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Short & Simple

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The Financial Market Infrastructure and Market Conduct in Securities and Derivatives Trading Act (FMIA; Financial Market Infrastructure Act) – Regulation on Derivatives Trading

The FMIA and its associated Financial Market Infrastructure Ordinance (FMIO) and FINMA Financial Market Infrastructure Ordinance (FMIO-FINMA) came into force on 1 January 2016. Through this, the following areas of Swiss capital markets law have been pooled in one act: (i) the licensing and organisation of financial market infrastructures, (ii) trading of derivatives, (iii) the disclosure of shareholdings and public takeover offers, (iv) insider trading and market manipulation and (v) administrative assistance. In three issue of «Short & Simple», we will give you an overview of the relevant changes in these areas. This issue of «Short & Simple» addresses the changes in the area of trading of derivatives.

You can find the other two issues of «Short & Simple» at the following links: Licensing and organisation of financial market infrastructures: Link; Disclosure of shareholdings, public takeover offers, insider trading, market manipulation and administrative assistance: Link.

I. Applicable provisions, goals and background

Until now, derivatives trading was only regulated in the Stock Exchanges and Securities Trading Act (SESTA) and in the Swiss Code of Obligations (CO). Trading in OTC derivatives was not regulated at all and was only subject to the provisions in the CO. This has all changed with the new art. 93-117 FMIA, art. 76-114 FMIO and art. 6-7 FMIO-FINMA. The FMIA aims to ensure functional and transparent securities and derivatives markets as well as the stability of the financial system and thus to reduce systemic risks.

The FMIA applies to all derivatives, including those listed on a stock exchange. If a derivative is centrally cleared, however, which is the rule in stock exchange trading, the obligations laid down in the FMIA do not apply or are fulfilled by the central counterparty. This is why the FMIA's regulation of derivatives trading can actually be regarded as regulation of OTC derivatives trading.

The new provisions are based on the Dodd Frank Act and the EU ordinance on OTC derivatives, central counterparties and transaction registers ("EMIR").

II. The personal scope of application of the provisions on derivatives trading

The FMIA differentiates between the following market participants:

1. Financial counterparties («FCP»)

FCPs are banks, securities dealers, insurance and reinsurance companies, group parent companies of financial or insurance groups of companies or conglomerates, fund administration companies, portfolio managers of collective investment schemes, collective investment schemes, pension institutions and investment foundations.

Independent asset managers and investment consultants are not regarded as FCPs, but as NFCPs. However, their clients may be classified as FCPs, especially if they are pension institutions.

In the case of contractual collective investment schemes, both the fund administration company and the collective investment scheme count as FCPs. If the collective investment scheme is managed by an asset manager, the asset manager also counts as an FCP.

2. Small financial counterparties («sFCP»)

sFCPs are FCPs whose gross notional value of all outstanding OTC derivatives over the course of 30 business days lies under the threshold of CHF 8 billion. Whether a collective investment scheme is regarded as an FCP or an sFCP is evaluated independently of its legal structure, meaning both contractual collective investment schemes and those organised as companies can be sFCPs or FCPs. Instead, the distinction is made based on the amount of OTC derivatives trading carried out for the account of the collective investment scheme.

3. Non-financial counterparties («NFCP»)

NFCPs are companies, including trusts and other bodies, that are registered in the commercial register and not excluded from the scope of application of the FMIA. They are mostly industrial and trading companies.

4. Small non-financial counterparties («sNFCP»)

sNFCPs are NFCPs whose gross notional value of each different class of derivatives over the course of 30 business days lies under the corresponding thresholds. Different thresholds apply depending on the derivative category.

5. Exceptions

The Swiss Confederation, the cantons, the municipalities, the Swiss National Bank and the Bank for International Settlements are excluded from the scope of application of the provisions on derivatives trading.

III. The material scope of application of the provisions on derivatives trading

The provisions on derivatives trading apply to all derivatives. Derivatives are financial contracts whose price is based on one or more underlying assets (shares, bonds, commodities and precious metals, reference values such as currencies, interest and indicators).

The scope of application does not include (i) spot transactions, (ii) certain electricity and gas derivatives, (iii) certain derivatives related to climate variables, freight rates and inflation rates, (iv) structured products, (v) securities lending transactions and (vi) certain commodity derivatives with physical settlement as well as securitized derivatives and structured deposits. Specific exceptions are also possible for the individual obligations outlined in section V below.

IV. The geographic scope of application of the provisions on derivatives trading

The FMIA is applicable to all FCPs, sFCPs, NFCPs and sNFCPs that have their seat in Switzerland, as well as to all their foreign branches. It is not applicable to Swiss branches of foreign financial market participants unless the foreign financial market participants are not subject to equivalent regulation.

Where the derivative transaction is carried out and the law applicable to such are irrelevant for the scope of application of the FMIA.

The FMIA is, however, not applicable when the obligations laid out in the FMIA are fulfilled under foreign legislation that is recognized by the FINMA as being equivalent to Swiss law.

V. The obligations for derivatives trading

The FMIA sets out the following obligations for derivatives trading:

1. The obligation of clearing via a central counterparty (clearing obligation, art. 97 et seqq. FMIA)

As long as derivatives are not processed via a multilateral trading venue pursuant to art. 26 FMIA, they must be cleared via a central counterparty licensed or recognised by the FINMA. Clearing involves the processing steps between the conclusion of derivatives contracts and the settlement of derivatives, such as the takeover of obligations by a central counterparty, charging, coordination and confirmation of the payments to be processed. This serves to mitigate the counterparty risk.

Not all derivatives are subject to the clearing obligation; the FINMA determines which derivatives are. In doing so, it must follow international standards. No clearing obligation exists for:

- derivatives that are not cleared by any central counterparty (impossibility);
- currency forwards and swaps, provided that they are settled on a payment v. payment basis;
- intragroup transactions, if both counterparties are subject to the same full consolidation and suitable risk assessment, measurement and control procedures (meaning they have a professional centralised treasury);
- derivatives with or under sFCPs and sNFCPs;
- multilateral development banks as well as organisations, including social security institutions, under public control or ownership or which are subject to state liability, to the extent that they do not qualify as a FCP;
- derivatives with foreign central banks, the ECB, the EFSF, the ESM and certain state institutions active in the area of debt repayment and promotional loans.

The clearing obligation extends across state borders if the foreign counterparty is also subject to a clearing obligation under the law applicable to it. If it is not subject to any clearing obligations under its own law, the clearing obligation still exists from a Swiss standpoint if the foreign counterparty would be subject to the clearing obligation if it were subject to Swiss law. In addition, no clearing obligation exists if the foreign counterparty has its seat in a state with equivalent regulations and is not subject to a clearing obligation there.

2. Reporting obligations to a trade repository (art. 104 et seqq. FMIA)

The conclusion, change and termination of derivative transactions must be reported to a trade repository licensed or recognised by the FINMA. This serves to improve transparency.

The content of the report is determined in art. 105 para. 2 FMIA and Annex 2 of the FMIO and is aimed at making the contract specifications clear in order to identify any possible risks.

Subject to the reporting obligations are:

- central counterparties in the case of centrally cleared derivatives (see section V.1). The reporting obligation is thus only applicable to OTC derivatives that are not subject to the clearing obligation;
- the FCP in the case of transactions between FCPs and NFCPs;
- the party that is not an sFCP, or otherwise the selling counterparty, in the case of transactions between two FCPs;
- the party with its seat in Switzerland if the foreign counterparty does not report;
- the party that is not exempted from reporting obligations in the case of transactions where one party is exempted.

3. Risk mitigation obligations (art. 107 et seqq. FMIA)

Derivatives that are not traded via a multilateral trading venue (e.g. a stock exchange) and that are not subject to clearing obligations (V.1) are subject to risk mitigation obligations. Exempted are:

- derivatives with multilateral development banks;
- derivatives with organisations, including social security institutions, under public control or ownership or which are subject to state liability, to the extent that they do not qualify as an FCP;
- currency forwards and swaps;
- derivatives that are voluntarily cleared via a central counterparty;
- derivative transactions that are not concluded between companies.
- The aim is to mitigate the risks connected to derivatives that are not subject to reporting and clearing obligations. This ultimately serves to reduce the counterparty risk.
- Risk mitigation is realised through the following measures:
- identification of operational and counterparty risks;
- daily valuation of outstanding transactions, except for transactions with sFCPs and sNFCPs;
- the exchange of securities, except for transactions with sNFCPs, which are to be adequately separated from one's own assets. Exceptions exist for intragroup transactions.

4. The obligation to trade via multilateral trading venues and organised trading venues (art. 112 et seqq. FMIA)

The obligation to trade certain derivatives via multilateral trading venues such as a stock exchange has been introduced now so that the FINMA can make use of it in the future. The FINMA is competent to determine which derivatives are subject to this obligation and are thus classified as derivatives traded on a stock exchange. It is to be expected that the FINMA will only take advantage of this competence at a later time, when this also occurs in the EU.

VI. Position limits for commodity derivatives (art. 118 et seq. FMIA)

Commodity derivatives are in principle also subject to the FMIA (for the exceptions, see section III). They are also subject to the clearing, reporting and risk mitigation obligations.

The FMIA provides the Federal Council with the competence to introduce guidelines as to the size of net positions in commodity derivatives that a person is allowed to hold. This serves to prevent price distortion on the commodities market due to speculation.

The Federal Council has not yet made use of this competence in the FMIO.

VII. Transitional provisions

Staggered transitional periods are laid out in the FMIA and the FMIO and apply to all of the obligations under the FMIA:

- The FINMA is to determine which derivatives are subject to the clearing obligations. Once the FINMA has determined this, the transitional regime pursuant to art. 85 FMIO applies.
- The staggered transitional periods for the reporting obligations are determined pursuant to art. 130 FMIO.
- The staggered transitional periods for the risk mitigation obligation are determined pursuant to art. 131 FMIO.
- The FINMA is to determine which derivatives must be processed via multilateral trading venues and organised trading venues. Once the FINMA has determined this, the transitional regime pursuant to art. 108 FMIO applies.

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