

October 2014

# Guide to the Financial Market Infrastructure Act

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## 1. Executive Summary

The Financial Market Infrastructure Act (**FMIA**) (*Bundesgesetz über die Finanzmarktinfrastrukturen und das Marktverhalten im Effekten und Derivatehandel (Finanzmarktinfrastukturgesetz, FinfraG)*) will impact all entities incorporated in Switzerland active in the derivatives market. FMIA is likely to enter into force not earlier than by mid-year 2016.

FMIA imposes three main obligations on market participants:

- **clearing obligation:** certain OTC derivatives entered into between certain market participants have to be cleared via a central counterparty (**CCP**); the clearing obligation does not apply where at least one of the parties is a small counterparty; in contrast to the European regulations, not only non-financial counterparties can qualify as small counterparties, but also financial counterparties; in particular currency swaps and FX forwards (which are settled by means of a payment versus payment mechanism) are exempt from the clearing obligation;
- **reporting obligation:** all OTC and exchange-traded derivatives trades have to be reported to a trade repository authorised or recognised by the Swiss Financial Market Supervisory Authority (**FINMA**);
- **risk mitigation obligations:** OTC derivatives entered into between certain market participants and which are not cleared via a CCP are subject to risk mitigation obligations; certain derivatives are exempt from the risk mitigation obligations (in particular currency swaps and FX forwards); the risk mitigation obligations include the mitigation of operational and counterparty risks, the daily mark-to-market valuation of trades and the exchange of collateral;
- **platform trading obligation:** certain OTC derivatives entered into between certain market participants will have to be traded over a platform; this obligation will not apply where at least one of the parties is a small counterparty, and will be effective only at the time when it is effective on the international markets.

The following chart sets out the obligations imposed on the market participants under FMIA:

| Participants \ Obligations         | Financial Counterparty | Small Financial Counterparty | Non-Financial Counterparty | Small Non-Financial Counterparty |
|------------------------------------|------------------------|------------------------------|----------------------------|----------------------------------|
| Clearing                           | yes                    | no                           | yes                        | no                               |
| Reporting                          | yes                    | yes                          | yes                        | yes                              |
| Risk mitigation – operational risk | yes                    | yes                          | yes                        | yes                              |
| Risk mitigation – valuation        | yes                    | no                           | yes                        | no                               |
| Risk mitigation – collateral       | yes                    | yes                          | yes                        | no                               |
| Platform trading                   | yes                    | no                           | yes                        | no                               |

FMIA provides in particular for the following exemptions:

- certain instruments (structured products, securities lending and borrowing and repo-transactions) are exempt from the derivatives trading obligations set out in FMIA;
- certain entities are exempt from the derivatives trading obligations set out in FMIA (e.g. the Swiss Federation, the Swiss cantons and the Swiss National Bank) or are only subject to certain duties (see section 2.7); according to the Federal Council Report (as defined below), this exemption could also apply to pension funds.

**With respect to cross-border derivatives transactions**, FMIA generally holds that the obligations set out in FMIA are satisfied if (i) they are fulfilled in compliance with foreign laws provided FINMA recognises the applicable foreign laws as equivalent to the Swiss regulations, and (ii) the foreign financial market infrastructure used to complete the transaction is recognised by FINMA (**Cross-border Rule**).

The Cross-border Rule will facilitate the compliance with FMIA of the derivatives trades concluded with EU/US counterparties pursuant to EU/US regulations. If however the conditions of the Cross-border Rule are not satisfied, FMIA will have an impact on the foreign counterparties as they will have to comply

with FMIA obligations if they wish to enter into derivatives with Swiss counterparties (e.g. compliance with the clearing obligations or the provision of collateral).

European regulations request the reporting of information which is beyond that required under FMIA. To avoid any conflict with Swiss law, FMIA provides a legal basis allowing Swiss entities to report additional information to foreign trade repositories. However, if the additional information includes personal data, banking secrecy law subjects the reporting to the consent of the person concerned.

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## **2. Basics**

### **2.1. What is the legal basis?**

The new framework for the regulation of the Swiss financial market is set out in FMIA. FMIA is still in draft form and consequently subject to changes. Any reference in this guide to FMIA shall be to the draft FMIA issued by the Swiss Federal Council on 3 September 2014 along with its extensive report on FMIA (**Federal Council Report**). FMIA is not expected to enter into force prior to the first half of 2016.

FMIA will be completed by and implemented in two ordinances: the Financial Market Infrastructure Ordinance to be issued by the Swiss Federal Council (**FMIO**) and the Financial Market Infrastructure Ordinance to be issued by the Swiss Financial Market Supervisory Authority (**FINMA**) (**FMIO-FINMA**).

### **2.2. What is the rationale behind FMIA**

The main rationale behind issuing FMIA is to align the Swiss regulatory framework with international standards, in particular with the EU regulations (MiFID II, MiFIR, EMIR and CSDR) with a view to preserving Switzerland's global competitiveness.

### **2.3. What is the content of FMIA and the scope of this guide**

The object of FMIA is to regulate:

- the organisation and operation of the financial market infrastructures (e.g. stock exchanges and central counterparties);
- the trading of derivatives; and
- the conduct of business rules (e.g. insider trading and market manipulations, shareholding disclosures and public takeover offers).

**This guide will only address the rules of FMIA applicable to the trading of derivatives.**

#### **2.4. Which entities are affected by FMIA?**

Subject to certain exceptions, FMIA affects all entities incorporated in Switzerland which enter into derivatives. This includes branches (*Niederlassungen*) of Swiss entities established abroad, but excludes foreign branches established in Switzerland (if and to the extent they are subject to similar regulations).

Like the European Market Infrastructure Regulation (**EMIR**), FMIA distinguishes between two types of entities: financial counterparties (**FC**) and non-financial counterparties (**NFC**).

#### **2.5. Which Swiss derivatives market participants fall into the FC category?**

Banks, securities dealers, insurance and re-insurance companies, parent companies of a financial or insurance group or conglomerate, fund management companies (*Fondsleitungen*), asset managers of collective investment schemes, collective investment schemes, pension funds (*Vorsorgeeinrichtungen*) and investment foundations (*Anlagestiftungen*).

#### **2.6. Which Swiss derivatives market participants fall into the NFC category?**

NFC are all legal entities that do not qualify as FC. This includes multilateral trading facilities (*multilaterale Handelssysteme*), asset managers of non-collective investment schemes (*Vermögensverwalter ausserhalb des Kollektivanlagenbereichs*) and investment advisors (*Anlageberater*).

## 2.7. Are any participants exempt from the derivatives trading rules of FMIA?

The Swiss Federation, the Swiss cantons, the municipalities, the Swiss National Bank and the Bank for International Settlement (BIS) will not be subject to the new regulations on the trading of derivatives.

Other participants are only subject to certain duties. For instance, multilateral development banks (e.g. the World Bank and the European Investment Bank) and organisations (including social security institutions (*Sozialversicherungseinrichtungen*)) owned by the Swiss Federation, the Swiss cantons or municipalities (provided these organisations benefit from a state guarantee and do not qualify as FC) are only subject to the reporting obligation.

In addition, in FMIO the Federal Council can exempt, fully or in part, additional public establishments or financial market participants from the new derivatives trading regulations on the grounds of proportionality and in consideration of international standards. The Federal Council Report mentions that the exemption could apply to pension funds or foreign central banks.

## 2.8. Are any derivatives exempt from FMIA?

The following instruments are exempt from the obligations set out in FMIA:

- structured products (such as capital-protected products, capped return products and certificates);
- securities lending and borrowing;
- repo-transactions.

## 2.9. What main obligations does FMIA impose?

FMIA imposes four main obligations on market participants:

- **clearing obligation:** certain OTC derivatives entered into between certain market participants have to be cleared via a CCP (see more detail in section 3);

- **reporting obligation:** OTC and exchange-traded derivatives have to be reported to a trade repository (see more detail in section 4);
- **risk mitigation obligations:** certain OTC derivatives which are entered into between certain market participants and which are not cleared via a CCP are subject to risk mitigation obligation (see more detail in section 5);
- **platform trading obligations:** certain OTC derivatives entered into between certain market participants have to be traded over a platform (see more detail in section 6).

## 2.10. Can the obligations be satisfied by complying with foreign laws?

The obligations set out in FMIA are also satisfied if:

- they are fulfilled in compliance with foreign laws, provided FINMA recognises the applicable foreign laws as equivalent to the Swiss regulations; and
- FINMA recognises the foreign financial market infrastructure used to complete the transaction.

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## 3. Clearing obligation

### 3.1. What is the general obligation?

Counterparties must clear their OTC derivatives via a CCP authorised or recognised by FINMA.

Clearing is defined in FMIA as the process between conclusion and settlement of a transaction, in particular the collection, conciliation and confirmation of the transaction data, the assumption by a CCP of the parties' positions under the contract or other risk mitigation measures, the netting of transactions and the reconciliation and confirmation or payment transfer of securities.

### **3.2. Which market participants will be subject to the clearing obligation?**

The clearing obligation applies if the relevant OTC derivative is of a category that has been declared subject to the clearing obligation and entered into between two FC, one FC and one NFC or two NFC, provided that at least one of the parties is incorporated in Switzerland.

The clearing obligation does not apply where at least one of the parties is a small counterparty (**SC**). In contrast to EMIR, not only NFC can qualify as SC, but also FC.

### **3.3. Which NFC fall into the SC category?**

A NFC is a SC when all of its gross rolling average positions over 30 working days are below the clearing thresholds in all relevant derivatives categories. Exceeding the threshold in only one derivative category triggers a clearing obligation for all derivative transactions (including the hedging transactions) entered into by the relevant counterparty.

The calculation of the gross average position does not include “hedging derivatives”, i.e. those derivatives entered into for risk mitigation purposes, provided they are directly connected with the business or the liquidity or financial management of the counterparty or the group.

### **3.4. Which FC fall into the SC category?**

An FC is a SC when all of the gross rolling average positions of all of its open OTC derivatives over 30 working days are below the clearing threshold.

### **3.5. What are the clearing thresholds?**

The clearing thresholds will be set out in FMIO. According to the Federal Council Report, the following principles will be applicable:

- for NFC, clearing threshold values will be set for each derivative category (such as commodity, credit, FX, equity and interest rate derivatives);



- for FC, only one clearing threshold value will be set for all open OTC derivatives;
- the gross position will consist of the notional position in the relevant open OTC derivatives;
- if the counterparty is part of a fully consolidated group, the calculation of the gross rolling average position will include all internal OTC derivatives transactions concluded by the group companies.

### **3.6. Which OTC derivatives are subject to the clearing obligation?**

FINMA will set out in FMIO-FINMA which categories of derivatives will be subject to the clearing obligation. A clearing obligation will apply only to derivatives which have the following features: a high degree of legal and operational standardisation, sufficient liquidity and trading volumes, availability of price data sources and existence of a counterparty risk. FINMA must take into account the international standards and may implement the clearing obligation in phases for each derivative category.

### **3.7. Are certain OTC derivatives exempt from the clearing obligation?**

The following derivatives are exempt from the clearing obligation:

- derivatives which no authorised or recognised CCP clears;
- currency swaps and FX forwards which are settled by means of a payment versus payment mechanism (e.g. that operated by Continuous-Linked-Settlement).

### **3.8. How does FMIA affect entities which are not incorporated in Switzerland?**

The clearing obligation applies also in the event that the foreign counterparty of a Swiss counterparty subject to the clearing obligation would be subject to the clearing obligation if it were incorporated in Switzerland. Consequently, the clearing obligation applies to third country entities if they wish to trade derivatives subject to the clearing obligation with certain Swiss derivatives market participants. According to the Federal Council Report, this will affect however

only foreign entities (outside of the EU and the USA) which are not already subject to the clearing obligations under equivalent foreign law.

### **3.9. Are group internal derivative transactions affected by the clearing obligations?**

Derivative transactions are exempt from the clearing obligation if:

- both counterparties are included in the consolidated statements of the group;
- both counterparties are subject to appropriate centralised procedures for risk assessment, risk measurement and risk control; and
- the transactions do not occur to circumvent the clearing obligation.

In contrast to the EU regulations, the exemption applies also to cross-border group internal derivative transactions.

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## **4. Reporting Obligation**

### **4.1. Which counterparties are subject to the reporting obligation?**

All FC, NFC and CCP must submit certain data relating to derivatives transactions to a trade repository authorised or recognised by FINMA, whether they enter into derivatives with other counterparties incorporated in Switzerland or elsewhere.

Third country counterparties are not subject to the reporting obligation under FMIA.

### **4.2. Which derivatives are subject to the reporting obligation?**

All derivatives (OTC and exchange-traded) are subject to the reporting obligation.

Derivatives subject to the reporting obligation are defined as bilateral financial contracts which price is derived from one or several underlying assets and which are not spot transactions. This includes swaps, options and forward contracts related in particular to interest rates, currencies, securities, credit risks or others (e.g. commodities or emission certificates). A financial contract does not need to be standardised or issued for mass trading to qualify as a derivative contract subject to the reporting obligations.

Spot transactions fall outside the definition of derivative. A spot contract is defined as a contract for settlement on the spot date, which is no later than two business days after the trade date or within a deadline generally accepted on the markets for this type of contract.

FMIA does not provide an exception for FX forwards or swap contracts.

#### **4.3. Which counterparty must report?**

In contrast to the European regulations, FMIA imposes the reporting on a specific counterparty to avoid duplicate reporting. Reporting is to be made by:

- the FC, where the derivatives are entered into between an FC and a NFC;
- the FC or the NFC which is not a SC, where the derivatives are entered into between two FC or two NFC, respectively;
- the selling counterparty, where the derivatives are entered into between two SC or two FC or NFC which are not SC;
- the counterparty incorporated in Switzerland, where the foreign counterparty does not report the transactions;
- the CCP, where the trade is cleared and reported by a CCP.

Counterparty can delegate the reporting to a third party.

#### **4.4. When the information needs to be reported?**

Market participants must ensure that they report to a trade depository the entry into, any modification and the termination of the derivatives by the working

day following the entry into, modification or termination of such derivatives (T+1).

FMIO will determine which derivatives entered into prior to the effective date of FMIA (i.e. historical trades) will be subject to the reporting obligation.

#### **4.5. Which information needs to be reported?**

For each trade, at least the following information must be reported: the identity of the parties to the derivative transaction, type, maturity, nominal value, price, settlement date and currency. FMIO can request additional information and set the format of the reporting in consideration of the international standards (e.g. use of the Legal Entity Identifier).

The Federal Council Report holds that the details of the beneficial owner of the trade are not to be reported as they are not relevant for the purpose of FMIA (in contrast to the European regulations).

#### **4.6. Can the reporting to foreign trade repositories include additional information (to the ones set out in section 4.5)?**

European regulations request the reporting of information which is beyond that required under FMIA. To avoid any conflict with Swiss law, FMIA provides a legal basis allowing Swiss entities to report additional information to foreign trade repositories. However, if the additional information includes personal data, banking secrecy law subjects the reporting to the consent of the person concerned.

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## **5. Risk Mitigation Obligations**

### **5.1. Which derivatives are subject to the risk mitigation obligations?**

The risk mitigation obligations apply generally to all OTC derivatives which are not cleared via a CCP authorised or recognised by FINMA (irrespective of whether they are concluded on a trading platform or directly with counterparties). The rationale behind this is that not all OTC derivatives must or can be cleared via a CCP (see section 3).

## **5.2. Are certain derivatives exempt from the risk mitigation obligations?**

The following derivatives are exempt from the risk mitigation obligations:

- derivatives concluded with the counterparties exempt from all or certain obligations relating to derivatives trading under FMIA (see section 2.7);
- currency swaps and FX forwards;
- derivatives which are cleared via a CCP without being obliged to do so.

FMIO can provide for additional exemptions in consideration of the principle of proportionality and international standards.

## **5.3. What are the risk mitigation obligations?**

The risk mitigation obligations set out in FMIA relate to:

- the mitigation of operational and counterparty risks (see section 5.4);
- the daily mark-to-market valuation of trades (see section 5.5);
- the exchange of collateral (see section 5.6).

Capital requirements for financial counterparties with respect to their OTC derivatives are set out in specific legislations, rather than in FMIA.

## **5.4. Mitigation of operational and counterparty risks**

All the counterparties must capture, monitor and mitigate the operational and counterparties risks related to OTC derivatives. They must in particular:

- timely confirm the trade obligations (the timeline for confirmation will depend in particular on the type of derivative and counterparty);
- have procedures in place to reconcile portfolios and to control the related risks (delegation to the counterparty or a third party should be possible);

- have dispute resolution processes in place (in particular through dispute jurisdiction and governing law clauses);
- conduct regularly (at least two times per year) a portfolio compression if this is appropriate to reduce the counterparty risks and if 500 or more non-cleared OTC derivatives are outstanding (as in the EU legislations, portfolio compression is requested only in specific circumstances and with reserve).

### **5.5. Daily mark-to-market valuation of trades**

Counterparties are required to mark the value of their outstanding non-cleared OTC derivatives to market on a daily basis. If market conditions prevent marking-to-market, counterparties must use appropriate mark-to-model recognised in practice.

This risk mitigation obligation is not applicable where the trades are concluded with SC.

### **5.6. Exchange of collateral**

Counterparties must exchange appropriate collateral. This risk mitigation obligation is not applicable to small NFC.

Since foreign entities do not fall into the scope of FMIA, this obligation is not directly applicable to them. Swiss entities will however not be able to enter into a derivatives trade with foreign entities if they do not receive appropriate collateral from such foreign counterparties.

FMIA stipulates in addition the following principles:

- counterparties must be able to segregate collateral from their own assets;
- parties' specific agreements on the realisation of collateral, which value can be objectively determined, also hold in enforcement proceedings and if insolvency measures are taken;

- no collateral needs to be exchanged with respect to intra-group trades if (i) both counterparties are included in the consolidated statements of the group; (ii) both counterparties are subject to appropriate centralised procedures for risk assessment, risk measurement and risk control; (iii) there are no legal or factual elements which prevent the immediate transfer of own capital or repayment of liabilities (the Federal Council Report indicates that this condition shall ensure that if a group company defaults the group as a whole will assume the shortfall); and (iv) the transactions do not occur to circumvent the collateral exchange obligation;
- FMIO will set out the requirements applicable to the exchange of collateral in due consideration of international standards.

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## **6. Trading over a platform**

### **6.1. What is the general obligation?**

Counterparties must trade their OTC derivatives over an authorised or recognised platform.

### **6.2. Will certain market participants be exempt from the platform obligation?**

The obligation to trade over a platform will not apply where at least one of the parties is a SC.

### **6.3. When will this obligation be effective?**

This obligation will apply only at the time when it is effective on the international markets.

### **6.4. How does FMIA regulate the obligation to trade over a platform?**

We cross-refer to sections 3.3 to 3.9 as these rules will apply *mutatis mutandis*.

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