OTC-Derivatives Business: Financial and Non-Financial Counterparties

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- **Financial / non-financial counterparties and their small equivalents**
- **Small financial counterparties as Swiss-specific element**
- **Thresholds defined in delegated regulation**

1. Introduction

The over-the-counter (OTC) derivatives business is one of the most volatile business areas worldwide with a specific cross-border orientation. Most market participants in Switzerland operate on a cross-border basis with global capital flows. The importance of equivalence of regulatory efforts by the Swiss legislator has therefore been a core concern during the construction of a new regulatory regime. The risk of fragmentation and regionalization of different financial markets remains imminent.

There are Swiss-specific elements that deviate in parts from regulatory regimes in the EU and in the US. Swiss market participants need to know in advance which obligations are being imposed on them and need to realize that knowing the EU and US regulatory framework is crucial but not in itself sufficient to navigate the new Swiss regulatory structures.

The Swiss regulatory regime distinguishes between financial and non-financial counterparties. This distinction has an effect on transparency rules, counterparty credit risk provisions and the implementation of measures to reduce operational risks. OTC-derivatives trading will get more expensive in the future because of the higher level of standardization and higher capital requirements, not only for speculative but also for hedging purposes. Regulatory duties can vary significantly under the new Swiss law depending on the categorization of the respective market participants.

Pestalozzi Rechtsanwälte AG
Feldeggstrasse 4
CH-8008 Zürich
T +41 44 217 91 11
zrh@pestalozzilaw.com

Pestalozzi Avocats SA
Cours de Rive 13
CH-1204 Genève
T +41 22 999 96 00
gva@pestalozzilaw.com

pestalozzilaw.com

2. Overview of the New Financial Market Regulation

In Switzerland, we expect slightly more leeway for market participants to tailor structures for FinfraG-postimplementation trading compared to the EU. Indeed interesting is that the Swiss legislator did not follow the EU regarding the simple but strict distinction between financial and non-financial counterparties, but has introduced an additional category: the small financial counterparty.

Generally the measures introduced by FinfraG mainly target big international boker-dealers, such as global banks. Global banks have the financial capacity, experience, and internal set-up to deal with the reformed rules; they have also already been working on the MiFID I / MiFID II / MiFIR and the Dodd-Frank implementation for their crossborder businesses. The main burden for smaller market participants are the high costs and the lack of capacity not only to stem and navigate through the new regulatory world but also to adjust their business activities accordingly.

The third title of FinfraG covers (i) the derivatives business, (ii) measures to reduce the respective risks and (iii) different rules for financial and (as mentioned above) the Swiss-specific small financial counterparties, as well as non-financial and small non-financial counterparties.

Thus, FinfraG recognizes that small financial counterparties as well as non-financial and small non-financial counterparties use OTC derivatives to protect themselves against market risks directly linked to their market activities or treasury financing activities. Thus, derivative transactions that protect these kinds of counterparties against risks – directly connected with their commercial activities and treasury financing activities – shall not be subject to the obligations of FinfraG. The same applies to those market participants that do not exceed the respective thresholds.

3. Key Points for Market Participants

Reporting requirements apply to both, financial counterparties and non-financial counterparties, including their small equivalents. Transparency is one of the key elements of global regulatory efforts and the Swiss legislator has decided not to exclude small market participants from reporting obligations.

Transaction information is reported to trade repositories and made accessible to the regulator. Trade repositories then publish aggregate trading positions by class of derivatives accessible to all market participants. Businesses will face significant and expensive internal hurdles. They will need to update internal processes, create teams, train their staff and tweak their systems (or outsource such tasks) and replace existing workflows with new electronic processes, i.e., for timely reporting. Fortunately in Switzerland, only one counterparty to the trade has the reporting obligation. On the contrary, under EMIR both counterparties to the trade have a reporting obligation, and therefore smaller institutions will find themselves responsible for the new regulatory reporting. As a result, specifically non-financial counterparties can rely on a certain assumption that their sell-side counterparties will handle the reporting obligations. Parties must have a clear understanding as to who assumes reporting responsibilities prior to entering into a trading relationship.

Clearing obligations, which are introduced by FinfraG, are a specific challenge for smaller players. As a general rule, the obligations to clear OTC derivatives transactions through a CCP will apply to firms with large positions in OTC derivatives. But the legislator's goal is also to have as many OTC derivatives trades cleared through a CCP as possible. The scope of exemptions and thresholds for small financial counterparties and small non-financial counterparties is expected to be rather insignificant (the Federal Council will still need to determine the class of derivatives). FinfraG stipulates that FINMA will determine which derivative products will be subject to the clearing obligation. FINMA is expected to follow the two MIFIR approaches to determine which derivatives contracts will need to be cleared: the "bottom-up" approach and the "top-down" approach.

The "bottom-up" approach states that where a competent authority has authorized a CCP to clear a class of derivatives, it will inform FINMA who will have the power to decide whether a clearing obligation should apply to that class in Switzerland.

The "top-down" approach provides FINMA with the power to identify contracts that should be subject to the clearing obligation but for which no CCP has yet received an authorization. A significant amount of unclear legal facts remain because the market has not yet seen the draft of the specifying regulation. Market participants are wise to determine for themselves as to whether they are likely to be exempt as an institution or not to assess if they are under pressure to determine their obligations regarding traded derivative products.

Risk mitigation obligations, again, target both financial and non-financial counterparties, including small financial and non-financial counterparties. Only public law entities (including their non-financial organizations), the Swiss National Bank, multinational development banks, and the Bank for International Settlements (BIS) will be exempt. All other market participants will have to make sure that appropriate processes for portfolio reconciliation, risk management, identification and resolution of disputes, daily valuations of transactions and the exchange of collateral for uncleared derivatives are in place. A core element of risk mitigation procedures under the new Swiss regulatory regime is the portfolio reconciliation process pursuant to FinfraG. Counterparties shall ensure adequate processes to reconcile their portfolios to identify discrepancies at an early stage. FinfraG avoids being more specific and – looking at the challenges faced by EU counterparties – is predestinated to cause major confusion among Swiss counterparties.

Under EMIR, market participants needed to overcome many challenges during the implementation of the risk mitigation processes. Beside the operational set-up, the questions as to when a discrepancy shall be relevant and the procedure in case of a discrepancy had both been heavily discussed in the EU. The same issues have emerged in Switzerland, once FinfraG went live. Important is that the parties contractually agree upfront that discrepancies that amount to a value below a pre-defined threshold do not count as disputes. Also, the parties should define the procedure they intend to follow in case of discovering a relevant discrepancy.

In conclusion, the categorization will trigger different regulatory obligations, which can be complex and expensive. It is therefore necessary for Swiss market participants to assess their category at an early stage and understand the depth of their need for action. Understanding the EU and US regulatory regimes and being familiar with their implementation hurdles will help to get on the right track.

Robert Furter

Senior Counsel
Attorney at law

Pestalozzi Attorneys at Law Ltd
Feldeggstrasse 4
8008 Zurich
Switzerland
T +41 44 217 91 55
robert.furter@pestalozzilaw.com



Oliver Widmer

Partner
Attorney at law
Head Financial Services

Pestalozzi Attorneys at Law Ltd
Feldeggstrasse 4
8008 Zurich
Switzerland
T +41 44 217 92 42
oliver.widmer@pestalozzilaw.com

