Update

Newsflash September 2015

Derivatives trading under the new Swiss Financial Market Infrastructure Act: implementing ordinances in draft form (*Follow-up III*)

The Lenz & Staehelin memoranda of April 2014, September 2014 and July 2015 highlighted several key aspects of the new Swiss Financial Market Infrastructure Act ("FMIA") which has been passed by parliament in its finalized form on June 19, 2015. With a view to an expected entering into force of the FMIA on January 1, 2016 the competent bodies have now published drafts of the implementing ordinances to the FMIA. Following up on the Lenz & Staehelin memorandum of July 2015 that provides an overview of the core obligations regarding the trading of derivatives under the FMIA, i.e. trade reporting, clearing, use of trade platforms and risk mitigation, the purpose of this memorandum is to outline how the implementing ordinances propose to further specify such obligations, their application to the different categories of counterparties and their phase-in.

FMIA concept of implementation

The object of the FMIA is to regulate (i) the organization and the operation of financial market infrastructures, (ii) the trading of derivatives and (iii) the conduct of business rules. Due to its technical nature and the need to quickly adapt FMIA rules to the development in international financial market legislation, the FMIA is construed as a framework act and, thus, in addition to the usual implementation powers granted to the Federal Council, provides for a comprehensive delegation of powers to the Federal Council as well as to the regulator, the Swiss Financial Market Supervisory Authority ("FINMA"), and to the Swiss National Bank ("SNB").

In their respective implementing ordinances and in circular letters, these authorities are to further specify, inter alia, which participant falls into which category of counterparty (by determining the respective threshold), to which categories of derivatives transactions the FMIA regulatory requirements shall apply (by defining such categories) and to provide for a phase-in of the various regulatory requirements in respect of such derivatives categories. In many instances, the FMIA specifically requires that such implementation and phase-in take into account the development of international standards.

FMIA draft implementing ordinances

On August 20, 2015 each of the competent bodies published drafts of their respective implementing ordinances accompanied by explanatory reports, i.e. the Federal Council's Financial Market Infrastructure Ordinance ("FMIO"), FINMA's Financial Market Infrastructure Ordinance ("FINMA-FMIO") and an amendment to the SNB's National Bank Ordinance ("SNBO"), and opened the consultation process that will end on October 2, 2015.

Implementation of derivatives trading obligations

The OTC derivatives trading obligations are principally implemented through the FMIO, supplemented only by some provisions in the FINMA-FMIO on the criteria for the determination of categories of derivatives to be cleared. Principally, though, the FINMA-FMIO provides for implementing provisions on reporting requirements for

securities trading and on ownership and voting rights disclosure in takeovers, while the amended provisions of the SNBO implement special requirements for systemically important financial market infrastructures, these aspects being outside the scope of this memorandum.

Scope of application

a) Substantive scope of application

The FMIA applies to the "trade in derivatives". Due to its broad definition of derivatives as "a financial contract, the price of which is derived from one or several underlying assets, and which is not a spot transaction", it then specifically carves out certain types of transactions, inter alia repo trades, securities lending and borrowing and structured products, from its scope of application. The FMIO further specifies underlying assets and the notion of "spot transactions". In line with international standards, it clarifies that derivatives in the form of transferable securities, book-entry securities or deposits are out of scope, while currency swaps and forward transactions are exempted from some of the FMIA obligations only, i.e. from clearing, risk mitigation and the use of trade platforms, under the condition that currency is actually being exchanged. Finally it exempts derivatives on electricity and gas, provided that such derivatives are traded on an organized trade platform and must be physically settled.

b) Personal scope of application

The personal scope of application under FMIA is based on the concept of different types of counterparties and distinguishes between financial and non-financial counterparties and in each case between minor and major counterparties. As set out below, some of the obligations in connection with the trading of derivatives only apply to certain counterparties or to trades between certain counterparties, depending of the type of counterparties involved in a derivatives transaction.

Financial counterparties are counterparties which act in a professional capacity in the financial market as listed in an exhaustive list in the FMIA. A financial counterparty qualifies as a minor financial counterparty if its aggregate average gross position in all outstanding OTC derivatives transactions calculated on a rolling basis over 30 working days is below a threshold which is determined in the FMIO at eight billion Swiss francs on a financial group level. This is in line with the thresholds set out in the European Market Infrastructure Regulation ("EMIR"), taking into account current exchange rates. According to the explanatory report to the FMIO, it is expected that roughly 20 banks and a few insurance companies will be above such threshold. The FMIO also provides for the method of calculation of such threshold which includes all outstanding derivatives transactions (i.e. including hedging transactions, but not transactions specifically exempted from clearing under the FMIA) on a consolidated basis to arrive at a nominal gross average. If an existing minor financial counterparty's average gross position exceeds the threshold for four months, such counterparty will no longer be deemed minor.

Non-financial counterparties are counterparties that do not as per the exhaustive list in the FMIA qualify as financial counterparties. Minor non-financial counterparties are non-financial counterparties whose aggregate average gross position in each relevant outstanding OTC derivatives category calculated on a rolling basis over 30 working days is below the applicable threshold. The respective thresholds set out in the FMIO are, in line with EMIR, 1,1 billion Swiss francs for credit derivatives and for equity derivatives and 3,3 billion Swiss francs for interest derivatives, currency derivatives, commodity derivatives, and other derivatives. Pursuant to the FMIA, derivatives transactions intended to reduce risks are not factored into the calculation of such gross position if they are directly associated with the business activity, liquidity management, or asset management of the counterparty or group. The FMIO sets-out detailed criteria for derivatives transactions to qualify for such exemption. If any of the thresholds is exceeded for four months, such counterparty will no longer be deemed a minor counterparty.

c) Intra-group exemptions

Intra-group derivatives transactions are exempted from clearing, risk mitigation and mandatory use of trading platform obligations, provided that, inter alia, (i) both counterparties are fully consolidated in the same group, (ii) both counterparties are subject to appropriate centralized procedures for risk assessment, risk monitoring and risk control, and (iii), with regards to the mandatory use of trade platforms, that there are no legal or factual impediments to the prompt transfer of own funds or the repayment of liabilities. The FMIO makes it clear that provisions on insolvency proceedings are not considered as such legal impediment. Under the FMIO, counterparties fulfil the requirement of being subject to appropriate centralized procedures for risk assessment, monitoring, and control if

the group has a professional centralized treasury function in place.

d) Jurisdictional scope of application

The FMIA provisions apply both to derivatives transactions entered into between counterparties which are incorporated in Switzerland and to derivatives transactions entered into between a Swiss counterparty and a foreign counterparty. For instance, the obligation to clear with a central counterparty applies in case the foreign counterparty of a Swiss counterparty subject to the clearing obligation would itself be subject to the clearing obligation if it were established in Switzerland. However, recognized foreign market infrastructures can be used by Swiss counterparties to discharge their obligations in connection with derivatives transactions under the FMIA if the relevant market infrastructure is recognized and if the foreign law is recognized as being equivalent (for the latter see below).

Obligations with respect to derivatives transactions

a) Trade reporting obligation

All financial and non-financial counterparties (with the exception of minor non-financial counterparties) as well as central counterparties shall report to a trade repository authorized or recognized by FINMA the material characteristics of their derivatives transactions. This obligation applies to one of the counterparties involved only, the FMIA providing for rules specifying which counterparty has to make such reporting depending of the type of counterparties involved.

The minimum content to be reported includes the identity of the parties entering into the transaction and the type, maturity, notional amount, settlement date and currency of the derivatives transaction, subject to the detailed requirements set out in an Annex to the FMIO including, as a rule, the reporting of the globally recognized legal entity identifier. Under the FMIA rules, the reporting shall be made at the latest on the day following the day on which the transaction has been concluded, amended or terminated.

As of today, there is no such trade repository in Switzerland. However, foreign trade repositories can be used by Swiss counterparties to discharge their reporting obligations if such foreign market infrastructure is recognized by FINMA. Under the FMIO transitional rules, counterparties are obliged to report trades starting six, nine or twelve months after the first trade repository is authorized or recognized by FINMA, depending on the type of counterparty. The FMIO extends these deadlines by six months respectively for derivatives traded over an authorized or recognized platform. In case neither a Swiss nor a foreign trade repository is available, the Federal Council is empowered to designate where transactions shall be reported.

b) Clearing obligation

Financial and non-financial counterparties (with the exception of minor financial and minor non-financial counterparties) are obliged to clear their derivatives transactions with a central counterparty authorized or recognized by FINMA. The FMIA provides for a delegation to FINMA to determine the categories of derivatives to be cleared and the FINMA-FMIO sets out an exhaustive list of criteria to be adhered to by FINMA when making such determination, including inter alia the criteria set out in the FMIA, i.e. the degree of legal and operational standardization, liquidity, trade volume, information necessary for the formation of prices and counterparty risks.

Additionally, the FMIA specifically states that international standards have to be considered when making such determination and that no clearing obligation may be imposed for derivatives that are not cleared by any authorized or recognized central counterparty or for currency swaps and forward transactions, provided they are settled on a payment versus payment basis. As stated in the FMIO, counterparties are required to clear transactions starting six, nine or twelve months after FINMA makes the determination that a category of derivatives is subject to the clearing obligation, depending on the type of counterparty. Pension schemes and investment foundations have a temporary exemption from clearing for hedging transactions until August 16, 2017.

c) Trading platform obligation

Financial and non-financial counterparties (with the exception of minor financial and minor non-financial counterparties) are obliged to trade their derivatives transactions over a platform authorized or recognized by FINMA. The FMIA provides for a later implementation in that the Federal Council will only determine the effective date of entering into effect of such obligation in light of international developments.

The determination of the categories of derivatives subject to the obligation to trade over trading platforms is delegated to FINMA, while the FMIA provides for criteria to be adhered to when making such determination and exempts certain types of derivatives altogether, these provisions being similar to the FMIA criteria for the determination of categories of derivatives to be subjected to the clearing obligation (see above). According to its explanatory report, FINMA will not include such criteria in the FINMA-FMIO before the trading platform obligation has been enacted by the Federal Council as discussed above. Counterparties shall be obliged to make use of trading platforms starting six, nine or twelve months after a category of derivatives is subjected to such obligation by FINMA, depending on the type of counterparty.

d) Risk mitigation obligation

Non-standardized derivatives transactions which are not mandatorily or voluntarily cleared with a central counterparty are subject to certain risk mitigation obligations. Counterparties may in such case be obliged to (i) cover the counterparty risk through the exchange of collateral, (ii) mark-to-market the value of their outstanding transactions on a daily basis and (iii) mitigate the operational risks arising from their derivatives transactions, i.e. by (a) timely confirming the terms of the derivative transaction as well as by (b) implementing an appropriate process to reconcile portfolios, mitigating the associated risks and identifying and resolving disputes between the counterparties at an early stage. Such risk mitigation obligations apply to all financial and non-financial counterparties, with the exception of the obligation to mark-to-market outstanding transactions on a daily basis which does not apply to minor financial and minor non-financial counterparties.

These obligations are being further specified in the FMIO. The FMIO inter alia makes timing requirements regarding the confirmation of the transactions' terms and the portfolio reconciliation process, requires the parties to agree on a minimum content of contractual rules on dispute resolution procedures, provides for exceptions to the obligation to perform portfolio compressions, and provides for requirements regarding the use of models instead of using a mark-to-market valuation.

The FMIO provides for very detailed provisions on the exchange of collateral and regulates inter alia, in line with international standards and practice, quality requirements for collateral, the amount and timing of initial and variation margin payments, and haircuts to be applied.

Fulfilment of FMIA obligations under foreign law

Counterparties subject to FMIA obligations regarding the trading of derivatives may fulfil such obligations under foreign law, if (i) the foreign law is recognized as being equivalent by FINMA and (ii) a foreign financial market infrastructure recognized by FINMA was used to execute the transaction. The recognition requirements for foreign financial market infrastructures are set out in the FMIA (as discussed in the memorandum of July 2015).

The FMIO further specifies the criteria to be applied by FINMA. Generally speaking, foreign law is deemed equivalent if the obligations regarding the trading of derivatives and the provisions regarding supervision are comparable in their material effects to the respective Swiss provisions. However, the FMIO sets out more detailed and, in some respects more restrictive, criteria as to when this requirement shall be deemed satisfied under the FMIO. Specifically, the requirement shall be deemed satisfied, with regard to clearing and risk mitigation, if clearing or risk mitigation measures, respectively, under foreign law largely reduce systemic and counterparty risks of standardized OTC derivatives, with regard to trade reporting, if the reporting obligations requires at least the contents required under the FMIA, and with regards to the use of a trading platform, if use of such platform for the trading of standardized derivatives adequately improves trading transparency.

As has been said, both the FMIA and the implementing ordinances are expected to enter into force on January 1, 2016. After the ending of the consultation process on October 2, 2015 it is expected that the implementing ordinances will be finalized without further public consultation.

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

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