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Derivatives – Impact of the New Financial Market Regulation

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- **Mandatory clearing**
- **Risk mitigation**
- **Reporting**

1. Introduction

Regulating derivatives transactions is a core concern of the Swiss legislator and with the implemented infrastructure rules, strict obligations have taken effect, for the most part following the rules in the European Union (EMIR). As a result, Swiss market participants need implement certain obligations within a tight timeframe. An impact is expected on existing derivative contracts with Swiss and non-Swiss counterparties, with a certain requirement to amend and supplement executed framework agreements.

2. Overview of the New Financial Market Regulation

The third title of the new Financial Market Infrastructure Act (FinfraG) covers the derivatives business, measures to reduce the respective risks and specific (trade) transparency rules. FinfraG – which entered into force in 2016 – is the core act for the regulation of the (OTC) derivatives business. It has introduced specific

- clearing obligations,
- risk mitigation obligations and
- reporting obligations.

Derivatives are also defined as financial instruments within the current draft of the Financial Services Act (FIDLEG). This means that market participants trading with and offering derivatives will need to comply with new rules that are introduced to protect their clients. Providing detailed information prior to trading is an important new feature and it will also apply to derivatives (offered to clients and – in a more comprehensive way – to private clients in Switzerland).

3. Key Points for Market Participants

Globally, legislators and regulators intend to have as many OTC derivative trades cleared through a central counterparty (CCP) as possible and the FinfraG is not an exception to this rule. Once market participants know that they are subject to clearing obligations, either by their categorization or due to the class of derivatives they trade, they will need to strategically decide how they wish to organize the clearing set-up so that it is in line with the FinfraG rules. The first step is the choice of a suitable CCP. To facilitate the clearing of certain derivative transactions, the parties must enter into a so called client clearing agreement that both incorporates and modifies certain client clearing standard terms. A precise negotiation of the respective terms in such a client clearing agreement is crucial because underlying master agreements (i.e. ISDA Master Agreements or Swiss Master Agreements OTC-derivative instruments) and trade confirmations will be amended by the terms of the client clearing agreement for cleared derivative transactions. The parties should also pay attention to collateral terms in client clearing agreements and the respective pricing impact in case of a deviation from the agreed terms in the bilateral collateral arrangement.

Market participants will also need to be aware that for derivative transactions that are not cleared by a CCP, they shall ensure that appropriate procedures and arrangements are put in place to measure, monitor and mitigate operational risks. The aforesaid has an effect on the obligation to send timely confirmations, formalize processes and to be able to reconcile portfolio data efficiently.

Reporting obligations under FinfraG ensure that details of any derivative contract, any modification to these contracts and their termination are reported to a trade repository registered or licensed by the Swiss regulator. In contrast to the requirements in the EU, FinfraG follows the US approach and allows one-way reporting. Counterparties need to agree as to who assumes the reporting responsibilities. Banks and larger financial institutions will be able to easily facilitate the set-up of reporting operations. Smaller institutions, such as small non-financial counterparties, will either rely on their larger counterparties to deal with the reporting or – in case they themselves face a smaller institution without such a set-up – update their internal systems to fulfill the operational and technical requirements to ensure compliance with the reporting obligations under FinfraG. Reporting obligations do not necessarily require an amendment of existing agreements. The Swiss regulator FINMA has now authorized and recognized the first two trade repositories under the Financial Market Infrastructure Act (FMIA): SIX Trade Repository AG and Regis-TR S.A. This means that the obligation to report derivatives transactions to a trade repository will now be phased-in and requires

- FC+/CCPs to report derivatives transactions from 1 October 2017;
- FC-/NFC+ to report derivatives transactions from 1 January 2018;

- Counterparties in all other cases from 1 April 2018 (i.e. NFC- in case that their non-Swiss counterparty refuses to comply with the reporting obligation under Swiss law or equivalent non-Swiss law).

As a result, clearing and risk mitigation obligations under FinfraG will require amendments to existing contracts, reporting obligations target the operational set-up of derivative counterparties, ,and compliance will be achieved by making sure that one of the derivative parties is set-up to ensure consistent application of reporting procedures.

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