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## SEC/CORPORATE

### SEC and Division of Corporation Finance Issue New Pay Ratio Disclosure Guidance

On September 21, the Securities and Exchange Commission (SEC) issued an interpretive release (available here) regarding compliance with Item 402(u) of Regulation S-K (the Pay Ratio Disclosure Rule), which sets forth the requirement that each registrant disclose the ratio of the compensation of its principal executive officer (PEO) to its median employee's compensation. In the interpretive release, the SEC emphasized that the Pay Ratio Disclosure Rule is designed to provide registrants with the flexibility to determine appropriate methodologies to identify and calculate the compensation of the median employee and prepare the required disclosures. Significantly, the SEC indicated in the interpretive release that, if a registrant uses reasonable estimates, assumptions or methodologies to determine the pay ratio, the pay ratio and related disclosure would not provide the basis for an SEC enforcement action, unless such disclosure was made or reaffirmed without a reasonable basis or was provided other than in good faith.

The interpretive release also provides that a registrant may use existing internal records (e.g., tax or payroll records) to identify and calculate the annual compensation of its median employee, even if the existing records do not include every element of compensation (such as widely-distributed employee equity awards). Such existing internal records may, according to the interpretive release, also be appropriately used to determine the availability of the *de minimis* exemption for foreign employees (i.e., the provision which, subject to certain limitations, allows a registrant to exclude non-US employees from the data used to determine its median employee's compensation, if non-US. employees account for 5 percent or less of the registrant's total number of employees).

The SEC also clarified that, although the Pay Ratio Disclosure Rule specifically excludes workers who provide services to the registrant or its consolidated subsidiaries, but are employed (or whose compensation is determined) by an unaffiliated third party (the Leased Workers Exclusion), the Leased Workers Exclusion is not the exclusive basis for a registrant to determine that a worker is not required to be included in the data used to identify and calculate the annual compensation of its median employee. The interpretive release goes on to provide that a registrant may apply a widely recognized test under another area of law (e.g., tax or employment law) that the registrant otherwise uses to determine whether its workers are employees and are, therefore, required to be included in the data for purposes of the Pay Ratio Disclosure Rule.

In light of the SEC's interpretive release regarding the Pay Ratio Disclosure Rule, on September 21, the SEC's Division of Corporation Finance (the Division) also issued a new Compliance & Disclosure Interpretation (C&DI) (available here) and a revised C&DI (available here) and withdrew a C&DI. New C&DI 128C.06 indicates that the SEC will not object if a registrant describes the disclosure required by the Pay Ratio Disclosure Rule as a reasonable estimate calculated in a manner consistent with Item 402(u) of Regulation S-K. C&DI 128C.01 was updated to add a reference to the SEC's interpretive release in order to clarify that, if a registrant elects to use a consistently applied compensation measure (CACM) (instead of total annual compensation calculated in accordance with Item 402(c)(2)(x) of Regulation S-K) to identify the median employee, the CACM may be formulated based on a registrant's internal records, even if such records do not include every element of compensation (as previously described above). C&DI 128C.05, which previously described the circumstances under which a worker is employed or his or her compensation is determined by an unaffiliated third party (for purposes of the Leased Workers Exclusion), was withdrawn.

Also on September 21, the Division issued detailed guidance (available here) regarding the use of reasonable estimates, statistical sampling and other reasonable methodologies to identify the median employee and calculate such employee's annual compensation. In particular, the Division's guidance and hypothetical examples indicate, among other things, that:

- a registrant must determine its own median employee compensation and may not rely upon industry estimates;
- a registrant may use a combination of methods to determine the employees from which the median employee is identified (such as using reasonable estimates for one geographic or business unit and using statistical sampling for another geographic or business unit);
- a registrant may use a combination of statistical sampling methods, so long as the methods draw observations from each geographical or business unit and infer the registrant's overall median employee's compensation based on the observations drawn;
- appropriate sampling methods, depending upon a registrant's particular facts and circumstances, may include random sampling, stratified sampling, cluster sampling and systematic sampling;
- situations where it may be appropriate to use reasonable estimates include analyzing the composition of a registrant's workforce, calculating a consistent measure of compensation (as to annual compensation and/or the elements of annual compensation) of a registrant's median employee and using the mid-point of a compensation range to estimate compensation; and
- "other reasonable methodologies" registrants may consider include reasonable methods of imputing or correcting missing values and reasonable methods of addressing extreme data (such as outliers).

## BROKER-DEALER

### SEC Chairman Testifies Before Senate Banking Committee

On September 26, Securities and Exchange Commission (SEC) Chairman Jay Clayton testified before the Senate Banking, Housing, and Urban Affairs Committee on the "Oversight of the US Securities and Exchange Commission." Highlights of his testimony included the following:

- Chairman Clayton has asked the SEC staff to prepare final rulemaking recommendations with respect to amendments to: (1) Rule 606 of Regulation NMS (proposed in July 2016), which would, among other things, require broker-dealers to disclose standardized information on their handling of large orders on a quarterly basis and in response to customer requests; and (2) Regulation ATS (proposed in November 2015) to establish new transparency requirements on alternative trading systems that facilitate transactions in NMS stocks.
- With respect to the Consolidated Audit Trail (CAT), which will provide regulators with consolidated cross-market data and is currently under development, Chairman Clayton indicated that he is focused on the issue of data security, which he has stressed to the CAT plan processor and the self-regulatory organizations that will report data into the CAT. The first phase of CAT data reporting takes effect on November 15.
- Preliminary analyses of the Tick Size Pilot (which began in October 2016 to test the impact of wider tick sizes on trading in stocks of smaller companies) suggests that for many covered securities, quoted spreads and depth of book have increased and volatility has decreased, although results have been mixed.
- At Chairman Clayton's request, the SEC staff is developing a pilot program to test the impact on equities trading of adjustments to the access fee cap under Rule 610 of Regulation NMS (which limits the fees that can be charged for access to protected quotations and manual quotations at the best bid and offer).

- To broaden the SEC's review of market structure to include fixed income markets, the SEC is establishing a Fixed Income Market Structure Advisory Committee (FIMSAC) with hopes that it will begin meeting as early as December of this year.

- The SEC has been focused on both determining the scope of the 2016 intrusion into its EDGAR system, which provided access to nonpublic filing information, and investigating trading related to the intrusion. The investigation related to the 2016 intrusion is part of an ongoing initiative to assess the SEC's cybersecurity risk profile and preparedness.

- On June 1, the SEC solicited input regarding standards of conduct for investment advisers and broker-dealers from interested parties and currently is reviewing this information as it evaluates its next steps in this area.

- With respect to enforcement, the SEC will focus its resources on retail investor fraud, investment professional misconduct, insider trading, market manipulation, accounting fraud and cyber matters.

- The SEC's Office of Compliance Inspections and Examinations plans to increase investment advisor examination coverage levels, as well as to increase the number of inspections to evaluate compliance with SEC rules (such as Regulation SCI) to ensure that the cybersecurity infrastructure of our markets is effective.

The full testimony is available here.

## CFTC

### CFTC's Division of Market Oversight Issues No-Action Letter Providing Reporting Parties With Additional Relief From OCR Final Rule Reporting Obligations

On September 25, the Commodity Futures Trading Commission's (CFTC) Division of Market Oversight (DMO) issued Staff Letter No. 17-45 (Staff Letter), which both extends current relief, and provides additional relief, to reporting parties that must comply with the reporting obligations required by the ownership and control reports (OCR) final rule (OCR Final Rule). DMO is providing this relief in response to the compliance challenges reporting parties have encountered with respect to certain OCR reporting obligations.

The Staff Letter addresses these challenges, in part, by extending the no-action relief provided in Staff Letter No. 16-32. (For a more complete discussion of Staff Letter No. 16-32, please refer to the April 15, 2016, edition of *Corporate and Financial Weekly Digest*). Such relief includes, but is not limited to, (1) providing reporting parties with two additional days to accurately report the names of trading account and volume threshold account owners, and (2) increasing the threshold for reporting certain data from 50 contracts to 250 contracts. The Staff Letter also provides reporting parties with several additional types of new relief, including relief from (a) the requirement to file annual refresh updates of Forms 102A, 102B and 102S (conditioned on filing timely and complete change updates), and (b) providing information on Forms 40 and 40S regarding those who have direct or indirect influence on, or exercise authority over, but not control of, a reporting party's trading (Question 12).

The relief provided in the Staff Letter will remain in effect until the earlier of (1) the later of the applicable effective date or compliance date of a CFTC action, such as a rulemaking or order addressing such obligation, and (2) September 28, 2020.

Staff Letter No. 17-45 is available here.

### CFTC Approves Delegated Authority Provisions Related to Designated Contract Markets

On September 26, the Commodity Futures Trading Commission (CFTC) adopted final rules delegating to the Director of the CFTC's Division of Market Oversight (DMO) (or such employee or employees as the Director designates) the authority to notify each designated contract market (DCM) whether it is classified as a "covered DCM" (as defined in CFTC Regulation 38.1051(h)(1)). A "covered DCM," defined as a DCM whose annual trading volume is five percent or more of the combined annual trading volume of all CFTC-regulated DCMs, is required to comply with enhanced reporting requirements regarding the frequency of its cybersecurity testing and the use of independent contractors to perform such testing. The annual notice provided to each DCM will include its percentage of the total annual trading volume among all CFTC-regulated DCMs.

The final rule is effective September 29.

The Federal Register notice is available here.

## EU DEVELOPMENTS

### Update on MiFID II ESMA Opinions for Pre-Trade Transparency Waivers and Position Limits

On September 28, the European Securities and Markets Authority (ESMA) issued a press release (Press Release) that it and the national competent authorities (NCAs) had agreed to a work plan (Work Plan) on completing the opinions that must be issued by ESMA under the Markets in Financial Instruments Directive (MiFID II) and Regulation (MiFIR) in regards to both pre-trade transparency waivers and position limits for commodity derivatives. The Work Plan is required because there is not sufficient time for ESMA to write all the requisite opinions before the MiFID II and MiFIR January 3, 2018, effective date; MiFIR does not include any transitional provisions for the issuance of the ESMA opinions.

Under the Work Plan, the NCAs will now publish position limits ahead of the ESMA opinions. The published NCA position limits will enter into force on January 3, 2018. ESMA will issue its opinions at a later date, at which point the relevant NCA has agreed to either modify its position limits to conform to the opinion or justify to ESMA why no modification is required. MiFID II currently mandates that ESMA must publish opinions on the commodity derivative position limits notified by an NCA before the limits can become effective, which means that all such opinions by ESMA would had to have been issued prior to January 3, 2018.

The Work Plan provides that ESMA will prioritize work on opinions for pre-trade transparency waivers for equity instruments, which it intends to have completed by the end of 2017. Although ESMA will try to complete as many opinions on non-equity instruments before the MiFID II and MiFIR become effective, ESMA recognizes that the majority of opinions to be issued may still be outstanding. Therefore, ESMA and the NCAs have agreed that pending the issuance of an ESMA opinion, the NCA will grant the requested pre-trade transparency waivers based on their own compliance evaluation. Any such grant by an NCA is subject to the condition that the waiver is granted: (1) on a temporary basis; (2) on a provisional basis; or (3) via other administrative arraignments to ensure that the waiver can be revaluated following the ESMA opinion, and the requesting trading venue is duly informed. ESMA has indicated that it intends to publish Q&A addressing non-equity waiver notifications.

A copy of the Press Release is available here.

A copy of the Work Plan is available here.

### European Commission Adopts Final Rules on Indirect Clearing

On September 22, the European Commission adopted two delegated regulations to implement new EU-wide rules on “indirect clearing arrangements” for the exchange-traded derivatives market (ETD Delegated Regulation) and for the over-the-counter (OTC) derivatives market (OTC Delegated Regulation). The term “indirect clearing arrangement” refers to a set of relationships—also called a “chain”—where at least two intermediaries are interposed between an end-client and the relevant central counterparty (CCP). The most basic indirect clearing chain, therefore, involves the following four entities: the CCP; a clearing member of the CCP (Clearing Member); the client of the Clearing Member that is itself an intermediary (Direct Client); and the client of such Direct Client (Indirect Client). Longer chains are permitted in certain limited circumstances. The OTC Delegated Regulation amends earlier indirect clearing rules for the OTC derivatives market in order to ensure that the provisions of the ETD Delegated Regulation and the OTC Delegated Regulation are identical.

The two Delegated Regulations are largely designed to provide greater protection of Indirect Client positions and assets in the event that the Direct Client defaults. The principal innovation in the Delegated Regulations is the introduction of two new types of segregated accounts for Indirect Clients in a standard indirect clearing chain. A CCP must permit a Clearing Member to open and maintain at least the following two types of segregated accounts for its Direct Client(s) that have Indirect Client(s): (1) one omnibus segregated account for all Indirect Clients of all such Direct Clients; and (2) one gross (position and margin) segregated account per Direct Client for all Indirect Clients of that Direct Client that choose gross segregation. A Clearing Member must also open and maintain corresponding types of accounts in its own books and records. The Delegated Regulations also provide for extensive default management provisions, including rules relating to porting and liquidation, as well as provisions relating to disclosure, documentation and risk management.

The Delegated Regulations take effect on January 3, 2018.

### ESMA Publishes Final Text of Mandatory Trading Obligation

On September 29, the European Securities and Markets Authority (ESMA) published the text of the final draft regulatory technical standards (TO RTS) for implementing the mandatory trading obligation under the Markets in Financial Instruments Regulation (MiFIR) for certain standardized over-the-counter (OTC) derivatives. Article 28 of MiFIR mandatory trade execution obligations affect OTC Derivatives that are subject to mandatory clearing under the European Markets Infrastructure Regulation (EMIR), have been entered into between certain types of counterparties and that have been determined to be subject to the mandatory trading obligation.

The TO RTS affect this final criterion in regards to certain interest rate swaps (IRS) and credit default swaps (CDS). For the trading obligation to take effect, MiFIR requires that an OTC derivative subject to mandatory clearing be admitted to trading, or traded, on at least one European trading venue, and also be sufficiently liquid to be restricted to trading on a trading venue. The final report accompanying the TO RTS—as well as the earlier consultation paper—focuses primarily on a liquidity assessment of the IRS and CDS under consideration. Notably, ESMA has determined to expand the classes of IRS that were originally proposed to be subject to the trading obligation, based on industry feedback, as well as to better align the European approach with the trade execution requirements in the United States.

The TO RTS propose applying the mandatory trading obligation to fixed-to-floating IRS denominated in Euros (with the floating leg referenced to three-month or six-month EURIBOR); US dollars (with the floating leg referenced to three-month or six-month USD LIBOR); and Sterling (with the floating leg referenced to three-month or six-month GBP LIBOR); in all cases on a constant notional basis and without optionality. The obligation also applies to two, three, four, five, six, seven, 10, 15, 20 and 30-year tenors in all cases, with 12-year tenors also included for the IRS denominated in US dollars and a portion of the IRS denominated in Euros. The TO RTS also propose to apply the mandatory trading obligation to the iTraxx Europe Main and iTraxx Europe Crossover index CDS for the on-the-run and first off-the-run series with five-year tenors.

The European Commission must now endorse the TO RTS. It is expected that such endorsement will be forthcoming, in which case the TO RTS will take effect on January 3, 2018. There will be no transitional implementation period for the largest market participants—designated as “Category 1” and “Category 2” for purposes of EMIR’s mandatory clearing requirements—who will need to comply with the trading obligation from the date the TO RTS take effect. By contrast “Category 3” counterparties will have until June 21, 2019, to comply with the trading obligation for all in-scope IRS and CDS, and “Category 4” counterparties will have until December 21, 2018, to comply with the trading obligation for in-scope IRS and May 9, 2019, for in-scope CDS.

The TO RTS are available here.

For additional coverage on financial and regulatory news, visit *Bridging the Week*, authored by Katten's Gary DeWaal.


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