Bär & Karrer Briefing

October 2015

BÄR & KARRER

Derivative Trading under the FMIA

After the Swiss parliament passed into law the Federal Act on Financial Market Infrastructures ("FMIA") on 19 June 2015, the Federal Department of Finance, the Swiss Financial Markets Authority FINMA and the Swiss National Bank opened a consultation on three ordinances implementing the FMIA. The consultation closed on 2 October 2015 and we expect the FMIA together with its implementing ordinances to enter into force on 1 January 2016 subject to the phasing-in of specific obligations.

Overview

In the wake of the Dodd-Frank Act in the United States and EMIR, MiFID II and CSDR in the European Union, the FMIA seeks, on the one hand, to put in place a dedicated regulatory framework for financial market infrastructures, a broad concept encompassing stock exchanges, multilateral trading venues and organized trading venues, central depositories, central counterparties, payment systems and trade repositories and, on the other hand, to regulate market conduct in securities and derivatives trading.

The main novelty for market participants and the focus of this client briefing will be the rules on derivatives trading. In this context, the FMIA provides for three duties:

- **clearing requirements** for OTC derivatives;
- **rreporting obligations** for OTC and exchange-traded derivatives;
- **risk mitigation obligations**, including requirements regarding timely confirmation, portfolio reconciliation, portfolio compression, mark-to-market valuation and margining.

Furthermore, the FMIA lays the legal foundation to introduce an **obligation to trade** certain designated derivatives on **trading platforms** and to introduce **position limits on commodities**. These last two duties, however, will probably not enter into force before an international consensus emerges on their implementation, which does not seem likely in the immediate future.

Scope

Entities in Scope

The FMIA is applicable to financial and non-financial counterparties that trade in derivatives. Fundamentally, the FMIA applies only to entities with a **seat in Switzerland**, including their foreign branches, as well as to **Swiss branches** of foreign market participants, provided they are not subject to equivalent regulation. At the same time, the rules distinguish among financial and non-financial counterparties and among small and non-small counterparties. Unlike EMIR, the classification small and non-small applies both to financial and non-financial counterparties.

	FC+	NFC+	FC-	FC-
Platform Trading	✓	✓	✗	✗
Clearing	✓	✓	✗	✗
Reporting	✓	✓	✓	✓
Risk Mitigation				
- Timely Confirmation	✓	✓	✓	✓
- Portfolio Reconciliation	✓	✓	✓	✗
- Dispute Resolution	✓	✓	✓	✓
- Portfolio Compression	✓	✓	✓	✓
- Mark-to-market	✓	✓	✗	✗
- Margining	✓	✓	✓	✗

Financial Counterparties v. Non-Financial Counterparties

Financial counterparties are defined to include most regulated financial institutions, such as

- banks, securities dealers,
- insurers and reinsurers,
- holding companies of financial groups and conglomerates,
- fund management companies and collective investment schemes as well as
- pension funds, which will, however, enjoy a phasing-in of their clearing obligations until 16 August 2017.

All other undertakings fall by default in the category of **non-financial counterparties**. Thus, only private persons acting in a private capacity are out of scope of the derivatives trading of the FMIA. Most governmental, international and supranational organizations, including the Swiss Confederation, Cantons and Communes, the Swiss National Bank, and foreign central banks benefit from partial or complete exemptions from the derivatives trading rules of the FMIA.

Although the FMIA does not apply directly to **foreign entities**, foreign counterparties will need to be classified too, since the obligations of Swiss entities will depend on their counterparty. With respect to foreign entities, the draft of the Ordinance on Financial Markets Infrastructures (**"draft FMIO"**) proposes to include in its scope foreign undertakings that have legal personality pursuant to the applicable law as well as trusts and similar constructs, thus using a slightly different definition than the one applicable in a domestic set-up.

The draft FMIO does not provide any guidance on how to classify foreign counterparties as **financial or non-financial counterparties**. It is, however, likely that Switzerland will apply by analogy the same criteria as for domestic counterparties.

Small v. Non-Small Counterparties

Although the threshold is based on the gross notional value of their outstanding OTC derivatives during a 30-business day-period calculated at a group level, it is set differently for **non-financial counterparties and financial counterparties**.

Regarding **non-financial counterparties**, the FMIA follows largely EMIR and applies different thresholds for different types of derivatives. The threshold is, thus, at CHF 1.1. billion for each of credit derivatives and equity derivatives contracts; whereas a CHF 3.3 billion threshold will apply for each of interest rate derivatives, FX derivatives as well as commodity derivatives and other derivatives.

As under EMIR, transactions of non-financial counterparties can be disregarded if they are directly related to the business, the liquidity or asset management of the counterparty or its group. In this respect, the draft FMIO follows largely the definition of **hedging** applied in the EU to include not only direct hedging strategies but also macro-hedging and portfolio hedging.

By contrast, a single threshold applies to **financial counterparties** and is set in respect of all their outstanding OTC derivatives at CHF 8 billion. Unlike non-financial counterparties, they cannot disregard their hedging positions.

Products in Scope

The rules of the FMIA on derivatives trading apply to "**derivatives**", which are defined under the FMIA as financial contracts whose value depends on one or more underlying instruments and do not constitute spot transactions.

The following instruments will, based on the draft FMIO, be out of scope:

- **structured products**, such as capital protection instruments, products with a maximum yield and certificates;
- **securitized derivatives** issued as a negotiable instrument or as book-entry certificate, such as plain vanilla warrants and hybrid instruments such as convertible bonds and contingent convertible bonds;
- **structured deposits** or more generally derivatives that are provided in connection with a deposit; and
- **commodity derivatives** traded over the counter, provided that they can only allow for physical delivery and cannot be settled in cash at the option of one or the other counterparty.

Furthermore, **futures and other non-securitized exchange traded derivatives** (including derivatives traded over a multilateral trading system, but not derivatives traded over less regulated organized trading platforms) are exempted from the clearing and risk mitigations obligations although they are in scope and remain subject to the reporting requirements. The FMIA provides for the same regime for **FX forwards and swaps**, provided they are settled on a payment versus payment basis.

Clearing Obligations

Under the FMIA, **OTC derivative trades** among counterparties that are not small need to be cleared through an authorized or recognized central counterparty (CCP).

As a matter of principle, the clearing obligations can apply to all OTC derivatives within the scope of the FMIA, provided clearing services are offered by an authorized or recognized CCP. **FINMA** has, however, a **large discretion** to determine which specific derivatives are subject to clearing obligations following both a bottom-up and a top-down approach, without, however, the power to compel CCPs to offer clearing services for a given product.

Intra-group transactions are exempt from the clearing requirements provided that the entities are included in the same consolidation perimeter and are subject to appropriate centralized risk assessment, measurement and control processes.

The clearing obligations also apply to **cross-border trades** with a foreign counterparty if it would have been subject to the clearing obligations had it been incorporated in Switzerland.

At the same time, the marginal burden of compliance should be limited for counterparties with a registered office in a jurisdiction that implemented equivalent regulation. First, the FMIA expressly **exempts from clearing requirements** cross-border transactions with a counterparty with a seat in a jurisdiction with an equivalent regulation **if the transaction is not subject to clearing requirements in the home country of the foreign counterparty**, thus ensuring that foreign counterparties will not be subject to additional clearing obligations merely because their counterparty is Swiss.

Second, counterparties that are in scope of the FMIA will have generally **the possibility to satisfy their duties** under the FMIA by applying foreign regulations that **are deemed equivalent** and, with respect to clearing and reporting obligations, by **using recognized foreign central counterparties or trade repositories**, as the case may be. These efforts will be further facilitated by a specific provision, allowing counterparties to exchange information required to comply with the FMIA within a group and to provide information required by Swiss law to foreign trade repositories without seeking prior consent of clients or even giving notice.

Reporting Obligations

In view of improving the transparency of derivatives markets, the FMIA requires counterparties to **report their derivative trades to a trade repository** on the day following the trade.

As a matter of principle, **all counterparties** are subject to reporting duties. Moreover, this duty also applies to transactions within a group of companies. Furthermore, **reporting duties also apply** when a counterparty enters into a derivative transaction with certain parties that are not in scope of the derivative market conduct rules under the FMIA, including **foreign counterparties** and **individuals residing in Switzerland**.

Following the model of the US Dodd-Frank Act and unlike EMIR, the FMIA provides for the one-sided reporting duties based on the following waterfall:

- when the trade is centrally cleared, the **CCP** is required as a matter of principle to report the trade.
- when a **financial counterparty** trades with a non-financial counterparty, the financial counterparty is required to report the trade;
- when two financial counterparties or two non-financial counterparties trade with each other, whichever party is **not a small counterparty** is required to report trade.
- When both parties are either small counterparties or non-small counterparties, the **selling party** is subject to the reporting requirement. Considering the practical difficulty in defining who is the selling party, the draft FMIO allows the **parties to define by contract** who will be required to report the trade.
- This being said, in a cross-border setting, the **Swiss counterparty** is always subject to reporting requirement, when the foreign counterparty or CCP is not required to report the trade under applicable law.

These reporting can, however **be delegated to a third party**.

Under the FMIA, counterparties are allowed to satisfy their duties either by reporting to a Swiss trade repository or to a recognized foreign trade repository. Importantly from a practical perspective, counterparties are **not required to inform and seek the consent of their clients** when reporting a transaction to **a Swiss or foreign trade repository** based on the requirement of the FMIA. Client consent, which may be granted through in general terms and conditions, is required only if a counterparty provides additional client data to a foreign repository, e.g., because it needs to also comply with foreign regulations.

Risk Mitigation

The FMIA provides, as a back-up, for the following requirements for counterparties to mitigate risks related to OTC derivatives that are not centrally cleared:

- **Timely confirmation:**
  the FMIA requires both parties to confirm derivatives transactions at the latest on the business day following the trade (T+1) or, for trades entered into after 16:00 two days after (T+2). Small counterparties have, however, another day to confirm their trades. However, the FMIA provides for the possibility for the parties to agree that a confirmation is deemed to be accepted, if the other party does not object.
- **Portfolio reconciliation:**
  all counterparties, with the exception of small non-financial counterparties, need to agree on a procedure to reconcile the material terms of OTC derivatives and their valuation. The frequency at which the reconciliation process must be carried out depends on the number of outstanding OTC transactions between two parties as further detailed in the draft FMIO.
- **Dispute resolution:**
  Counterparties must agree on applicable law and

jurisdiction as well as set up a process to identify, record and monitor disputes between the parties. Moreover, the dispute resolution system should provide for a specific process for disputes that could not be solved within five business days.

- **Portfolio compression:**
  all counterparties are, as a matter of principle, required to carry out a portfolio compression at least twice a year.

  A the same time, to avoid costly but futile exercises, this obligation only applies to the extent that it contributes to diminishing the overall counterparty risk, a term that is defined in further detail in the draft FMIO, and that the counterparties have more than 500 outstanding OTC transactions that are not cleared through a CCP, thus substantially limiting the scope of this obligation.

  - **Valuation**: financial and non-financial counterparties, to the exclusion of small counterparties, are required to mark-to-market the value of their outstanding contracts on a daily basis. If the market conditions do not permit a mark-to market, they are required to use appropriate and recognized marking-to-model approaches as further detailed in the draft FMIO.
  - **Exchange of collateral: all counterparties, to the exclusion of small non-financial counterparties**, are required to exchange collateral. The draft FMIO includes detailed provisions on the amount and timing of initial and variation margin requirements, the quality requirements and applicable haircuts to be applied. Furthermore, the FMIA requires that collateral be provided in a bankruptcy-proof form and held on segregated accounts. Furthermore, re-hypothecation of collateral provided as initial margin is expressly prohibited.

The **duty to exchange collateral does not apply, on a cross border basis** if the counterparty is based in a jurisdiction that was deemed to have **equivalent regulations and that does not provide for such an obligation.**

Additionally, as a matter of principle, **intra-group trades are exempted from the duty to exchange collateral** among counterparties that are fully consolidated and have an appropriate common central risk-valuation, measurement, and control process provided that no legal or factual obstacles (other than insolvency rules) prevent the immediate transfer of capital or repayment of liabilities and that the contracts do not seek to avoid the duty to exchange collateral.

Documentation and audit

Financial and non-financial counterparties are required to **document in writing the processes** through which they ensure the implementation of their obligations under the FMIA. If they do not trade in derivatives, this decision also needs to be documented.

Compliance by financial counterparties will be monitored as part of the general compliance framework through **regulatory auditors** who will report material breaches to the regulator. **Non-financial counterparties** will also be subject to audit requirements as part of their **normal audit cycles**. However, compliance issues are expected to be resolved primarily within the entities. The Federal Department of Finance will be involved to sanction breaches only in the event of repeated non-compliance.

Phasing-in

The Swiss government announced that it expect the FMIA together with its implementing ordinances to enter into force on 1 January 2016. However, due to the complexity of the obligations, the FMIA provides for several **phasing-in periods of six to twelve months** for most obligations allowing counterparties to adjust their operations to the new regulatory environment.

The **margining requirements** will be implemented over **a longer period** starting on 1 September 2016 and extending until 1 September 2019.

Finally, an **obligation to trade** certain designated derivatives on **trading platforms** and to introduce

BÄR
& KARRER

position limits on commodities will be introduced once an international consensus emerges on their implementation, which does not seem likely in the immediate future.

Author:

Rashid Bahar
rashid.bahar@baerkarrer.ch
T: +41 58 261 50 00

Additional Contacts:

Urs Bruegger
urs.bruegger@baerkarrer.ch
T: +41 58 261 50 00

Peter Hsu
peter.hsu@baerkarrer.ch
T: +41 58 261 50 00

Roland Truffer
roland.truffer@baerkarrer.ch
T: +41 58 261 50 00

Zurich
Bär & Karrer AG, Brandschenkestrasse 90, CH-8027 Zurich,
T: +41 58 261 50 00, F: +41 58 261 50 01, zurich@baerkarrer.ch

Geneva
Bär & Karrer SA, 12, quai de la Poste, CH-1211 Geneva 11,
T: +41 58 261 57 00, F: +41 58 261 57 01, geneva@baerkarrer.ch

Lugano
Bär & Karrer SA, Via Vegezzi 6, CH-6901 Lugano,
T: +41 58 261 58 00, F: +41 58 261 58 01, lugano@baerkarrer.ch

Zug
Bär & Karrer AG, Baarerstrasse 8, CH-6301 Zug,
T: +41 58 261 59 00, F: +41 58 261 59 01, zug@baerkarrer.ch

www.baerkarrer.ch