Update

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New proposed Swiss legislation on financial market infrastructures, trading of derivatives and conduct of business rules (*Follow-up*)

Reference is made to Lenz & Staehelin's memorandum of April 2014 which provided an overview of the key aspects of the new Swiss Financial Market Infrastructure Act ("FMIA") as they relate to derivatives. On September 3, 2014 the Federal Council adopted the final draft of the FMIA ("Draft") and the respective Federal Dispatch that will form the basis of the debate in parliament. The purpose of this follow-up memorandum is to provide an overview of the key differences as they relate to derivatives between the preliminary draft published by the Swiss Federal Department of Finance in January 2014 ("Preliminary Draft") commented on in our April 2014 memorandum and the Draft. The focus is on the response given in the Draft with respect to the concerns that had been raised during the consultation.

Definitions

a) Direct and Indirect Participants

The Draft FMIA draws a clear distinction between direct participants (i.e. clearing members) and indirect participants (i.e. customers of clearing members). Furthermore, the Draft contains a broader definition of the term central counterparty. A central counterparty is now defined as an entity that interposes itself as a party to both parties of a securities transaction or other finance contracts whereas the Preliminary Draft referred to finance contracts only. In the context of the Draft FMIA, though, the central counterparty remains in essence an infrastructure for derivatives transactions.

b) Derivatives

The Draft FMIA clarifies that (i) structured products (i.e. capital protected products, products with maximum yield and certificates) and (ii) securities lending and borrowing transactions are not deemed derivatives/derivatives transactions for purposes of the particular obligations provided for in the FMIA with respect to derivatives trading. Contrary to the Preliminary Draft, the Draft FMIA does not any longer mention repo-trades. Pursuant to the Federal Dispatch such mention was deleted as it seemed evident that repos fall outside the scope of the definition of derivatives.

Recognition by FINMA of foreign trading platforms, foreign central counterparties and foreign trade repositories

It was proposed in the Preliminary Draft FMIA to subject each individual (i) foreign trading platforms (ii) foreign central counterparties and (iii) foreign trade repositories to a formal recognition by the Swiss Financial Market Supervisory Authority ("FINMA") that required that the relevant foreign financial market infrastructure is subject to an "appropriate" regulation and supervision and that the competent foreign supervisory authority does not object to the cross-border activities of the respective financial market infrastructure. In the Draft FMIA the recognition regime has now been eased for foreign trading platforms and foreign trade repositories but not for foreign central counterparties. Pursuant to the wording of the Draft FMIA in addition to the individual recognition, recognition shall be deemed given by FINMA if the state in which the respective foreign trading platform/trade repository has its

registered seat (i) generally subjects its trading platforms and trade repositories to appropriate regulation and supervision and (ii) the foreign supervisory authorities do not object to cross-border activities of the respective foreign trading platforms/trade repositories. Pursuant to the Federal Dispatch these requirements are presumably fulfilled for trading platforms/trade repositories with registered seat within the European Union. However, at this stage it is not clear in what form FINMA would confirm generally that these requirements are fulfilled. It is conceivable that FINMA will issue respective circular letters.

Obligations with respect to Derivatives Trading

With respect to derivatives trading the Draft FMIA as was the case for the Preliminary Draft provides for the obligations of (i) clearing over a central counterparty, (ii) reporting to a trade repository and (iii) risk mitigation.

a) Fulfilment of obligations under Foreign Law

The Draft FMIA explicitly clarifies that the clearing and reporting obligations shall be deemed fulfilled if (i) said obligations are being fulfilled under foreign law that has been recognized as equivalent by FINMA and (ii) the central counterparty or trade repository which has been used has been recognized as equivalent by FINMA.

b) Reporting

Contrary to the Preliminary Draft, the Draft FMIA clearly establishes a non-dual reporting regime. To this end the Draft FMIA designates the person responsible for the reporting to the trade repository in various constellations. With respect to transactions between two minor financial- or two minor non-financial counterparties the selling party shall be responsible for the reporting. We note that with respect to certain transactions it might be difficult to allocate the roles of buyer and seller.

c) Clearing

With respect to clearing obligations the Draft FMIA now in line with EMIR limits the clearing obligation to over-the-counter derivatives. However, the Draft FMIA still grants an authority to the Federal Council to extend the clearing obligation to both over-the counter and exchange traded derivatives. Such clearing obligation for exchange traded derivatives would be in addition to the obligation to trade derivatives over platforms already contemplated by the Preliminary Draft FMIA. The Draft FMIA, though, explicitly states that the Federal Council shall only bring into force such obligation to trade all derivatives over platforms if this seems warranted in line with international developments.

Derivatives transactions with or between minor counterparties are exempt from the clearing obligation (with respect to the definition of minor counterparties see d.) below). Furthermore, the Draft FMIA now also exempts (i) derivatives which are not cleared by any recognized central counterparty and (ii) currency swaps and forward currency transactions if they provide for payment versus payment settlement.

d) Minor Counterparties

The Preliminary Draft FMIA already proposed a category of "minor financial counterparties" that should be exempted from the clearing obligations. Such minor financial counterparty was quite narrowly defined as a counterparty that (i) concludes derivative transactions only as a risk mitigation measure in connection with its mortgage business and (ii) where the average position of its open derivative transactions is below a certain threshold. In the Draft FMIA the category of minor financial counterparties has now been considerably broadened in that any financial counterparty whose gross rolling position of open derivative transactions over 30 days is below a certain threshold falls into that category. In this respect the Draft FMIA deviates from EMIR but provides for an exemption along the same logic as under Dodd-Frank.

The calculation of thresholds is different for minor financial counterparties and minor non-financial counterparties. Whereas for non-financial counterparties separate thresholds have to be considered for different categories of derivatives, the Draft FMIA provides for one single threshold only for all categories of derivatives with respect to financial counterparties when determining whether such counterparties may be deemed minor counterparties.

e) Risk Mitigation

All counterparties, with the exception of minor non-financial counterparties, have to exchange adequate collateral when entering into non cleared derivatives transactions. The Draft FMIA states that any agreement with respect to the private realization of collateral that has been provided based on the risk mitigation obligation shall continue to be enforceable following the opening of bankruptcy proceedings against the collateral provider where the value of such collateral can be objectively established. In practice, though, minor non-financial

counterparties will also have to provide collateral, and there seems little reason not to apply the same principle where collateral has been provided on a "voluntary" basis or between counterparties of cleared derivative transactions.

The Draft FMIA now explicitly stipulates a portfolio compression obligation for financial and non-financial counterparties where this seems advisable in order to reduce counterparty risk and where such counterparties have 500 or more OTC derivative contracts outstanding which are not centrally cleared.

f) Reporting of Violations

The Preliminary Draft and the Draft FMIA provide that the examination of compliance of counterparties with obligations with respect to derivatives trading is part of an audit firm's tasks. With respect to financial counterparties supervised by FINMA the audit firm has to report the result of such examination to FINMA. With respect to non-financial counterparties, under the Preliminary Draft the audit firms had a duty to report violations directly to the Swiss Federal Department of Finance. The Draft FMIA now provides that such notification shall first be made to the board of directors of the respective participant and only if the participant does not implement adequate organizational measures the audit firm shall notify the Swiss Federal Department of Finance.

Insolvency provisions

One key element to be achieved under Swiss law is to ascertain the effectiveness of the central counterparty rules (be it Swiss or foreign central counterparties), in particular on netting, private realisation of collateral and portability in case of an insolvency of a central counterparty, a direct counterparty and, ideally, the latter's indirect counterparty. In the consultation process the industry has expressed concerns that the Preliminary Draft FMIA fell short of this legislative objective. Such concerns have, to the extent possible in the FMIA and the Banking Act ("BA"), been addressed in the Draft FMIA and proposals to amend the BA.

a) Netting/Private Realization of Collateral/Portability

With respect to protective, restructuring or insolvency measures that shall apply to financial market infrastructures the Draft FMIA now consequently limits itself to a general and broader reference to the provisions of articles 24-37 and article 37 lit. d-g of the Banking Act ("BA") applicable to banks.

In this regard it is to be noted that article 27 BA shall be revised and thereby confirm that (i) netting arrangements (ii) private realization of collateral and (iii) portability are not affected by protective measures, restructuring and insolvency proceedings. The priority of netting arrangements explicitly also comprises the agreed method of netting. With respect to private realization of collateral in the form of securities or other financial instruments the ambiguous and controversial requirement of a representative market shall be replaced by the concept of an objectively determinable value for such collateral. The enforceability of portability finally should permit a transfer of customer derivatives transactions and credit support provided therefor from an insolvent clearing member (where such clearing member is a Swiss bank or securities dealer) of a central counterparty to another clearing member.

The provision in the Preliminary Draft FMIA providing for a concept of a transfer by operation of law in case of an insolvency of a clearing member, that had been criticized as not being viable has been deleted entirely. A major concern of the industry in this respect has thereby been addressed. However, the Draft FMIA still provides that the indirect participant shall determine the clearing member to whom such porting shall be made. In this respect the concern expressed by the industry has not so far been addressed. In order to ascertain a proper and orderly porting it seems essential that this election be made by the central counterparty in accordance with its processes set out in its rules.

b) Temporary stay of contractual termination rights in the context of restructuring procedures

The Draft FMIA proposes to introduce a new article 30a BA which creates a formal legal basis for the FINMA's power in the course of protective measures or restructuring procedures to order a temporary stay of contractual termination rights predicated upon such measures. Furthermore, the new article 30a BA rules out contradictions with the revised article 27 BA by stating that a temporary stay of contractual termination rights in accordance with art. 30a BA prevails over article 27 BA. Finally under the proposed article 30a BA, to the extent that any protective or restructuring measures succeed in re-establishing the lawful order of a counterparty or any

transferee of the respective contracts as confirmed by FINMA, such termination rights cannot be invoked by a counterparty any longer.

c) Default of Clearing Member

The Draft FMIA now provides for a clear waterfall with respect to steps that a central counterparty shall take in order to cover losses that occur as a result of a clearing member's default. Moreover the Draft FMIA sets clear guidelines with respect to the rules that a central counterparty can implement in order to cover further losses that occur because of a default of a clearing member and ascertains that collateral provided by a defaulting clearing member's customer or other clearing members are not being used to cover obligations of the defaulting clearing member.

Please note that the Draft FMIA is still subject to potential changes that might occur in the context of the debates in the Swiss parliament.

Please do not hesitate to contact us in case of any questions.

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