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Swiss financial market regulations related to derivatives



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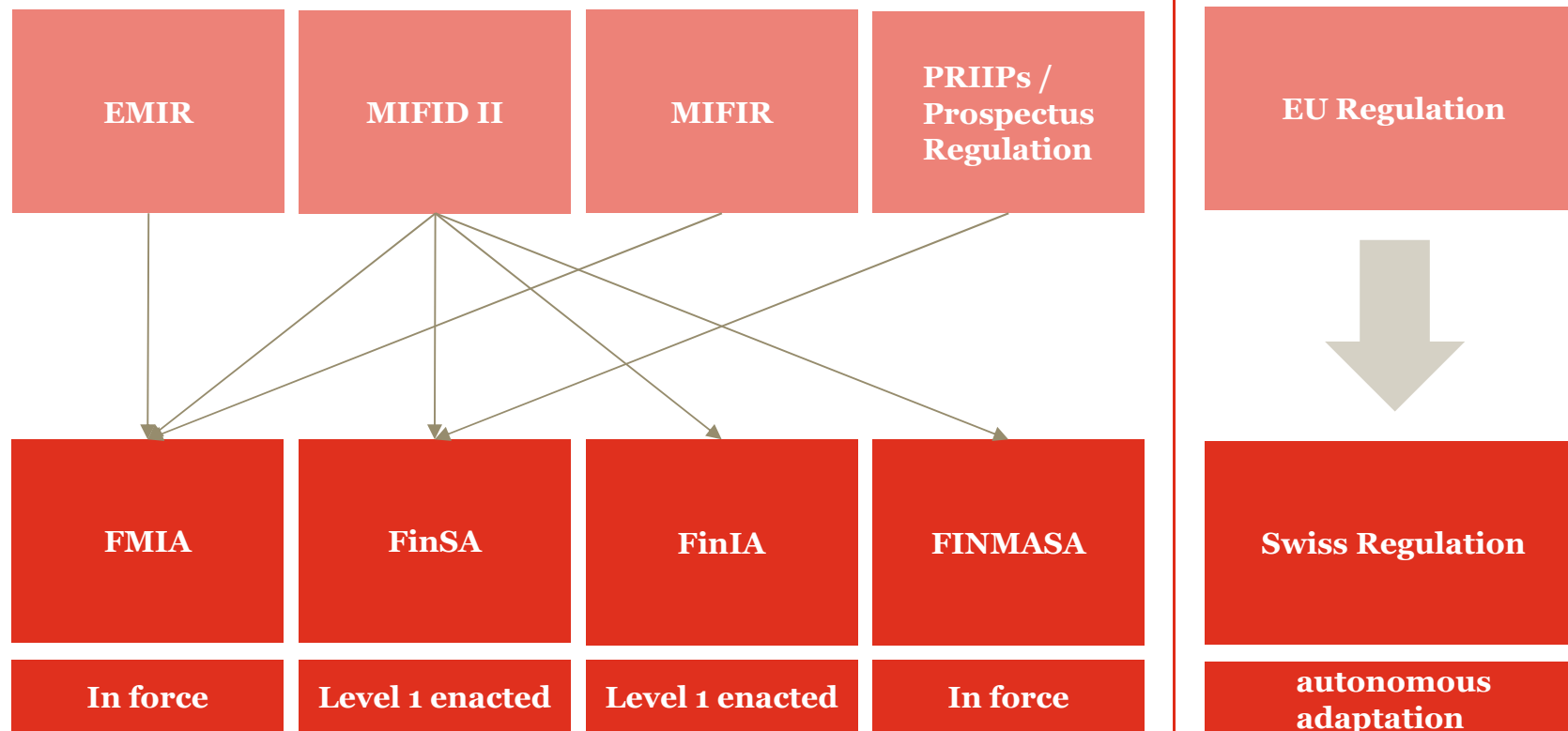
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The Swiss regulatory framework

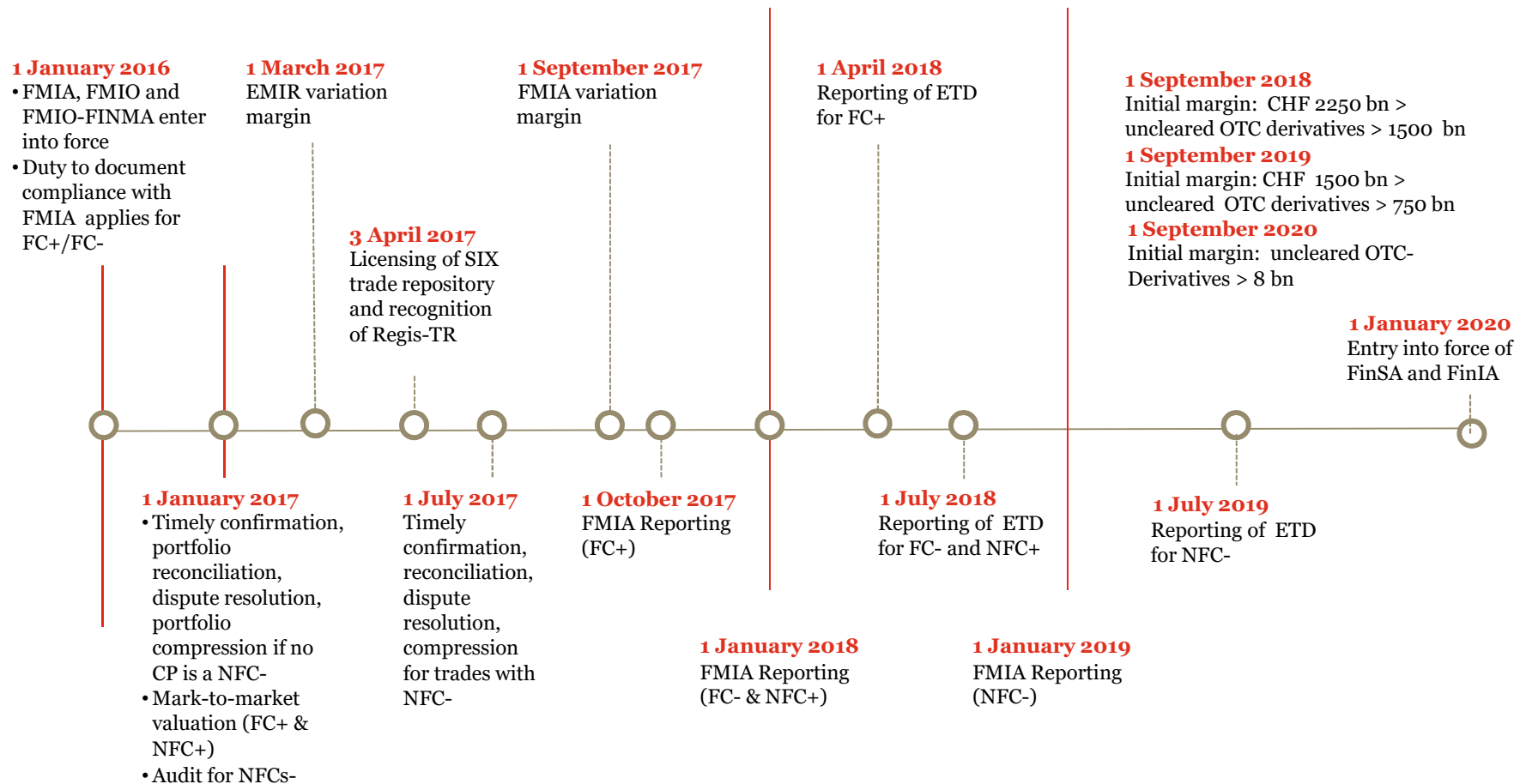
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Adaptation landscape – reality



FMIA, FinSA, FinIA Implementation Timeline

FMIA came into force on 1 January 2016, however most of the key obligations are set to come into force over a staggered timeframe



Swiss Financial Market Infrastructure Act

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Overview of requirements

FMIA obligations differ based on the counterparty status



		<i>Counterparty FMIA classification</i>			
		FC	FC-	NFC+	NFC-
Reporting	Reporting obligation 104-106 FMIA	YES	YES	YES	YES NO (if two NFC-)
Clearing	Clearing obligation 97 FMIA	YES	NO	YES	NO
Risk mitigation	Confirmation, dispute resolution 108 FMIA	YES	YES	YES	YES
	Portfolio compression (if more than 500 trades) - 108 FMIA	YES	YES	YES	YES
	Portfolio reconciliation 108 FMIA	YES	YES	YES	NO
	Risk mitigation (valuation) - 109 FMIA	YES	NO	YES	NO
	Risk mitigation (collateral exchange) - 110 FMIA	YES	YES	YES	NO
Trading	Platform trading obligation	YES	NO	YES	NO

FMIA scope and classification

Is the entity in scope?

- 1) Counterparty 1 is domiciled in Switzerland and Counterparty 2 outside of Switzerland
- 2) Derivatives are traded



Financial Counterparty (FC)

1. MiFID investment firm/CH securities dealer
2. CRD credit institution/CH bank
3. EU/CH insurance undertaking
4. EU/CH reinsurance undertaking
5. UCITS and, where relevant, its mgmt company
6. EU/CH institution for occupational retirement
7. Alternative investment fund (EEA **and non EEA**) managed by AIFM

Non-financial Counterparty (NFC)

NFC +
Group company's NFC entity OTC trading threshold (gross notional) over **any** of:

- Credit: €/CHF 1.1 bn
- Equities €/CHF 1.1 bn
- Rates: €/CHF 3.3 bn
- FX: €/CHF 3.3 bn
- Commodities: €/CHF 3.3 bn

Hedging transactions can be deducted.

NFC –
NFCs below the clearing threshold
Clearing and non-centrally cleared margin requirements do not apply!

3rd Country Entities

TCE
Entities established outside of Switzerland are also in scope for all obligations under the FMIA.
This is a key difference to EMIR.

FMLA: Derivatives in scope

Key requirements

What is a derivative?



Derivatives or derivatives transactions: financial contracts whose value depends on one or several underlying assets and which are not cash transactions. Such underlyings are in particular assets such as shares, bonds, commodities and precious metals; or reference values such as currencies, interest rates and indices.

No derivatives



a.spot transactions;
b.derivatives transactions relating to electricity and gas which:
1.are traded on an organised trading facility,
2.must be physically delivered, and
3.cannot be settled in cash at a party's discretion;
c.derivatives transactions relating to climatic variables, freight rates, inflation rates or other official economic statistics that are settled in cash only in the event of a default or other termination event.

Derivatives not subject to the derivatives rules



a.structured products such as capital-protected products, capped return products and certificates;
b.securities lending and borrowing;
c.derivatives transactions relating to goods that:
1.must be physically delivered,
2.cannot be settled in cash at a party's discretion, and
3.are not traded on a trading venue or an organised trading facility
d.derivatives issued in the form of a security or uncertificated security;
e.derivatives accepted in the form of a deposit.

FMLA: Derivatives in scope

Key requirements

FX derivatives



The currency swaps and currency forward transactions that are exempt from the clearing duty, the risk mitigation duties and the platform trading duty comprise all transactions for the exchange of currencies in which real execution is guaranteed, irrespective of the clearing method.

FMIA Reporting in a nutshell

FMIA	EMIR	Dodd-Frank
One-sided reporting model	Dual-sided reporting model	One-sided reporting model

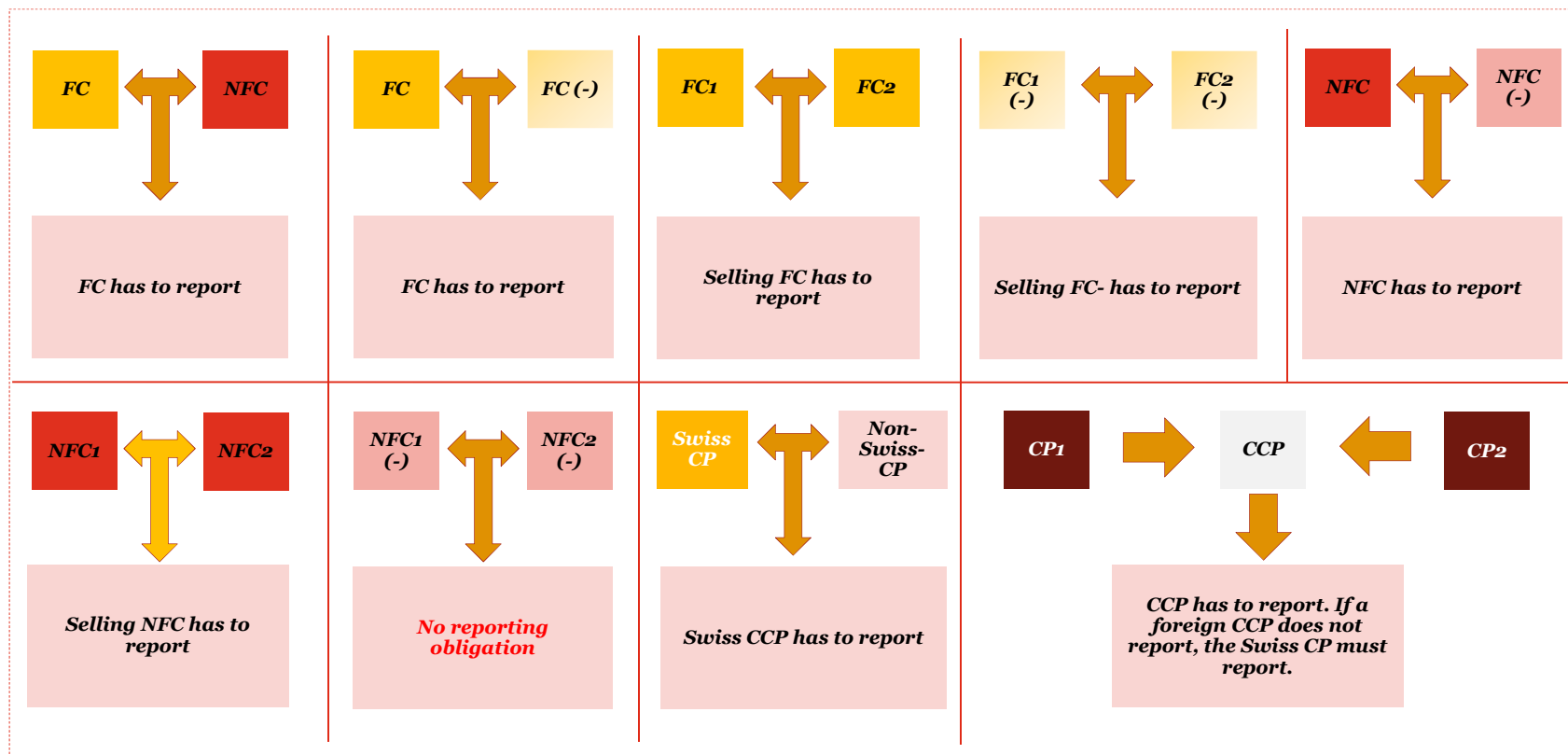
FMIA Reporting in a nutshell

- Under the reporting obligation, all derivatives transaction data, including OTC and exchange-traded derivatives have to be reported to a trade repository recognized by FINMA. This includes the details of any derivative contract, any modification to these contracts and their termination.
- The first reporting has to be made from the 3rd of October 2017 on – depending upon the status of the obliged entity.

Implementation approach

- It is required to review the **current reporting set-up** under EMIR. The existing infrastructure including connectivity and formats can be **leveraged** to fulfil both FMIA and EMIR reporting standards. Therefore synergies can be built between FMIA and EMIR. Please note: Regis TR is currently not recognized by FINMA for EMIR reporting.
- A **consistent reporting approach** has to be developed in order to **avoid duplications** and to set up an effective reporting mechanism.
- The selection of IT-/reporting service providers and **trade repository alternatives** has to be (re-) considered.
- **Current contracts and arrangements** with IT-/reporting service providers need to be reviewed.
- Processes for the **determination of responsibilities** (e.g. reporting party) have to be established.

Who has to fulfil the reporting obligation? “Cascade principle”



FC = Financial Counterparty
 FC (-) = Small Financial Counterparty
 NFC = Non-Financial Counterparty

NFC (-) = Small Non-Financial Counterparty
 CP = Counterparty
 CCP = Central Counterparty

Reporting obligation

(FMIA Art. 104-106; FMIO Art 92 and 93, Appendix 2)

Reporting duty

- One sided reporting duty
- Delegation of responsibility to a third party is possible
- SIX (based in CH) and Regis-TR (based in EU) are the two trade repositories that have been authorized or recognized by FINMA

Timing of the reporting

- T+1 following the inception, change or closing of the derivative

Content of the reporting

- Minimal requirements; according to the FMIO appendices, there are 79 fields to report, and additional requirements from the trade repository
 - a) Identity of the counterparties
 - b) Type of derivative
 - c) Maturity date
 - d) Nominal value
 - e) Price
 - f) Settlement date
 - g) Currency

Clearing obligation (1/2)

The clearing obligation will enter into force on 1 March 2019 at the earliest and 1 March 2020 the latest depending upon the status of the counterparties. The effective date of the clearing obligation of each counterparty will be determined as follows:

1 September 2018 plus six months: for derivatives transactions which participants in an authorised or recognised central counterparty conclude anew with one another;

1 September 2018 plus 12 months: for derivatives transactions which:

1. participants in an authorised or recognised central counterparty conclude anew with other financial counterparties that are not small, or
2. other financial counterparties that are not small conclude anew with one another;

1 September 2018 plus 18 months: for all other derivatives transactions concluded anew.

Clearing obligation (2/2)

Derivatives subject to the Clearing Obligation

1. Basis-Swap	EURIBOR	EUR	28d-50y		
2. Basis-Swap	LIBOR	GBP	28d-50y		
3. Basis-Swap	LIBOR	JPY	28d-30y		
4. Basis-Swap	LIBOR	USD	28d-50y		
5. Fixed-to-Float	EURIBOR	EUR	28d-50y		
6. Fixed-to-Float	LIBOR	GBP	28d-50y		
7. Fixed-to-Float	LIBOR	JPY	28d-30y		
8. Fixed-to-Float	LIBOR	USD	28d-50y		
9. Forward Rate Agr.	EURIBOR	EUR	3d-3y		
10. Forward Rate Agr.	LIBOR	GBP	3d-3y		
11. Forward Rate Agr.	LIBOR	USD	3d-3y		
12. Overnight Index Swap	EONIA	EUR	7d-3y		
13. Overnight Index Swap	FedFunds	USD	7d-3y		
14. Overnight Index Swap	SONIA	GBP	7d-3y		
1. Index-CDS Index, non-tranched Europa iTraxx Europe Main	EUR			5y	
2. Index-CDS Index, non-tranched Europa iTraxx Europe Crossover	EUR			5y	

Margin exchange under the FMIA

Overview

Both under Swiss and EU law, counterparties to a non-cleared derivative may be required to exchange appropriate collateral. This shall take the form of:

1. an **initial margin (IM)** that is suitable for protecting the transaction partners from the potential risk that there could be market price changes during the closing and replacement of the position in the event of default on the part of one counterparty; and
2. a **variation margin (VM)** that is suitable for protecting the transaction partners from the ongoing risk of market price changes following execution of the transaction.

Swiss requirements	EU requirements
<p>FMIA:</p> <ul style="list-style-type: none"> • Articles 110 to 111 <p>FMIO:</p> <ul style="list-style-type: none"> • Articles 100 to 107 <p>FINMA Guidance:</p> <ul style="list-style-type: none"> • FINMA Guidance 01/2017 Financial Market Infrastructure Act: Deadlines for the exchange of collateral (31 June 2018) • FINMA Guidance 01/2016 Financial Market Infrastructure Act: FINMA's next steps (6 June 2016) 	<p>Level I</p> <p>Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (“EMIR”): Article 11 (3, 5 to 15)</p> <p>Level II</p> <ul style="list-style-type: none"> • Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing EMIR with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty (“Margin RTS”) • Commission Delegated Regulation (EU) No 285/2014 of 13 February 2014 supplementing EMIR (RTS on direct, substantial and foreseeable effect of contracts within the Union and to prevent the evasion of rules and obligations) <p>Level III</p> <ul style="list-style-type: none"> • ESMA Q&A on the Implementation of the Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (3 April 2017)

Variation Margin

Key requirements

General



The **VM to be collected corresponds to the positive mark-to-market value** of the OTC derivative contracts. The mark-to-market value reflects the current mid-market replacement cost of those OTC contracts. VM must be collected netting set by netting set.

Timing of the calculation



The VM requirements **must be calculated on each business day** based on the previous business day's values for the transactions that were in the netting set on that previous business day. If the counterparties to the netting set are in **two different time zones**, the population of the netting set is determined as of **4pm** in the earlier of the two time zones on that previous business day.

Timing of the collection



The posting party must provide the VM **within the same business day of the date of calculation** of the amount of VM, unless additional collateral has already been posted to cover a longer “margin period of risk”.

CSA and netting agreements



Under the FMIA, FC and NFC+ shall regulate in writing the processes with which they ensure fulfilment of the duty to exchange margins. Under EU law, the risk management procedures shall include procedures providing for or specifying the terms of all necessary agreements to be entered into by counterparties, at the latest, at the moment in which a non-centrally cleared OTC derivative contract is concluded, including the terms of the **netting agreement** and the terms of the **exchange of collateral agreement**.

Eligible collateral



* Including issued by governments, central banks, credit institutions or investment firms

Non-exhaustive list.

- There are certain **liquidity requirements** in relation to collateral.
- Further, the collecting party must evaluate collateral for:

Credit quality,

- “**Wrong-way risk**” (i.e. the risk that the value of the collateral correlates with the creditworthiness of the collateral provider, arising for example if the collateral is issued by the posting counterparty), and

Concentration limits

- **Non-cash Initial Margin** is subject to concentration limits on securities issued by a single issuer (including issuers belonging to the same corporate) and on equity and equity-linked securities.

Haircuts on the value of the collateral

Cash VM is not subject to a haircut.

The collecting party must apply a haircut to the **value of all non-cash IM and VM that reflects the collateral's market risk and credit risk.**

The applicable haircut can either be **calculated using a standard methodology set out or by the collecting counterparty itself** so long as its process for determining the haircuts meets regulatory requirements.

A further 8 per cent currency mismatch haircut applies to

Non-cash VM denominated in a currency other than those **currencies agreed in the governing master agreement or collateral agreement**, or in a confirmation.

A 8 percent currency mismatch haircut applies to

Cash and non-cash IM denominated in a **currency other than the currency in which payments on default are** required (typically meaning the "Termination Currency" specified in the ISDA master agreement).

Financial Services Act

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Scope of Application of the FinSA/FinIA

Purpose



The FinSA intends to **regulate and harmonise** the rules applicable to financial services providers that are either **based in Switzerland or provide the financial services cross-border from outside of Switzerland to Swiss clients** (Art. 3 lit. e FinSA).

Extraterritorial application



The FinSA does thus have an **extraterritorial application even if a foreign financial services provider has no permanent establishment** and no permanently employed persons in Switzerland. This means that **for the first time also the pure cross-border provision of financial services to Swiss clients is subject to Swiss rules.**

Key Term: Financial Services (the following activities on behalf of clients)



- Acquisition or disposal of financial instruments
- Reception and transmission of orders in relation to financial instruments
- Administration of assets (portfolio management)
- Giving personal recommendations on transactions with financial instruments (investment advice)
- Granting loans to finance transactions with financial instruments

Key Term: Financial Instrument



- Equity securities: (shares, share like securities, in equity convertible securities)
- Debt instruments
- Units in collective investment schemes
- Structured products
- Derivatives
- Redeemable life insurance policies
- Structured deposits

Comparison between MiFID II and FinSA

The draft FinSA is broadly geared towards MiFID II conduct of business standards. Exceptions however apply for certain client classification and information requirements. Further details in relation to FinSA are expected in the Level 2 measures.

Topic		FinSA compared to MiFID II	Comments
Client classification		Comparable standard	<ul style="list-style-type: none"> In principle aligned. Overall FinSA is less granular with a narrower definition of “institutional clients”, there is no possibility for Professional Clients to opt up to ECPs. Opting-up / down is currently only generically regulated; final rules pending.
Information to Clients	General information at on-boarding	Comparable standard	<ul style="list-style-type: none"> In principle aligned, however FinSA is less granular. Final provisions depend on regulation ordinance.
	Information about specific services	Comparable standard	<ul style="list-style-type: none"> In addition to MiFID II rules on client information, FinSA requires information to clients in context of discretionary mandates.
	Information about specific products	Higher standard	<ul style="list-style-type: none"> Goes beyond MiFID II (and PRIIPs) by requiring a Basic Information Sheet for all financial instruments / products other than securities, i.e. including plain vanilla bonds. A prospectus is even required after the secondary offering and each time if admitted on a second platform.

Comparison between MiFID II and FinSA

	Topic	FinSA compared to MiFID II	Comment
Information to Clients	Suitability Assessment	Lower standard	<ul style="list-style-type: none"> In principle aligned. Diverging rules apply to the extent that MiFID II requires suitability check at financial instrument level, while FinSA allows it at portfolio level.
	Appropriateness Assessment	Comparable standard	<ul style="list-style-type: none"> FinSA does not distinguish between complex/non-complex products i.e. higher standard apply for suitability checks however lower standard insofar as no appropriateness check required for execution-only transactions.
	Suitability Reports	Higher standard	<ul style="list-style-type: none"> FinSA requires a written documentation ('Advisory Protocol') in case of a personal recommendation for financial instruments, documenting client needs and reason for recommendation, in current wording both for investment advisory and portfolio management. Under MiFID II, such written documentation is only required for recommendations related to investment advisory. For portfolio management, a periodic reporting has to be provided.
	Periodic Assessment of suitability	Comparable standard	<ul style="list-style-type: none"> In principle aligned. Slightly higher standards under MiFID II.
Conflicts of interest	Independent Advice and Inducements	Lower Standard	<ul style="list-style-type: none"> FinSA scope is wider in principle as it applies to all financial instruments which includes bank account, safekeeping, execution only and execution of transactions. FinSA is less stringent as firm can accept inducements for portfolio management if properly disclosed and client has waived right to inducements.

Comparison between MiFID II and FinSA

	Topic	FinSA compared to MiFID II	Comment
Registration	Registration	Lower standard	<ul style="list-style-type: none"> Client advisors must be registered with a corresponding registry. The registration duty applies also for Client advisors of non-Swiss based financial services providers.
	Staff training	Comparable standard	<ul style="list-style-type: none"> The registration of the client advisors requires as a precondition that the person is sufficiently trained. Another requirement for registration is that the client advisor is in good standing and has no criminal record.
Product Issuances	Prospectus requirements	Comparable standard to Prospectus Regulation	<ul style="list-style-type: none"> Public offers of securities, meaning a notification to the public containing sufficient information on the terms of the offer and the securities themselves for the purchase or subscription of securities, require a prospectus. The exemptions for not having to publish a prospectus are very similar to the ones applicable under the corresponding EU-provisions.
	Information Document	Lower standard than PRIIPs	<ul style="list-style-type: none"> The offering of Financial Instruments to Retail Clients requires an information document that has to meet certain requirements.
Disp. Res.	Ombudsman	Higher standard	<ul style="list-style-type: none"> The FinSA sets forth that a Swiss client of a Financial Services Provider domiciled outside of Switzerland can request that disputes are being resolved with a Swiss based Ombudsman.

Comparison between MiFID II and FinSA

	Topic	FinSA compared to MiFID II	Comment
Registration	Documentation	Comparable standard	<ul style="list-style-type: none"> Financial services providers must keep a written record about the services agreed with the client and the information collected, the information or warning given, and the services provided.
	Rendering account	Comparable standard	<ul style="list-style-type: none"> Financial services providers must give their clients a copy of the documentation recorded. They must inform the clients about the services provided (transactions, portfolio, and the costs associated with the services).
Transparency	Best Execution	Comparable standard	<ul style="list-style-type: none"> The financial services provider must ensure in the execution of its clients' orders that the best possible outcome is achieved in terms of cost, timing, and quality. The best execution policy must be written from the perspective of the Swiss client and in particular his special regulatory status.
	Duty of loyalty	Comparable standard	<ul style="list-style-type: none"> Financial services providers must uphold the principles of good faith and equal treatment when handling client orders.

Cryptocurrencies

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Regulation of cryptocurrencies in Switzerland

General



In its media release of 16 February 2018 the Swiss Financial Market Supervisory Authority FINMA published its guidance on cryptocurrencies and Initial Coin Offerings (ICO) which defines the minimum information required and principles for requests for negative clearance.

ICO



An ICO is a digital form of public fund-raising for entrepreneurial purposes. Blockchain-based “coins” or “tokens” are sold in exchange for cryptocurrencies (e. g. Bitcoin) or FIAT currencies. The token represents a certain value or service that the issuer defines prior to the ICO.

Types of Tokens



FINMA basically distinguishes between three different types of tokens (although hybrid forms are possible):

- Payment tokens: These are considered standard cryptocurrencies. They can be used as means of payment for the purchase of goods or services as well as for the transfer of money and values. They are not associated with any other functions or projects.
- Utility tokens: They provide access to a blockchain-based applications or services.
- Investment tokens: These tokens represent assets (such as shares of companies, revenues or entitlements to dividends or interest payments). Depending on its design, this type of token is similar to a share, bond or derivative financial instrument.

Regulation of cryptocurrencies in Switzerland

Legal assessment

Based on the functionality of the various tokens FINMA makes the following legal considerations with respect to ICOs:

- Payment ICOs: Payment tokens fall within the scope of the Anti-Money Laundering Act (“AMLA”) but do not qualify as securities under the Financial Markets Infrastructure Act (“FMIA”) and the Securities Trading and Exchange Act (“SESTA”).
- Utility ICOs: Utility tokens are basically not qualified as securities provided that they are intended to provide access digitally to an application or service and may be used in this capacity at the moment of issuance. Conversely, if a utility token is also used for investment purposes it is qualified as security.
- Asset ICOs: Asset tokens are treated as securities by FINMA.

Trading in cryptocurrencies

For more information please see:

<https://news.pwc.ch/40415/a-primer-on-the-regulation-of-the-trading-in-cryptocurrencies-and-the-asset-management-related-to-cryptocurrencies-in-switzerland/>

Questions?

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Questions?



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Qualifications

- Ph.D. (Zurich)
- LL.M. (Stanford)
- Attorney-at-law (Switzerland & New York)
- MSc. (Harvard)
- CAIA
- Lecturer in law at the University of Zurich

Languages

- German (native)
- French (fluent)
- English (fluent)
- Russian (basic)

Dr. Martin Liebi

Director – Legal Financial Services Regulatory & Compliance Services

Relevant Experience

- Martin has more than 14 years experience with leading Swiss and US law firms as well as Big4-companies in the areas of capital market law, derivatives regulation, banking law (private banking, asset management, and investment banking), financial market regulation, securities law, corporate law, M&A, and general commercial law. He has been Head Legal with a Swiss bank for more than 3 years and Head Compliance with a Swiss Fund-of-Hedge Funds being part of a banking group and active in the commodities futures markets for more than 4 years.
- Martin is a regular speaker on banking and capital market topics at conferences and publishes frequently in leading journals. He is also a part-time judge at the commercial court of Zurich and a lecturer at the LL.M. program of the University of Zurich (regulation of banks and securities dealers and regulation of European capital markets). Martin is a Swiss legal advisor to many industry leading organizations, such as the CMCE and the ACI-The Financial Market Association.
- He represents financial market participants in licencing procedures of banks and securities dealers/investment firms and other issues with Swiss and European regulators. His main focus is on derivatives, capital markets, trading, infrastructure, securities (fixed income and equity) and banking regulation.
- He plans, structures, and manages as Head L&C Capital Markets at PricewaterhouseCoopers Ltd., FS Regulatory & Compliance Services, with his team large regulatory and compliance projects, such as but not limited to, BMR, EMIR, REMIT, MiFID II/MiFIR, CRD4, MAR, and Dodd-Frank. He collaborates in these activities with many different internal and external stakeholders such as, but not limited to, IT, risk, strategy, compliance, and the line functions.

Thank you for your time.

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