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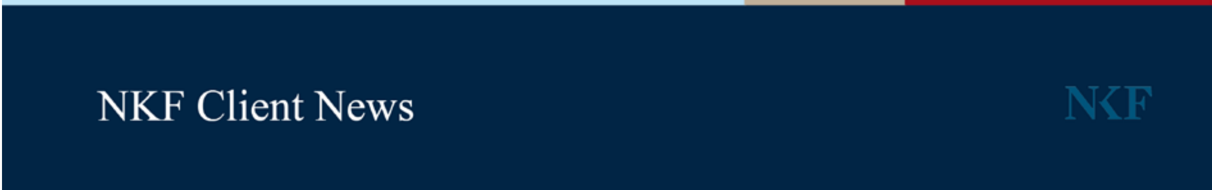

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NKF Banking, Finance & Regulatory Team – Update 4/2017

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I. CONTRACTUAL RECOGNITION OF STAY – CHANGE OF FINMA BANKING INSOLVENCY ORDINANCE

Together with the entering into force of the Swiss Financial Market Infrastructure Act (FMIA) on 1 January 2016, a new art. $12(2)^{bis}$ was introduced to the Banking Ordinance whereby banks shall ensure, both on a single entity as well as at the group level, that new agreements or amendments to existing agreements which are subject to foreign law or a foreign place of jurisdiction are only entered into if the **counterparty recognises FINMA's right to impose a stay** on the termination of agreements in accordance with art. 30a of the Swiss Banking Act.

On 16 March 2017, FINMA published certain **amendments to the FINMA Banking Insolvency Ordinance** (arts. 56 ss.) that further specify the requirements in connection with the recognition clause pursuant to art. $12(2)^{bis}$ of the Banking Ordinance. The amendments to the FINMA Banking Insolvency Ordinance became effective on 1 April 2017, but foresee transitional periods of 12 months for contracts with banks and securities dealers and 18 months for contracts with all other counterparties.

The **key aspects** are the following:

1. Scope

Swiss Securities Dealers also within Scope. The Swiss Stock Exchange and Securities Dealing Act, which governs Swiss securities dealers, does not contain such a provision, neither does it cross-refer to the relevant part of the Swiss Banking Act, so it was questionable whether art. $12(2)^{bis}$ of the Banking Ordinance should also be applicable to Swiss securities dealers. FINMA made clear in its accompanying documentation and the revised FINMA Banking Insolvency Ordinance that these new rules shall also be applicable to Swiss securities dealers and not only to Swiss banks.

Other Group Companies also within Scope. According to the new rules, the following parties must ensure that a recognition clause is included in the relevant financial contracts: (i) Swiss banks and Swiss securities dealers, (ii) group companies active in the finance industry of a Swiss bank or a Swiss securities dealer and (iii) foreign group companies active in the finance industry of a Swiss bank or Swiss securities dealer if such Swiss bank or Swiss securities dealer stands in (e.g. by way of a guarantee or security) for the performance of such foreign group company assumed under the relevant financial contract.

Limitation to Financial Contracts. FINMA makes clear that the obligation under art. $12(2)^{bis}$ of the Swiss Banking Ordinance shall apply only to certain types of financial contracts as enumerated in the new art. 56. Such list is intended to be in line with international standards, in particular those in the EU (BRRD where reference is made to "financial contracts" (art. 2(100))[1] or the PRA Rulebook where reference is made to "financial arrangement"[2]). The most relevant financial contracts for Swiss banks and Swiss securities dealers that will require an amendment are ISDA derivative agreements as well as US and UK law governed securities lending (MSA/GMSLAs) and repurchase agreements (MRA/GMRAs).

2. Amendment of Agreements

The **entering into a new transaction/loan under a financial contract** would be deemed to be an amendment that triggers the obligation to include a recognition clause. However, pre-agreed changes to a financial contract that will become effective without further action of the parties involved do not trigger a requirement to amend an existing financial contract.

3. Exemptions

Article $12(2)^{bis}$ Banking Ordinance is not applicable if the relevant financial contract **does not (directly or indirectly) allow for a termination** or the exercise of netting, realisation and transfer rights in accordance with art. 27 of the Swiss Banking Act **as a consequence of FINMA exercising any of its rights pursuant to the eleventh title of the Swiss Banking Act** (Measures in case of Insolvency Risk) which includes protective measures (*Schutzmassnahmen*) as well as the initiation of a restructuring proceeding (*Sanierungsverfahren*). Furthermore, financial contracts that are concluded or settled directly or indirectly via a **financial market infrastructure** or an organised trading facility (**OTF**), contracts with **central banks**, contracts of **group entities that are not active in the financial sector**, contracts with **counterparties that are not companies** in the sense of art. 77 of the Swiss Financial Market Infrastructure Ordinance (e.g. natural persons) or contracts relating to the **placement of financial instruments in the market** (e.g. underwriting agreements) are not subject to art. $12(2)^{bis}$ Banking Ordinance.

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1 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council

2 PRA Rulebook (from 1 June 2016), Stay in Resolution Part at 1.4, definition of "financial arrangement"

4. Write-off / Bail-in during Stay – Protection of Netting Right

Article 30a of the Swiss Banking Act has been introduced to extend FINMA's right to order a stay regarding termination, netting, realisation and transfer rights in relation to contracts concluded by Swiss banks and securities dealers in order to enhance the possibilities of a successful restructuring of a Swiss bank or securities dealer for a period of two working days. However, it is our understanding and view that **FINMA's right to stay shall not prejudice the concepts of netting, realisation and transfer of rights as such but that such concepts are and shall generally remain protected pursuant to art. 27 of the Swiss Banking Act also during the "stay-period"**. This may be of relevance in case FINMA would, in addition to a stay, also order a partial or full write-off/bail-in of claims against the Swiss bank or securities dealers during the "stay-period". Such partial or full write-off/bail-in during the "stay-period" could hence only be effected by FINMA **on a "netted" basis** if the conditions for a netting of claims were (except for the stay) met. Alternatively, a complete ignorance of netting rights during the "stay-period" could trigger further financial instability and would materially prejudice the whole purpose and efforts over the past years to enhance the stability of netting concepts globally. In our understanding, FINMA does not intend such result.

5. Implementation

FINMA indicated that they are working on a **"Swiss Jurisdictional Module to the ISDA Resolution Stay Jurisdictional Modular Protocol"** which, once finalised and published, should satisfy the requirements pursuant to art. 12(2)^{bis} Banking Ordinance. It is further planned that such Swiss module will not only apply to ISDA agreements but to all relevant contracts subject to art. 12(2)^{bis} Banking Ordinance. Adherence to the "Swiss Jurisdictional Module to the ISDA Resolution Stay Jurisdictional Modular Protocol" by counterparties to financial contracts by way of an "opting in" would override the relevant termination, netting, realisation and transfer rights, notwithstanding the governing law of their agreements. Accordingly, if both parties to a contract adhere to the Jurisdictional Modular Protocol and the respective Swiss Module, in-scope contracts (including future contracts if a reference to the Jurisdictional Module is incorporated in the terms of the agreement) are automatically amended to include the relevant resolution stay recognition clauses. Contracts that are not covered by a protocol will not automatically include a stay recognition clause. To the extent such contracts fall into the scope of the obligation to include stay recognition clauses, parties will have to include such a clause on a bilateral basis.

II. SWISS DERIVATIVES TRADING REGULATIONS

REPORTING OBLIGATION UPDATE

1. Key Aspects of the Reporting Obligation

The Swiss Financial Market Infrastructure Act (FMIA) introduced an obligation for counterparties to derivatives contracts to report certain data to a Trade Repository (TR) that is either *licensed* by FINMA (in case of Swiss-based TRs) or *recognised* by FINMA (in case of foreign TRs).

Only one of the counterparties to a derivatives contract (or the Central Counterparty (CCP), if applicable) **must report**, and the reporting obligation is, in principle, on the counterparty belonging to a "higher" counterparty category (e.g., the FC when transacting with a NFC) or, if both counterparties are on the same level, the selling counterparty, unless agreed otherwise. In the context of cross-border transactions, the same concept applies, except that the Swiss counterparty must report in any case if the foreign counterparty does not report to a FINMA licensed or recognised TR. Counterparties or CCPs **may delegate reporting** to a third-party service provider.

The reporting obligation under the FMIA is not limited to derivatives concluded over the counter (OTC) only, but **also applies to exchange traded derivatives (ETDs)**. While basically all counterparty categories under the FMIA are subject to the reporting obligation, there is an exemption for derivatives contracts concluded between Small Non-Financial Counterparties (NFC-).

Substituted compliance. The FMIA provides for the possibility to comply with the reporting obligations under FMIA by complying with the corresponding requirements under a foreign regime that has been declared equivalent to the Swiss regime by FINMA (substituted compliance). To date, FINMA has declared EMIR as equivalent (currently on a provisional basis), so counterparties may choose to comply with the reporting requirements under the FMIA by complying with the EMIR reporting rules. It should though be noted that under EMIR there is an obligation that both counterparties must report to a TR (dual-sided reporting system), whereas under the FMIA, only one party must do the reporting.

2. Trade Repositories eligible to satisfy reporting obligation

On 1 April 2017, FINMA licensed **SIX Trade Repository AG, Zurich**, as a Swiss Trade Repository and recognised **Regis-TR S.A., Luxembourg**, as a foreign Trade Repository. Accordingly, counterparties may fulfil their reporting obligation under the FMIA by reporting to either of these TRs.

In case of substituted compliance. Currently, only SIX Trade Repository AG is available for counterparties choosing to comply with the FMIA reporting requirements by way of complying with the EMIR reporting rules (substituted compliance); reporting to Regis-TR S.A. is not sufficient in this case due to its limited scope of recognition.

3. Reporting obligation phase-in

FINMA's granting of license/recognition to the two Trade Repositories on 1 April 2017 also triggered the deadlines for the reporting obligation, which will be **phased in** as follows:

- Central Counterparties (**CCP**) and Large Financial Counterparties (**FC+**) are required to comply from **1 October 2017**
- Small Financial Counterparties (**FC-**) and Large Non-Financial Counterparties (**NFC+**) are required to comply from **1 January 2018**
- in all **other cases**, the reporting obligation starts from **1 April 2018**

For derivatives contracts executed through a trading venue (Stock Exchange or MTF) or an OTF, the above deadlines are **extended** by six months.

Any derivatives contract that is **outstanding** on, or **concluded** on or after, the applicable reporting start date (as mentioned above) requires reporting. The FMIA does however not require counterparties to report transactions that are terminated before the applicable reporting start date (as mentioned above), i.e., unlike EMIR, there is **no obligation** under the FMIA **to "backload" data**.

MARGIN RULES UPDATE

1. Key Aspects of the Margin Requirement

Counterparties, with the exception of NFC-, are subject to the FMIA margin requirements. If collateral is to be exchanged, this is done in the form of an **initial margin (IM)**, which shall protect the counterparties from the potential risk of market price changes in the event of a default of a counterparty, and a **variation margin (VM)**, which shall protect the counterparties from the ongoing risk of market price changes after the transaction has been executed.

Substituted compliance. Counterparties may choose to fulfil the FMIA margin requirements by way of substituted compliance, i.e. counterparties may comply with the margin requirements under the FMIA by complying with the EMIR margin rules.

2. Revised Financial Market Infrastructure Ordinance (FMIO)

The rules for margining non-cleared OTC derivatives under the Financial Market Infrastructure Ordinance (FMIO) are currently being revised with the main goal of further aligning them with the EMIR rules. The consultation period ended on 13 April 2017 and the revised rules are expected to enter into force in the first half of August 2017. A final version of the revised rules is not yet available.

Based on the **draft FMIO**, which may be **subject to change**, the amendments include the following:

a. Exemptions

Counterparties may **waive** the exchange of both **IM and VM** if (i) the margin to be exchanged would be less than CHF 500,000 or (ii) one of the counterparties is a Small Non-Financial Counterparty (NFC-). In addition, counterparties may **waive** the exchange of **IM** for the FX "leg" of a currency swap, i.e. "a currency swap where the nominal value and the interest in a currency are exchanged against the nominal value and the interest in another currency at a pre-determined point in time and at a pre-determined method" (unofficial translation of art. 100a(2) FMIO). Further, certain exceptions in the context of the **issuance of covered bonds** apply.

In particular with respect to **cross-border transactions:**

– The Swiss counterparty is entitled to **waive the payment** of both **IM** and **VM** to the foreign counterparty if (i) the foreign counterparty is incorporated or domiciled in a legal system in which set-off or collateral arrangements are not legally enforceable *or* (ii) agreements for the separation of collateral are not internationally recognised standards.

– The Swiss counterparty may **waive to request both IM** and **VM** from the foreign counterparty if one of the conditions (i) or (ii) above (previous para.) is met and, in addition, (i) an independent legal assessment has shown that it would not be possible to receive IM or VM from the foreign counterparty in accordance with the provisions of the FMIA/FMIO *and* (ii) after the entry into force of the obligation to claim IM and VM, the ratio of unsecured transactions concluded and outstanding to all OTC derivative transactions is less than 2.5 percent, whereby intra-group transactions are not to be included in the calculation.

b. Eligible collateral

In addition to the types of collateral listed in art. 104(1)(a)–(g) FMIO, the draft FMIO (art. 104(1)(h)) also declares **shares in securities funds** according to the Swiss Act on Collective Investment Schemes (CISA) as eligible to satisfy the margin requirements, provided that such shares are valued daily and that the underlyings of the securities fund are exclusively assets pursuant to art. 104(1)(a)–(g) FMIO or derivatives which hedge assets pursuant to art. 104(1)(a)–(g) FMIO. Haircuts are also applied to shares in securities funds (appendix 4 of the draft FMIO).

c. Timeline

IM phase-in depending on the counterparty's "aggregate month-end average gross notional amount" (***AANA***)* of uncleared OTC derivatives at a group level (financial group, insurance group or group of companies):

– AANA > **CHF 3tn**: from **4 February 2017** and, in the case of intra-group transactions, from **4 July 2017** (pursuant to the FINMA Guidance 01/2017 of 31 January 2017)

– AANA > **CHF 2.25tn**: from **1 September 2017**

– AANA > **CHF 1.5tn**: from **1 September 2018**

– AANA > **CHF 0.75tn**: from **1 September 2019**

– AANA > **CHF 8bn**: from **1 September 2020**

* on March, April and May immediately preceding.

VM phase-in depending on the counterparty's "aggregate month-end average gross notional amount" (***AANA***) of uncleared OTC derivatives at a group level (financial group, insurance group or group of companies):

– AANA > **CHF 3tn***: from **4 February 2017** and, in the case of intra-group transactions, from **4 July 2017** (pursuant to the FINMA Guidance 01/2017 of 31 January 2017)

– for all other counterparties subject to the VM requirement: from **1 September 2017**

* on March, April and May immediately preceding.

Regarding both **IM and VM**: Obligations relating to OTC derivatives transactions involving single equity or index options or similar equity derivatives will apply to all counterparties from **4 January 2020**.

d. Initial Margin (IM) in particular

Calculation of the ***"aggregate month-end average gross notional amount" (AANA)*** *of non-centrally cleared derivatives / exchange period.* The draft FMIO makes clear that derivatives transactions between entities of the same group (financial group, insurance group or group of companies) are counted only once, i.e. there is no duplication of trades in the context of intra-group transactions. If a counterparty exceeds the threshold (see art. 100(2) draft FMIO), IM is to be exchanged from 1 January to 31 December of the following year.

Reduction of IM. Counterparties may reduce IM by a maximum amount of CHF 50 million. Thereby, the IM is calculated on the basis of the entire group (financial group, insurance group or group of companies). For intra-group transactions, the IM may only be reduced by a maximum amount of CHF 10 million.

Time of calculation and exchange. The IM is to be calculated for the first time within a business day after execution of the transaction, and it is to be re-calculated regularly, at least every 10 business days. If both counterparties are in the same time zone, the calculation shall be based on the netting-set of the previous day; otherwise, the calculation shall be made on the basis of the transactions in the netting-set which were made in the earlier of the two time zones on the previous day before 4 pm (art. 101(2) FMIO). The IM is to be delivered on the respective calculation day. For settlement, the time limits usual in trading apply.

Treatment of IM. IM in the form of cash must be held with (i) a central bank, (ii) a Swiss bank that is independent of the transferring counterparty or (iii) an independent foreign bank that is subject to appropriate regulation and supervision. IM in any other forms than cash may be held by the collecting counterparty or by a third party mandated by the latter; such third party may also be the transferring counterparty. A re-use of IM is not permissible, but excluded is the re-use

of cash IM by a third-party depositary, insofar as it is contractually ensured that the re-use does not affect the security and its realisation.

Haircuts. In addition to the haircuts as set out in appendix 4 of the FMIO, the draft FMIO introduces haircut of 8% in cases where the collateral posted as IM is denominated in a currency other than the agreed termination currency.

e. Variation Margin (VM) in particular

Time of calculation and exchange. VM is to be re-calculated at least once every business day. Basis of the calculation is the valuation of the outstanding transaction pursuant to art. 109 FMIA. Moreover, art. 101(2) FMIO applies *mutatis mutandis* (see above, d.). For settlement, the time limits usual in trading apply.

VM is to be transferred on the calculation day. However, as an exception, VM may be transferred within two business days after the calculation date if:

a. a counterparty that is not obliged to transfer IM has made additional collateral before the calculation date and the following conditions are fulfilled:

   – the additional collateral was calculated taking into account a one-sided confidence level of 99 percent in the valuation of the OTC derivative transactions to be collateralised over the relevant margin risk period,

   – the margin risk period shall be at least as many days as between the calculation day and the day of the performance of the margin payments, the calculation day and the performance day being also counted; *or*

b. the counterparties have made IM under consideration of a margin risk period covering at least the following time periods:

   – the period from the last performance of VM to the possible loss of the counterparty plus the number of days between the calculation day and the day of the performance of the VM, the calculation day and the day of the performance being also counted, and

   – the period which is estimated to be necessary to replace the relevant OTC derivative transactions or to hedge the resulting risks.

Haircuts. In addition to the haircuts as set out in appendix 4 of the FMIO, the draft FMIO introduces haircut of 8% in cases where the currency of the VM not paid in cash differs from the currencies agreed in the derivative contract, the netting framework agreement or in the credit support annex for the VM.

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