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Derivative Trading under the FMIA – Impact on Cross-border Transactions

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 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. This briefing expands our more general briefing on Derivative Trading under the FMIA by focusing on the impact of the FMIA on foreign financial institutions and market counterparties with a special focuses on the impact of FMIA on foreign entities.

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:**
  OTC derivative trades among counterparties that are not small need to be cleared through an authorized or recognized central counterparty (CCP);
- **reporting obligations:**
  counterparties are required to **report their trades in OTC and exchange traded derivatives to a trade repository** on the business day following the trade;
- **risk mitigation obligations:**
  non-cleared OTC derivatives are be subject to risk mitigation requirements, 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

As a matter of principle, 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. Other foreign entities, including their Swiss branches are otherwise, not in scope.

Although foreign entities are not in scope, otherwise than possibly through a Swiss branch, the FMIA has a **cross-border reach**. Most duties under the FMIA also apply when a Swiss entity trades with a foreign counterparty. In such situations too, the duties depend on the classification of the counterparty, e.g., in connection with clearing obligations or when determining which party should report a trade.

Therefore, foreign counterparties should be able to determine how they would be classified under the FMIA, when dealing with Swiss counterparties. In this context, 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 different definition than the one applicable in a domestic set-up.

Moreover, the draft FMIO does not provide any guidance on how to classify foreign counterparties as **financial or non-financial counterparties**. It is, nevertheless, likely that, as with other financial regulations, the determination will depend on the question whether the entity would be regulated as a financial counterparty if it were in Switzerland or if it is subject to a comparable regulation in its home country. This classification is therefore likely to characterize unregulated foreign vehicles used by private equity funds and hedge funds as collective schemes under Swiss law.

The determination whether a counterparty is small or not will be more straightforward and will probably follow the same thresholds as for Swiss entities. Under this approach, a non-financial counterparty will be deemed small if its gross outstanding derivative positions over a 30-business-day period for different types of derivatives does not exceed certain thresholds, which are calculated and set fundamentally in line with the standard under EMIR. The Swiss regime for small financial counterparties focuses, by contrast, on a single threshold relating to the overall gross outstanding derivative position over a 30-business-day period, which will be set at CHF 8 billion including hedging transactions.

Substitute Compliance Regime

To facilitate cross-border compliance, the FMIA generally permits counterparties to satisfy their duties under the FMIA by applying foreign regulations. This substitute compliance regime will be available if (a) the **foreign regulations are deemed equivalent** to the FMIA and (b), with respect to clearing and reporting obligations, the counterparties use **foreign central counterparties or trade repositories that are recognized by FINMA**.

As a matter of principle, these efforts will be further facilitated by specific provisions of the FMIA **allowing** counterparties to **exchange of 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 them notice. However, if by virtue of applying foreign laws, additional information needs to be provided to foreign group entities or trade repositories, it will remain necessary to comply with disclosure and consent requirements applicable under the **Data Protection Act** and **Swiss banking secrecy**.

Cross-border Transactions

As a matter of principle, transactions between a Swiss and a foreign counterparty are also subject to clearing, reporting and risk-mitigation obligations as the case may be.

However, in addition to the substitute compliance regime, the FMIA aims to facilitate compliance when dealing with foreign counterparties, by generally allowing counterparties to clear and/or report their transactions not only with an authorized (Swiss) financial market infrastructure provider, but also with a recognized foreign market infrastructure. Thus, allowing foreign counterparties to use their usual channels.

As mentioned above, 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 is required only if a

counterparty provides additional client data to a foreign repository, e.g., because it complies with the requirements of another regulatory framework.

Cross-border Exemption

Notwithstanding the fact that a transaction is in scope, 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 requirement in the home country of the foreign counterparty**.

Although no such rules exist for the reporting obligations, the same system applies to the **risk-mitigation** requirements that require the cooperation of a foreign counterparty, including timely confirmations, portfolio reconciliation, portfolio compression and dispute resolution as well as the margining requirements. In particular, the **duty to exchange collateral does not apply on a cross border basis**, if a counterparty is based in a jurisdiction that was deemed to have **equivalent regulations and that does not provide for such an obligation**.

By virtue of this exemption, the mere fact that a derivative is subject to obligations under the FMIA is not sufficient to trigger obligations for a Swiss counterparty dealing with a foreign counterparty, thus ensuring that foreign counterparties will not be subject to an additional compliance burden merely because their counterparty is Swiss and avoiding putting Swiss market participants at a disadvantage with their foreign competitors.

Intra-Group Exemptions

In addition to the exemptions for cross-border transactions, the FMIA also provides for exemptions for **intra-group transactions**. Unlike under EMIR, groups will be allowed to take advantage of this exemption without giving prior notice to a regulator.

Thus, 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.

Similarly, the **margining requirement** does not apply to intra-group transactions 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.

Nevertheless, the reporting obligations as well as most risk mitigation requirements also need to be complied with even within a group of companies.

Equivalence

As suggested above, from a domestic perspective, the FMIA provides for a deemed compliance regime and various exemptions for counterparties based in jurisdictions with equivalent regulatory standards. Furthermore, it contemplates the possibility to recognize foreign CCPs and trade repositories, provided, among others, that they are subject to equivalent regulations.

Against this backdrop, the **question of equivalence** will undoubtedly play a central role for the implementation of the FMIA on a cross-border basis. At this stage, it is expected that **EU jurisdictions applying EMIR** will be recognized as equivalent and that the **U.S. Dodd Frank Act** will also enjoy a similar status, if only because one purpose of the FMIA was precisely to ensure that Swiss regulations would be recognized as equivalent from the perspective of the EU. The status of other jurisdictions is less clear, although we expect Switzerland to follow the determination of European Commission and the technical advice ESMA and also recognize Australia, Hong Kong, Japan and Singapore as having equivalent regulations.

Phasing-in

The Swiss government announced that it expects 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.

Notably, however, neither the FMIA nor the implementing ordinance provide for a **deadline for FINMA to determine which jurisdictions are equivalent** or for an extended phasing-in period for foreign counterparty, which will therefore need to move in sync with their Swiss counterparties.

Finally, an **obligation to trade** certain designated derivatives on **trading platforms** and to introduce **position limits on commodities** shall be introduced once an international consensus emerges on their implementation, which does not seem likely in the immediate future.

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