SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 229 and 240

[Release No. 33–10593; 34–84883; IC–33333; File No. S7–01–15]

RIN 3235–AL49

Disclosure of Hedging by Employees, Officers and Directors

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: We are adopting a rule to implement a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The new rule requires a company to describe any practices or policies it has adopted regarding the ability of its employees (including officers) or directors to purchase financial instruments, or otherwise engage in transactions, that hedge or offset, or are designed to hedge or offset, any decrease in the market value of equity securities granted as compensation, or held directly or indirectly by the employee or director. The new rule requires a company to describe the practices or policies and the categories of persons they affect. If a company does not have any such practices or policies, the company must disclose that fact or state that hedging transactions are generally permitted. The new disclosure is required in a proxy statement or information statement relating to an election of directors.

DATES:

Effective date: March 8, 2019.

Compliance dates: Companies that do not qualify as ''smaller reporting companies'' or ''emerging growth companies'' (each as defined in 17 CFR 240.12b–2) must comply with these disclosure requirements for proxy and information statements with respect to the election of directors during fiscal years beginning on or after July 1, 2019.

Companies that qualify as ''smaller reporting companies'' or ''emerging growth companies'' must comply with these disclosure requirements for proxy and information statements with respect to the election of directors during fiscal years beginning on or after July 1, 2020.

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, U.S. Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are amending 17 CFR 229.402 (''Item 402'' of Regulation S–K [1]) by revising paragraph (b) to add Instruction 6; 17 CFR 229.407 (''Item 407'' of Regulation S–K) to add new paragraph (i); and 17 CFR 14a–101 (''Schedule 14A'') to revise Item 7.

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[1] 17 CFR 229.10 *et seq.*

I. Introduction

On February 9, 2015, the Commission proposed rule amendments [2] to implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the ''Act'').[3] Section 955 added Section 14(j) to the Securities Exchange Act of 1934 (the ''Exchange Act'').[4] 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 shareholders whether any of its employees or members of its board of directors, 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.

The Senate Committee on Banking, Housing, and Urban Affairs stated in its report on the Act 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.'' [5] In this regard, we infer that the statutory purpose of Section 14(j) is to provide transparency to shareholders at the time of an annual meeting, which is when directors are elected, about whether a company's employees or directors may engage in transactions that reduce or avoid the incentive alignment associated with equity ownership related to their employment or board service.

[2] *See* Rel. No. 33–9723 (Feb. 9, 2015) [80 FR 8485 (Feb. 17, 2015)] (the ''Proposing Release''), *available at: http://www.sec.gov/rules/proposed/2015/33-9723.pdf.*

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

[4] 15 U.S.C. 78a *et seq.*

[5] *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'').

Twenty-two commenters, including individuals, professional and trade associations, law firms, consulting firms, pension funds, and institutional investor associations, submitted comment letters in response to the Proposing Release. We have reviewed and considered all of the comments that we received on the Proposing Release. In general, commenters supported the proposed amendments and their objectives,[6] although several commenters provided suggestions for clarifying the proposed amendments' disclosure standard.[7]

As discussed below, we are adopting new Item 407(i) of Regulation S–K, along the lines proposed, but with certain modifications, consistent with commenters' suggestions. We believe the adopted amendments will fulfill the statutory purpose of Section 14(j), while providing a clearer and more straightforward standard of disclosure that should benefit both registrants and investors.

II. Background

The Commission's rules currently require some disclosure about company hedging policies and practices. Item 402(b) of Regulation S–K requires a Compensation Discussion and Analysis (''CD&A'') that discloses material information necessary to an understanding of a company's compensation policies and decisions regarding the ''named executive officers.'' [8] Under Item 402(b)(2)(xiii), an example of the kind of information that should be provided, if material, includes a description of 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 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. CD&A does not apply to smaller reporting companies (''SRCs''),[9] emerging growth companies (''EGCs''),[10] registered investment companies [11] or foreign private issuers (''FPIs'').[12]

Other disclosure requirements also 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, which requires disclosure of the amount of company equity securities beneficially owned by directors, director nominees and named executive officers,[16] also requires disclosure of the amount of shares that are pledged as security.[17] The rule amendments we are adopting today will require additional disclosure about an issuer's hedging practices or policies, but will not affect these existing requirements.

III. Discussion of the Amendments

The Commission proposed to implement Section 14(j) by amending Item 407 of Regulation S–K, to add new paragraph (i), which would require companies to disclose whether they permit employees and directors to hedge their company's equity securities. The disclosure called for by Section 14(j) is primarily corporate governance-related because it requires a company to provide information in its proxy statement about whether the company's employees and directors may engage in

[6] *See, e.g.,* letters from Chris Barnard, Council of Institutional Investors dated Apr. 16, 2015 and Sept. 7, 2017 (collectively ''CII''), Taylor Dove, Susie E. Hawthorne, Michael Nau and Public Citizen expressing general support for the proposed rules.

[7] *See, e.g.,* letters from American Bar Association Section of Business Law Committee on Federal Regulation of Securities dated Jul. 8, 2015 and Oct. 13, 2015 (collectively ''ABA'' unless specified by date), Keith P. Bishop, Business Roundtable, and Davis Polk suggesting modifications.

[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]. The Commission recently amended the definition of ''smaller reporting company'' to include registrants with a public float of less than $250 million, as well as registrants with annual revenues of less than $100 million for the previous year and either no public float or a public float of less than $700 million. *See Smaller Reporting Company Definition,* Release No. 33–10513 (Jun. 28, 2018) [83 FR 31992 (Jul. 10, 2018)].

[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. *See also* Exchange Act Rule 12b–2 [17 CFR 240.12b–2], which reflects inflation adjustments to the definition of ''emerging growth company.''

[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) [17 CFR 240.16a–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 (Aug. 17, 1994)] 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 (Jun. 14, 1996)] 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 (Jun. 27, 2002)] 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 Website Posting for Forms 3, 4 and 5,* Release No. 33–8230 (May 7, 2003) [68 FR 25788 (May 18, 2003)], 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] *See Executive Compensation and Related Person Disclosure,* Release No. 33–8732A (Aug. 29, 2006) [71 FR 53158 (Sept. 8, 2006)] (the ''2006 Executive Compensation Disclosure Release'') at Section IV.

transactions that could reduce the extent to which their equity holdings and equity compensation are aligned with shareholders' interests. Because Section 14(j) calls for disclosure about employees and directors and their alignment with shareholders' interests, it 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 executive officers and directors. Two commenters expressed general support for locating the new disclosure requirement in the Commission's corporate governance-related disclosure rules.[18] Accordingly, we are implementing Section 14(j) by amending Item 407 to keep the disclosure requirements relating to corporate governance matters together in a single item of Regulation S–K.[19]

The final amendments will:

- Require the company to describe any practices or policies regarding the ability of employees, directors or their designees to purchase financial instruments, or otherwise engage in transactions, that hedge or offset, or are designed to hedge or offset, any decrease in the market value of company equity securities. A company will be required either to provide a fair and accurate summary of any practices or policies that apply, including the categories of persons covered and any categories of hedging transactions that are specifically permitted and any categories that are specifically disallowed, or to disclose the practices or policies in full;
- if the company does not have any such practices or policies, require the company to disclose that fact or state that hedging transactions are generally permitted;
- specify that the equity securities for which disclosure is required are only equity securities of the company or of any parent or subsidiary of the company or any subsidiary of any parent of the company;
- require the disclosure in any proxy statement on Schedule 14A or information statement on Schedule 14C[20] with respect to the election of directors; and
- clarify that the term ''employee'' includes officers of the company.

Nothing in these amendments or this release should be construed as suggesting companies need to have a practice or policy regarding hedging, or a particular type of practice or policy. These amendments relate only to disclosure of hedging practices or policies.

A. Scope of the Disclosure Requirement

1. Proposed Amendments

Section 14(j) was enacted to require 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) that are designed to hedge or offset any decrease in the market value of equity securities. While Section 14(j) specifically refers to particular transactions,[21] it also requires disclosure more generally of whether any employee or director of the issuer, or any designee of such employee or director, is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities.

The proposed amendments would have implemented Section 14(j) by requiring disclosure of ''whether the registrant permits'' any employees (including officers) or directors, or any of their designees, to purchase these specific types of financial instruments, and also would have required the same disclosure with respect to other transactions that could have the same economic effects as those specified in the statute, consistent with the purpose of Section 14(j). The proposed amendments were intended to cover all transactions that establish downside price protection—whether by purchasing or selling a security, derivative security or otherwise.

Consistent with the statute, the proposed amendments applied to hedging transactions relating to equity securities that are held, directly or indirectly, by employees or directors. The proposal did not define the circumstances in which securities would be considered held, directly or indirectly.

Establishing downside price protection is the essence of the transactions contemplated by Section 14(j). While this principle guided the Commission's consideration of the transactions subject to disclosure, the Commission did not propose to define the term ''hedge.''[22] Under the proposed amendments, a company would disclose the categories of transactions it permits and the categories of transactions it prohibits.[23] The proposed amendments would have required a company that permits hedging transactions to disclose sufficient detail to explain the scope of the permitted transactions. Additionally, the proposed amendments would have required a registrant that permits hedging by some, but not all, of the categories of covered persons to disclose the categories of persons who are permitted to engage in hedging transactions and those who are not.

2. Comments on the Proposed Amendments

Commenters expressed a variety of views on the scope of the proposed amendments. One commenter expressed general support for requiring disclosure of the types of hedging transactions that a company permits as well as those that it prohibits, and the categories of persons that it allows and does not allow to hedge.[24] Similarly, another commenter stated that the rule, as proposed, would provide investors with a more complete understanding regarding the persons permitted to engage in hedging transactions and the types of hedging transactions allowed.[25] Another commenter stated that mandating disclosure of whether a company ''permits'' hedging would imply that affirmative company permission is required for these transactions and suggested that the relevant disclosure requirement instead should be whether the company prohibits hedging by employees.[26] Several other commenters similarly indicated that requiring disclosure of the categories of hedging transactions that a registrant permits as well as prohibits could result in a disclosure standard that is confusing, overly broad and onerous for registrants to satisfy without accurately reflecting the policy decisions that a company has made with

[18] *See* letters from Business Roundtable and CFA Institute.

[19] As a result, the new 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 new disclosure as it relates to existing CD&A obligations. See Section III.D.3, below.

[20] 17 CFR 240.14c–101.

[21] By covering ''exchange funds,'' we believe that Section 14(j) should 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.

[22] In the context of Section 16, the Commission has stated that ''[t]he term 'hedging' means lessening the risk of loss by offsetting the risk of a securities position with an opposite position in a related security.'' *See* Release No. 34–26333 (Dec. 2, 1988) [53 FR 49997 (Dec. 13, 1988)] at n. 137.

[23] Proposed Instructions 3 and 4 to Item 407(i).

[24] *See* letter from CFA Institute.

[25] *See* letter from CII.

[26] *See* letter from Keith P. Bishop.

respect to hedging.[27] Instead, these commenters recommended that the Commission adopt a more focused disclosure standard. For example, two of these commenters recommended an approach that would require companies to describe the material aspects of their policies regarding hedging.[28]

In response to a specific request for comment on the scope of transactions covered by the proposed amendments, commenters made varying recommendations. Some supported a principles-based approach to defining the scope of covered hedging transactions.[29] One stated that covering all transactions with comparable economic consequences to the specified financial instruments would provide more complete disclosure and would be in line with legislative intent.[30] Another said that the proposed approach is preferable to defining the term ''hedge,'' because any definition of that term would encourage circumvention and may require constant updating as new financial instruments are developed.[31]

In contrast, two commenters specifically recommended defining the term ''hedge.'' One commenter suggested including common examples of derivative instruments and any instrument that produces the effect of limiting the insider's equity risk in the company without engaging in an outright sale, while explicitly excluding exchange funds from the definition.[32] The other commenter suggested limiting the definition to financial instruments that are substantially similar to those listed in Section 14(j) and providing objective criteria for determining what is, and is not, a financial instrument subject to the new disclosure requirement.[33] This commenter recommended excluding any financial instrument that is not a ''derivative security'' [34] with respect to the company's equity securities that is designed to hedge or offset decreases in the market value of a company's equity securities.[35]

In addition, some commenters recommended that the proposed amendments be modified to clarify that the new disclosure requirement will not apply to portfolio diversification transactions.[36] For example, these commenters noted that the purchase of equity securities of one or more unrelated companies as an investment strategy could be considered a hedging transaction subject to the proposed disclosure if those securities ''are negatively correlated at any level as compared to the company's equity securities,'' [37] or if they are diversification transactions in securities of market sectors that are counter-cyclical to the company's equity securities.[38] One commenter recommended specific language to clarify that portfolio diversification is not within the scope of the new disclosure requirement.[39] Two commenters also recommended that all long and short positions relating to equity securities other than the company's own equity securities be excluded from the scope of the new disclosure requirement.[40]

The Commission solicited comment on whether it is necessary to clarify the application of the proposed amendments to account for 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. Commenters generally agreed that there is a meaningful distinction between such a broad-based index and a financial instrument designed to, or having the effect of, hedging the economic exposure to company equity securities.[41] In this regard, several commenters recommended that the new disclosure requirement not apply to certain categories of transactions.[42] For example, commenters suggested that a company be able to disclose that it prohibits all hedging transactions even if it permits: (1) Transactions in a broad-based index that includes company equity securities; [43] (2) the purchase and sale of mutual funds, index funds and other diversified investment vehicles; [44] or (3) the purchase of broad-based indexes, exchange traded funds, indexes and baskets.[45]

Some commenters recommended that we provide guidance on the meaning of the concept of ''held, directly or indirectly'' as used in the new disclosure requirement,[46] for example by reference to the term ''beneficial ownership'' as defined in Exchange Act Rule 13d–3(d)(1).[47]

Finally, the Commission requested comment on whether to require disclosure of any hedging transactions that have occurred—in the annual proxy statement as well as in promptly filed Form 4 filings. Comments on whether to require new annual proxy statement disclosure of hedging transactions were mixed, with some commenters generally supporting requiring such disclosure,[48] and others stating that it is unnecessary due to the existing Section 16 reporting requirements.[49]

3. Final Amendments

The scope of the disclosure requirement we are adopting is in line with the proposed amendments but with certain modifications to address commenters' concerns about potential implementation challenges. As adopted, Item 407(i) requires the company to describe any practices or policies it has adopted (whether written or not) [50] regarding the ability of employees (including officers) or directors of the

[27] *See* letters from ABA, Business Roundtable and Davis Polk.

[28] *See* letters from Business Roundtable and Davis Polk.

[29] *See* letters from ABA, Business Roundtable, CFA Institute and Chris Barnard.

[30] *See* letter from Chris Barnard.

[31] *See* letter from ABA.

[32] *See* letter from Clinton Carlisle.

[33] *See* letter from McDermott Will & Emery (''McDermott''). *See also* letter from ABA (recommending that we consider this approach).

[34] As defined in Exchange Act Rule 16a–l(c) [17 CFR 240.16a–1(c)].

[35] *See* letter from McDermott.

[36] *See* letters from ABA, McDermott and Society of Corporate Secretaries & Governance Professionals (''SCSGP'').

[37] *See* letter from McDermott.

[38] *See* letter from ABA.

[39] *See* letter from SCSGP, recommending that it cover ''. . . transactions that are designed to ~~or~~ *and* have the *direct* effect of hedging or offsetting any decrease in the market value of equity securities. . .,'' and to add a new instruction stating that ''[t]he disclosure mandated here is limited to instruments that are tied to and principally designed to perform opposite of the [company's] equity securities. It does not include investments that provide general portfolio diversification.''

[40] *See* letters from ABA and McDermott.

[41] *See e.g.,* letters from Business Roundtable, Davis Polk & Wardwell LLP (''Davis Polk''), McDermott and SCSGP. In contrast, one commenter did not agree that the new disclosure requirement should explicitly distinguish between instruments that provide exposure to a broad range of companies or securities and those that are designed to hedge particular securities or have that effect, and that all should be covered by the disclosure requirement. *See* letter from Joyce Dillard.

[42] *See* letters from ABA, Business Roundtable, Clearly Gottlieb, Davis Polk, McDermott and SCSGP.

[43] *See* letters from ABA, Business Roundtable, Cleary Gottlieb Steen & Hamilton LLP (''Cleary Gottlieb'') and McDermott.

[44] *See* letter from Davis Polk.

[45] *See* letter from SCSGP.

[46] *See* letters from ABA, Davis Polk and Joyce Dillard.

[47] 17 CFR 240.13d–3(d)(1). *See* letters from ABA and Davis Polk.

[48] *See* letters from Clinton Carlisle and Joyce Dillard.

[49] *See* letters from ABA and Business Roundtable.

[50] For example, a company that does not have a written hedging policy might have a practice of reviewing, and perhaps restricting, hedging transactions as part of its program for reviewing employee trading in company securities. Similarly, a company might have a practice of including anti-hedging provisions in employment agreements or equity award documentation.

company, 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 hedge or offset, or are designed to hedge or offset, any decrease in the market value of company equity securities granted to the employee or director by the company as part of the compensation of the employee or director, or held, directly or indirectly, by the employee or director. The company will be required to provide a fair and accurate summary of the practices or policies that apply, including the categories of persons covered and any categories of hedging transactions that are specifically permitted and any categories that are specifically disallowed. Alternatively, the company will be required to disclose the practices or policies in full. The rule does not direct companies to have practices or policies regarding hedging, or dictate the content of any such practice or policy. If the company does not have any such practices or policies, the company must disclose that fact or state that hedging transactions are generally permitted.[51]

Although Section 14(j) refers to whether certain categories of persons are ''permitted'' to engage in covered transactions, we recognize, as one commenter observed, that the statute's use of ''permitted'' is potentially confusing, as companies generally do not affirmatively permit hedging transactions, and could result in uncertainty in making the required disclosure.[52] We also are mindful of concerns that requiring disclosure of categories of hedging transactions that are permitted could result in lengthy disclosures that do not accurately reflect the policy decisions that a company has made with respect to hedging.[53]

In implementing Section 14(j), we have sought to fulfill the statutory purpose of informing shareholders whether the covered persons can avoid downside price risk with respect to company equity securities with a clear and simple disclosure requirement. In doing so, we have construed the statute's use of the term ''permit'' as calling for disclosure as to whether the company has a practice or policy regarding the ability of covered persons to engage in such transactions. Therefore, as adopted, Item 407(i) requires disclosure about whether the company has adopted any practices or policies regarding the ability of covered persons to engage in transactions that hedge or offset any decrease in the market value of these securities. If the company does not have any such practices or policies, Item 407(i) requires it to disclose that fact or state that hedging transactions are generally permitted.

In the Proposing Release, the Commission solicited comment on whether, as an alternative to the proposed disclosure, the company should be required to describe its applicable hedging policies.[54] As noted above, some commenters recommended such an approach, with one such commenter stating that it would focus the required disclosures on material information.[55] After considering the comments received, we are persuaded that the approach we are adopting is a better means of achieving Section 14(j)'s statutory purpose. By requiring the company to describe any practice or policy it has adopted and the categories of persons covered, we believe investors will be informed with greater clarity as to the scope of the company's practices or policies regarding hedging transactions, and the compliance challenges associated with the proposed approach will be addressed. One commenter expressed concern that the proposed rules would discourage the use of hedging.[56] Neither Section 14(j) nor the rule amendments would require a company to prohibit hedging transactions or to otherwise adopt practices or policies addressing hedging by any category of individuals.

As in the proposal, Item 407(i) as adopted does not define the term ''hedge'' because we believe the language of Section 14(j), which refers to financial instruments ''that are designed to hedge or offset any decrease in the market value'' is clear and indicates that ''hedge'' should be applied as a broad principle. Like the proposed rule, the rule as adopted applies to transactions with the same economic effects—to hedge or offset any decrease in the market value of company equity securities—as the transactions specified by the statute, the disclosure of which is consistent with the purpose of Section 14(j).[57] While we recognize commenters' observations that the language of the proposal could be far reaching,[58] potentially scoping in transactions that may not necessarily raise the same concerns as the financial instruments specified by Section 14(j), such as portfolio diversification transactions, we believe the adopted approach will alleviate these concerns by requiring disclosure of any practice or policy the company has adopted regarding these types of transactions. In this regard, a company would only need to describe portfolio diversification transactions, broad-based index transactions, or other types of transactions, if its hedging practice or policy addresses them.

As in 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,[59] the scope of the new disclosure requirement is not limited to any particular types of hedging transactions. Moreover, by focusing on the company's practices or policies, the rule avoids adopting a definition that could prove either over- or under-inclusive, and allows for flexibility to address new downside price protection techniques as they develop. Based on their CD&A disclosures, it appears that many companies already have, and presumably enforce, practices or policies that rely on an undefined concept of ''hedging.'' Under the final amendments, each company will continue to make its own judgments in determining what activities, if any, should be covered by a practice or policy. Further, to the extent a company currently discloses its practices or policies regarding hedging transactions in the CD&A, (either in full or in a summary that would meet the requirements of Item 407(i)), the amendments will not require the company to revise its practices or policies—or its disclosure. A company that has disclosed a policy that covers only a subset of employees or directors would not be required to further disclose that it did not have a policy with regard to the company's other employees or directors.

Consistent with the statutory language, Item 407(i) as adopted applies to hedging transactions relating to

[51] Item 407(i) of Regulation S–K. For example, if a company does not have any such practices or policies, it could state: ''Our company does not have any practices or policies regarding hedging or offsetting any decrease in the market value of registrant equity securities.''

[52] *See* letter from Keith P. Bishop.

[53] *See* letters from ABA, Business Roundtable and Davis Polk.

[54] Proposing Release at 8490.

[55] *See* letter from Business Roundtable.

[56] *See* letter from John A. Olagues.

[57] For example, a short sale can hedge the economic risk of ownership, as can entering into a borrowing or other arrangement involving a non-recourse pledge of securities. Similarly, selling a security future that establishes a position that increases in value as the value of the underlying equity security decreases can provide the downside price protection that is the essence of the transactions contemplated by Section 14(j).

[58] *See* letters from ABA, McDermott and SCSGP.

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

company equity securities that are ''held, directly or indirectly,'' by employees (including officers) or directors. This terminology covers a broad variety of means by which equity securities can be held. As adopted, the new disclosure requirement does not define the term ''held, directly or indirectly.'' [60] Rather, under the amendments as adopted, companies will describe the scope of their hedging practices or policies, which may include whether and how they apply to securities that are ''indirectly'' held. Because companies can address this issue in describing the scope of their practices or policies, we do not believe that further guidance on this topic is necessary.

As noted above, while comments were mixed on whether to require disclosure in the annual proxy statement of any hedging transactions that have occurred, the final amendments will not require annual meeting proxy statement disclosure about such hedging transactions. We believe that such disclosure would be largely duplicative of disclosures required by the existing Section 16 reporting requirements, which shareholders can review to determine if officers and directors are in fact hedging, and take into consideration in their voting decisions. In addition, while disclosing information about hedging transactions of employees other than officers and directors may potentially provide some benefits to investors, collecting such information and preparing the disclosure would likely impose significant additional costs on companies.[61]

B. Defining the Term ''Equity Securities''

1. Proposed Amendments

Section 14(j) uses the term ''equity securities,'' but does not by its terms limit disclosure to equity securities of the reporting company.[62] As such, the term ''equity securities'' could be interpreted to include the equity securities of any company that an employee or director holds. A proposed instruction specified that the term ''equity securities,'' as used in the proposed rule, would mean any equity securities (as defined in Exchange Act Section 3(a)(11) [63] and Exchange Act Rule 3a11–1 [64]) issued by the company, or of any parent or subsidiary of the company or any subsidiary of any parent of the company, which equity securities are registered under Section 12 of the Exchange Act.[65]

2. Comments on the Proposed Amendments

Commenters recommended various approaches to defining the scope of ''equity securities'' for purposes of the new disclosure requirement. Some commenters agreed with the proposal,[66] with one expressing the view that the level of complexity of disclosure due to including equity securities of affiliated companies would reflect the level of complexity of the hedging policy of the company in question.[67] Others suggested using a broader definition, for example by including ''equity securities'' of additional categories of affiliated entities.[68] Two commenters stated that the new disclosure requirement should not be limited to transactions relating to equity securities that are registered under Exchange Act Section 12 or traded in an established public market.[69] Some commenters recommended including only ''equity securities'' of the company,[70] or otherwise narrowing the definition, for example by including equity securities of certain other entities if they are reported as compensation under Item 402, or if the company allows them to count towards an executive's equity retention requirements.[71]

3. Final Amendments

As was proposed, the Item 407(i) disclosure requirement will apply to equity securities issued by the company and its parents, subsidiaries or subsidiaries of the company's parents.[72] We have included these other entities within the scope of ''registrant equity securities'' because we understand that these equity securities can be relevant to the compensation practices of some issuers. Further, in a change from the proposal, Item 407(i) uses the term ''registrant equity securities,'' rather than ''equity securities,'' to indicate the scope of the rule is narrower than potentially any equity security, but broader than only the equity security of the particular company that is the employer or on whose board the director sits.[73] The relevant instruction specifies the scope of covered equity securities for both compensatory equity securities grants [74] and other equity securities holdings.[75]

Disclosure of whether a company has adopted practices or policies regarding a director's or employee's ability to hedge such 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. For example, 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, or have ownership requirements or guidelines regarding such equity securities.[76] In instances such as these, the rule would require disclosure regarding whatever practice or policy regarding hedging applies.

Consistent with Item 407(i)'s focus on the company's hedging practices or policies, the final amendments do not limit coverage to company equity

[60] Further, the final amendments do not reference the term ''beneficial ownership,'' as determined under Exchange Act Rule 13d–3(d)(1), as suggested by some commenters, because the voting power and investment power standards articulated in that rule do not necessarily correlate to whether a person has the risk of loss in an equity security that would be mitigated by a hedge.

[61] *See* letter from Clinton Carlisle.

[62] In addition, the Exchange Act's and Exchange Act Rules' definitions of ''equity security'' do not limit the scope of this term to equity securities of a particular company.

[63] 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.

[64] 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.

[65] Proposed Instruction 1 to Item 407(i).

[66] *See, e.g.,* letters from CFA Institute, CII and Florida State Board of Administration.

[67] *See* letter from Florida State Board of Administration.

[68] *See* letter from Joyce Dillard.

[69] *See* letters from Joyce Dillard and Michael Nau.

[70] *See* letters from ABA and SCSGP.

[71] *See* letter from SCSGP.

[72] Instruction 1 to Item 407(i).

[73] This term also avoids confusion with the broader definitions of ''equity security'' in Exchange Act Section 3(a)(11) [15 U.S.C. 78c(a)(11)] and Rule 3a11–1 [17 CFR 240.3a11–1].

[74] Item 407(i)(1)(i).

[75] Item 407(i)(1)(ii).

[76] An example is where a company creates a publicly-traded subsidiary.

securities that are registered under Exchange Act Section 12. Instead, the company's practices or policies will determine which, if any, classes of securities are covered. For example, to the extent a company has a different hedging practice or policy with respect to different classes of equity securities, the company's disclosure should reflect that fact.

C. Employees and Directors Subject to the Disclosure Requirement

1. Proposed Amendments

Section 14(j) covers hedging transactions conducted by any employee or member of the board of directors or any of their designees. The Commission proposed to apply the term ''employee'' to anyone employed by an issuer, including its officers. Further, under the proposed rule, whether someone is a ''designee'' would be determined based on the particular facts and circumstances.

2. Comments on the Proposed Amendments

Some commenters supported the proposed Item 407(i) disclosure requirement covering all employees of the company.[77] These commenters expressed the view that shareholders should have information about whether employees can dilute the original intention of company-provided compensation incentives,[78] and that all employees have an ability to affect share price and contribute to the prosperity of a company.[79] Another commenter recommended expanding the scope to include consultants.[80] Two commenters specifically supported the inclusion of ''officers'' in the group of employees, which the proposed disclosure requirement would cover.[81]

The Commission requested comment on whether to 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, or to add an express materiality qualifier to the definition to permit each issuer to determine whether disclosure about all of its employees would be material information for its investors. Some commenters suggested narrowing the scope of the new disclosure requirement to cover a more limited group of employees,[82] such as directors and executive officers,[83] or only requiring disclosure about a policy that governs non-executive employees if a company determines the information is material to its investors.[84] Some of these commenters stated that including only ''executive officers'' as defined by Exchange Act Rule 3b–7 [85] or ''officers'' as defined in Exchange Act Rule 16a–1(f) [86] would result in disclosure of the information that is material to shareholders, and that limiting the scope of covered ''employees'' would reduce company costs.[87]

The Commission also requested comment about whether to include an instruction clarifying who is a ''designee.'' Some commenters expressed the view that it is not clear who the term ''designee'' is intended to cover, and recommended that the Commission provide guidance as to its meaning.[88] One of these commenters recommended defining ''designee'' as someone specifically appointed to make decisions that the authorizing person would reasonably believe could result in the hedging of equity securities the person beneficially owns.[89] Another recommended defining ''designee'' to include immediate family members and family or affiliated investment vehicles.[90]

3. Final Amendments

The final amendments require disclosure of practices or policies that apply to employees, including officers, as well as directors. We believe the inclusion of officers is consistent with Congress' intent.[91] Accordingly, as was proposed, Item 407(i) adds the parenthetical ''(including officers)'' after the term ''employees'' in the language of the new disclosure requirement.[92]

Describing the persons covered by the new disclosure requirement as ''any employees (including officers) or directors of the registrant, or any of their designees'' is consistent with the mandate in Section 14(j). Although some commenters suggested that we limit the persons covered by Item 407(i), in light of the statutory mandate, we have not narrowed the scope of the requirement to address only policies directed at directors and executive officers or to add a materiality qualifier. We also note that the change in the final rules to focus Item 407(i)'s disclosure on the company's practices or policies should help to alleviate concerns about the rule's compliance costs. Companies of different sizes, industries and workforces may have different kinds of practices or policies with respect to hedging, and each company will make its own judgments in determining the categories of persons to which they apply. The rule as adopted will require companies to provide disclosure reflecting their particular policy choices with respect to hedging.[93]

The amendments as adopted require disclosure of any company practices or policies regarding ''designees.'' While we continue to believe that whether someone is a ''designee'' depends on the particular facts and circumstances involved, the focus of Item 407(i), as adopted, is on disclosure of a company's particular practices or policies. Because companies with hedging practices or policies will determine who is covered by the scope of the practice or policy, we do not believe that further guidance on this topic is necessary.

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[77] *See* letters from CII, Florida State Board of Administration and Public Citizen.

[78] *See* letters from CII and Florida State Board of Administration.

[79] *See* letters from CII and Public Citizen.

[80] *See* letter from Joyce Dillard.

[81] *See* letters from CFA Institute and Florida State Board of Administration.

[82] *See* letters from ABA, Business Roundtable, Cleary Gottlieb, Davis Polk, McDermott and SCSGP.

[83] *See, e.g.,* letters from Business Roundtable, Cleary Gottlieb and SCSGP.

[84] *See* letter from Davis Polk.

[85] *See, e.g.,* letters from Cleary Gottlieb and SCSGP. Exchange Act Rule 3b–7 [17 CFR 240.3b–7] defines ''executive officer'' as a company's ''. . . president, any vice president of the [company] in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the [company],'' and includes executive officers of subsidiaries of the company if they perform such policy making functions for the company.

[86] *See* letters from ABA and Davis Polk. Exchange Act Rule 16a–1(f) defines ''officer'' as ''. . . an issuer's president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer,'' and if they perform policy-making functions for the issuer, includes officers of a company's parent(s) or subsidiaries and officers or employees of the general partner(s) or of the trustee(s), respectively, of an issuer that is a limited partnership or a trust.

[87] *See, e.g.,* letters from ABA, Davis Polk and SCSGP.

[88] *See* letters from ABA, Davis Polk and Keith P. Bishop.

[89] *See* letter from Davis Polk.

[90] *See* letter from ABA.

[91] For example, the Senate Report 111–176 contemplates disclosure under Section 14(j) regarding ''executives.''

[92] This clarification is needed because Exchange Act Rule 12b–2 defines ''employees'' as not including a ''director, trustee or officer,'' unless the context otherwise requires.

[93] We have not, however, specified that ''employees'' includes consultants, because we have not heard concerns about the alignment of their interests with those of shareholders and they may be more likely to monetize their equity compensation.

D. Implementation

1. Manner and Location of Disclosure

1. Proposed Amendments

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.[94] We proposed to implement Section 14(j) by amending Items 7 and 22 of Schedule 14A to require the new Item 407(i) information if action is to be taken with respect to the election of directors. Although the language of Section 14(j) refers to disclosure in any proxy or consent solicitation material for an annual meeting of the company's shareholders, this language, construed strictly, could 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 [95] 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.[96] The proposal reflected the view that Item 407(i) disclosure similarly would be relevant information for shareholders evaluating a company's corporate governance practices in the context of director elections.

The proposal did not call for Item 407(i) disclosure to be included in Securities Act or Exchange Act registration statements or in the Form 10–K Part III disclosure,[97] even if that disclosure is incorporated by reference from the company's definitive proxy statement or information statement.[98]

In addition to including the new disclosure requirement, the Commission proposed to amend Item 7 of Schedule 14A to streamline its current provisions by more succinctly cross-referencing disclosure Items.

2. Comments on Proposed Amendments

Most commenters supported requiring the new Item 407(i) disclosure only in proxy or consent solicitation material and information statements with respect to the election of directors.[99] Two of these commenters stated that the new Item 407(i) disclosure would not be relevant to investors in Securities Act or Exchange Act registration statements or annual reports.[100] In contrast, one commenter stated that the new Item 407(i) disclosure also should be required in annual reports to capture companies that are not holding annual meetings.[101]

One commenter expressed support for the proposal to streamline Item 7, and stated that it would facilitate compliance with the new item.[102]

3. Final Amendments

We are adopting the amendments to Item 7 of Schedule 14A as proposed. By providing the disclosure in a proxy statement when action is to be taken with respect to the election of directors, shareholders will be able to consider the new disclosure at the same time they are considering the company's other corporate governance disclosures and voting for directors.[103] The disclosure will provide additional information on whether the company has practices or policies affecting the alignment of incentives for employees and directors of the company whose securities they hold. We believe that this disclosure is most relevant when providing information about the election of directors. This will be the case whether shareholders are voting for directors at an annual or special meeting of shareholders, or in connection with an action authorized by written consent.[104]

As adopted, the amendments provide that the new Item 407(i) information will not be required in Form 10–K Part III disclosure even if that disclosure is incorporated by reference from the company's definitive proxy statement or information statement.[105]

In addition, we are amending Item 7 of Schedule 14A to streamline its current provisions in the manner proposed.[106]

2. Disclosure on Schedule 14C

1. Proposed Amendments

Exchange Act Section 14(c) applies to companies not soliciting proxies or consents from some or all holders of a class of securities registered under Exchange Act Section 12 entitled to vote at a meeting or authorize a corporate action by execution of a written consent.[107] 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. Section 14(j) expressly calls for proxy or consent solicitation materials for an annual meeting of the shareholders of the issuer to include the required disclosure. Our proxy rules require these solicitation

[94] 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, such as state corporate law. *See, e.g,* Delaware General Corporate Law, Section 211(b).

[95] 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.

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

[97] 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 in Part III of Form 10–K.

[98] As permitted by General Instruction G to Form 10–K.

[99] *See* letters from ABA, Business Roundtable, CII and Davis Polk.

[100] *See* letters from ABA and Davis Polk.

[101] *See* letter from Clinton Carlisle.

[102] *See* letter from ABA.

[103] We are not adopting the proposed amendment to Item 22 of Schedule 14A because, as discussed in Section III.D.3.c.i., below, we are excluding listed closed-end funds from the new disclosure requirement.

[104] 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 amendments do not require Item 407(i) disclosure in the proxy statement.

[105] Instruction 2 to Item 407(i), providing that information disclosed pursuant to Item 407(i) is not deemed incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent the company specifically incorporates that information by reference. The disclosure also is not subject to forward incorporation by reference under Item 12(b) of Securities Act Form S–3 [17 CFR 239.13] or Item 12 of Securities Act Form S–1 [17 CFR 239.11].

[106] Amended Item 7(b) and Instruction to Item 7 of Schedule 14A.

[107] 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.

materials to be filed under cover of Schedule 14A.[108] 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.[109] An information statement 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.

The Commission did not propose to exclude the new Item 407(i) disclosure from Schedule 14C.[110]

2. Comments on Proposed Amendments

One commenter supported the inclusion of new Item 407(i) disclosure in Schedule 14C, noting that the Item 407(i) disclosure differs in type and nature from the disclosures currently excludable.[111] The commenter indicated that the proposed approach was appropriate because it would maintain consistency in the corporate governance disclosure provided in proxy statements and information statements with respect to the election of directors. No commenters opposed the proposed approach.

3. Final Amendments

As proposed, the final amendments do not exclude Item 407(i) disclosure from Schedule 14C. Applying the disclosure obligation to Schedule 14C filings will have the effect of applying the new Item 407(i) requirement 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. Consistent with the views of one commenter, we believe that doing so is appropriate to retain consistency in the corporate governance disclosure provided in proxy statements and information statements with respect to the election of directors.

3. Relationship to Existing CD&A Obligations

a. Proposed Amendments

As noted above, one of the non-exclusive examples currently listed in the Item 402(b) requirement for CD&A calls, in part, for disclosure of any company policies regarding hedging the economic risk of company securities ownership,[112] to the extent material. CD&A requires information about named executive officers.

The Commission proposed amending 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 new Item 407(i) to the extent that the information disclosed there satisfies this CD&A disclosure requirement.[113]

b. Comments on Proposed Amendments

Comments on this proposed instruction were mixed. Two commenters supported permitting cross-referencing, stating that this may reduce potentially duplicative disclosure in proxy and information statements.[114] One of these commenters suggested also permitting companies to include the new Item 407(i) disclosure in their CD&A,[115] expressing the view that companies should have the flexibility to locate the disclosure where it best fulfills their communication objectives. Another commenter expressed concern about permitting cross-referencing the new Item 407(i) disclosure in CD&A, noting the importance of hedging policy disclosure and its direct relevance to the CD&A.[116] In contrast, a different commenter recommended eliminating the Item 402(b) hedging disclosure requirement as unnecessary and redundant in light of the new Item 407(i) disclosure.[117]

c. Final Amendments

We are amending Item 402(b) of Regulation S–K to add the instruction as proposed. We believe this new instruction to Item 402(b) will allow companies that are subject to both Item 407(i) and Item 402(b) to avoid the potential for duplicative disclosure in their proxy or information statements with respect to the election of directors.[118] We are not eliminating Item 402(b), as one commenter suggested, as it applies to Item 402 disclosure in registration statements and annual reports, as well as proxy statements.

In response to comments, we note that companies have flexibility in where they present the new Item 407(i) disclosure. A company could choose to include its Item 407(i) disclosure outside of CD&A and provide a separate Item 402(b) disclosure as part of CD&A without a cross reference. Alternatively, it could incorporate the Item 407(i) disclosure into CD&A, either by directly including the information or by providing the Item 407(i) information outside of CD&A and adding a cross-reference within CD&A.[119]

4. Issuers Subject to the Amendments

a. Proposed Amendments

The Proposing Release discussed whether certain categories of issuers should be exempted from the new Item 407(i) disclosure requirement, or, alternatively, whether they should be subject to a delayed implementation schedule. Under the proposal, the new disclosure requirement would apply to EGCs and SRCs. Securities registered by an FPI are not subject to the proxy statement requirements of Exchange Act Section 14,[120] and therefore FPIs are not

[108] As noted 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.

[109] 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 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].

[110] Because the proposed amendments did not add a new exclusion for information called for by the amendment to Item 7 of Schedule 14A, the effect of the proposal was to require Item 407(i) disclosure in Schedule 14C.

[111] *See* letter from ABA dated Oct. 13, 2015.

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

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

[114] *See* letters from ABA and Chris Barnard.

[115] *See* letter from ABA.

[116] *See* letter from Florida State Board of Administration.

[117] *See* letter from Davis Polk.

[118] We have modified the text of new Instruction 6 to clarify that this new instruction applies to CD&A disclosure in these proxy or information statements.

[119] 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 a company chooses to make it part of CD&A either directly or pursuant to the new cross-reference instruction, the final rule will not effect any change in the scope of disclosure currently subject to say-on-pay votes. We note that issuers may, if they prefer, avoid making the Item 407(i) disclosure part of CD&A by not cross-referencing or directly including that disclosure in their Item 402 disclosure.

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

subject to Section 14(j) and hence would not be required to provide Item 407(i) disclosure.

The Commission proposed to apply the disclosure requirements to closed-end investment companies with shares listed on a national securities exchange and registered under Exchange Act Section 12(b) [121] (''listed closed-end funds'') as well as business development companies (''BDCs'').[122] The Commission also requested comment on whether to require the proposed disclosure for other investment companies registered under the Investment Company Act (''funds'' or ''registered investment companies'') that do not hold annual meetings, including exchange-traded funds (''ETFs'') [123] and other open-end funds.

b. Comments on Proposed Amendments

Comments on whether EGCs or SRCs should be subject to the proposed disclosure requirement were mixed. Four commenters supported requiring the new Item 407(i) disclosure for EGCs and SRCs.[124] One commenter opposed an ''early stage exemption'' for EGCs or SRCs, stating that it could allow for poor hedging policies at early growth stages that would eventually need to be corrected.[125] Two commenters indicated that the Item 407(i) disclosure would be useful, and might be of greater value, to investors in these companies than to investors in other public companies because: (1) EGCs and SRCs are not subject to the CD&A requirement to disclose policies about hedging by named executive officers; (2) EGCs and SRCs are generally subject to greater market risk than other public companies; and (3) the breadth of usage of hedging transactions at those companies supports requiring disclosure.[126] Three commenters indicated that they did not expect the new disclosure requirement to impose a significant compliance burden on EGCs and SRCs.[127]

In contrast, two commenters recommended exempting EGCs and SRCs from the new disclosure requirement,[128] stating that requiring the new Item 407(i) disclosure for these companies could lead to misalignment of the interests of employees and directors with their shareholders. These commenters indicated that, since EGCs and SRCs are not required to provide CD&A disclosure, they are less likely to have hedging policies in place, and that rather than disclosing they do not have such a policy, these companies may feel compelled to adopt one. In their view, such an action may not be in the best interests of shareholders if it results in company executives, who are more likely than those of larger companies to be heavily invested in the company: (1) Refraining from undertaking risks that could be in the best interests of the company's shareholders; [129] or (2) reducing their company stock holdings so their interests are less aligned with shareholders.[130] In addition, these commenters believed that applying the new disclosure requirement to EGCs and SRCs would impose costs that are disproportionate to the benefits to be obtained.

Two commenters agreed with the proposed treatment of FPIs.[131] Both noted that securities registered by FPIs are not subject to the proxy statement requirements of Exchange Act Section 14 and do not need to make other governance disclosures under existing Item 407.

A few commenters addressed registered investment companies and none specifically addressed BDCs. Three commenters agreed with the Commission's approach in the Proposing Release not to subject open-end investment companies and ETFs to the proposed disclosure requirement.[132] No commenter explicitly supported the application of the proposed disclosure requirement to listed closed-end funds and three commenters opposed making listed closed-end funds subject to the proposed requirement.[133] Two commenters asserted that it is difficult to hedge shares of closed-end funds, either by selling short or entering into derivative positions.[134] One commenter agreed with the Commission's observation that closed-end funds typically are externally managed and do not employ executives or have employees like operating companies.[135] Two commenters suggested that since closed-end funds share many similar characteristics regarding corporate governance with open-end funds, they should be treated similarly for purposes of the proposed disclosure.[136] Finally, one commenter stated that the Commission had not demonstrated that closed-end fund executives had engaged in problematic hedging practices similar to those used by operating company executives and that because most closed-end funds did not have specific hedging policies already in place, they would need to develop, revise, and maintain such policies.[137]

c. Final Amendments

The amendments will apply to the categories of issuers proposed, except with respect to listed closed-end funds, which we are exempting from the Item 407(i) disclosure requirement. 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 a company's employees or directors may engage in transactions that mitigate or avoid the incentive alignment associated with equity ownership.

i. Investment Companies

In a change from the proposal, after considering the comments received, we have determined not to apply the new Item 407(i) disclosure requirement to listed closed-end funds,[138] but it will apply to BDCs. We believe that this approach is consistent with the Commission's treatment of BDCs regarding executive compensation disclosure requirements,[139] and no commenter suggested that BDCs should be excluded.

Registered investment companies have a management structure, regulatory regime, and disclosure obligations that

[121] 15 U.S.C. 78l(b).

[122] BDCs 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, BDCs would be treated in the same manner as non-investment company issuers.

[123] 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.

[124] *See* letters from CFA Institute, CII, Florida State Board of Administration and Public Citizen.

[125] *See* letter from Florida State Board of Administration.

[126] *See* letters from CII and Florida State Board of Administration.

[127] *See* letters from CFA Institute, CII and Public Citizen.

[128] *See* letters from ABA and SCSGP.

[129] *See* letters from ABA and SCSGP.

[130] *See* letter from SCSGP.

[131] *See* letters from ABA and Davis Polk.

[132] *See* letters from ABA, ICI and MFDF.

[133] *Id.*

[134] *See* Letters from ABA and MFDF.

[135] *See* Letter from ICI.

[136] *See* Letters from ICI and MFDF.

[137] *See* Letter from ICI.

[138] 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.

[139] *See* 2006 Executive Compensation Disclosure Release, at Section II.D.3.

differ in various respects from operating companies, which we believe makes the proposed disclosure less useful for investors in funds. Nearly all funds, unlike other issuers, are externally managed and have few, if any, employees who are compensated by the fund. Rather, personnel who operate the fund and manage its portfolio generally are employed and compensated by the fund's investment adviser.[140]

Although fund directors, including directors of listed closed-end funds, may hold shares of the funds they serve, fund compensation practices can be distinguished from those of operating companies.[141] We believe that the granting of shares as a component of incentive-based compensation is uncommon, and in some cases is prohibited, for both open-end and closed-end funds.[142] From a practical standpoint, even if fund directors were to acquire shares of listed closed-end funds, commenters indicated that it is difficult to hedge such shares by selling short or trading in derivatives.[143] 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 open-end and closed-end funds.[144]

Section 14(j) of the Exchange Act directs the Commission to require certain disclosures in connection with any proxy or consent solicitation material for an annual meeting of shareholders. Most funds, other than listed closed-end funds, are not required to hold annual meetings of shareholders.[145] ETFs, although traded on an exchange, do not generally hold annual meetings of shareholders, and ETFs organized as UITs do not have boards of directors. Listed closed-end funds, on the other hand, generally are required to hold annual meetings of shareholders.[146]

The Commission has considered, in the context of compensation and corporate governance, whether listed closed-end funds are more like operating companies or more like ETFs and open-end funds. As recognized in the Proposing Release, shares of listed closed-end funds trade at negotiated market prices on a national securities exchange and often trade at a ''discount'' to the fund's net asset value per share.[147] While the Commission suggested in the Proposing Release that information as to whether a listed closed-end fund's directors and employees, if any, would receive the discounted price upon a sale of the shares without an offset from a hedging transaction may be important to the voting decision of an investor, we received no public comment in support of this premise. On the contrary, a number of commenters opposed the inclusion of listed closed-end funds for a variety of reasons.[148]

We are persuaded by commenters that listed closed-end funds are more similar to open-end funds in this context and it is not necessary to apply the hedging disclosure requirements to listed closed-end funds. Accordingly, we find it is in the public interest and consistent with the protection of investors to exclude listed closed-end funds from the Item 407(i) disclosure requirements.

ii. Emerging Growth Companies and Smaller Reporting Companies

As adopted, the amendments do not exempt EGCs or SRCs from the new disclosure requirement. We believe that information about potential alignment of shareholder interests with those of employees and directors would be relevant to shareholders of an EGC or an SRC. Moreover, given the change in the disclosure requirement to focus on a company's existing practices or policies, we do not expect the new disclosure to impose a significant compliance burden on companies.

We are mindful that that the JOBS Act excludes EGCs from some, but not all, of the provisions of Title IX of the Act, of which Section 955 is a part,[149] and that EGCs and SRCs are in many instances subject to scaled disclosure requirements, including with respect to executive compensation.[150] We believe that it would be more consistent with our historical approach to corporate governance related disclosures,[151] as well as the statutory objectives of Section 14(j), not to exempt these companies from the new disclosure requirement. EGCs and SRCs are not required to provide CD&A disclosure required by Item 402(b) and therefore may be less likely to have hedging practices or policies. Item 407(i) as adopted, however, does not direct them to adopt such practices or policies, or dictate the content of any such practices or policies. We believe the amendments would not impose a substantial direct cost on companies as they would simply require the company to disclose what, if any, practices or policies it has adopted and to whom they apply, or in the absence of any such practices or policies, disclose that none exists or state that hedging transactions are generally permitted. Accordingly, a company that does not believe a hedging policy would be in the best interests of its shareholders would be able to comply with the disclosure requirement without creating a practice or policy. As with any company, the complexity of the disclosure would reflect mainly the level of complexity of the hedging practices or policies of the individual company.

As discussed in Section VI below, in addition to direct costs, companies subject to the disclosure requirement

140 In 2017, staff identified 5 (1%) internally managed listed closed-end funds based on a review of filings with the Commission. Funds also typically will contract with other service providers in addition to the investment adviser.

141 *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.*

142 Registered 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,'' the Commission staff has suggested 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) (discussing, among other matters, the staff's views on application of Section 23(a) to the compensation of directors in closed-end funds using fund shares).

143 *See* note 132 above and accompanying text.

144 *See* note 5 above and accompanying text.

145 The requirement to hold an annual meeting of shareholders at which directors are to be elected is imposed by a source of authority other than the federal securities laws. *See* note 94 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.

146 *See, e.g.,* Section 302.00 of the New York Stock Exchange's Corporate Governance Standards.

147 Proposing Release at 8494.

148 *See* notes 134–137 above and accompanying text.

149 Section 102 of the JOBS Act exempts EGCs 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.

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

151 *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, which provides a phase-in period for SRCs from the disclosure required by Item 407(d)(5) of Regulation S–K and does not require SRCs 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 EGCs and SRCs are subject to the obligation under Exchange Act Section 16(a) to report transactions involving derivative securities.

may also incur indirect costs associated with the disclosure, which may be larger for companies without practices or policies regarding hedging in place. We thus recognize that EGCs and SRCs may incur greater costs as a result of the disclosure requirement. Accordingly, we are adopting a delayed compliance date for EGCs and SRCs.

As noted below,[152] in order to give companies adequate time to implement the new disclosures, we are providing a transition period. Companies that are not SRCs or EGCs are required to comply with Item 407(i) in proxy and information statements with respect to the election of directors during fiscal years beginning on or after July 1, 2019. We believe that providing a delayed compliance date for SRCs and EGCs will benefit those companies by allowing them to observe how other larger and more established companies implement Item 407(i). Accordingly, to assist SRCs and EGCs in preparing to implement Item 407(i), we are requiring them to comply with Item 407(i) in proxy and information statements with respect to the election of directors during fiscal years beginning on or after July 1, 2020.

iii. 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 FPI are not subject to the proxy statement requirements of Exchange Act Section 14,[153] under the amendments, FPIs are not required to provide the new Item 407(i) disclosure.

IV. Other Matters

If any of the provisions of these rules, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

V. Compliance Dates

In order to give companies adequate time to implement these disclosures, we are requiring companies that are not SRCs or EGCs to begin complying with Item 407(i) in proxy and information statements with respect to the election of directors during fiscal years beginning on or after July 1, 2019. We are delaying the required compliance for SRCs and EGCs until fiscal years beginning on or after July 1, 2020.

VI. Economic Analysis

A. Background

We are adopting amendments to implement Section 955 of the Act, which added Section 14(j) to the Exchange Act concerning disclosure about a company's hedging policies in proxy or consent solicitation materials.[154] We are mindful of the costs imposed by and the benefits obtained from our rules. Exchange Act Section 3(f)[155] 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 also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. Additionally, Exchange Act Section 23(a)(2)[156] requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule will have on competition and not to adopt any rule that will 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 expected economic effects of the final amendments, including the likely benefits and costs, as well as the likely effects of the final amendments on efficiency, competition, and capital formation. The Commission has, where possible, quantified the economic effects expected to result from the final amendments in the analysis below. However, we are unable to quantify some of the potential effects discussed below. Notably, the benefits of the final amendments are difficult to quantify because we lack data on the extent to which shareholders currently factor information on hedging practices or policies into their decisions and the extent to which the availability of the new disclosure under the final amendments will inform shareholder decisions. Further, we are unable to quantify the indirect costs of the final amendments because we lack information to predict the extent of changes to hedging policies that companies may undertake following the amendments and the incremental costs companies may incur as a result of implementing such changes, including costs to develop and administer new or revised hedging policies and costs associated with potential changes to incentives of directors and employees. Therefore, much of the discussion below is qualitative in nature, although the Commission describes, where possible, the direction of these effects. Finally, for purposes of this economic analysis, we address the benefits and costs resulting from the statutory mandate and our exercise of discretion together because the two types of benefits and costs are not readily separable.

B. Baseline and Affected Parties

The final amendments will affect all companies with a class of securities registered under Section 12 of the Exchange Act, including SRCs, EGCs, and BDCs. The final amendments do not apply to FPIs and investment companies registered under the Investment Company Act. In a change from the proposal, listed closed-end funds will not be subject to the final amendments.[157] We estimate that approximately 5,795 companies will be subject to the final amendments.[158] Among the companies subject to the final amendments, we estimate approximately 2,086 to be SRCs;[159]

[152] *See* Section V, below.

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

[154] *See* Section I, above.

[155] 15 U.S.C. 78c(f).

[156] 15 U.S.C. 78w(a)(2).

[157] Based on data from Morningstar, we identify approximately 512 closed-end funds that were listed on an exchange as of December 31, 2017.

[158] We estimate the number of unique operating companies subject to the final amendments by analyzing companies that filed annual reports on Form 10–K in calendar year 2017 with the Commission. This estimate excludes ABS issuers (identified based on prior ABS-related filings), registered investment companies, issuers that have not filed Form 10–K, and foreign issuers filing Forms 20–F and 40–F. We identify companies that have securities registered under Section 12(b) or Section 12(g) from Form 10–K. Companies not identified as having a class registered either under Section 12(b) or Section 12(g) are excluded. We determine whether a company identifies itself as a SRC from Form 10–K. We determine whether a company identifies itself as an EGC based on Ives Group's AuditAnalytics data. This estimate is an upper bound on the number of affected filers to the extent that not all of these filers file a proxy statement or an information statement in a given year (for example, some filers may not hold a director election).

[159] *See* note 9, above. These estimates are based on calendar year 2017 data, the last full year of data available to us. Following the amendments to the SRC definition, which expanded the range of companies that qualify for SRC status, effective September 10, 2018, we expect the proportion of SRCs among companies subject to the final amendments to be higher than estimated based on 2017 data. Among companies subject to the final amendments based on 2017 data, approximately 814 additional companies, including 567 companies that are not EGCs, would have qualified as SRCs under the expanded definition.

Those non-EGCs that were in existence prior to the recent expansion of the SRC definition and that newly qualify for SRC status under the expanded definition would have been subject to Item 402(b) in prior years.

1,224 to be EGCs;[160] and 80 to be BDCs.[161] Besides companies, affected parties include employees (including officers) and directors of the affected companies, as well as investors in these companies. Equity securities covered by the final amendments include equity securities issued by the company and its parents, subsidiaries or subsidiaries of the company's parents.

We assess the economic effects of the final amendments relative to the baseline, which includes the existing state of disclosure requirements and practices. As discussed in Section II above, among the registrants subject to the final amendments, Section 12 registrants other than SRCs and EGCs are currently subject to the CD&A disclosure requirement in Item 402(b) of Regulation S–K. Under Item 402(b)(2)(xiii), an example of the kind of information that should be provided, if material, includes a description of 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. Although Item 402(b)(2)(xiii) addresses only hedging by the named executive officers, some companies describe policies that address hedging by employees and directors, as well as named executive officers, in providing their CD&A disclosure.[162]

Additionally, Section 16(a) of the Exchange Act requires officers and directors of Section 12 registrants, including SRCs and EGCs, to report their hedging transactions involving the company's equity securities.[163] However, unless a company discloses a policy regarding hedging by officers and directors, it is not possible for investors to obtain full information about whether a company has a hedging policy or how one may apply. For example, investors may not be able to discern from current disclosure whether the disclosure of hedging transactions by officers and directors indicates that the company does not have a hedging policy; the company has a policy regarding hedging, but that the particular types of transactions are not restricted by the policy; or a company's hedging policy was violated, but the transaction was reported in accordance with Section 16(a). Similarly, it is not possible to discern from current disclosure whether the absence of reported hedging transactions indicates that the company prohibits hedging; the company does not prohibit hedging, but that officers and directors did not engage in hedging transactions; or officers and directors engaged in hedging transactions but did not comply with Section 16(a).

The extent to which there will be a change in the hedging policy disclosures under the final amendments will vary for different categories of registrants subject to the amendments. While a number of reporting companies already make hedging policy disclosures, others will need to do so for the first time. To establish the baseline of existing practices related to disclosure of hedging policies, we analyzed information from comment letters and industry surveys of large companies' hedging policy disclosure practices[164] and reviewed proxy statements for information on disclosures of hedging policies for four samples of companies.[165] The first sample includes a randomly chosen subset of 100 S&P 500 companies that filed proxy statements during the calendar year 2017.[166] The second sample includes 100 randomly selected companies from the S&P SmallCap 600 that filed proxy statements during the calendar year 2017.[167] These companies are smaller than S&P 500 companies; however, all of them are exchange-listed, and none are SRCs (based on the pre-2018 definition).[168] In addition, we have examined hedging policy disclosure practices for random samples of 100 SRCs and 100 non-SRC EGCs (using the pre-2018 SRC definition).[169]

In general, the sampled S&P 500 companies disclosed hedging policies more frequently than the other categories of sampled companies.

TABLE 1—CURRENT HEDGING POLICY DISCLOSURE PRACTICES

Covered companies	Size of the examined sample	Covered persons	Disclosed hedging policy	No disclosed policy
Companies in the S&P 500 index	100	NEOs	97 (97%)	3 (3%)
		Directors	77 (77%)	23 (23%)
		Employees	51 (51%)	49 (49%)
Companies in the S&P SmallCap 600 index	100	NEOs	71 (71%)	29 (29%)
		Directors	60 (60%)	40 (40%)

[160] The estimate is based on Ives Group's AuditAnalytics data on filers that identified themselves as EGCs during 2017.

[161] The EGC, SRC, and BDC filer categories partly overlap. The estimate of the number of BDCs is based on September 2017 data at *https://www.sec.gov/open/datasets-bdc.html.*

[162] Listed closed-end funds, which are not subject to the final amendments, are not subject to the CD&A disclosure requirement.

[163] Section 30(h) of the Investment Company Act subjects officers and directors of listed closed-end funds to the same duties and liabilities as those imposed by Section 16(a) of the Exchange Act.

[164] *See* notes 171–175, below.

[165] We did not receive comment on the methodological approach used in this baseline analysis in the Proposing Release. Our baseline analysis in this release is generally consistent with the baseline analysis in the Proposing Release; however, we are considering data from proxy statements filed in 2017, which is the most recent full calendar year of filings available to us. We also are making some modifications in light of the availability of information in other sources about the prevalence of hedging policy disclosure among large companies. Specifically, we are considering a random sample of 100, rather than the set of all, S&P 500 companies, in light of other information on hedging policies of large companies that has become available from commenters and industry surveys. *See* notes 171–175, below. In light of comments regarding the potentially greater effects of the disclosure requirement on SRCs and EGCs, in a change from the baseline analysis in the Proposing Release, we are adding an analysis of samples of 100 SRCs and 100 non-SRC EGCs. Similar to the analysis in the Proposing Release, we also examine a sample of 100 S&P SmallCap 600 companies.

We note that the estimated rate of hedging policy disclosure obtained based on a sample of companies, rather than the entire set of companies, can differ from the actual rate of hedging policy disclosure for the full set of companies. However, such differences should not be systematic in light of our use of random sampling.

[166] A total of 489 S&P 500 companies filed proxy statements during the calendar year 2017.

[167] A total of 586 S&P SmallCap 600 companies filed proxy statements during the calendar year 2017.

[168] *See* note 159, above. SRC status is based on status reported in filings in calendar year 2017. Twenty-one EGCs were included in the S&P SmallCap 600 index during the calendar year 2017.

[169] *See* note 159, above. SRC status is based on status reported in filings in calendar year 2017. The SRC sample therefore does not include companies that would become newly eligible for SRC status under the expanded SRC definition following the 2018 amendments, while the non-SRC EGC sample may include such companies. Because companies newly eligible for SRC status under the 2018 amendments would tend to be larger than the companies eligible for SRC status prior to the 2018 amendments, to the extent that larger companies are more likely to disclose hedging, the prevalence of hedging disclosure in the analyzed sample of SRCs from 2017 may be lower than the prevalence of hedging disclosure among SRCs under the amended definition.

TABLE 1—CURRENT HEDGING POLICY DISCLOSURE PRACTICES—Continued

Covered companies	Size of the examined sample	Covered persons	Disclosed hedging policy	No disclosed policy
		Employees	33 (33%)	67 (67%)
SRCs (pre-2018 definition)	100	NEOs	7 (7%)	93 (93%)
		Directors	6 (6%)	94 (94%)
		Employees	1 (1%)	99 (99%)
EGCs that are not SRCs (pre-2018 definition)	100	NEOs	15 (15%)	85 (85%)
		Directors	13 (13%)	87 (87%)
		Employees	11 (11%)	89 (89%)

Table 1 shows that disclosures and hedging policies are not uniform across covered categories of companies. Almost all of the S&P 500 companies sampled (97%) disclosed policies regarding hedging by named executive officers. A large majority of the S&P 500 companies sampled (77%) also disclosed their policy about hedging by directors, but only 51% disclosed hedging policies for non-executive employees. These percentages are smaller for smaller companies. Of the 100 S&P SmallCap 600 companies sampled, only 71% disclosed hedging policies for named executive officers, 60% disclosed such policies for directors, and 33% disclosed hedging policies for non-executive employees. An even smaller proportion of the sampled SRCs and non-SRC EGCs (based on the pre-2018 definition)[170] disclosed hedging policies: 7% of SRCs and 15% of non-SRC EGCs disclosed policies regarding hedging by named executive officers; 6% of SRCs and 13% of non-SRC EGCs disclosed policies regarding hedging by directors; and 1% of SRCs and 11% of non-SRC EGCs disclosed policies regarding hedging by non-executive employees. Among the different categories of the sampled companies that disclosed hedging policies, all or almost all such companies disclosed policies that either prohibited or restricted hedging.

These results are broadly in line with those reported by commenters and industry reports. One commenter stated that 49% of Russell 3000 companies and 84% of S&P 500 companies have hedging policies governing their officers and directors.[171] Another commenter indicated that approximately 54% of Russell 3000 Companies and 84% of S&P 500 companies have prohibited employees from hedging company shares.[172] A different commenter indicated that a survey of 100 companies among the Fortune 500 found that 95% of companies disclosed hedging policies during the 2014 proxy season, and the vast majority of these policies involved a ban.[173] Another commenter reviewed company disclosures in Commission filings and corporate governance documents available on company websites, and found that: (1) 95% of a cross-section of 60 publicly traded companies whose CEOs are members of Business Roundtable prohibit hedging of company securities by executive officers, and (2) 85% prohibit hedging by directors.[174] More recent industry studies of large companies have reported that the majority of the surveyed companies disallow executive hedging.[175]

Discussion of Economic Effects

To help inform our analysis of the potential benefits and costs of disclosure of practices or policies regarding hedging to shareholders, we consider the potential ways in which hedging by employees and directors may affect shareholder value. However, as discussed in Section III above, these amendments relate only to disclosure of hedging practices or policies and should not be construed as suggesting that companies should have a practice or policy regarding hedging, or a particular type of practice or policy.

Generally, by linking employees' and directors' wealth to shareholder wealth, an ownership stake in the company can provide employees and directors with an incentive to improve shareholder value.[176] Permitting employees and directors to hedge their exposure to the company's stock price can reduce the alignment of their incentives with the interests of shareholders, potentially resulting in less optimal corporate investment decisions and lower shareholder value. Alternatively, permitting hedging could, in some circumstances, more closely align the risk preferences of employees and directors with those of shareholders, potentially resulting in more efficient corporate investment decisions and higher shareholder value. Compared to shareholders, employees and directors are more likely to have undiversified

[170] *Id.*

[171] *See* letter from Davis Polk.

[172] *See* letter from CII.

[173] *See* letter from Public Citizen.

[174] *See* letter from Business Roundtable.

[175] A 2015 report found that among the 250 largest market capitalization S&P 500 companies, the prevalence of policies prohibiting hedging by executives is 92%. *See* Frederic W. Cook & Co., Inc., Corporate Governance Study 1 (December 2015), available at *https://www.fwcook.com/content/Documents/Publications/FWC_2015_Corp_Gov_Study_Final.pdf.*

Another recent report found hedging policies to be present in 96% of large publicly traded companies and attributed that percentage to the influence of legislation, proxy advisory firms, and shareholder scrutiny. The report considered ''110 companies from 10 industries, selected to provide a broad representation of market practice among large U.S. public companies.'' *See* Compensation Advisory Partners (CAP), CAP 100 Company Research Industry Report 2017–2018 13, *https://www.capartners.com/cap-thinking/cap-100-company-research-17-18/.*

In another report, 93 of the largest 100 companies (93%) that have equity securities listed on the NYSE or Nasdaq were found to prohibit hedging. *See* 2018 Shearman & Sterling LLP Corporate Governance survey, at 103.

An analysis of 2017 data indicated that 98% of a random subset of S&P 500 companies and 71% of a random subset of S&P SmallCap 600 companies disclosed hedging policies for named executive officers. In the Proposing Release, an analysis of 2012 data indicated that 67% of S&P 500 companies and 29% of a random subset of S&P SmallCap 600 companies disclosed hedging policies for named executive officers. *See* Proposing Release, at 8498. We cannot identify the causes of increased incidence of hedging policy disclosure among large companies with certainty and note that estimates based on samples of companies may contain noise, although differences in estimates are not likely to be biased because samples are drawn randomly. The increase in the rate of hedging policy disclosure over this time period may be partly due to the anticipation of a future requirement to provide hedging disclosures as a result of the Dodd-Frank Act and the Proposing Release, as well as due to demand from shareholders and other market participants. *See also* Section VI.B below, analyzing the prevalence of disclosure of hedging practices and policies in a randomly drawn sample of companies.

[176] *See* Proposing Release, at 8498, n. 86. *See, e.g.,* Michael C. Jensen & William H. Meckling, *Theory of The Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. Fin. Econ. 305–360 (1976); Bengt Holmstrom, *Moral Hazard and Observability,* 10 Bell J. Econ. 324–340 (1979); Bengt Holmstrom & Joan Ricart I. Costa, *Managerial Incentives and Capital Management,* 101 Q. J. Econ. 835–860 (1986). Terms of employee and director compensation contracts, including holding and vesting periods, may also affect the alignment of incentives with shareholder value over time.

exposure to their company, which could lead them to avoid making risky corporate investments, even if such actions would enhance shareholder value.[177] Allowing employees and directors to hedge equity holdings could in some circumstances partly ameliorate the imperfect alignment of risk-taking incentives created by undiversified exposure.[178] The net effect of hedging by employees on the efficiency of corporate investment decisions would depend on the relative impact of these tradeoffs; the availability and cost-effectiveness of other tools to address these concerns;[179] and the extent and types of hedging used by employees and directors. In particular, the impact of hedging on the incentives of employees and directors may depend on the amount of hedging as well as on the type of hedging transactions used and payoffs provided by the particular instrument.

There is limited research on hedging transactions by corporate insiders. In an effort to understand these incentives, one academic study concludes that there is significant variation in the motivations for the use of derivative transactions for hedging by corporate insiders.[180] However, the study does not find evidence that the use of hedging instruments is associated with significant changes in earnings management, investment policy, including R&D, or company risk, and concludes that the evidence is mixed as to whether these instruments are a contractual response to agency problems, or suboptimal contracts.[181]

1. Effects of the Item 407(i) Disclosure Requirements

Item 407(i) is being adopted to require a company to describe any practices or policies it has adopted regarding the ability of employees or directors of the company to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds), or otherwise engage in transactions that hedge or offset, or are designed to hedge or offset, any decrease in the market value of company equity securities granted to the employee or director by the company as part of the compensation of the employee or director, or held, directly or indirectly, by the employee or director.[182] If the company does not have any such practices or policies, the company must disclose that fact or state that hedging transactions are generally permitted. The rule does not direct companies to have such practices or policies, or dictate the content of any such practices or policies.

Similar to the proposal, and similar to the existing Item 402(b)(2)(xiii), the final amendments do not define the term ''hedge.'' Instead, the final amendments use the term as a broad principle for transactions that hedge or offset, or are designed to hedge or offset, any decrease in the market value of registrant equity securities. Not limiting the disclosure requirement to specific transaction types will enable it to comprehensively capture policies related to those hedging transactions that companies view as relevant in light of their specific circumstances and incentive structures. The final amendments allow for flexibility to address new downside price protection techniques as they develop, providing relevant information to investors, and avoid adopting a definition that could prove either over- or under-inclusive. However, we acknowledge that the principles-based approach could lead to less comparability in the required disclosures across companies.

Generally, information about hedging practices or policies may be relevant for shareholders seeking to assess the equity incentives of employees and directors and the extent of alignment of those incentives with shareholder interests. As is shown in Table 1, such information is not always available to shareholders, particularly for companies not presently subject to Item 402(b)(2)(xiii). Providing this information could help mitigate the information asymmetry between companies and shareholders about the strength of employees' and directors' equity incentives, thus potentially enhancing the ability of shareholders to make fully informed voting and, potentially, investment decisions.

As discussed below, the potential economic effects of the final amendments are expected to vary across companies, depending on the nature and amount of new information contained in the disclosures, whether a company decides to implement or revise hedging policies, the nature of investment opportunities available to the company, and whether employees and directors currently engage in hedging.

The economic effects of the final amendments will likely be smaller for companies that are subject to Item 402(b)(2)(xiii), which requires disclosure of policies regarding hedging by named executive officers, if material.[183] If such companies currently disclose practices or policies regarding hedging by named executive officers, their existing disclosure may satisfy Item 407(i) requirements as to those officers. Companies subject to Item 402(b)(2)(xiii) that do not currently disclose practices or policies regarding hedging by named executive officers (either because they do not have such policies or because their disclosure would not be material), will need to provide new disclosure under Item 407(i). Because investors may already draw inferences about a company's hedging practices or policies regarding named executive officers from the absence of an Item 402(b)(2)(xiii) disclosure, the incremental effects of the Item 407(i) disclosure for investor understanding of hedging practices or policies of such companies as to those

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[177] *See* Proposing Release, at 8498–99, nn. 88–89. *See, e.g.,* Lisa Meulbroek, *Company Stock in Pension Plans: How Costly Is It?,* 48 J. L. & Econ. 443, (2005); Brian J. Hall &Kevin J. Murphy, *Stock Options for Undiversified Executives* 33 J. Acct. & Econ.no. 1, 3–42 (2002) (stating that a large literature has studied the resulting underinvestment concern).

See, e.g., Alfred Rappaport, *Executive Incentives vs. Corporate Growth,* 57 Harv. Bus. Rev. 81–88 (1978); Clifford Smith & Rene Stulz, *The Determinants of Firms' Hedging Policies,* 20 J. Fin. and Quantitative Analysis 391–405 (1985); Robert Kaplan, Advanced Management Accounting, (Prentice-Hall, 1982); and Richard Lambert, *Executive Effort and the Selection of Risky Projects,* 17 RAND J. Econ. 77–88 (1986).

[178] Besides concentrated financial wealth exposure, employees and directors have human capital exposure to the company. Hedging by employees and directors affects the former.

[179] For example, corporate hedging of cash flow risk, or a requirement that executive officers hold stock options, also can strengthen executives' incentives to take on risky but value-enhancing investment projects; however, both can involve costs. *See* Proposing Release, at 8499, n. 91.

[180] *See* J. Carr Bettis, John Bizjak & Swaminathan Kalpathy, *Why Do Insiders Hedge Their Ownership? An Empirical Examination,* 44 Financial Management, 655 (2015). The study also finds that insider derivative transactions are more likely among companies with overvalued equity, higher CEO pay-for-performance sensitivity, and higher insider equity ownership. Given the sample period used in the study (1996–2006), it is not clear if their findings reflect the current situation.

[181] *Id.* We also note that the likelihood of employees and directors using hedging at a particular firm may also be affected by other factors, including firm characteristics, risk preferences and tax circumstances of individual employees and directors, and the specific features of a firm's hedging policy.

[182] *See* Section III, above.

[183] SRCs and EGCs are not subject to Item 402(b). The incremental effects of the final amendments on BDCs depend on whether the BDC currently qualifies as an SRC or EGC and thus whether it is subject to Item 402(b)(2)(xiii). Further, the incremental effects of the amendments are expected to be greater for internally managed BDCs than for BDCs that are externally managed by an investment adviser's portfolio manager because employees of the investment adviser are outside the scope of Item 407(i). Based on staff estimates, among BDCs with a class of securities registered under Section 12, approximately 87.5% are externally managed. However, directors of externally managed BDCs play a role in overseeing the BDC's investment adviser, and policies regarding director hedging are within the scope of Item 407(i).

officers may be small. Further, irrespective of whether companies subject to Item 402(b)(2)(xiii) currently disclose practices or policies regarding hedging by named executive officers, if such companies have practices or policies regarding hedging by other employees or directors, they will be required to disclose such practices or policies under Item 407(i), which will provide additional information to investors. Companies without any practices or policies regarding hedging will be required to disclose that fact or state that hedging transactions are generally permitted.

On the other hand, the incremental economic effects of the final amendments are expected to be larger for Section 12 registrants that have been reporting as SRCs or EGCs. As discussed in Section VI.B above, a relatively smaller proportion of companies that are not subject to Item 402(b)(2)(xiii) presently discloses information about hedging practices or policies. Under the final amendments, such registrants will be required to provide new disclosure about whether they have practices or policies regarding hedging by employees (including officers) and directors.

a. Benefits

Investors may benefit from the disclosures required by the final amendments in several ways.

First, new disclosures provide more clarity and transparency about incentives of employees and directors, thereby potentially reducing the information asymmetry between corporate insiders and shareholders regarding such incentives and promoting more informed voting and, potentially, investment decisions. Although shareholders currently have access to officers' and directors' historical hedging transactions through Section 16(a) reports, those shareholders may not have information about whether officers and directors can engage in hedging in the future.

Several commenters agreed that the required disclosure will enhance transparency and investor understanding of hedging practices.[184] For example, one commenter indicated that the new disclosures will help investors to better understand the incentives of employees (including officers) and directors to improve shareholder value.[185] Another commenter stated that the disclosure of a company's hedging policy may be considered by investors in the course of voting on proposals prohibiting hedging, advisory votes on executive compensation, and director elections.[186]

Second, the final amendments may reduce the costs for investors of researching and analyzing equity-based incentives. While Section 16(a) reports provide transaction-specific information about officer and director hedging, investors may incur costs to search and aggregate information from Forms 3, 4, and 5 and to determine whether a reported transaction constitutes hedging. Information about whether employees and directors are subject to a practice or policy regarding hedging could confirm for investors whether the reported equity holdings of officers and directors represent their actual incentives.

Third, the final amendments may potentially yield indirect benefits for investors if the public nature of the required disclosures leads companies subject to Item 407(i) to adopt changes in hedging practices or policies. If such changes better align the incentives of employees and directors with those of shareholders, such companies may experience an increase in shareholder value. Alternatively, as discussed in Section VI.C.1.b below, if the change in hedging practices or policies reduces incentive alignment, such changes could reduce shareholder wealth. We do not have data by which to be able to assess whether companies will adopt changes in hedging practices or policies, and if so, whether such changes will result in net benefits or costs.

The three types of benefits described above are likely to be most significant with respect to the disclosure practices or policies for executive officers. Some of these types of benefits may also apply to disclosure about practices or policies for directors and non-executive employees, although as discussed below, the benefits may be less pronounced.

Directors may receive equity-based compensation to better align their interests with those of the shareholders they represent.[187] The benefits of disclosure about hedging policies for non-officer directors may be smaller than for officers because non-officer directors generally are less involved in corporate investment decisions than officers. Also, because their exposure to the company as a proportion to their overall wealth is likely to be lower, non-officer directors may be less likely to engage in hedging than officers.[188]

Disclosure of hedging policies regarding employees generally may also benefit investors to the extent that they contribute, individually or as a group, to shareholder value. This potential benefit can be greater in the case of critical non-executive employees (*e.g.,* key research scientists and founding employees), who may have equity stakes or option holdings and whose actions and decisions can also affect the company's stock price, than in the case of those employees who do not participate in making and shaping key operating or strategic decisions to the same extent. While some non-executive employees may receive equity grants as part of the companies' broad-based equity plans, their equity ownership and compensation levels on average are much lower compared to executive

[184] *See, e.g.,* letters from Chris Barnard, CII and Taylor Dove.

[185] *See, e.g.,* letter from Chris Barnard, who also stated that hedged equity exposures do not reflect the economic exposure to actual equity performance.

[186] *See* letter from CII.

[187] 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. However, director incentives are typically smaller than incentives for CEOs. *See* David Yermack, *Remuneration, Retention, and Reputation Incentives for Outside Directors,* 59 J. Fin. 2281–2308(2004); Kathleen Farrell, Geoffrey Friesen & Philip Hersch, *How Do Firms Adjust Director Compensation?,* 14 J. Corp. Fin. 153 (2008); James Linck, Jeffry Netter & Tina Yang, *The Effects and Unintended Consequences of the Sarbanes-Oxley Act on the Supply and Demand for Directors,* Review of Financial Studies 22(8): 3287–3328 (2009); and Viktar Fedaseyeu, James Linck, & Hannes Wagner, *The Determinants of Director Compensation* (J. Corp. Fin. 2014) working paper available at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2335584.*

Although these studies used samples prior to 2011, we have no reason to believe that director incentives and compensation have declined significantly in more recent years. For example, according to a 2017 industry study of ''non-employee director compensation at 300 companies of various sizes and industries,'' equity represented 58% of total director pay across all companies. The share of equity in director compensation was higher at large-cap companies (market cap above $5 billion) (62%) than at mid-cap (market cap of $1–5 billion) (58%) or small-cap (market cap below $1 billion) (54%). Median total director pay in the survey was $150,000 for small-cap, $201,667 for mid-cap, and $274,000 for large-cap companies. *See* Frederic W. Cook & Co., Inc., *Director Compensation Report,* 1, 6 (November 2017) available at *https://www.fwcook.com/content/documents/publications/11-21-17_FWC_2017_Director_Comp_Final.pdf.*

However, directors of listed closed-end funds generally do not receive equity-based compensation. *See* notes 141–142, above.

[188] Average levels of equity pay awarded to non-officer directors are lower than for executives. *Id.*

In addition, most non-officer directors have other sources of income and wealth (*e.g.,* seats on other boards or an officer position at a different company) not tied to the company on whose board they sit. *See, e.g.,* Ronald Masulis & Shawn Mobbs, *Independent Director Incentives: Where Do Talented Directors Spend their Limited Time and Energy*? 111 J. Fin. Econ. 406, 410, Table 1 (2013).

officers.[189] Further, individual rank-and-file employees are unlikely to have a notable impact on the company's equity market value.

Nevertheless, while a decision by a single non-executive employee is unlikely to affect the stock price, the combined actions of non-executive employees motivated by equity incentives may have a significant effect on the company.[190] Several commenters stated that it is important to require disclosure of hedging policies for all employees, asserting that such information is useful, whether or not the employees are officers of the company.[191] However, several other commenters stated that information about hedging below the executive level is not material to shareholders since non-executive employees do not make or shape key operating and strategic decisions that influence the company's stock price.[192] Importantly, the rule requires disclosure of a company's hedging practices or policies but does not require the practices or policies to be the same for officers as for other employees or to cover any category of employees.

While the potential benefits discussed above may apply to investors in all companies subject to the final amendments, the magnitude of the benefits may vary across companies. The potential benefits of the new disclosure could be higher for shareholders of EGCs and SRCs, which are not presently subject to Item 402(b)(2)(xiii) with respect to named executive officer hedging policies and a relatively smaller proportion of such companies presently discloses hedging practices or policies. In turn, investors in companies that currently disclose hedging policies may be unlikely to realize significant additional benefits from the prescribed disclosure or changes in hedging policies as a result of the final amendments.

The potential benefits to investors also will depend on the likelihood that officers and directors engage in hedging transactions. Information about hedging policies may be more relevant to investors in companies for which there are stronger incentives for employees and directors to hedge. The evidence on which types of companies are likely to have stronger incentives to hedge is inconclusive. For example, we expect the benefits of the new disclosure to be higher for shareholders of companies with volatile stock prices and a higher risk of stock price decline because such companies' employees and directors may have relatively stronger incentives to hedge.[193] This category of companies is likely to include EGCs and SRCs because smaller companies have generally been linked to greater distress risk.[194] Additionally, since company age is among the most important predictors of failure, younger companies such as EGCs are more likely to have a higher risk of financial distress.[195] EGCs also tend to have more growth opportunities,[196] riskier cash flows, and fewer financial resources. Some commenters stated that SRCs and EGCs have greater exposure to market risk and that, as a result, officers and directors of these companies may use hedging transactions more often, and therefore the value of hedging policy disclosure to investors in these companies may be greater.[197] However, because it is costlier to hedge the risk of illiquid stocks,[198] officers and directors of these companies may instead be less likely to engage in hedging. Thus, the potential benefits of the new disclosure could instead be lower for investors in smaller companies or those companies not listed on a national securities exchange. Overall, the effects of greater risk and lower liquidity associated with small cap stocks on hedging practices may partly offset one another.[199]

b. Costs

The costs of complying with the final amendments include direct costs of preparing the disclosures they require as well as potential indirect costs.

The costs are expected to be lower for companies that already disclose some of the information that will be required by Item 407(i), most notably for companies subject to Item 402(b)(2)(xiii). As part of the final amendments, we are adding an instruction to Item 402(b) providing that a company may, in certain circumstances, satisfy its CD&A obligation to disclose any material policies on hedging by named executive officers by cross-referencing the information disclosed pursuant to Item 407(i), if the disclosure would satisfy the Item 402(b) requirement. This approach could reduce potentially duplicative disclosure under the existing Item 402(b) requirements and the new Item 407(i) requirements, thereby reducing issuers' cost of compliance with the final amendments.

As discussed above, companies that do not currently provide any hedging

[189] *See, e.g.,* Paul Oyer & Scott Schaefer, *Why Do Some Firms Give Stock Options to All Employees? An Empirical Examination of Alternative Theories,* 76 J. Fin. Econ. 99–133 (2005); Serdar Aldatmaz, Paige Ouimet, & Edward D. Van Wesep, *The Option to Quit: The Effect of Employee Stock Options on Turnover,* 127 J. Fin. Econ. 136–151 (2018); Ehan Kim & Paige Ouimet, *Broad-Based Employee Stock Ownership: Motives and Outcomes,* 69 J. Fin. Econ. 1273–1319 (2014).

[190] *See, e.g.,* Kim and Ouimet (showing that small employee stock ownership plans, comprising less than 5% of shares, granted by companies with moderate employee size, increase productivity and benefit both employees and shareholders but that the effects are weaker when there are too many employees to mitigate free-riding or for large employee stock ownership plans); Xin Chang., Kangkang Fu, Angie Low & Wenrui Zhang, *Non-Executive Employee Stock Options and Corporate Innovation,* 115 J. Fin. Econ. 168 (2015) (showing a positive effect of non-executive employee stock options on corporate innovation, mainly through the risk-taking incentive, rather than the performance-based incentive); Francesco Bova, Kalin Kolev, Jacob Thomas & X. Frank Zhang, *Non-Executive Employee Ownership and Corporate Risk,* 90 Acct. Rev. 115 (2015) (showing a positive effect of non-executive stock options and a negative effect of stock holdings on corporate risk taking).

[191] *See* letters from CII, Florida State Board of Administration and Public Citizen.

[192] *See* letters from ABA, Business Roundtable, Cleary Gottlieb and McDermott.

[193] For example, Bettis, Bizjak, and Kalpathy, find in two out of three specifications in Table 4 of their study a significant positive effect of volatility on the probability of executives using derivatives in the 1996–2006 sample.

[194] *See, e.g.,* Nishad Kapadia, *Tracking Down Distress Risk,* 102 J. Fin. Econ. 167 (2011).

[195] *See, e.g.,* Sarah Lane & Martha Schary, *Understanding the Business Failure Rate,* 9 Contemp. Econ. Pol'y 93 (1991); *See id.*

[196] While EGCs may have higher company-specific risk, be smaller on average, and have more exposure to market risk, as Kapadia notes, growth companies have less exposure to aggregate distress risk than more mature companies, holding constant the effects of size and exposure to market risk.

[197] *See* letters from CII and Florida State Board of Administration.

[198] Officers and directors can hedge by, for example, entering into exchange-traded or over-the-counter derivative contracts. When the underlying stock is illiquid, the price of the derivative contract 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.

[199] To our knowledge, studies have not conclusively determined whether insiders of smaller companies tend to hedge more often. For example, Bettis, Bizjak, and Lemmon (2001) find a total of 87 zero-cost collar transactions, one method of executive hedging, by searching Forms 3, 4 and 5 filed between January 1996 and December 1998. Companies in this sample have total assets with a mean (median) value of $3.4 billion ($401 million). These companies 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 more frequent in smaller companies. *See* J. Carr Bettis, John Bizjak & Michael Lemmon, *Managerial Ownership, Incentive Contracting, and the Use of Zero-Cost Collars and Equity Swaps by Corporate Insiders,* 36 J. Fin. & Quantitative Analysis No. 3, 345 (2001). At the same time, liquidity may also affect the ability to hedge.

Bettis, Bizjak, and Kalpathy (2015) state that ''smaller firms may not have enough market liquidity for investment banks to either structure these instruments or hedge their own risk exposure.'' Table 4 of their study reports a statistically significant positive relation between larger company size and the probability of executives using derivatives, but the effect becomes either statistically insignificant or only significant at the 10% level in specifications incorporating additional covariates.

policy disclosure will incur relatively higher costs of complying with Item 407(i). The costs are expected to be highest for EGCs and SRCs, which are not subject to Item 402(b)(2)(xiii).[200] These companies will incur costs of disclosing the information required by Item 407(i) in proxy or information statements. Some commenters stated that, since EGCs and SRCs are not required to provide CD&A disclosure, they are less likely to have hedging policies in place, and implementation for these companies would impose costs that are disproportionate to the benefits to be obtained.[201] These commenters also stated that the EGCs and SRCs may not have the resources to develop hedging policies or implement compliance programs, which may involve compensation for consultants and legal counsel.[202] We recognize that direct, as well as indirect, costs of the disclosure requirement, which are discussed in detail below, are likely to be greater for EGCs and SRCs. We note, however, that under the final amendments, companies are not required to develop hedging practices or policies and can instead disclose the fact that they do not have practices or policies regarding hedging or state the hedging transactions are generally permitted, which may enable such companies to decrease some of these potential costs (although companies disclosing that they have no practices or policies regarding hedging may still incur some costs).

On average, we expect the direct costs of the final amendments to be relatively modest, and potentially lower than the costs would have been under the proposed amendments, especially because it should be less burdensome to provide clarity as to the scope of the company's practices or policies regarding hedging transactions. As discussed in Section III.A.3 above, in recognition of commenters' concerns about implementation challenges, the final amendments require filers to disclose their practices or policies regarding hedging transactions. To satisfy this obligation, the company will be required either to provide a fair and accurate summary of the practices or policies that apply, including the categories of persons to which they apply and any categories of transactions that are specifically permitted or specifically disallowed, or to disclose the practices or policies in full. If the company does not have any such practices or policies, the company must disclose that fact or state that hedging transactions are generally permitted. By reducing the complexity of the disclosure, this change from the proposal is expected to potentially reduce filer costs of preparing disclosures and investor costs of interpreting these disclosures.

While we cannot quantify these disclosure costs with precision, many of the direct 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, the Commission estimated in the Proposing Release that the amendments would result in an average incremental paperwork burden of three hours per filing of a proxy or information statement in the first three years of the amendments.[203] We did not receive comment on these estimates. However, because the final amendments focus on the disclosure of a company's particular practices or policies regarding hedging, we anticipate that compliance with the final amendments will be easier and more straightforward, resulting in potentially lower compliance burdens. If the company does not have any such practices or policies, the company must disclose that fact or state that hedging transactions are generally permitted. Thus, for purposes of the PRA, the final amendments are expected to result in an average incremental paperwork burden of two hours per proxy or information statement filing in the first year that a filer is subject to the amendments and one hour per filing in subsequent years. This estimate is less than the estimated burdens of the approach in the Proposing Release, which we estimated would have been five hours per filing in the first year that a filer is subject to the amendments and two hours per filing in subsequent years that a filer is subject to the amendments.[204]

Indirect costs may also be incurred by some companies to the extent that companies adopt new, or revise existing, hedging policies in anticipation of complying with the amendments, given the public nature of the disclosure required by Item 407(i). As discussed above, these indirect costs may be greater for companies that do not presently disclose practices or policies regarding hedging. These indirect costs could include potential costs associated with retaining compensation consultants and legal counsel, administering a hedging policy, and changes to the incentive structure within the company that may result from changes to the hedging policy. Several commenters suggested that companies may feel compelled to adopt or modify hedging policies in light of the new disclosure requirement.[205] Such costs will be affected by the scope of hedging policies that companies choose to adopt and by company characteristics. One commenter asserted that limiting the covered persons to executive officers would lower costs and that costs for compliance and enforcement mechanisms for policies that cover all employees would vary based on the size of a company's employee base, the geographic dispersion of employees, and the nature of the company's efforts toward ensuring compliance.[206] Some commenters also indicated that excluding non-executive employees from the scope of the final amendments would lower the burden on companies.[207]

Indirect costs may also be incurred by companies that already have optimal compensation arrangements but that make changes to compensation policies that reduce incentive alignment between shareholders and officers or directors after the final amendments. If changes in hedging policies reduce incentive alignment between shareholders and officers or directors, resulting in underinvestment in potentially value-enhancing projects, they could lead to a reduction in shareholder wealth.

The likelihood that adopting or changing hedging policies will distort the company's investment decisions may depend on the company's growth opportunities. The incentives of officers and directors to make efficient corporate investment decisions may be more important for shareholder value at companies with more growth opportunities, such as EGCs and potentially SRCs. However, the expected effect of hedging restrictions on shareholder value at such companies is unclear. On the one hand, the problem of underinvestment in risky, value-enhancing projects as a result of

[200] Some SRCs would incur relatively lower costs of complying with the Item 407(i) disclosure. In particular, those non-EGCs that were subject to Item 402(b) prior to the 2018 SRC amendments but that newly qualified for SRC status under the amended definition might already have incurred the cost of complying with named executive officer hedging disclosure, if material, in prior years and thus may have systems in place for making such disclosures as to named executive officers, resulting in lower ongoing costs of complying with Item 407(i). *See also* note 159, above.

[201] *See* letters from ABA and SCSGP.

[202] *Id.*

[203] *See* Section VII, below.

[204] *See* Section VII, below.

[205] *See, e.g.,* letters from ABA, Cleary Gottlieb, Davis Polk, McDermott, and SCSGP.

[206] *See* letter from Davis Polk.

[207] *See* letters from ABA, Cleary Gottlieb, Davis Polk, and SCSGP.

excess risk aversion of executives may have a relatively greater impact on firm value at such companies. For instance, one commenter argued that executives of many EGCs and SRCs have a large portion of their personal wealth exposed to their company and therefore will be more negatively affected if they are prohibited from mitigating the exposure of their holdings through hedging.[208] On the other hand, restrictions on hedging could strengthen the alignment of managerial and shareholder incentives by tying executives' wealth more closely to share price. The extent of the potential cost resulting from the distortion of corporate investment incentives also may depend on the likelihood that officers and directors engage in hedging transactions. As discussed above, evidence on executive hedging at small companies is mixed.[209] These factors make it difficult to predict whether small and growth companies, such as SRCs and EGCs, will incur a larger or a smaller indirect cost, should such companies implement hedging policies after the final amendments.

To the extent that the final amendments may lead some companies to implement or revise hedging policies, the rule also could impose costs on affected employees and directors by limiting their ability to achieve optimal portfolio allocations and potentially resulting in a lower risk-adjusted performance of their holdings. In turn, restrictive hedging practices and policies may affect employees' and directors' willingness to work for such companies, which may adversely affect the ability of some companies to attract and retain employees and directors, resulting in potential costs to such companies and their shareholders. The ability or inability to engage in hedging under a company's policy may be taken into account as part of the negotiation of the total level of compensation between companies and employees or directors. It is difficult to determine the relative magnitude of these effects and whether companies will offer higher (lower) compensation in consideration of a restrictive (permissive) hedging policy.[210] This might depend, for instance, on the distribution of the bargaining power between the company and current and prospective employees and directors, as well as on the nature of labor market conditions in a specific industry and with regard to specific occupations and types of employees.

c. Exclusion of Listed Closed-End Funds

In a change from the proposal, after consideration of public comments,[211] the final amendments do not apply to listed closed-end funds.[212] While this change reduces the overall costs of the rule, it may also reduce the overall benefits of the rule due to the potential relevance of information about the alignment of incentives of shareholders and those of employees and directors of closed-end funds.[213] However, we expect that the Item 407(i) disclosure would be less useful for investors in such funds compared to investors in operating companies because closed-end funds, like other registered investment companies, differ from operating companies with respect to management structure, regulatory regime, and disclosure obligations. In particular, almost all funds are externally managed, with portfolio managers generally employed and compensated by the fund's investment adviser. This attenuates the relation between incentives of fund employees and fund performance and makes the disclosure of employee hedging policies less useful for investors.

While the disclosure of hedging policies applicable to directors of listed closed-end funds might potentially be informative, since directors oversee the fund's investment advisers and other service providers, based on evaluating input from commenters,[214] we do not believe that such potential benefits are likely to be significant.

d. Disclosure in Schedule 14C

Similar to the proposal, the final amendments will require Item 407(i) disclosure in Schedule 14C, in addition to Schedule 14A. This was supported by a commenter.[215] Requiring Item 407(i) disclosure in Schedule 14C will extend the economic effects of the amendments to Section 12 registrants 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. While this provision will increase the overall costs of the rule, it also will provide additional information to investors and promote consistency of disclosure requirements in the context of an action authorized by shareholders with respect to the election of directors.

e. Compliance Dates

As discussed above, SRCs and EGCs currently disclose less information about hedging practices or policies than other types of filers. Under the final amendments, registrants will be required to provide disclosure about whether they have practices or policies regarding hedging by employees (including officers) and directors. In a change from the proposal, after considering the concerns of some commenters about the burden of complying with the disclosure requirement for SRCs and EGCs,[216] we are adopting a delayed compliance date for these companies. SRCs and EGCs will be required to comply with the rule for fiscal years beginning on or after July 1, 2020, one year after the compliance date for the remaining filers subject to the final amendments.[217] A delayed compliance date will defer the potential benefits of the final amendments for investors in SRCs and EGCs that choose to utilize the delayed compliance date. However, a delayed compliance date is also expected to defer the costs of the final amendments for such SRCs and EGCs. We expect that deferring the compliance date by one year will allow SRCs and EGCs to observe how Item 407(i) operates in practice for other, larger and more established companies, which may incrementally reduce the costs associated with initially preparing the required disclosure.

2. Efficiency, Competition, and Capital Formation

[208] *See* letter from ABA.

[209] *See* notes 193–199, above, and accompanying text.

[210] *See also* Proposing Release, at 8501 (n. 103 and accompanying text) and 8503 (n. 111 and accompanying text).

[211] *See* letters from ABA, ICI and MFDF.

[212] Similar to the proposal, other types of registered funds, including closed-end funds not listed on an exchange and open-end funds, will remain outside the scope of the Item 407(i) requirement.

[213] *See* Proposing Release, at 8499. *See also* Youchang Wu, Russ Wermers & Josef Zechner, *Managerial Rents vs. Shareholder Value in Delegated Portfolio Management: The Case of Closed-End Funds,* 29 Rev. Fin. Stud. 3428–3470 (2016).

[214] *See* letters from ABA, ICI and MFDF.

[215] *See* letter from ABA dated Oct. 13, 2015.

[216] *See* letters from ABA and SCSGP.

[217] Based on calendar year 2017 data, we estimate that approximately 5,795 companies will be subject to the amendments, of which 2,086 are SRCs under the pre-2018 definition (including 1,349 companies that were not EGCs), 814 additional companies are newly eligible as SRCs under the amended SRC definition (including 567 companies that were not EGCs), and 1,224 are EGCs. In the aggregate, EGCs and SRCs (including companies eligible under the amended definition) are estimated to comprise 54% of the companies subject to the amendments: (1,349 SRCs that are not also EGCs + 567 companies estimated to be eligible as SRCs under the amended definition that are not also EGCs + 1,224 EGCs) = 3,140. 3,140/5,795 = 54%. *See* notes 158–160, above.

As discussed above, the final amendments may make it easier for investors to obtain information about hedging practices and policies. To the extent that the Item 407(i) disclosure yields new information, or makes it easier for investors to obtain information that is relevant for gauging the extent of incentive alignment of employees and directors with the interests of shareholders, the final amendments may facilitate better informed voting decisions. To the extent the disclosure has the ancillary effect of enabling investors to make more informed investment decisions, it may also potentially incrementally improve the efficiency of capital allocation.

The direct disclosure costs incurred by Section 12 registrants to comply with the final amendments are expected to be relatively modest.[218] While such costs may vary across companies and may have a relatively greater impact on smaller companies, after considering public comment, we continue to believe that these costs are unlikely to put any category of companies at a significant competitive disadvantage, as the Commission stated in the Proposing Release.[219] In recognition of the fact that SRCs and EGCs may benefit from observing how Item 407(i) operates in practice for other, larger and more established companies, in a change from the proposal we are adopting a delayed compliance date that provides SRCs and EGCs with an additional year to comply. We expect this accommodation to facilitate compliance with the final amendments for EGCs and SRCs, which would include smaller filers.

However, as discussed above, the effects of the final amendments may vary from company to company. We further recognize that some companies may incur indirect costs if, as a result of the final rule, they choose to implement new, or revise existing, practices or policies regarding hedging by employees and directors, as discussed above. To the extent that any such new or revised practice or policy would restrict corporate insiders from hedging, those insiders could engage in less efficient corporate investment decisions resulting in lower shareholder value, and such changes could potentially lead to additional costs for some companies. However, these potential indirect costs may be limited for some companies that find other means of promoting investment in risky but value-enhancing projects to be cost-effective.[220] After considering commenter input, although we acknowledge that smaller companies may be incrementally more affected by the costs of the new disclosure requirement, we continue to believe, consistent with what the Commission stated in the Proposing Release,[221] that the amendments should not have significant adverse effects on the overall competitiveness of the labor market for employees and directors, competition among U.S. companies or between U.S. companies and FPIs, or the ability of private companies to go public.

3. Reasonable Alternatives

Consistent with the statutory mandate of Section 14(j), and as proposed, the final amendments will require disclosure of hedging practices and policies pertaining to ''any employees (including officers) or directors of the registrant, or any of their designees.'' As an alternative, we considered limiting the required disclosure to hedging practices and policies pertaining to executive officers and directors only. Compared to the final amendments, this alternative could reduce costs for registrants that do not presently disclose practices or policies regarding hedging by non-executive employees. Compared to the final amendments, this alternative could also reduce the amount of information available to shareholders about the incentives of non-executive employees, which may be valuable to some shareholders in gauging the extent of incentive alignment, as supported by several commenters.[222]

As an alternative to requiring Item 407(i) disclosure on Schedule 14C information statements as well as Schedule 14A proxy statements, we considered requiring it only in proxy 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, requiring Item 407(i) disclosure in information statements provides consistency in hedging disclosures between 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 is 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 under this alternative would reduce the benefit of availability of information about hedging policies to shareholders in those cases.

We also considered extending the disclosure requirement to all Form 10–K filings in order to impose consistent disclosure obligations upon all registrants, irrespective of whether they file proxy or information statements. While extending the Item 407(i) requirement to companies that do not solicit proxies or information statements would not result in a more informed evaluation of corporate governance in the context of director elections, this alternative could result in potentially more informed investment decisions. However, this alternative also would increase the disclosure obligations for companies that do not solicit proxies or file information statements.

As another alternative, we considered exempting EGCs and SRCs. As discussed in Section VI.B above, EGCs and SRCs currently are not subject to Item 402(b)(2)(xiii) and a relatively smaller proportion of such companies presently discloses hedging policies. Thus, EGCs and SRCs may incur higher costs of complying with Item 407(i). Providing such companies with an exemption from Item 407(i), as suggested by some commenters,[223] may reduce or defer costs for these entities. However, this alternative would also eliminate the potential benefits to investors in such companies, as suggested by several commenters that did not support an exemption from the proposed requirement for EGCs and SRCs.[224] Because currently a relatively smaller proportion of such companies discloses hedging policies, the potential incremental informational benefits from Item 407(i) are expected to be greater for shareholders of EGCs and SRCs than for shareholders of companies presently subject to Item 402(b).

We have discussed above the tradeoffs associated with excluding listed closed-end funds from the scope of the final amendments, in a change from the proposal.[225] As another alternative, we considered extending the Item 407(i) requirement to open-end registered investment companies. This alternative poses similar tradeoffs. Compared to the final amendments, it would impose costs on these companies. The disclosure also would yield minimal benefits to investors given the distinct regulatory and management structure of such funds. As discussed in the Proposing Release, the benefits are

[218] *See* Section VII, below.

[219] *See* Proposing Release, at 8504.

[220] *See* note 179, above.

[221] *See* Proposing Release, at 8504.

[222] *See* letters from CII, Florida State Board of Administration and Public Citizen.

[223] *See* letters from ABA and SCSGP.

[224] *See* letters from CFA Institute, CII, Florida State Board of Administration and Public Citizen.

[225] *See* Section III.D.3.c.i., above.

expected to be attenuated in cases of mutual funds whose shares do not have a trading market and are redeemed at the NAV; ETFs that trade on the secondary market at prices closest to the NAV; or any open-end fund shares that have a secondary trading market with low liquidity, which increases hedging costs, deterring hedging by employees and directors.[226]

VII. Paperwork Reduction Act

A. Background

Certain provisions of the final amendments contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (the ''PRA'').[227] We published a notice requesting comment on the collection of information requirements in the Proposing Release for the rule amendments, and we submitted these collections of information requirements to the Office of Management and Budget (''OMB'') for review in accordance with the PRA.[228] The titles for the collections 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); and

(3) ''Regulation S–K'' (OMB Control No. 3235–0071).[229]

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. The regulations and schedules 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 final rule will be mandatory for affected companies. Responses to the information collection will not be kept confidential, and there will be no mandatory retention period for the information disclosed.

B. Summary of Information Collections

We are adopting new paragraph (i) to Item 407 of Regulation S–K to implement Section 14(j) of the Exchange Act, as added by Section 955 of the Act. As discussed in more detail above, Item 407(i), as adopted, requires disclosure of the company's practices or policies regarding the ability of employees (including officers) or directors of the company, or their designees, to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) or otherwise engage in transactions that hedge or offset, or are designed to hedge or offset, any decrease in the market value of company equity securities that are granted to them as compensation, or that are held, directly or indirectly, by them. The company will be required either to provide a fair and accurate summary of the practices or policies that apply or to disclose the practices or policies in full. If the company does not have any such practices or policies, it must disclose that fact or state that hedging transactions are generally permitted. Pursuant to the amendments to Item 7 of Schedule 14A, this new disclosure is required in proxy or consent solicitation materials with respect to the election of directors, or information statements in the case of such corporate action authorized by the written consent of security holders.

In addition, to reduce potentially duplicative disclosure between new Item 407(i) and the existing requirement for CD&A under Item 402(b) of Regulation S–K, we are amending 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 new Item 407(i) to the extent that the information disclosed there satisfies this CD&A disclosure requirement.[230] This new instruction, like the new Item 407(i) disclosure requirement, applies to the company's proxy or information statement with respect to the election of directors.

C. Burden and Cost Estimates Related to the Amendments

New Item 407(i) requires 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 thus increases the burden hour and cost estimates for each of those forms. For some filers, this may be mitigated to some extent by a minimal reduction in the burden to prepare their CD&A, as they would be permitted to instead cross reference the disclosure in Item 407(i). The amendment to the CD&A requirement under Item 402(b) would not be applicable to SRCs or EGCs 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. We have taken this amendment into account in our estimates below.

In the Proposing Release, for purposes of the PRA, we estimated 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.[231] We did not receive substantive comments on the PRA that would affect this analysis. 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 new Item 407(i) requires to be disclosed would be readily available to the management of a company because it only requires disclosure of practices or policies they already have but does not direct them to have a practice or policy or dictate the content of such a practice or 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.[232] Since the first year of compliance with the 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.

[226] *See* Proposing Release, at 8504. *See also* letters from ABA, ICI and MFDF.

[227] 44 U.S.C. 3501 *et seq.*

[228] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

[229] 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.

[230] Instruction 6 to Item 402(b).

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

[232] *See* the 2006 Executive Compensation Disclosure Release.

Accordingly, 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.

The final amendments incorporate some changes from the proposal. In particular, the proposal would have required every company to disclose the categories of hedging transactions it permits and those it prohibits, and to specify those categories of persons who are permitted to engage in hedging transactions and those who are not. In contrast, the final amendments require disclosure of a company's practices or policies regarding hedging transactions, including the categories of persons covered and any categories of hedging transactions that are specifically permitted or specifically disallowed. A company will be required either to provide a fair and accurate summary, or to disclose the practices or policies in full. Because we anticipate that this change in emphasis may make compliance easier and more straightforward, we expect it to affect the burden hour and cost estimates per company. Accordingly, we estimate that the amendments will instead increase the burden hour and cost estimates per company by two hours per form in the first year and one hour per form in all subsequent years. As discussed in Section III.D.4.c.ii above, in a change from the proposal, we are providing SRCs and EGCs with an additional year to comply with the amendments. Therefore, we adjust the aggregate annual average burden during the first three years of the amendments to account for the phase-in. Companies eligible for an extended compliance date will incur no burden in the first year of the amendments, two burden hours to prepare each Schedule 14A or Schedule 14C filing in the second year, and one burden hour per filing in the third year, for an average of 1.0 total hour per year over the first three years of the amendments for each Schedule 14A or 14C with respect to the election of directors.[233] Companies that are not eligible for the extended compliance date will incur an average of 1.3 total hours per year over the first three years of the amendments for each Schedule 14A or 14C with respect to the election of directors.[234]

In another change from the proposal, the final rules exclude listed closed-end funds. We anticipate that this change will reduce the number of affected companies from the proposal, and the numbers in the table below reflect that reduction, as well as more recent numbers of affected companies compared with the numbers in the Proposing Release.

We recognize that the burdens may vary among individual companies based on a number of factors, including the size and complexity of their organizations, whether they have adopted practices or policies regarding hedging, and complexity of those practices or policies.

The table below shows the average aggregate compliance burden, in hours and in costs, of the collection of information pursuant to new Item 407(i) of Regulation S–K, in the first three years of compliance with the amendments. 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 new 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 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 2—INCREMENTAL PAPERWORK BURDEN UNDER THE AMENDMENTS AFFECTING SCHEDULES 14A AND 14C—THREE-YEAR AVERAGE COSTS[235]

	Number of responses (A)[236]	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	5,586					
Filers eligible for an extended compliance date[237].	5,586 * 0.54 = 3,016	1.0	3,016	2,262	754	$301,600
Filers not eligible for an extended compliance date.	5,586 * 0.46 = 2,570	1.3	3,341	2,505.75	835.25	334,100
Sch. 14A total	5,586		6,357	4,767.75	1,589.25	635,700
Sch. 14C	569					
Filers eligible for an extended compliance date.	569 * 0.54 = 307	1.0	307.0	230.25	76.75	30,700
Filers not eligible for an extended compliance date.	569 * 0.46 = 262	1.3	340.6	255.45	85.15	34,060
Sch. 14C total	569		647.6	485.7	161.9	64,760
Sch. 14A and Sch. 14C Total	6,155		7,004.6	5,253.45	1,751.15	700,460

[233] (0 + 2 + 1)/3 = 1.0.

[234] (2 + 1 + 1)/3 = 1.3.

[235] Rounding affects totals.

[236] 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.

[237] We estimate that 54% of the filers subject to the amendments will have an additional year to comply. *See* note 217 above. We therefore assume that approximately 46% (100% − 54%) of the filings will be subject to the amendments in the first year. We recognize that filers that receive an additional year to comply may account for a lower or higher proportion of filings than estimated, thus these estimates are approximate.

VIII. Final Regulatory Flexibility Act Analysis

The Commission has prepared the following Final Regulatory Flexibility Analysis in accordance with the Regulatory Flexibility Act.[238] This analysis relates to the adoption of new Item 407(i) of Regulation S–K and related amendments. An Initial Regulatory Flexibility Analysis (''IRFA'') was prepared in accordance with the Regulatory Flexibility Act and included in the Proposing Release.

A. Need for, and Objectives of, the Amendments

The amendments are designed to implement Section 14(j), which was added to the Exchange Act by Section 955 of the Act. A report issued by the Senate Committee on Banking, Housing, and 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.'' [239] Consistent with the mandate in Section 14(j), the amendments will provide transparency to shareholders at the time of an annual meeting, which is when directors are elected, about whether employees or directors may engage in transactions that mitigate or avoid the incentive alignment associated with equity ownership. The need for, and objectives of, the final amendments are discussed in more detail in Sections I through III above.

B. Significant Issues Raised by Public Comments

In the Proposing Release, we requested comments on every aspect of the IRFA, including the number of small entities that would be affected by the proposed amendments, the existence or nature of the potential impact of the proposals on small entities discussed in the analysis, and how to quantify the impact of the proposed amendments. We did not receive any comments explicitly addressing the IRFA. As discussed more fully above in Section III.D.4.b., comments on whether EGCs or SRCs should be subject to the proposed amendments were mixed, with four commenters opposing an exemption from the disclosure obligation for EGCs and SRCs [240] and two commenters recommending exempting them from the new disclosure requirement.[241] While the latter commenters believed that applying the new disclosure requirement to EGCs and SRCs would impose costs that are disproportionate to the benefits to be obtained, other commenters did not expect the new disclosure requirement to impose a significant compliance burden on EGCs and SRCs.[242]

C. Small Entities Subject to the Amendments

The amendments affect some companies that are small entities. The Regulatory Flexibility Act defines ''small entity'' to mean ''small business,'' ''small organization,'' or ''small governmental jurisdiction.'' [243] 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) [244] 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 currently 1,144 companies that qualify as ''small entities'' under the definitions set forth above.[245] We estimate that 876 of these small entities have a class of securities registered under Section 12(b) or 12(g) and therefore will be subject to the amendments. 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.[246] We estimate that there are approximately 26 BDCs that will be subject to the amendments that may be considered small entities.[247] We solicited comment in the Proposing Release on our estimates of the number of small entities affected by the proposed amendments and did not receive any comments on them. However, we have adjusted our estimates to reflect that, unlike the proposed amendments, the final amendments will not apply to listed closed-end funds.

D. Reporting, Recordkeeping and Other Compliance Requirements

The amendments 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 amendments. Specifically, new Item 407(i) requires disclosure of whether the company has adopted any practices or policies regarding the ability of any employee or director of the company or any designee of such employee or director, to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) or otherwise engage in transactions hedge or offset, or are designed to hedge or offset, 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 company will be required either to provide a fair and accurate summary of the practices or policies that apply, or to disclose the practices or policies in full. If the company does not have any such practices or policies, the company must disclose that fact or state that hedging transactions are generally permitted. The amendments do not impose any additional recordkeeping requirements on a company.

The amendments will incrementally increase compliance costs for registrants, although we do not expect these additional costs to be significant. In addition, compliance with the amendments may require the use of professional skills, including legal skills. The amendments are discussed in detail in Section III above. We discuss the economic impact, including the estimated compliance costs and burdens, of the amendments in Sections VI and VII above.

E. Agency Action To Minimize Effect on Small Entities

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 amendments, we considered the following alternatives:

- Establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;

[238] 5 U.S.C. 603.

[239] *See* Senate Report 111–176.

[240] *See* letters from CFA Institute, CII, Florida State Board of Administration and Public Citizen.

[241] *See* letters from ABA and SCSGP.

[242] *See* letters from CFA Institute, CII and Public Citizen.

[243] 5 U.S.C. 601(6).

[244] 17 CFR 240.0–10(a).

[245] This estimate is based on staff analysis of XBRL data submitted by filers, excluding co-registrants, with EDGAR filings of Forms 10–K filed during the calendar year of January 1, 2017 to December 31, 2017.

[246] 17 CFR 270.0–10(a).

[247] This estimate is based on staff analysis of Morningstar data and data submitted by filers on EDGAR that covered the period between April 1, 2018 and June 30, 2018.

• 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 requirements.

In a change from the proposal, the final amendments will require disclosure of any practices or policies adopted by a company regarding employees' or directors' ability to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds), or otherwise engage in transactions that hedge or offset, or are designed 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. By focusing on a company's existing practices or policies, we believe that the final amendments will result in a clearer, more straightforward disclosure standard that will be easier for all companies, especially small entities, to apply. Given the straightforward nature of the new disclosure, we do not believe that it is necessary to further simplify or consolidate the disclosure requirement for small entities.

We have used performance standards in connection with the amendments by requiring disclosure of the practices or policies that a company has adopted regarding hedging. The company will be required either to disclose a fair and accurate summary of the practices or policies or to disclose the practices or policies in full. 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 practice or policy regarding employee and director hedging activities. If the company does not have any such practices or policies, it must disclose that fact or state that hedging transactions are generally permitted.

We considered, but have not adopted, an alternative approach of different compliance or reporting requirements that take into account the resources available to small entities. While we have not adopted different compliance or reporting requirements based on company size, we note that the change in the rule to provide for disclosure of a company's practices or policies should result in reporting that is more tailored to each company's particular circumstances and thus may have a similar effect to this alternative.

Two commenters recommended exempting EGCs and SRCs from the new disclosure requirement, noting that these companies may not have hedging policies in place.[248] We carefully considered these comments but are not exempting small entities from all or part of the amendments. The amendments are intended to provide transparency regarding whether the company has practices or policies regarding the ability of employees, directors, or their designees 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.[249] We believe this transparency will be just as beneficial to shareholders of small companies as to shareholders of larger companies. By increasing transparency regarding these matters, the amendments are designed to improve the quality of information available to all shareholders, thereby promoting informed voting decisions. 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 modest additional compliance costs for issuers although there could be indirect costs for some small entities, depending on their current hedging policies. Overall, we believe that the amendments, as adopted, will elicit disclosure about relevant hedging practices and policies in a manner that is tailored to each company's particular circumstances, so as to avoid creating a significant new burden for small entities.

However, in another change from the proposal, after considering the concerns of some commenters about the burden of complying with the disclosure requirement for SRCs and EGCs,[250] we are adopting a delayed compliance date for these companies. SRCs and EGCs will be required to comply with the rule for fiscal years beginning on or after July 1, 2020, one year after the compliance date for the remaining filers subject to the final amendments. A delayed compliance date will defer the costs of the final amendments for SRCs and EGCs. We expect that a delayed compliance date will allow SRCs and EGCs, which would include smaller filers, to observe how Item 407(i) operates in practice for other, larger and more established companies, which may incrementally reduce the costs associated with initially preparing the required disclosure.

[248] *See* letters from ABA and SCSGP.

[249] *See* Senate Report 111–176.

[250] *See* letters from ABA and SCSGP.

Statutory Authority and Text of the Amendments

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

List of Subjects in 17 CFR Parts 229 and 240

Reporting and recordkeeping requirements, Securities.

Text of the Amendments

For the reasons set out in the preamble, the Commission amends 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, 78l, 78m, 78n, 78n–1, 78o, 78u–5, 78w, 78ll, 78 mm, 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.;* 18 U.S.C. 1350; sec. 953(b), Pub. L. 111–203, 124 Stat. 1904 (2010); and sec. 102(c), Pub. L. 112–106, 126 Stat. 310 (2012).

■ 2. Section 229.402 is amended 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. In proxy or information statements with respect to the election of directors, if the information disclosed pursuant to Item 407(i) would satisfy paragraph (b)(2)(xiii) of this Item, a registrant may refer to the information disclosed pursuant to Item 407(i).

* * * * *

■ 3. Section 229.407 is amended 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:

(1) Describe any practices or policies that the registrant has adopted regarding the ability of 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 hedge or offset, or are designed to hedge or offset, any decrease in the market value of registrant equity securities—

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

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

(2) A description provided pursuant to paragraph (1) shall provide a fair and accurate summary of the practices or policies that apply, including the categories of persons covered, or disclose the practices or policies in full.

(3) A description provided pursuant to paragraph (1) shall also describe any categories of hedging transactions that are specifically permitted and any categories of such transactions specifically disallowed.

(4) If the registrant does not have any such practices or policies regarding hedging, the registrant shall disclose that fact or state that the transactions described in paragraph (1) above are generally permitted.

Instructions to Item 407(i).

1. For purposes of this Item 407(i), ''registrant equity securities'' means those 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) that are issued by the registrant or by any parent or subsidiary of the registrant or any subsidiary of any parent of the registrant.

2. The information required by this Item 407(i) will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange 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, 78l, 78m, 78n, 78n–1, 78o, 78o–4, 78o–10, 78p, 78q, 78q–1, 78s, 78u–5, 78w, 78x, 78ll, 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, 7201 *et seq.;* and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; and Pub. L. 111–203, 939A, 124 Stat. 1887 (2010); and secs. 503 and 602, Pub. L. 112–106, 126 Stat. 326 (2012), unless otherwise noted.

* * * * *

■ 5. Section 240.14a–101 is amended by:

■ a. Revising paragraph (b) of Item 7;

■ b. Removing paragraphs (c) and (d) of Item 7;

■ c. Removing the Instruction to Item 7(e) of Item 7;

■ d. Redesignating paragraph (e) as paragraph (c) of Item 7;

■ e. Redesignating Instruction to Item 7(f) as Instruction to Item 7 and revising it;

■ f. Redesignating paragraph (f) as paragraph (d) of Item 7; and

■ g. Redesignating paragraph (g) as paragraph (e) of Item 7.

The revisions 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.

* * * * *

Dated: December 20, 2018.

By the Commission.

Brent J. Fields,

Secretary.

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