Update

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New proposed Swiss legislation on financial market infrastructures, trading of derivatives and conduct of business rules

The purpose of this memorandum is to provide for an overview of the key aspects of the new Swiss Financial Market Infrastructure Act ("FMIA") as they relate to derivatives and to highlight some of the concerns which have been discussed among market participants in Switzerland in the context of the consultation process, which ended on March 31, 2014, and followed the publication in January 2014 by the Swiss Federal Department of Finance of a draft of the FMIA.

Object and background of the draft FMIA

As an implementation of the principles resolved within the context of the G20/FSB and also as a response to the "third country rules" provided by the European Market Infrastructure Regulation ("EMIR"), the Swiss Federal Department of Finance has published a draft FMIA in December 2013. The object of the draft FMIA is to regulate (i) the organisation and the operation of financial market infrastructures, (ii) the trading of derivatives and (iii) the conduct of business rules (including shareholding disclosures, public takeover offers, insider trading and market manipulations).

While the proposed rules under the draft FMIA on the organisation and the operation of financial infrastructures and the trading of derivatives in substance closely follow EMIR, the proposed new Swiss legislation, thus, has a much broader scope than EMIR. Indeed, it does not only aim at regulating the trading of derivatives, but also intends to consolidate the entire financial market infrastructure regulation into one framework act.

As regards the new rules on the trading of derivatives, the proposed draft FMIA shows a number of notable differences with EMIR, such as the introduction of a category of so-called "small financial counterparties", and the obligation to clear both over-the-counter derivatives and exchange traded derivatives.

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

It is proposed under the draft FMIA to subject (i) foreign trading platforms (meaning stock exchanges, multilateral trading systems and organised trading systems which enable multilateral trading), (ii) foreign central counterparties and (iii) foreign trade repositories to formal recognition by the Swiss Financial Market Supervisory Authority ("FINMA"). The current version of the draft FMIA provides that FINMA would grant said recognition, among other requirements, if the relevant foreign trading platform, foreign central counterparty or foreign trade repository is subject to an "appropriate" regulation and supervision. Even though the test of an "appropriate" regulation leaves room for a certain flexibility and may be seen as less stringent as compared to the "equivalency test", which is known in other cases of Swiss financial laws, the fact that each single foreign market infrastructure may have to request recognition by FINMA is seen by market participants as cumbersome. Therefore, certain market

participants aim at introducing in the FMIA a mutual recognition system or at least a mere notification procedure, rather than one based on individual filings.

Insolvency provisions

Although the Swiss rules applying to central counterparties have already been recognized by the EU as partially equivalent according to Article 25 EMIR following the revision of the Ordinance on the Swiss National Bank in 2013, a full recognition of the Swiss legislative framework will only occur once the Swiss insolvency provisions, namely as regards the effectiveness of the portability provisions, shall have been revised to ensure the enforceability of those provisions in case of the insolvency of CCPs and clearing members.

a) Netting, private realisation of sureties and portability

The key element to be achieved as a matter of Swiss law is to guarantee the effectiveness of the central counterparty rules (be it Swiss or foreign central counterparties), in particular on netting, private realisation of sureties and portability in case of an insolvency.

The proposed rules under the draft FMIA seek to clarify the insolvency related issues by introducing (i) the priority over Article 211 para. 2bis of the Swiss Federal Act on Debt Enforcement and Bankruptcy ("SDEBA") of the netting arrangements between the central counterparties and the participants as well as of any agreement on the private realisation of credit support exchanged in the context of the risk mitigation duties, and (ii) in case of insolvency of a clearing member (meaning a direct participant), a transfer at law of the financial transactions held by such clearing member to its customer (meaning the indirect participant) or to another clearing member.

While the fundamental intent of the FMIA is to ensure the effectiveness of netting, private realisation of credit support and portability, the industry has expressed concerns that the current proposal falls short of the legislative objective:

> Under the current draft FMIA, there is a mere reference to the principle of priority of the provisions of the regulations of central counterparties with respect to Article 211 para. 2bis SDEBA which merely provides for an automatic termination by operation of law of all derivates transaction in case of an insolvency of a Swiss counterparty under certain circumstances and does neither deal with private realization of credit support nor portability of derivative transactions. Considering that these priority rules may not be sufficient to obtain the required legal clarity, the prevailing view is that the principle of priority of the central counterparty rules on netting, private realisation of credit support and portability in case of insolvency should be of a general applicability, i.e. with respect to all participants and market infrastructures involved in derivatives transactions and, hence, introduced directly into the SDEBA and the particular insolvency regimes for regulated financial institutions.

> In order to implement "portability" under Swiss law, the draft FMIA currently provides for a concept of a transfer at law of customer derivate transactions in case of the insolvency of a clearing member. The industry's concern is that this transfer by operation of law is not an adequate means to ensure the effectiveness of portability in case of an insolvency of a clearing member both in a Swiss and also in an international context. In the industry's view, the effectiveness of the portability mechanism in case of insolvency of a clearing member should be directly addressed in the SDEBA and the particular insolvency regimes for regulated financial institutions, by making an exception to the current rule pursuant to which the insolvent loses his power to dispose of his assets in case of an insolvency to the extent that such loss would prevent a transfer of customer derivative transaction and credit support provided therefor.

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

The proposed rules under the draft FMIA introduces the FINMA's power, in the course of restructuring procedures of a financial market infrastructure, to link the transfer of all or part of the contracts related to the services of such financial market infrastructure that are to be transferred to another entity with a temporary stay on the contractual termination rights of these contracts for a maximum of 48 hours.

A temporary stay has been first introduced in the Ordinance of the Swiss Financial Market Supervisory Authority on the Insolvency of Banks and Securities

Dealers (“BIO-FINMA”). This provision has been criticized inter alia for its lack of a formal legal basis and its potential contradiction with the rules of the Swiss Federal Act on Banks and Savings Banks (“BA”), which provides that netting arrangements should not be affected by protective measures, restructuring and liquidation procedures.

With the proposed insertion of the temporary stay at the level of the FMIA, a formal legal basis would be introduced. However, contrary to what prevails under the BIO-FINMA, the draft FMIA does not clearly address the reinstatement of termination rights following the lapse of the stay. More generally, though, both the transfer of services and the institution of such a temporary stay is not necessarily seen in the industry as a viable and adequate means to address financial difficulties of a market infrastructure like a central counterparty.

c) Segregation of assets

As under EMIR, the draft FMIA provides, on the one hand, for the segregation of the central counterparty’s own assets from the direct participant's (meaning the clearing member's) assets and, on the other hand, for the segregation of the direct participant’s own assets from the indirect participant’s (meaning the customer's) assets, with the option for the indirect participant to choose between a collective or an individual segregation of assets. The objective of the segregation provisions is to protect the customer assets and the clearing member assets and, in the case of customer transactions, to facilitate portability of such segregated assets in case of an insolvency of a central counterparty or a clearing member. The proposals under the draft FMIA do, however, not explicitly provide for an appropriate protection of the above segregation provisions in case of insolvency of a central counterparty or a clearing member.

d) Definition of participants

Under the draft FMIA, the concepts of “participants”, respectively “direct participants” and “indirect participants” are not used in a consistent manner throughout the draft. A specification of each of these concepts is important for the purposes of applying consistently the correspondent rules in case of an insolvency of a participant. As the draft FMIA stands, there is generally a lack of a clear distinction between, on the one hand, the relationship between the clearing members and the central counterparty and, on the other hand, the relationship between the clearing member and the end customer.

Trading of derivatives

As under EMIR, the draft FMIA provides for the obligations of (i) clearing over a central counterparty, (ii) reporting to a trade repository and (iii) risk mitigation.

a) Definitions of derivatives and central counterparties

The draft FMIA defines derivatives or transactions in derivatives as a financial contract the price of which is derived from one or several underlying assets and which is not a spot transaction. The current definition is basically taken over from the definition under the Swiss Federal Stock Exchange and Securities Act, which is seen as being too broad. Indeed, taken literally, this definition does not only address derivatives, but could also address securities lending and repurchase transactions or even structured products.

Similarly, the definition of central counterparties under the proposed draft FMIA, is basically transposed from EMIR. However, contrary to EMIR, the definition of central counterparties under the draft FMIA refers to “financial contracts” as opposed to "derivative transactions". According to this definition, a central counterparty could act as clearing house for many other financial contracts than derivatives.

b) Clearing obligations on exchange traded derivatives

The proposed rules under the draft FMIA provide for the obligation to clear both over-the-counter derivatives and exchange traded derivatives. As indicated above, the obligation to clear exchange traded derivatives goes beyond the requirements under EMIR. There is a general view among market participants that, the FMIA should not go beyond the scope of application under EMIR.

c) Minor financial counterparties

The draft FMIA provides for the institution of the category of “minor financial counterparties”, which should be exempted from the clearing obligations, if such counterparty (i) concludes derivative transactions only as a risk mitigation measure in connection with its mortgage business and (ii) the average position of its open derivative

transactions is below a certain threshold. The institution of this new category of financial counterparty will not be recognized in Europe and is so narrowly defined that it is questionable whether its implementation as is worthwhile.

Based on the consultation process which ended on March 31, 2014, a revised draft FMIA will be prepared and submitted to Swiss parliament. The dates of the debates in parliament are not yet finally set, but debates may start as early as this summer. Lenz & Staehelin will update you with a further Newsflash.

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

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