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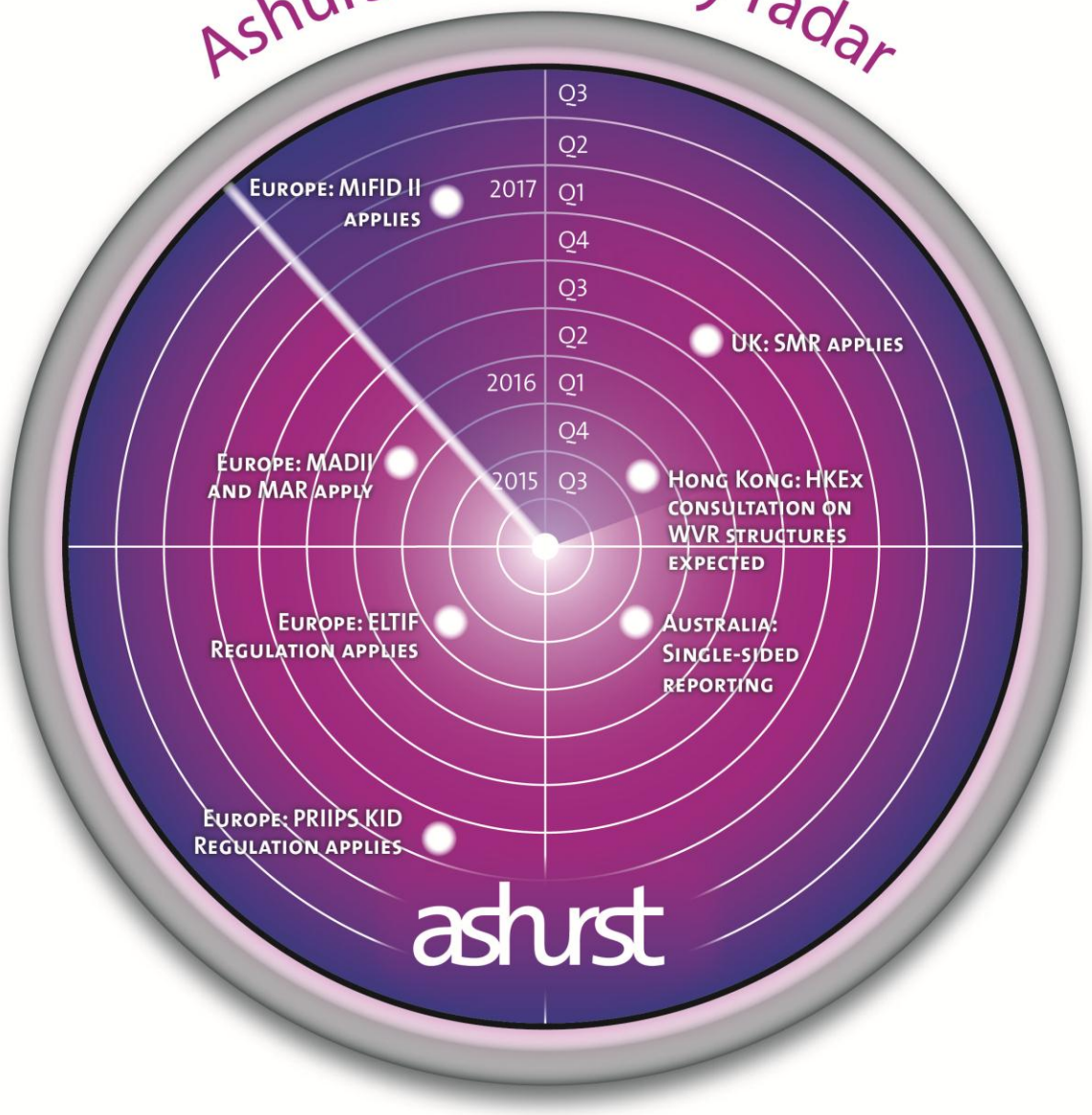
Ashurst regulatory radar



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Foreword

Welcome to the third 2015 edition of the Ashurst Global Regulatory Radar

We have a number of different developments to report in this edition. A trend that we are continuing to see is how international influence affects domestic initiatives. In the UK, the regulator has announced that firms should be looking to the IOSCO principles, despite these being non-binding, to assess how firms deal with financial benchmarks. In Australia and Hong Kong, there is a clear focus on derivative reporting, an issue that has already caused European counterparts much work (and pain) as a result of the EMIR reporting requirements.

Europe has also seen an emphasis on product governance, with publications released in relation to PRIIPs KIDs and new guidelines proposed for retail banking products, both of which reflect the regulator's focus on how manufacturers and distributors communicate with their intended target market.

On the home front, we also have some significant developments of our own. On 1 October 2015 Detmar Loff will join Ashurst's financial services regulatory practice as a partner in our Frankfurt office. Detmar joins from Allen & Overy where he was a counsel advising clients on a broad range of regulatory requirements. In particular, Detmar advises national and international banks, investment services firms and investment managers on their regulatory requirements. He specialises in advising on the implementation of European directives including MiFID II, AIFMD, UCITS, and PRIIPS KID, as well as on the structuring of investment vehicles for institutional investors in relation to the Anlageverordnung (AnlV) and Solvency II directives. His joining strengthens our leading market position in regulatory work and will go a long way to assisting our clients at a time when the regulatory burden is high.

And on that high note, these significant developments give us plenty to digest and we hope you enjoy this serving.




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Singled-sided reporting for Phase 3B reporting entities

With Phase 3B of the derivatives transaction reporting regime in Australia commencing on 12 October 2015, the Australian Treasury has consulted on a long-awaited initiative by the industry to allow for single-sided trade reporting for entities that will report in Phase 3B.

Single-sided reporting is where only one party to an OTC derivative transaction is required to report the transaction under the Derivative Transaction Rules (Reporting) (Reporting Rules). In the absence of single-sided reporting relief, the Reporting Rules require both parties to an OTC derivative transaction to report the transaction.

The single-sided reporting relief will apply to Phase 3 reporting entities whose notional exposures remain below the AU$5bn threshold for two consecutive quarters. This is particularly relevant to the Phase 3B entities, who become subject to the Reporting Rules for the first time on 12 October 2015. Phase 3B entities are those with less than AU$5bn gross notional outstanding OTC derivative positions as at 30 June 2014.

To qualify for the single-sided reporting relief, a Phase 3 reporting entity (which may be a Phase 3A or 3B reporting entity) must have a total gross notional outstanding position of less than AU$5bn, as assessed at the end of each quarter, for two consecutive quarters. Conversely, a reporting entity who qualifies for the relief will only lose the relief if they remain above the AU$5bn threshold for two consecutive quarters.

The basic premise of single-sided reporting is that the counterparty to the transaction is required to report the transaction. The draft regulations therefore contemplate that the relief will apply in three specific scenarios, namely, where the counterparty to the transaction is:

- an entity required to report information about the transaction under the Reporting Rules – e.g. a Phase 1, Phase 2 or Phase 3 entity;
- an entity that is otherwise reporting information about the transaction in accordance with the Reporting Rules; or
- a foreign entity that is relying on the alternative reporting regime provided under the Reporting Rules where the entity reports the relevant transaction to an offshore prescribed repository and "tags" the information reported as information that is taken to also have been reported under the Reporting Rules.

Where an OTC derivative transaction is between two Phase 3 reporting entities, and both would claim to be entitled to rely on the single-sided reporting relief, then the parties will need to agree which of them will report the transaction.

We expect the final form of the regulations will be issued shortly, noting that the relief will commence in October 2015, prior to Phase 3B implementation.

Development on implementation of mandatory clearing

Mandatory clearing of interest rate derivatives denominated in Australian Dollars, US Dollars, Euros, Japanese Yen and British Pounds (the G4 currencies) is imminent, as the Australian Treasury released a draft ministerial determination and ASIC released a draft of the ASIC Derivative Transaction Rules (Clearing) 2015 (Draft Clearing Rules) to give effect to this initiative.

Mandatory clearing is intended only to apply to the financial institutions with the largest OTC derivative exposures. Under the Draft Clearing Rules, the following institutions will be subject to mandatory clearing obligations:

- an Australian authorised deposit-taking institution (ADI) or Australian financial services (AFS) licensee that is incorporated or formed in Australia whose derivatives activities meet or exceed the clearing threshold of AU$100bn or more of total gross

notional outstanding of OTC derivatives for two consecutive quarters (Australian Clearing Entity);

- a registered foreign body under Part 5B.2 of the Corporations Act, that is an ADI, AFS licensee or exempt foreign licensee, and whose derivatives activities meet or exceed the clearing threshold of AU$100bn or more of total gross notional outstanding of OTC derivative positions that are entered into in Australia, or booked to the profit-and-loss account of a branch in Australia, for two consecutive quarters (Foreign Clearing Entity); or
- the entity that is acting in the representative capacity in conducting transactions in relation to a trust or registered scheme (i.e. trustees or responsible entities).

The AU$100bn threshold is calculated for each legal entity (i.e. there is no aggregation of clearing threshold across corporate groups).

The OTC derivatives exposures to be included in the calculations are not just those that are subject to the mandatory clearing requirements – the calculation includes all OTC derivatives (i.e. those that are not traded on a financial market or regulated foreign market).

There are also opt-in provisions available for Australian or foreign entities that do not exceed the relevant AU$100bn threshold.

The four types of "Clearing Derivatives" which are subject to the clearing requirement are fixed-to-floating swaps, basis swaps, forward rate agreements and overnight index swaps. There are also some carve-outs in respect of Clearing Derivatives with features such as optionality, multi-currency or conditional notional principal amount. Only Clearing Derivatives which are denominated in Australian Dollars, US Dollars, Euros, Japanese Yen and British Pounds are the subject of the draft ministerial determination.

It is proposed that the clearing requirements will only apply to transactions in Clearing Derivatives entered into between:

- two Australian Clearing Entities;
- an Australian Clearing Entity and a Foreign Clearing Entity;
- two Foreign Clearing Entities, where a branch of a Foreign Clearing Entity has booked the trade in Australia, entered into the trade in Australia or, if it has opted in to the nexus test, conducted a "nexus derivative" (i.e. based on the location of salespersons or traders performing particular functions in relation to the OTC derivative);
- an Australian Clearing Entity and a "foreign internationally active dealer" (i.e. an entity that is registered or provisionally registered as a swap dealer with the US Commodity Futures Trading Commission or as a security-based swap dealer with US Securities Exchange Commission); and
- a Foreign Clearing Entity and a foreign internationally active dealer, where the Foreign Clearing Entity has booked the trade in Australia, entered into the trade in Australia or, if it has opted in to the nexus test, conducted a nexus derivative.

Clearing must be undertaken by T+1. Exemptions to mandatory clearing also include intra-group transactions and transactions that result from multilateral trade compression.

Similar to the alternative transaction reporting regime, the Draft Clearing Rules also provide alternative clearing where both Clearing Entities (whether Australian or Foreign) can comply with their clearing requirements by clearing in accordance with clearing requirements in a foreign jurisdiction, subject to certain conditions. The conditions to alternative clearing are:

- the Clearing Entity or its counterparty must be subject to clearing requirements in another jurisdiction;
- the foreign clearing requirements must require the relevant derivative transaction to be cleared no later than T+3;
- a clearing entity must ensure the derivative transaction is cleared no later than T+3; and
- a clearing facility used to comply with foreign clearing requirements must be a licensed clearing and settlement facility or a prescribed central counterparty.

The commencement date is currently set to be 4 April 2016, with the clearing threshold calculated as at 30 September 2015 and 31 December 2015.

Consultation on the Draft Clearing Rules closed on 10 July 2015 and we now await the final rules.

Hong Kong

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Proposal by the Hong Kong Stock Exchange for weighted voting rights

In August 2014, the Hong Kong Exchanges and Clearing Limited (HKEx) published a concept paper seeking views on whether governance structures that give certain persons voting power, or other related rights disproportionate to their shareholding (i.e. weighted voting rights (WVR) structures), should be allowed for companies listed or seeking to list on the Hong Kong Stock Exchange. The conclusions of this consultation were published in June 2015.

In 2014, following a highly publicised debate with the Hong Kong Stock Exchange, Alibaba Group Holding Limited (Alibaba), the People's Republic of China's e-commerce giant, decided to list on the New York Stock Exchange (NYSE) instead of the Hong Kong Stock Exchange. The debate with the Hong Kong Stock Exchange had centred on Alibaba's proposed partnership structure. This structure would give the founder and senior management as a group an absolute right to nominate a majority of the members of Alibaba's board of directors, regardless of those individuals' combined equity ownership of Alibaba. The Hong Kong Stock Exchange rejected this structure, and Alibaba found a more accommodating alternative venue in the NYSE.

Under the Rule 8.11 of the Rules Governing the Listing of Securities on the Hong Kong Stock Exchange (the Listing Rules), a company can list on the Hong Kong Stock Exchange only if its shares have a voting power that has a reasonable relationship to the equity of those shares; what is usually referred to as a "one vote per share" structure.

On the NYSE, however, it is possible for companies to list with dual classes of common equity. The NYSE therefore permits one class of shares in a company (such as those held by founders or management) to have "super" voting power, while another class of shares enjoy only one vote per share in shareholder vote.

Market reaction to the concept paper would be best described as mixed. The Securities and Futures Commission (SFC), the Hong Kong Stock Exchange's regulator, published an objection statement to the concept paper, voicing its main concerns that:

- although it was proposed that eligible applicants for WVR structures should be required to have a very high expected market capitalisation, the SFC was concerned that this offers no reassurance that the applicant would treat its shareholders fairly. In fact, the SFC argued, any corporate misconduct by such companies would be likely to affect a large number of investors and so have a greater impact on Hong Kong's markets;
- the concept paper proposed that regulators should be required to assess applicants' compliance with a set of "enhanced suitability criteria". The SFC was concerned that this would give rise to regulatory uncertainty and could result in inconsistent and unfair decision-making; and
- Hong Kong's securities and market and reputation would be harmed if WVR structures became commonplace, and it was insufficient to permit these structures only for new listing applicants, as companies could circumvent the rules through corporate restructuring or arrangements such as spin-offs and asset transfers. Moreover, it was concerned that it was inadequate simply to control the number of listed companies with WVR structures, as the potential impact of acquisitions of existing listed assets by these companies also needs to be addressed (i.e. post-listing transactions).

On the other hand, the HKEx reported that law firms, accountants, sponsors, banks and listed company staff overwhelmingly supported the use of WVR in some circumstances.

Based on responses to its concept paper, the HKEx has concluded that the market is receptive to its proposed changes to the Listing Rules but that the use of WVR structures should be restricted to new applicants only to avoid undermining the relative value and voting power of existing shareholders in existing listed companies. It has also suggested that the use of WVR structures should not be restricted to particular

industries or "innovative" companies since classification based on industry would be challenging. Instead, it proposes that the Hong Kong Stock Exchange should be given the power to decide which companies with WVR structures should be listed, with restrictions imposed on these companies in order to mitigate the heightened investor protection risk. In order to allow these companies to list, changes to the Listing Rules and Takeover Code are expected to be needed.

The HKEx also concluded that although it is unreasonable to limit the form of WVR structure permitted, structures which confer WVR through multiple classes of shares (i.e. voting rights varying by share class) can be more easily accommodated within the current legal and regulatory framework in Hong Kong and should be the preferred method of introducing WVR structures.

The HKEx is in the process of refining its draft proposal with a view to publishing a second stage formal consultation. The following issues are expected to be discussed in the draft proposal:

- ring-fencing measures to prevent existing listed companies from listing as WVR vehicles through re-corporation, restructuring, spin-offs or reverse takeovers, etc;
- safeguards such as strengthening the role of independent non-executive directors and amendments to the existing Listing Rules to avoid controlling shareholders extracting private benefits at the expense of minority shareholders;
- additional corporate governance measures, such as the establishment of a Corporate Governance Committee and enhanced disclosure requirement for these listed companies with WVR structures;
- the possibility of giving greater flexibility to secondary listed companies in relation to their WVR structures (provided their primary listing is subject to credible regulatory standards); and
- limited waiver from the current "centre of gravity" test which generally prevents secondary listing of companies that have "centre of gravity" in Greater China.

A formal consultation by HKEx on its draft proposals is expected to commence in the third quarter or early in the fourth quarter of 2015.

Mandatory reporting under the Hong Kong OTC derivatives regime

In April 2014, the Securities and Futures (Amendment) Ordinance 2014 (Amendment Ordinance) was enacted to establish a statutory framework for the regulation of the OTC derivatives market in Hong Kong. In July 2014, the Hong Kong Monetary Authority (HKMA) and the SFC issued a joint public consultation paper on the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules (Reporting Rules), setting out their proposals for the mandatory reporting of OTC derivatives.

The Reporting Rules came into effect on 10 July 2015, introducing mandatory reporting obligations for certain firms in Hong Kong. The key features of the Reporting Rules are outlined below.

The reporting obligations will be implemented in phases. In the initial phase (which commenced on 10 July 2015), the reporting requirements apply to:

- authorised institutions (AIs);
- approved money brokers (AMBs);
- licensed corporations (LCs); and
- recognised clearing houses (RCHs) acting as central counterparty (CCP) under section 37 of the Securities and Futures Ordinance (SFO) (together, Reporting Entities).

Firms authorised under section 95 of the SFO to provide automated trading services and who act in their capacity as CCP (ATC-CCP) and other firms will be subject to the reporting requirement in a later phase, which is yet to be announced.

Only OTC derivative transactions in "specified product types", as set out in Part 3 of Schedule 1 of the Reporting Rules, are required to be reported. In the initial phase, the products classes that are required to be reported are: (i) interest rate swaps; and (ii) non-deliverable forwards, as defined in Part 1 of Schedule 1 of the Reporting Rules.

Other types of OTC derivatives are likely to be specified for reporting by HKMA and SFC at a later date. The SFC has indicated that they are likely to consult with the market on the reporting of other types of OTC derivatives in late Q2 or early Q3 of 2015. A consultation on the reporting obligations in respect of dealer-to-dealer transactions is also expected to be conducted in late 2015.

Reporting Entities are required to report all reportable transactions to which they are a counterparty. For an AI incorporated overseas, the transaction is reportable when booked in Hong Kong and, for an ATC-CCP, where the counterparty to the transaction is a Hong Kong incorporated entity.

AIs, AMBs and LCs are **also** required to report a transaction when the transaction is conducted in Hong Kong either: (i) on behalf of an affiliate; or (ii) on behalf of their head offices or their branch/office outside Hong Kong (in the case of a Hong Kong branch of an overseas incorporated AI).

AIs, AMBs and LCs may be exempt from the reporting obligations if they maintain small positions in the transactions, subject to certain criteria. For example, they will be exempt if the notional amounts of all outstanding OTC derivative transactions within a specified product class does not exceed US$30m at any time.

Generally, a transaction must be reported within two business days after the transaction is executed. The Reporting Rules provide for a "concession period", which is a six-month period from the date on which a product type is specified for reporting (Effective Date), and which is intended to give Reporting Entities time to set up or upgrade their internal reporting system.

Transactions executed after the concession period must be reported within two business days after the transaction is executed. Transactions that are outstanding at the Effective Date (i.e. transactions entered into before the date on which a product type is specified for reporting) or which are entered into during the concession period, must be reported within nine months from the Effective Date (Grace Period). However, transactions that have matured or are terminated within the Grace Period are not required to be reported.

After the initial report, any "subsequent events", namely events that occur after the transaction has been executed, such as changes to the notional amount, rate or counterparty, etc, or reporting errors, must also be reported.

The information required to be reported is set out in the HKTR Reporting Manual. This information includes (among other matters) the product class and product type to which the transaction belongs and the particulars of the transaction, counterparty and any subsequent events.

Notably, when a transaction involves a counterparty in another jurisdiction and the jurisdiction prohibits the identification of the counterparty's particulars or requires the consent of the counterparty for disclosure, the counterparty's particulars can be "masked" for reporting purposes. The SFC has issued a list of 18 designated jurisdictions for which masking relief applies, including the People's Republic of China and Indonesia.

The reporting obligations under the Reporting Rules are likely to be onerous and Reporting Entities must ensure that they are fully prepared to meet them. Failure to comply with the reporting obligations is treated seriously. The HKMA and the SFC may take disciplinary actions against the Reporting Entities or apply to the Court of First Instance, which may impose a fine of up to HK$5m, if satisfied that there is no reasonable excuse for the breach of the Reporting Rules.

Licensed banks have been reporting some of their OTC derivative transactions under interim reporting requirements imposed by the HKMA in 2013. The HKMA has indicated that such banks should already have had their reporting systems ready, but they would still need to transition from the interim regime to the reporting obligations under the Reporting Rules.

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Proposed amendment of Act on Protection of Personal Information in Japan

On 21 May 2015, the bill to amend the Act on the Protection of Personal Information (Act No. 57 of 2003, as amended) (the Bill) (the original Act was referred to as the APPI) was passed at the House of Representative (the House of Counsel has not yet begun to discuss the Bill). The Bill makes some significant changes to the current framework of the APPI. These include:

- Expansion of entities required to comply with APPI to foreign entities that obtain the personal information of a person in Japan through its sale of goods or services to a person in Japan. Small business operators that handle the personal information of 5,000 or fewer individuals are exempt from the requirement.
- Expansion of the definition of personal information – this now includes the letters, numbers, symbols or any other codes converting physical characteristics of specific individuals, or the letters, numbers, symbols or any other codes related to services or products provided to individuals, or those described in the card or other documents to be issued to individuals or recorded in the electronic device.

- Establishment of the Personal Information Protection Commission as the independent administrative commission – this will act as the supervisory authority as well as set the rules.
- Establishment of the framework required to store, use and provide a third party with big data, i.e. the Anonymised Information without the need to obtain prior consent from the individual. The Bill defines Anonymised Information as personal information which is processed but which cannot be used to identify a specific individual. The framework sets out the procedure to create the Anonymised Information. The act of identifying the individual in the Anonymised Information by collating other information is prohibited.
- Measures to strengthen the protection of personal information, including:
  - strengthening the treatment of sensitive information, such as information relating to race, creed, social status, medical history or past criminal record; and
  - a ban on business operators handling personal information from: (i) obtaining the sensitive information without prior consent; or (ii) providing the sensitive information to third parties by the opt-out arrangement.
- Changes to record-keeping requirements to ensure the traceability of personal data transfer, which will require the business operator handling the personal information to record information related to the provision and the receipt of the personal data.

Although the current APPI lacks the provision for the transfer of the personal data to foreign regulators, the Bill provides a legal basis for the Commission to deliver information to a foreign enforcement organisation if the requirements set out in Article 78 of the amended APPI are satisfied.

Furthermore, the Bill prescribes certain conditions which must be fulfilled before the business operator can transfer personal information globally. Extraterritorial transfer can only take place where: (i) the personal data is transferred to a jurisdiction that has been certified as having equivalent data protection standards to those of Japan; (ii) the personal data is transferred to a third party outside Japan which has been certified to have the same safety control measures as those taken by the Japanese business operators handling personal information under the APPI; or (iii) the individual whose personal information is transferred to a third party gives prior consent to the extraterritorial transfer of the information.

One issue that remains under negotiation is whether the APPI will satisfy the EU data protection directive requirement for adequate protection. While this issue is still under discussion, it is anticipated that the amended APPI would struggle to be assessed as an adequate level of protection because the current degree of independence of the Committee is not enough to fulfil the EU directive requirements.

Europe

EU

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ESAs Technical Discussion Paper on PRIIPS KID

On 23 June 2015, the Joint Committee of the European Supervisory Authorities – EBA, EIOPA and ESMA (the ESAs) – published a Technical Discussion Paper on risk, performance scenarios and cost disclosures for Key Information Documents for Packaged Retail and Insurance-based Investment Products. The objective of the PRIIPS KID regulation is to create a standardised short form (maximum three pages) document for investors to be able to compare and contrast different PRIIPs products.

The ESAs issued a first Discussion Paper in November 2014 seeking views on how these standardised KIDs should be developed. This Technical Discussion Paper does not provide full feedback on the responses to the first Discussion Paper, but includes some feedback on the areas of risk and reward and costs that the first Discussion Paper addressed. A number of different methodological options are identified for each element of disclosure.

Risk and reward

As set out in its first Discussion Paper, the ESAs consider that there are three risks to be considered in the risk indicator: market, credit and liquidity risk. Four approaches for risk indicators are considered as viable.

- Qualitatively based indicator – this combines credit and market risk, complemented by a quantitative market risk measure.
- Indicator which separates market risk and credit risk – market risk in this indicator is assessed by a quantitative volatility measure and credit risk is assessed by a qualitative external credit rating.
- Indicator based on quantitative market and credit risk measures – this is calculated by using forward-looking simulation models.
- Two-level indicator – here, the first level roughly separates products based on their qualitative characteristics and the second level specifies the risk based on a quantitative assessment.

Another four approaches are highlighted for performance scenarios:

- Let the manufacturer of a PRIIP decide which scenarios to present in the KID (the so-called "manufacturer choice").
- Prescriptive rules on which scenarios should be included in the KID.
- Outcome probabilities (taking into account the scenario selection).
- A combination of the above.

Costs
The aim of the costs section is to identify the different types of costs of the different types of PRIIPs (in particular funds, structured products and life insurance products) and identify the specific issues related to the calculation of some of these costs (e.g. transaction costs and performance fees, notably in the case of funds, or costs related to biometric risk premium in the case of life insurance products). The Technical Discussion Paper assesses the different ways of aggregating these costs, including the possible definitions of the overall cost ratio (summary cost indicator), and the possible ways of calculating the cumulative effect of costs.

Two main possible approaches for aggregating the costs of the different types of PRIIPs are presented: total cost ratio and reduction in yield.

Total cost ratio
This means that the costs of operating a PRIIP are aggregated and presented as an annual percentage rate on the investment. Specific issues related to the TCR in the case of different types of PRIIPs are examined in the Technical Discussion Paper (e.g. the most appropriate definition of the denominator of this ratio) and the extent to which the principles that govern the use of the ongoing charges figure of UCITS could apply to the TCR if applied to the different types of PRIIPs.

Reduction in yield
This is a method for expressing the overall impact of costs in terms of their negative impact on a notional "gross" yield for a product. It is currently implemented in different national markets, and notably in the case of life insurance products.

The discussion on performance indicators in the Technical Discussion Paper illustrates the extremely thorny issue that the regulators have of needing to produce rules for such a diverse range of products. For more information, please see our Ashurst briefing here.

ESMA Advice and Opinion on AIFMD passports and national private placement regimes

On 30 July 2015, ESMA published its delayed Advice and Opinion to the European Commission, Council and Parliament on certain aspects of the Alternative Investment Fund Managers Directive (AIFMD).

The Opinion relates to the passporting of EU AIFs (by EU AIFMs) and the respective national private placement regimes (NPPRs); and the Advice relates to the passporting of non-EU AIFMs and AIFs into the European Union. The Advice and Opinion, which were both required from ESMA under Article 67(1) AIFMD, will now be considered by the European Commission, Parliament and Council.

The AIFMD makes provision for the passport – which is currently limited to EU AIFMs with EU AIFs – to be potentially extended. In its Advice, ESMA has considered an extension to six non-EU countries: Guernsey, Hong Kong, Jersey, Switzerland, Singapore and the US. ESMA considers that the passport regime should be extended to Guernsey, Jersey and Switzerland, but not (currently) the others. This makes a US passport look like a very distant prospect.

In its Opinion, ESMA says that it believes that the NPPRs and passport regime have not raised any major issues, although they do not go as far as to say that they are working well. Importantly, ESMA believes that it is difficult to give an opinion on the functioning of the passport and NPPRs in such a short time-frame, and believes that a more considered opinion should be given after a longer period of implementation. ESMA has said that it will go on to look at a number of issues that have been raised by respondents to its request for feedback. Key among these are:

- Fees levied under AIFMD by different Member States are likely to be harmonised and set by ESMA. This is likely to be good for funds marketed in the expensive countries but bad for funds marketed where it is free.
- Gold-plating requirements in some Member States, such as France's centralising agent (which has since been removed and is discussed below), will likely be held invalid. We called this early on so it doesn't come as a surprise.
- Guidance is likely to be given to harmonise Member States' interpretation of what amounts to marketing as well as the professional investor passport. This will remove the issue surrounding when marketing notifications must be made and will be a welcome relief to managers.
- Guidance is also likely to be given in relation to what constitutes a "material change" which requires notification under AIFMD. At present, there is divergent approaches taken in different Member States which can make it difficult for fund managers who are active across Europe.

EBA final guidelines on product oversight and governance arrangements for retail banking products

On 15 July 2015, the EBA published its final report setting out guidelines on product oversight and governance arrangements for retail banking products. There are 12 guidelines in total, eight aimed at manufacturers and four aimed at distributors. National regulators have two months from the date of publication of the guidelines to state whether they intend to comply or explain. The guidelines are a good illustration of regulatory creep in Europe, as we have seen very similar guidelines for structured products, and now the EBA has turned its attention to retail banking products.

The retail banking products which are included in the guidelines are: mortgages; deposits; payment accounts; payment services; payment instruments; e-money; and other forms of credit for consumers. In summary, the guidelines state that:

For manufacturers

- Establishment, proportionality, review and documentation – Manufacturers should establish, implement and review effective product oversight and governance arrangements, which should be updated regularly, to ensure that the interests, objectives and characteristics of consumers are taken into account, to avoid consumer detriment and to minimise conflicts of interest. The arrangements should be proportionate to the nature, scale and complexity of the business.
- Manufacturers' internal control functions – The manufacturers' product oversight and governance arrangements should be integral to the firms' governance, risk management and internal control framework and endorsed by management. Senior management should be responsible for continued internal compliance with support from compliance and risk management (whose responsibilities in this area should form part of their normal line of duties).
- Target market – Manufacturers should include steps to be followed to identify and update the target market for a product. The manufacturer should consider how the product fits within its existing product range and whether too many variants prevents the customer making an informed decision.
- Product testing – Before a new product is brought to market or an existing product is significantly changed, the manufacturer should conduct product testing to assess how the product will affect its consumers under a wide range of scenarios (including stressed scenarios).
- Product monitoring – The manufacturer must monitor the product on an ongoing basis to ensure the interests and characteristics of the consumers are taken into account.
- Remedial action – Manufacturers should take action to mitigate a situation if a problem is identified or to prevent a reoccurrence of a detriment, which should include promptly notifying the distributor of changes to existing products and any additional actions.
- Distribution channels – Manufacturers should select distribution channels that are appropriate for the target market and distributors that have the appropriate knowledge, expertise and capability to correctly place each product.
- Information for distributors – Manufacturers should provide the distributor with a description of the main characteristics of the product, its risks, any limitations, and the total price of the product (including fees, charges and expenses), to enable the distributor to understand and place the product properly on the market and recognise the target market for which the product is designed.

For distributors

- Establishment, proportionality, review and documentation – The distributor should establish, implement and review effect product oversight and governance arrangements (which are reviewed regularly and adequately documented) to ensure

that the interests, objectives and characteristics of consumers are taken into account, to avoid consumer detriment and minimise conflicts of interest.

- Distributors' governance – The distributor should ensure its product oversight and governance arrangements are an integral part of its general systems and control, which are endorsed by the management body.
- Knowledge of the target market – The distributor should use the information provided by the manufacturer and have relevant knowledge and the ability to determine whether a consumer belongs to a target market.
- Information and support for the manufacturers' arrangements – The distributor should take into account the information provided by the manufacturer and disclose to the consumer a description of the main characteristics of the product. Sales to consumers who are not part of the target market should be on a justified basis only and the distributor should be able to provide information to the manufacturer on why it was justified. The distributor should collect information to permit the manufacturer to decide whether the product meets the interests, objectives and characteristics of the target market. The distributor should also notify the manufacturer promptly of any problems it identifies in the product features, product information or target market.

France

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Marketing of AIFs in France via the EU passport no longer requires a centralising correspondent

The initial implementation of the AIMFD in France contained gold-plating provisions in respect of the marketing of AIFs through the EU passport, which were included in the General Regulation of the French Autorité des Marchés Financiers (AMF). The French provisions stated that AIFMs wishing to market a non-French AIF into France (including via a passport when available) needed to appoint a centralising correspondent (*correspondant centralisateur*) before being able to carry out such marketing.

This requirement was heavily criticised; it was considered a hurdle to the efficient functioning of the European marketing passport under the AIFMD.

The AMF General Regulation has been amended to delete this requirement when EU AIFMs market EU AIFs to professional clients in France through the "passport" implemented by the AIFMD.

The requirement to appoint a centralising correspondent is, however, maintained in the following cases (which relate to the situations where, for the time being, the EU passport is not available):

- marketing of non-French EU or non-EU AIFs to retail clients in France;
- marketing of non-EU AIFs in France; and
- marketing of EU or non-EU AIFs by non-EU AIFMs in France.

The AMF has also adapted other regulatory guidance relating to the marketing of AIFs in France in order to reflect this amendment. This is a significant improvement in the procedure governing the marketing of AIFs in France through the EU "passport".

New obligations on portfolio managers

The AMF has recently amended its Position no. 2007-21 on the obligations of portfolio managers towards non-professional clients. The purpose of these amendments is to improve the protection of non-professional clients by imposing upon individual portfolio managers certain obligations that apply to fund managers, and adding some further obligations when portfolios are invested in securities which are not admitted to trading on a regulated market.

In this Position, the AMF recommends:

- the presentation of the return/risk profile in a certain form by the portfolio manager prior to the signing of the portfolio management agreement;
- the enhancement of the readability of the risk profile (for example, by using such titles as "prudent profile" in an appropriate manner);
- the improvement of the assessment of the performance of the portfolio (for example, by introducing a systematic comparison of the portfolio's performance with a benchmark); and
- a strict definition of outperformance commissions by ensuring that they comply with certain conditions.

The AMF also provides for some further obligations in relation to portfolio management agreements entered

into with non-professional clients when portfolios are invested in securities which are not admitted to trading on a regulated market. Such obligations aim to enhance the transparency vis-à-vis the clients and relate in particular to:

- the marketing materials used to promote such portfolio management activities;
- the fees paid to the portfolio manager;
- the situations of conflict of interest;
- the valuation of financial instruments held in the portfolio; and
- information to be provided by the portfolio manager on the investments in preference shares.

Public consultation on the implementation of the Transparency Directive in France

A public consultation has been launched by the AMF on the amendments to be made to the AMF General Regulation for the proper implementation in France of the revised Directive (EU) 2013/50 (Transparency Directive).

The public consultation relates to:

- the information to be disclosed by the issuers, in particular with respect to the quarterly information and the publication timeline for the half-yearly financial reports; and
- the clarification of certain concepts of the Transparency Directive and in particular of the definitions of "home Member State" and "issuer".

The implementation of the Transparency Directive in France will continue to be carried out during the coming months through an ordinance *(ordonnance*) to be taken by the French Government, which will implement the provisions of the Transparency Directive relating to the sanctions and the shareholding disclosure requirements.

The AMF suggests that the implementation of the Transparency Directive in France should be done in a timely manner, by 27 November 2015.

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Spain concludes the transposition of Basel III

Last May, the Royal Decree 358/2015 on Investment Firms, which also partly modifies the Spanish regulation on UCITS, entered into force. This Royal Decree completes, within the Spanish Investment Firms regime, the transposition of the Basel III Directive in Spain.

The most significant amendments to the original regime are made in the field of corporate governance, where many of the requirements previously imposed on the board of directors of the credit institutions (such as professional integrity, knowledge and good corporate governance) is required from managers of the investment firms. This new Royal Decree also reduces the minimum capital requirements needed for incorporation, meaning that broker-dealers need €730,000, brokers €125,000 and portfolio management companies €50,000.

With regard to solvency, some aspects relating to the systems, procedures and mechanisms for risk management and capital buffers are also now in place.

Ban on Spanish intraday short-selling operations

On 16 June 2015, the Spanish National Securities Market Commission (CNMV) published a very significant communication regarding the interpretation of article 12 of Regulation (EU) Nº 236/2012 of the European Parliament and of the Council of 14 March 2012, on short-selling and certain aspects of credit default swaps.

The CNMV has stated that short-selling transactions which are not compliant with article 12, including those executed on an intraday basis and even where the settlement is justified as a result of the acquisition by the short seller of the relevant shares later in the current trading day, will be considered an infringement of article 12.

New Spanish Law on the recovery and resolution of Credit Institutions and Investment Firms

Due to the transposition of the Directive 2014/59/UE (commonly known as the Bank Recovery and Resolution Directive) on 18 June, this new law has come into force in Spain. It creates a specific framework with regard to the recovery and resolution of certain Credit Institutions and Investment Firms.

It aims to protect the stability of the Spanish financial system by giving the public authorities power to act in the event that certain large financial institutions face financial difficulties that may affect the banking stability. The bail-in procedure deserves a special mention; this procedure implements a new scheme that involves an absorption by the shareholders and the creditors of the future losses, and making it less likely that there is recourse to the taxpayer in such a situation. The main goal of the BRRD is to internalise the cost of the resolution within the financial entity, meaning that the creditors would know for themselves at an earlier stage the impact of the entity's insolvency.

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The SFSA issues a warning to Nordea Bank AB (publ) and a fine of SEK50m for insufficient efforts against money laundering

On 19 May 2015, the Swedish Financial Supervisory Authority (SFSA) issued a warning and ordered Nordea Bank AB (publ) (Nordea or the bank) to pay a fine in the maximum amount SEK50m for insufficient efforts against money laundering.

At the end of 2009, the SFSA noted that Nordea's compliance function did not act in accordance with the money laundering laws. The bank made improvements and the SFSA accepted the measures being taken. However, during 2012, the SFSA investigated Nordea again, this time for insufficient fulfilment of the European Union's sanction statutes. The SFSA also investigated a specific case of the bank's anti-money laundering and financing of terrorism function. The SFSA found that the bank had an unsatisfactory internal management and control. Moreover, the bank had failed to fulfil its obligations when it froze 58 transactions without reporting it to the SFSA, contrary to the sanction statutes. SFSA decided to give the bank a warning and to issue a fine of SEK30m.

In 2015, a further investigation exposed major flaws. This time, the SFSA investigated Nordea's fulfilment of the money laundering and financing of terrorism laws and the bank's internal management and control. The SFSA examined records for customers who were resident abroad, namely politically exposed persons, correspondent bank connections, private banking customers and legal entities with fiscal domicile outside the Nordic countries. The SFSA reached the conclusion that the bank, during several years, had been gravely unsuccessful in its efforts against money laundering and financing of terrorism. The bank had not assessed the risk of different customer groups and in some cases had no knowledge of high risk customers. Nordea did not have sufficient control over these customers or their transactions. Moreover, the bank had not performed basic controls of these customers and/or followed up the information given. This enabled money laundering or financing of terrorism. The SFSA found this to be a serious breach.

The SFSA found that these breaches occurred systematically and that they were serious enough to warrant Nordea's bank licence being revoked. Nonetheless, the SFSA found that a warning and a fine of SEK50m was sufficient.

Development of SPIS risk indicator

The self-regulatory industry body Strukturerade Placeringar I Sverige, better known as "SPIS", has for some time been under pressure from the Swedish FSA to develop better methods to convey the essential risk/reward profile of structured products being offered to retail investors in Sweden. As a result SPIS has developed its own risk indicator. This project has been undertaken and launched notwithstanding the implementation of the PRIIPS KID Regulation in 2016 which will include a prescribed format for the risk/reward indicator.

SPIS' members (i.e. the local distributors and local product providers) will be required to provide the prescribed risk indicators in their marketing materials for each structured product offered to the public in Sweden. Under the SPIS proposals, the risk indicator information will consist of the following:

- a figure from 1-7 (low to high) reflecting the market risk inherent in the relevant product if held to maturity;

- a figure from 1-7 (again low to high, but only shown as the relevant figure) reflecting the market risk in stressed scenarios; and
- a designation of the credit risk using credit ratings from Standard & Poor's or Moody's.

The calculation methodology is intended to reflect the maximum potential loss at maturity in 99% level of confidence as calculated by using a Monte Carlo based model.

The use of the risk indicators will be mandatory for SPIS' members from 31 October 2015. However, we have recently seen a sizeable portion of the SPIS' members launching the risk indicators on a voluntary basis in their marketing materials for recent public offers of products.

Some work appears to be continuing, e.g. the applicability of the risk indicators to credit-linked products (i.e. the credit risk not associated with the issuer of the structured product), and some practical issues will need to be addressed in the implementation, e.g. where the issuer has no rating but a guarantor does.

The pressure applied by the Swedish FSA is indicative of the regulatory focus on marketing literature in addition to the disclosures required under the Prospectus Directive.

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FCA thematic review on financial benchmarks

The FCA's continued focus on benchmarks has again been illustrated with the publication on 29 July 2015 of a thematic review of oversight and controls for financial benchmarks. The review was carried out between August 2014 and June 2015 on 12 banks and broking firms to provide an assessment of whether firms had learned the lessons from previous failures around benchmark activities and taken appropriate action in response. Overall, the FCA considers that there have been a number of positive changes around governance and controls surrounding benchmark activity, however significant work is still needed to ensure that all risks are managed appropriately.

One of the key messages from this paper is that the FCA is not just looking at how firms treat the specified benchmarks which are regulated in the UK. Instead, it is an assessment of how firms look at the wider definition of benchmarks set out in the IOSCO principles and the processes in place to capture these activities. One particular criticism from the FCA is that some firms are not aware of when they are acting in a capacity as a submitter to a benchmark. This is seen as a serious failing by the regulator.

The FCA discussed in some detail the IOSCO Principles for Financial Benchmarks which firms are encouraged to implement if they are involved in benchmark activity. The thematic review used the IOSCO definition of benchmarks which is far wider than for UK regulated benchmarks. The FCA expects all firms, not just those who were part of the review, to identify, manage and control the risks arising from benchmark activities and to put in place appropriate oversight and controls. There is emphasis on embedding a culture in which market integrity and consumers' interests are at the heart of the business, a continued theme from the UK regulator.

For more information see our Ashurst briefing here.

(Near) final rules on the new Senior Managers Regime

The FCA and PRA has set out their near-final rules for the new accountability framework for individuals working in banks, building societies and credit unions in a series of four different papers published in July. The new regime ensures that senior managers can be held accountable for any misconduct that falls within their area of responsibility. It also aims to ensure that all employees have appropriate standards of conduct.

As a reminder, there are three different pillars to the new regime: (i) the Senior Managers Regime; (ii) the Certification Regime; and (iii) Conduct Rules. The former is the most defined within the four papers published in July.

There are some useful points to note from the FCA and PRA papers, particularly on the Senior Managers Regime:

- **Sharing responsibilities**: A prescribed responsibility may be shared between individuals, however the FCA expects this to be unusual. If this

does occur, however, each of the individuals will be deemed wholly responsible for that prescribed responsibility.

- **Territoriality of the regime**: The FCA has clarified that the SMR has no territorial limitation. Therefore, firms must allocate responsibility to a Senior Manager for all activities, business areas and management functions overseas, including from a branch overseas. This includes all transactions which take place, either in part or in full, overseas.
- **Legal entities**: The regime applies to legal entities, not banking groups as a whole, so firms must assess who falls into the Senior Manager category on a case-by-case basis for each legal entity within a group.
- **Outsourced roles**: Outsourced roles that constitute a senior management function will still need those individuals performing that role to be FCA/PRA approved even if they are employed on a contractual basis.
- **NEDs**: There is further clarification from these papers that "ordinary NEDS", i.e. those who are not chair of the Audit, Remuneration or Nomination committees, nor Chairman, nor Senior Independent Director, would not need approval but the regulators should be "notified" about them when their appointment is confirmed. This will relate to a small majority of NEDs who will now be known as "notified NEDs".

The Certification Regime places importance on firms assessing for themselves (both at the point of recruitment and ongoing) the fitness and propriety of staff who carry out "significant harm" functions. Again, these papers provide some clarification on the issues such as:

- temporary cover for a certified person position can be up to four weeks by someone who is not certified; and
- criminal record checks are not required for certified persons by the regulators' rules.

The scope of the Certification Regime differs according to the FCA and PRA rules; the PRA regime is narrower, although a further consultation is expected from the PRA on this issue to reduce this anomaly.

There is a key proposal in the FCA paper to extend the scope of the Certification Regime to cover wholesale activities including: (i) individuals dealing with clients – which will include retail clients, professional clients and eligible counterparties, and broadly means having contact with these clients (and is intended to have a wider scope than the current CF30 approved persons); (ii) algorithmic traders; and (iii) overseas material risk-takers in firms (thus removing the territorial limitation in the FCA rules).

The FCA states that their Conduct Rules focus on the concepts of acting with integrity, skill, care and diligence, and with regard to the interests of customers. This paper sets out the requirement to report both known and suspected breaches of the Conduct Rules to the regulator. These reports should be on an annual basis, other than for actual or suspected breaches by Senior Managers under the SMR, which must be reported within seven days of the firm becoming aware. Other members of staff who are suspected of, or who breach, the Conduct Rules need only be reported annually, allowing the firm to carry out internal investigations. Thus, suspected but not proven breaches by other staff members are not required to be reported.

See our Ashurst briefing here for more detail.

Remuneration

In July 2014, the PRA and FCA published a joint consultation paper on "Strengthening the alignment of risk and reward: new remuneration rules (PRA CP15/14/ FCA CP14/14)". The consultation paper contained key proposals to amend the rules relating to deferral and clawback, as well as the rules on remuneration of non-executive directors and bonus provisions for bailed-out banks. In June 2015, almost a year after the consultation was originally published, the regulators have produced a policy statement (PRA PS12/15/ FCA PS15/16) which sets out their final approach to these issues.

It is no surprise that there has been considerable delay in the production of these final rules considering the ongoing debate both at national and European level on the issue of bankers' pay. In Autumn last year, the UK withdrew its challenge to the European bankers' bonus cap in the European Court of Justice, and earlier this year the EBA published a consultation on guidelines for sound remuneration policies which proposed the removal of the principle of proportionality for remuneration rules in European Member States.

It is worth noting in that context that, to accompany the policy statement, the regulators have republished their respective guidance and supervisory statements on the principle of proportionality. What is striking is that there is no mention whatsoever of the political disagreement between the UK and the EBA on the subject – still less any substantive amendment to the existing UK approach. In effect, the UK regulators

seem to be confirming their legal and policy position despite the EBA's guidelines. It will be interesting to see what the EBA's next step will be, given the stance taken by national regulators such as the FCA and PRA.

Otherwise, there is little change to the substance of what was proposed in the remuneration rules consulted on last year and which we have summarised in our briefing here.

Germany

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Loan origination and loan restructuring by German AIFs

Previously, loan origination by German investment funds was limited. Only real estate funds were allowed to grant loans to the fund's real estate vehicles in prescribed circumstances. Other alternative investment funds (AIFs) were allowed to acquire granted loans/loan receivables but were always restricted when it came to the restructuring or extension of such loans. This has now changed: in March 2015 the German Financial Regulatory Authority (BaFin) issued a letter regarding its more flexible view (Letter) and the current draft of the German UCITS V implementation act (Draft Act) has now given even more clarity.

In the Letter BaFin pointed out that those AIFs that are special funds (Special-AIFs) and that do not have to comply with detailed product requirements (such as UCITS) are allowed to originate loans. Special-AIFs are those that can only have professional investors in terms of the MiFID and so-called semi-professional investors in terms of the German Capital Investment Act – Kapitalanlagegesetzbuch (KAGB). This means that based on the wording of the Letter open-ended general Special-AIFs, hedge funds, closed-ended Special-AIFs and all AIFs that fall under the threshold exemption may originate loans. However, BaFin strongly recommended that only closed-ended Special-AIFs should originate loans.

This recommendation has been recognised in the Draft Act: pursuant to section 20 para 9 of the Draft Act the managers of AIFs (AIFMs) are allowed to originate loans for the account of or on behalf of the AIF if:

- the AIF is structured as an:
  - EuVEC (European Venture Capital fund);
  - EuSEF (European Social Entrepreneurship fund);
  - ELTIF (European Long Term Investment fund);
- the AIF is a real estate investment fund; or
- the AIF is a closed-ended Special-AIF.

The most interesting categories that will benefit from this change are the latter two: real estate funds and closed-ended Special-AIFs. Closed-ended Special-AIFs granting loans are subject to some limitations:

- Borrowing from third parties to leverage the investment is limited to 30% of the investment amount already received by the Special-AIF plus any capital commitments from the investors minus some costs. If the Special-AIF is invested into another company, loan amounts provided to that other company will be taken into account.
- The AIFM/AIF may not take deposits or other repayable amounts from the public.
- Loans are not allowed to be granted to consumers.
- To avoid unduly concentration risks, loans to a single borrower shall not exceed 20% of the investment amount already received plus any capital commitment from the investors minus some costs. It is still not clear whether other group companies will also be allocated to the "single borrower" as it is the case in some other regulations.

Closed-ended Special-AIFs can still acquire loan receivables and manage and restructure such loan receivables similar to the rules for open-ended funds that invest into loan receivables. AIFMs that manage loan-originating AIFs must have proper and adequate risk management procedures, as well as complying with reporting requirements and in some cases liquidity management requirements where the AIFM and their AIFs not only grant loans but also use leverage.

Loan origination by closed-ended Special-AIFs are still subject to some obstacles, such as unclear and changing tax rules, licence requirements when granting loans into other jurisdictions and certain risk management procedures. The tax issues will hopefully remedied in the course of the discussions of the amendment of the German Investment Tax Act.

AIFs that are allowed to invest into loan receivables are also – much to the surprise of some market participants in particular with regard to open-ended Special-AIFs with fixed investment guidelines (Spezial-AIF mit festen Anlagebedingungen) – subject to

limitations. The good news, however, is that AIFs (open-ended and closed-ended) that are allowed to acquire loan receivables are now generally also allowed to restructure such loan receivables. This is particularly relevant for the so-called "Other Investment Funds" (Sonstige Sondervermögen), general open-ended Special-AIFs and open-ended Special-AIFs with fixed investment guidelines which are very common in Germany for institutional investors.

However, also this flexibility comes at a price:

- A maximum of 50% of the value of the open-ended Special-AIF with fixed investment guidelines can be invested into loan receivables. This limitation was heavily discussed as the current wording of the KAGB would have allowed up to 100% of the value of such fund to be invested into loan receivables. This limitation is based on the legislator's view that open-ended investment funds may get into trouble if the investment fund is too heavily invested into non-liquid loan receivables. Whether this holds true (in particular with regard to short term borrowing) is neither here nor there as the legislator's is pretty firm in its view on this. In addition, typical institutional investors, such as German insurance companies, are subject to similar restrictions based on limitations for these investors (at least until Solvency II enters fully into force).
- The above named risk management and organisational requirements have to be complied with (except the large-scale credit reporting obligations).

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FinCEN proposal for AML rule for US SEC registered investment advisers

On 25 August 2015, the Financial Crimes Enforcement Network (FinCEN) proposed a new anti-money laundering rule which would require Securities and Exchange Commission (SEC) registered investment advisers (RIAs) (including hedge fund and private equity fund managers) to establish AML programmes and report suspicious activity to FinCEN in accordance with the Bank Secrecy Act (BSA). FinCEN stated that requiring RIAs to establish AML programmes and file reports of suspicious activity would bring them under a similar regulatory regime as other financial institutions subject to the BSA, such as mutual funds, broker-dealers, banks and insurance companies.

The rule would require RIAs to develop, adopt and comply with tailored AML policies and file suspicious activity reports with FinCEN as applicable. Many RIAs have already implemented AML programmes, either voluntarily or in response to an SEC no action letter that allows broker-dealers to rely on investment advisers to perform their AML-related customer identification programme obligations under certain circumstances. However, for other RIAs, developing and implementing a written AML policy and complying with the applicable new reporting requirements could be a significant undertaking.

FinCEN proposes to delegate examination authority with respect to the rule to the SEC.

The proposed rule will be open for a 60-day comment period.

SEC approves CEO pay ratio rule

On 5 August 2015, the SEC approved a new rule requiring US public companies to disclose the ratio between their CEO's compensation and that of their median employee. Companies will now be required to disclose the following:

- the median of the total annual compensation of all their employees except the CEO;
- the annual total compensation of the CEO; and
- the ratio of the two amounts.

According to the SEC Chair, the final rule provides companies with substantial flexibility in determining the pay ratio. For example, the final rule allows companies to use estimates and sampling as a means to determine the median employee and the employee's compensation. In addition, companies can keep the same median employee for up to three years unless there are major changes to their employee population or the median employee's compensation.

There are limits to the flexibility afforded under the new rule, however: companies must calculate the median employee's annual total compensation using the same methodology used to calculate the CEO's compensation. The rule allows companies to apply a cost-of-living adjustment in calculating the median employee's total annual compensation and CEO pay ratio, although companies must also disclose

compensation and pay ratio figures without the cost-of-living adjustment.

The new pay ratio disclosure requirement applies to all companies required to provide executive compensation disclosure under Item 402(c)(2)(x) of Regulation S-K. Smaller reporting companies, foreign private issuers, emerging growth companies and registered investment companies are exempt from the requirement.

The rule requires companies to report the pay ratios starting with their first fiscal year beginning on or after 1 January 2017.

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