Update

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

Reference is made to the Lenz & Staehelin memoranda of April 2014 and September 2014 which provided an overview of the key aspects of the new Swiss Financial Market Infrastructure Act ("FMIA") as they relate to derivative transactions, highlighted the main differences between earlier FMIA drafts throughout the legislative process and addressed FMIA insolvency provisions. On June 19, 2015 parliament has passed the FMIA in its finalized form and it is expected to enter into force in early 2016. The purpose of this follow-up memorandum is to provide an overview over the core obligations regarding the trading of derivatives, i.e. trade reporting, clearing, mandatory use of trade platforms and risk mitigation obligations, as they apply to the different categories of counterparties under the finalized FMIA.

Background and object of the FMIA

As an implementation of the principles resolved in the context of the G20/FSB and as a response to the "third party rules" provided by the European Market Infrastructure Regulation ("EMIR"), a draft FMIA has been submitted to parliament in September 2014 and has been adopted by parliament with relatively minor amendments in June 2015.

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 (including shareholding disclosures, public takeover offers, insider trading and market manipulations).

Basic concept and implementation of the FMIA

While FMIA rules on the organization and the operation of financial infrastructures and the trading of derivatives closely follow EMIR, FMIA is not meant to be a literal translation of EMIR into Swiss law. In particular, the new Swiss legislation has a much broader scope than EMIR: It does not only regulate the trading of derivatives but also consolidates the entire financial market infrastructure regulation into one framework act. Also, as regards the new rules on derivative transactions, the FMIA contains noteworthy differences to EMIR, most notably the introduction of a category of so called "minor financial counterparties" and the obligation to clear both over-the-counter derivatives and exchange traded derivatives.

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"), to further specify in implementing ordinances and circular letters, inter alia, which participant falls into which category of counterparty (by determining the respective threshold), to which categories of derivative transactions the FMIA regulatory requirements should apply (by defining such categories) and to provide for a phase-in of the various regulatory

requirements in respect of such derivative categories. In many instances, the FMIA specifically requires that such implementation and phase-in provisions take into account the development of international standards and it is expected that this requirement be viewed as an overarching principle by the Federal Council and FINMA when designing and, in the future, adapting such implementing ordinances and circular letters.

Scope of application

a) Substantive scope of application
The FMIA applies to the "trade in derivatives" and defines 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 FMIA specifically carves out from its scope of application certain types of transactions that could otherwise be captured by such broad definition, inter alia repo trades, securities lending and borrowing and structured products.

Further, the FMIA provides for a delegation to FINMA to designate the particular types of derivative transactions which will be subject to the obligation to clearing with a central counterparty and, once such obligation shall have been enacted by the Federal Council, which will have to be traded over a trading venue platform. As mentioned, it is expected that FINMA make such determinations in line with international standards, in particular with the determination made in Europe.

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 as well as between minor and major counterparties.

Financial counterparties are counterparties which act in a professional capacity in the financial market and include, as named in an exhaustive list in the FMIA, financial institutions which are supervised by FINMA as banks, securities dealers, insurance and reinsurance companies, fund management companies, SICAV, limited partnerships for collective investment, SICAF or asset managers of Swiss collective investment schemes, but not unregulated asset managers; ultimate holding companies of a financial or insurance group or of a financial or insurance conglomerate; and pension funds and investment foundations.

Minor financial counterparties are financial counterparties whose average position of derivative transactions is below a certain threshold. The introduction of minor financial counterparties constitutes a significant difference to the European regulation under EMIR.

Non-financial counterparties are counterparties which are not financial counterparties but are above one of several thresholds applicable to different categories of derivatives yet to be determined by implementing ordinances or circular letters of FINMA. It is to be noted that as a principle only legal entities incorporated in Switzerland are counterparties under the FMIA, thus excluding partnerships and individuals. Branches of foreign entities may be subjected to the FMIA by the Federal Council.

Minor non-financial counterparties are counterparties which are not financial counterparties and whose positions are below the non-financial counterparty thresholds, yet to be determined by implementing ordinances or circular letter which are expected to stay in line with international standards, particularly those adopted under EMIR. As set out in more detail below, such counterparties are not subject to all of the obligations in connection with the trading of derivatives under the FMIA.

c) Intra-group exemptions and possible further exemptions through the implementing legislation
Intra-group derivative transactions are exempted from clearing, risk mitigation and mandatory use of trading platform obligations, provided that (i) both counterparties are fully consolidated in the same group and that (ii) both counterparties are subject to appropriate centralized procedures for risk assessment, risk monitoring and risk control.

Furthermore, the FMIA empowers the Federal Council to exempt further financial market participants.

d) Jurisdictional scope of application
The FMIA provisions apply both to derivative transactions entered into between counterparties which are both incorporated in Switzerland and to derivative 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 the Swiss counterparty subject to the clearing obligation would be subject to the clearing obligation if it were established in Switzerland. Similarly, the obligation to trade derivatives over a trading platform also applies if the foreign counterparty of the Swiss counterparty that is obliged to trade over a trading platform would be subject to the trading platform obligation if it was incorporated in Switzerland.

Obligations with respect to derivative transactions

With respect to derivative trading, the FMIA sets out obligations regarding (a) trade reporting, (b) clearing, (c) risk mitigation and (d) mandatory use of trade platforms.

Clearing and reporting obligations may also be satisfied with a foreign central counterparty or trade repository that has been recognized by FINMA as set out below.

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 derivative transactions. This obligation applies to only one of the counterparties involved, the FMIA providing for rules specifying which counterparty has to make such reporting depending of the type of counterparties involved, e.g. to the financial counterparty with regards to its trades with a non-financial counterparty, or to the central counterparty if the transaction is cleared with such counterparty, failing which though a counterparty remains obligated to make such reporting. The reporting obligation may be satisfied by a third party mandated to this end.

The minimum content to be reported includes the identity of the parties entering into the transaction and the type, maturity, notional value, settlement date and currency of the derivative transaction, subject to further details to be reported mandated by the implementing legislation. 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. As discussed below, 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 FMIA conditions. 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 derivative transactions with a central counterparty authorized or recognized by FINMA. As indicated above, the FMIA provides for a delegation to FINMA to determine the categories of derivatives to be cleared, while specifically stating 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.

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 derivative transactions over a platform authorized or recognized by FINMA. The FMIA provides for a delayed implementation in that the Federal Council will 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.

d) Risk mitigation obligation

Non-standardized derivative transactions which are not 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, to (ii) mark-to-market the value of their outstanding transactions on a daily basis and to (iii) mitigate the operational risks arising from their derivative transactions, i.e. to (a) timely confirm the terms of the derivative transaction as well as to (b) implement an appropriate process to reconcile portfolios, mitigate the associated risks and identify and resolve 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.

Recognition of foreign market infrastructures
The FMIA is based on a concept of recognizing foreign market infrastructures, including foreign central counterparties, foreign trading platforms (meaning stock exchanges, multilateral trading systems and organized trading systems which enable multilateral trading) and foreign trading repositories that are equivalent. Based on such recognition these foreign market infrastructures can be used by Swiss counterparties to discharge their obligations in connection with derivative transactions under the FMIA.

FMIA rules with respect to such recognition differ with respect to different foreign market infrastructures. While foreign central counterparties are subject to individual formal recognition by FINMA, such recognition shall be deemed given by FINMA with respect to foreign trade repositories and foreign trading platforms if the state in which the respective foreign market infrastructure has its registered seat generally subjects its trading platforms and trade repositories to appropriate regulation and supervision and the foreign supervisory authorities do not object such cross-border activities of the respective foreign market infrastructure. These requirements are presumably seen as fulfilled for market infrastructures with registered seat in the European Union. However, at this stage it is not clear in what form FINMA would confirm the fulfillment of such requirements.

As has been set out, the FMIA provides for a comprehensive delegation of implementation powers to the Federal Council and to FINMA, the regulator. At this stage, no draft implementing ordinances have been published yet.

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

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