PART 229—STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975—REGULATION S–K

■ 1. The authority citation for part 229 continues to read as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z–2, 77z–3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78j–3, 78*l,* 78m, 78n, 78n–1, 78o, 78u–5, 78w, 78*ll,* 78mm, 80a–8, 80a–9, 80a–20, 80a–29, 80a–30, 80a–31(c), 80a–37, 80a–38(a), 80a–39, 80b–11, and 7201 *et seq;* and 18 U.S.C. 1350, unless otherwise noted.

■ 2. Amend § 229.402 by adding Instruction 6 to Item 402(b), to read as follows:

§ 229.402 (Item 402) Executive compensation.

* * * * *

(b) * * *

Instructions to Item 402(b). * * *

6. If the information disclosed pursuant to Item 407(i) would satisfy the registrant hedging policy disclosure requirements of paragraph (b)(2)(xiii) of this Item, a registrant may satisfy this Item in its proxy or information statement by referring to the information disclosed pursuant to Item 407(i).

* * * * *

■ 3. Amend § 229.407 by adding paragraph (i) before the Instructions to Item 407, to read as follows:

§ 229.407 (Item 407) Corporate governance.

* * * * *

(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 have the effect of hedging or offsetting any decrease in the market value of equity securities—

(1) Granted to the employee or director by the registrant as part of the compensation of the employee or director; or

(2) Held, directly or indirectly, by the employee or director.

Instructions to Item 407(i).

1. For purposes of this Item 407(i), ''equity securities'' (as defined in section 3(a)(11) of the Exchange Act (15 U.S.C. 78c(a)(11)) and § 240.3a11–1 of this chapter) shall mean 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 (15 U.S.C. 78*l*).

2. A registrant that permits hedging transactions by some, but not all, of the categories of persons covered by this Item 407(i) shall disclose the categories of persons who are permitted to engage in hedging transactions and those who are not.

3. A registrant shall disclose the categories of hedging transactions it permits and those it prohibits. In disclosing these categories, a registrant may, if true, disclose that it prohibits or permits particular categories and permits or prohibits, respectively, all other hedging transactions. If a registrant does not permit any hedging transactions, or permits all hedging transactions, it shall so state and need not describe them by category.

4. A registrant that permits hedging transactions shall disclose sufficient detail to explain the scope of such permitted transactions.

5. The information required by this Item 407(i) will not be deemed to be incorporated by reference into any filing under the Securities Act, the Exchange Act or the Investment Company Act, except to the extent that the registrant specifically incorporates it by reference.

* * * * *

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

■ 4. The authority citation for Part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c–3, 78c–5, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l,* 78m 78n, 78n–1, 78o, 78o–4, 78o–10, 78p, 78q, 78q–1, 78s, 78u–5, 78w, 78x, 78*ll,* 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, 7210 *et seq.;* and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5521(e)(3); 18 U.S.C. 1350; and Pub. L. 111–203, 939A, 124 Stat. 1376, (2010), unless otherwise noted.

* * * * *

■ 5. Amend § 240.14a–101 by:

■ a. Revising Item 7 paragraph (b);
■ b. Removing Item 7 paragraphs (c) and (d);
■ c. Redesignating Item 7 paragraph (e) as paragraph (c);
■ d. Removing the Instruction to Item 7 paragraph (e);
■ e. Redesignating Item 7 paragraph (f) as paragraph (d);
■ f. Redesignating Instruction to Item 7 paragraph (f) as Instruction to Item 7 and revising the newly redesignated Instruction to Item 7;
■ g. Redesignating Item 7 paragraph (g) as paragraph (e); and
■ h. Adding to Item 22(b) paragraph (20).

The revisions and addition read as follows:

§ 240.14a–101 Schedule 14A. Information required in proxy statement.

SCHEDULE 14A INFORMATION

* * * * *

Item 7. Directors and Executive Officers. * * *

(b) The information required by Items 401, 404(a) and (b), 405 and 407 of Regulation S–K (§§ 229.401, 229.404(a) and (b), 229.405 and 229.407 of this chapter), other than the information required by:

(i) Paragraph (c)(3) of Item 407 of Regulation S–K (§ 229.407(c)(3) of this chapter); and

(ii) Paragraphs (e)(4) and (e)(5) of Item 407 of Regulation S–K (§§ 229.407(e)(4) and 229.407(e)(5) of this chapter) (which are required by Item 8 of this Schedule 14A).

* * *

Instruction to Item 7. The information disclosed pursuant to paragraphs (c) and (d) of this Item 7 will not be deemed incorporated by reference into any filing under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*), the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*), or the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*), except to the extent that the registrant specifically incorporates that information by reference.

* * *

Item 22. Information required in investment company proxy statement.

* * * * *

(b) * * *

(20) In the case of a Fund that is a closed-end investment company that is listed and registered on a national securities exchange, provide the information required by Item 407(i) of Regulation S–K (§ 229.407(i) of this chapter).

* * * * *

Dated: February 9, 2015.

By the Commission.

Brent J. Fields,

Secretary.

[FR Doc. 2015–02948 Filed 2–13–15; 8:45 am]

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