

Update

Newsflash January 2017

FinfraG Update – The International Swaps and Derivatives Association has published new documentation allowing counterparties to implement their obligations concerning the trading of derivatives – Implication for Swiss counterparties

The Swiss Financial Market Infrastructure Act (FMIA) and its implementing Ordinances (FMIO and FMIO-FINMA) entered into effect on January 1, 2016. The FMIA imposes on counterparties a number of obligations, namely clearing as well as reporting and risk mitigation obligations which include the obligation to post margins. These new obligations shall be incorporated by counterparties into their contractual documentation. In this context, the International Swaps and Derivatives Association (ISDA) has published new documents which specifically take into account the FMIA obligations. The purpose of this Newsflash is to provide Swiss market participants with an update on this new documentation with a particular focus on documentation to implement the margin rules.

Background

Documentation has always played a significant role when trading OTC derivatives, namely to reduce risks and thereby capital adequacy requirements. The Master Agreement developed by ISDA is the most frequently used standardized documentation when trading OTC derivatives. The ISDA Master Agreement may be supplemented by a Credit Support Document such as a Credit Support Annex (CSA) to its Schedule to set the rules that shall apply to the posting of margins. In the following, we

specifically refer to the English law documents and the documents implementing the EMIR, analogous documents including for the implementation of the FMIA obligations discussed herein, however, also exist for e.g. the New York law governed documents and the documents implementing Dodd Frank.

Against the background of variation margin requirements becoming compulsory in many jurisdictions around the globe, ISDA has inter alia published a new 2016 CSA for Variation Margin (VM) to supplement its suite of Credit

Support Documents and which is tailored to the particular regulatory requirements with respect to such variation margin. With respect to other risk mitigation obligations such as portfolio reconciliation, dispute resolution and disclosure, ISDA issued Protocols to address such obligations inter alia for EMIR. ISDA has now published additional documents that shall allow Swiss parties and their counterparties to implement the FMIA obligations.

There are mainly four new documents that may be considered to implement the FMIA obligations: (a) the ISDA EMIR FMIA Top-up Agreement, (b) the ISDA Regulatory Margin Self-Disclosure Letter, (c) the ISDA 2016 Variation Margin Protocol, and (d) the 2016 Credit Support Annex for Variation Margin (VM).

The deadline for the implementation of the contractual documentation for the FMIA risk mitigation obligations, such as portfolio reconciliation and dispute resolution expired on December 31, 2016. The date for the implementation of the new FMIA margin obligations is still uncertain as the Swiss Financial Market Supervisory Authority (FINMA) has not yet confirmed the final dates for their entry into effect. However, most of the counterparties trading OTC derivatives will be impacted by these new requirements in 2017.

For variation margin, the deadlines had previously been scheduled to apply as from September 1, 2016 for counterparties having in excess of CHF 3'000 bn. gross derivatives positions and as from September 1, 2017 for all other counterparties (Art. 131 para. 4 FMIO).

For initial margin, the deadlines had previously been scheduled to apply from September 1, 2016 through September 1, 2019 depending on their threshold of gross derivatives positions.

However, in order to align these deadlines with those of the EU, FINMA has provisionally extended these deadlines in its FMIA Guidance 01/2016. Nevertheless, this extension was subject to the condition that the deadlines initially set in Art.131 para. 4 FMIO differ from the EU deadlines as set out in the Final Regulatory Technical Standards (RTS).

The Final RTS were published in October 2016 and most of the deadlines were not modified. It is expected that FINMA will publish shortly a new Guidance as to the final deadlines for the implementation of the variation margin requirements under the FMIA.

Finally, it is important to note that under EMIR the deadlines to implement the variation margin requirements as well as to adopt the relevant documentation are entering into effect in the next coming weeks. Indeed, the variation margin obligation for the largest counterparties by OTC derivative trading volume is entering into effect on February 4, 2017. For all other counterparties, the deadline to implement the variation margin requirements is entering into effect on March 1, 2017. By contrast, the initial margin requirements shall be phased-in from February 4, 2017 through September 2020 depending on their OTC derivatives trading volume. In sum, Swiss counterparties which trade with EU counterparties may be directly impacted by these EU deadlines. This being said, we cannot exclude that FINMA will the FMIA deadlines align with the EU deadlines and decide that the variation margin requirements shall enter into effect on March 1, 2017.

Cross-border application and availability of “substituted compliance”

FINMA has provisionally recognized EMIR as being equivalent to the FMIA within the meaning of Art. 95 let. a FMIA. This allows Swiss parties trading with EU counterparties to meet their FMIA requirements while complying with the EMIR variation margin regime as this no doubt satisfies the test of an objective connection with the chosen legislation.

In deciding under which supervisory legislation the risk mitigation obligations shall be fulfilled, Swiss counterparties shall consider the differences between the FMIA requirements and the EMIR requirements bearing in mind that the intent of the Swiss legislator is either to align with EMIR or to be less stringent. In addition, if Swiss counterparties decide to meet their risk mitigation obligations under EMIR, there is no need to adhere to the ISDA EMIR FMIA Top-up Agreement and the FMIA rules in general.

ISDA FMIA Documentation

a) ISDA EMIR FMIA Top-up Agreement

The purpose of the Top-up Agreement is to allow counterparties that have already entered into an ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol to meet their requirements under the FMIA as well. By entering into such Top-up Agreement, that by contrast to the underlying protocol is a bilateral agreement, the parties agree to incorporate the FMIA portfolio reconciliation and dispute resolution provisions and/or a confidentiality waiver in order to report under the FMIA into the ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure.

The main benefit of using such Top-up Agreement for counterparties that have already adhered to an ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol is to maintain the processes in place to comply with the FMIA requirements. As an alternative, counterparties may consider entering into the FMIA Agreement published by the Swiss Banking Association which provides for Portfolio Reconciliation Procedure, Dispute Resolution Procedure and Exchange of Confirmation in accordance with the FMIA rules. In addition and by contrast to the ISDA documentation, the FMIA Agreement provides for a self-classification letter that can be used by all counterparties to classify themselves. We note, however, that at this stage neither of these agreements address the margin rules. Finally, some large entities have prepared an ad hoc documentation to define the FMIA procedures that will apply exclusively to their relationship with a specific counterparty. This documentation is generally tailor made.

b) ISDA Margin Documentation

The main ISDA documents for the implementation of the margin rules are: (i) the ISDA Regulatory Margin Self-Disclosure Letter which is a tool to assist counterparties in classifying themselves and their counterparties, (ii) The ISDA 2016 Variation Margin Protocol which will allow counterparties amending their existing ISDA to implement the margin

requirements and (iii) the parties may also bilaterally enter into a 2016 CSA for Variation Margin (VM).

The Self-Disclosure Letter (SDL) is intended to provide market participants with a standard form for providing counterparties with the information necessary to determine if and when compliance with one or more of the new regulatory margin regimes will be required.

The SDL is mainly a tool designed to determine which covered margin regimes apply. It contains 6 sections and 2 appendices. Section 1 requests general information about the market participant on whose behalf the SDL will be delivered. The remaining sections contain information specific to each jurisdiction. The Swiss section is relevant if either the principal or recipient is an entity regulated by the FMIA rules. We note, however, that if the counterparty is not a Swiss counterparty, such party's regulatory regime may also be relevant.

The SDL is available on ISDA Amend tool to facilitate the exchange of information necessary to determine whether compliance with one or more of these new regulatory margin regimes will be required.

ISDA has published a specific Variation Margin Protocol which also contains specific rules to comply with the FMIA requirements. One should note that the Variation Margin Protocol only addresses variation margins and not initial margins. This Protocol can mainly be used to amend existing written ISDA Master Agreements or any other form of Master Agreements that uses one of the forms of Credit Support Documents published by ISDA so as to bring them in line with the regulatory regimes.

The Variation Margin Protocol provides participants with the three following distinct "Methods" of amending existing documentation so that it is regulatory compliant:

(i) **Amend Method:** Terms in existing CSAs are amended as needed to comply with relevant regulations;

(ii) **Replicate and Amend Method:** Same as the Amend Method, but a duplicate CSA is created

from the existing CSA and then amended as needed to comply with relevant regulations;

(iii) **New CSA:** Parties enter into a new CSA with standard terms and certain optional terms produced through questionnaire elections.

In deciding which Method to use, market participants should consider at least the following elements: (i) operational complexity and number of CSA in place/collateral calls, (ii) treatment of legacy trades, (iii) preservation of existing terms.

All these documents include standardized definitions for each relevant jurisdiction, including Switzerland. The three documents contain a useful table that lists the FMIA eligible collateral and the applicable haircut. At present, neither the ISDA nor the Swiss Banking Association has provided for documents to implement initial margins as the implementing deadlines are phased-in over a longer period of time.

c) 2016 Credit Support Annex for Variation Margin (VM)

The 2016 CSA for Variation Margin (VM) has been developed based on the ISDAVM Protocol and extended to cover the margin regimes in

Singapore, Australia and Hong Kong. Parties using the English law version of the 2016 CSA for Variation Margin (VM), may modify Paragraph 11 of such CSA in order to establish variation margin arrangements that meet the requirements of new regulations on margin for uncleared swaps (“Covered Margin Regimes”). This template is intended to address the requirements of the different jurisdictions by allowing parties to put in place derivatives documentation that is compliant with the variation margin requirements of the Covered Margin Regimes. Each new CSA is now designed to be usable for multiple relevant regulatory regimes and thus is capable of addressing different and potentially inconsistent margin regulations.

Implications for Swiss market participants

The margin requirements will have significant impact on derivatives trading. In order to prepare themselves, Swiss market participants need to adapt, in priority, their contractual documentation to implement the FMIA requirements within the legal deadlines.

For any further questions regarding this matter please do not hesitate to contact us.

Legal Note: The information contained in this UPDATE Newsflash is of general nature and does not constitute legal advice. In case of particular queries, please contact us for specific advice.

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