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## Newsletter

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Who's Who Legal

## BANKING &amp; FINANCE

## Margin Requirements for Uncleared Derivatives

The Swiss Financial Market Infrastructure Act (**FMIA**), which entered into effect on 1 January 2016, introduced an obligation to exchange variation and initial margin for uncleared OTC derivatives transactions. The phase-in of variation margin requirements is about to start for the majority of the affected market participants.

## 1 INTRODUCTION

The FMIA introduces risk mitigation obligations for **uncleared OTC derivatives transactions** (e.g. an obligation to exchange trade confirmations on a timely basis and to perform portfolio reconciliations). In addition to such obligations that started to go live on 1 January 2017, the FMIA will require Financial Counterparties (**FCs**) and large Non-Financial Counterparties (**NFCs**) to **exchange margin** in respect of uncleared OTC derivatives transactions.

Such margin requirements include an obligation to exchange (i) **variation margin (VM)** for the exposure that one party has towards the other on the basis of current mark-to-market values and (ii) **initial margin (IM)** to cover the risk of a loss in value when closing-out the transactions.

The introduction of such margin requirements under the FMIA follows the regulatory agenda set by the **G20** jointly with the **BIS and IOSCO** (see the BIS/IOSCO principles of March 2015 <http://www.bis.org/bcbs/publ/d317.htm>).

In the **EU**, the margin rules are regulated in Commission Delegated Regulation 2016/2251 published on 15 December 2016 as regulatory technical standards under the European Market Infrastructure Regulation EMIR (the **EMIR RTS**). The obligation to **exchange VM** under the EMIR RTS applies as of **1 March 2017** for all FCs and large NFCs except for parties with outstanding transactions exceeding **EUR 3'000 bn** in aggregate average notional amounts (**AANA**). For such large parties, the compliance date for the exchange of VM and IM was **4 February 2017**. In the **US**, the

US Commodity Futures Trading Commission (CFTC) granted a relief on 13 February 2017 to the effect that VM compliance for parties subject to the 1 March 2017 compliance date will only be enforced starting **1 September 2017** (see <http://www.cftc.gov/PressRoom/PressReleases/pr7531-17>).

Given that it is the intention throughout the **Swiss derivatives regulation** under the FMIA to be closely aligned with the EU rules, and since the Swiss rules became final before the final EMIR RTS were released, an amendment of the Swiss margin rules was necessary. To that effect, the Federal Council has proposed an amendment to the Swiss Financial Market Infrastructure Ordinance (FMIO) to close the gaps to the EMIR RTS, where needed. The consultation for such amendment started on 13 February 2017 (the **FMIO Amendment**). It is intended that the FMIO Amendment will come into effect **before 1 September 2017**, i.e. the date the VM obligations will go live under the Swiss margin rules for all FCs and large NFCs, other than those with AANAs of more than CHF 3'000 bn in March, April and May 2016.

## 2 SCOPE

### 2.1 PARTIES IN SCOPE

The obligation to exchange margin only applies to **FCs and large NFCs**.

**FCs** are entities subject to prudential supervision (such as banks, broker-dealers, insurance companies and collective investment schemes).

All other parties are **NFCs**, as long as they are registered in the commercial register or, as regards foreign companies, they are commercially operating legal persons, trusts or similar structures. An NFC qualifies as a **large NFC** if the notional amounts of the outstanding OTC derivatives (average gross positions, calculated over 30 working days, except for hedging transactions and physically settled FX forwards and swaps) exceed at least one of the following thresholds: (i) for credit derivatives CHF 1.1 bn; (ii) for equity derivatives CHF 1.1 bn; (iii) for interest rate derivatives CHF 3.3 bn; (iv) for FX derivatives CHF 3.3 bn; and (v) for commodity derivatives and other derivatives CHF 3.3 bn.

To the extent that an NFC does not reach any such threshold, it is a small NFC and out of scope of the margin rules.

**"The obligation to exchange margin only applies to FCs and large NFCs."**

**Intra-group transactions** are exempted without prior approval of a regulator, where: (i) the parties are part of a fully consolidated group; (ii) they are subject to centralised risk-measurement, -control and -monitoring procedures; (iii) there are no legal or factual obstacles to payments between group companies; and (iv) the intra-group transactions are not entered into for the purposes of evading margin requirements.

### 2.2 COVERED TRANSACTIONS

All **OTC derivatives** are in scope of the Swiss margin requirements, **except** for the following transactions:

a) OTC derivatives **cleared through a central counterparty**;

b) **FX forwards and swaps** that must be **physically** settled;

c) **physically** settled **commodity derivatives** exempted from the derivatives regulation under the FMIA;

d) OTC derivatives entered into with an **exempted counterparty** (e.g. an exempted sovereign entity);

e) OTC derivatives entered into with **small NFCs**;

f) OTC derivatives entered into with **counterparties not qualifying as FCs or NFCs**.

Any **exchange-traded derivatives** (including those traded on multilateral trading facilities), derivatives in securitized form or those in the form of a deposit are not OTC derivatives and therefore out of scope as well.

### 2.3 COMPLIANCE DATES

	VM	IM
<b>4 February 2017</b>	AANA 3'000 bn	AANA 3'000 bn
	(for intra-group transactions: 4 July 2017)	
<b>1 September 2017</b>	All other FC and large NFC	AANA 2'250 bn
<b>1 September 2018</b>		AANA 1'500 bn
<b>1 September 2019</b>		AANA 750 bn
<b>1 September 2020</b>		AANA 8 bn
<b>AANAs calculated in CHF for the months March, April and May of the relevant year.</b>		

As regards **equity options and index options**, the margin requirements will only go live on 4 January 2020 pursuant to the FMIO-Amendment. As far as this is in line with the interpretation according to the EMIR RTS, this transitional period may also apply to options on share baskets.

## 3 VARIATION MARGIN

### 3.1 REQUIREMENTS FOR EXCHANGE OF MARGIN

Where the VM requirement applies, the parties must exchange **eligible collateral assets** for the outstanding exposures under the transactions in place. This is calculated on a net basis if the transactions are entered into under a master agreement for OTC derivatives transactions (such as an ISDA Master Agreement or a Swiss Master Agreement for OTC derivatives transactions).

The following assets qualify as eligible collateral assets:

a) **cash** and money market instruments issued by a bank;

b) investment grade **sovereign debt** instruments;

c) investment grade **debt** instruments issued by **corporates**;

d) investment grade **mortgage- and asset-backed securities** (but excluding resecuritisations);

e) **shares forming part of an index** comprising all or the

most important names listed on an exchange, including convertible bonds;

f) **gold**; and

g) **money market funds** and, as proposed under the FMIO Amendment, also **securities funds** with daily valuations.

The VM must be exchanged on a **daily basis**. For these purposes, the calculation may be based on the values of the **previous trading day**. The exchange of the eligible collateral must occur within the **customary settlement cycle** for the type of collateral asset concerned. Under certain circumstances, it is sufficient that VM is exchanged by T+2.

The FMIO specifies the **valuation percentages** that must be applied to value the collateral assets posted. In addition, the FMIO also specifies under which circumstances an **FX haircut** must be applied. While under the FMIO as applicable before the adoption of the FMIO Amendment, an 8% FX haircut would have applied generally where the collateral assets are not denominated in the currency of the transactions, after the adoption of the FMIO Amendment – in line with the EMIR RTS – an 8% FX haircut will only apply to **non-cash VM collateral assets**, where their currency does not match any of the following currencies: (i) a currency specified in the master agreement, (ii) a currency specified in the underlying transactions; or (iii) an eligible currency pursuant to the collateral agreement.

The margin rules specify that the **minimum transfer amount** must not exceed **CHF 500'000** (for VM and IM combined).

### 3.2 NEW DOCUMENTATION

The VM requirements will require a **redocumentation of existing collateral arrangements** by 1 September 2017. This may be done on a bilateral basis by agreeing new credit support documents (e.g. (i) for ISDA Master Agreements, a new ISDA Credit Support Annex on the basis of the **2016 ISDA Credit Support Annex** for VM published by ISDA, as amended to ensure compliance with the Swiss margin requirements, or (ii) for Swiss Master Agreements, a new **VM compliant Credit Support Annex** as published by the Swiss Bankers Association).

ISDA intends to provide supplemental documentation to the **ISDA VM Protocol** to cover the Swiss margin requirements. Parties may adhere to such documentation, when available.

"The VM requirements will require a redocumentation of existing collateral arrangements by 1 September 2017."

## 4 INITIAL MARGIN

### 4.1 PARTIES IN SCOPE

The obligation to exchange **initial margin (IM)** will only apply to parties that both reach an AANA of CHF 8 bn, as calculated pursuant to the methodology specified in the FMIO.

### 4.2 MODEL- VS. STATUTORY APPROACH

The calculation of the required collateral may be based either on the **statutory method** specified in the FMIO or it may be based on a **model** permitted to be used by the FMIO. Such model may be either a model that a bank or insurance

company is using for regulatory capital purposes or the internationally recognized model ISDA Standard Initial Margin Model (SIMM™). Unlike the EMIR RTS, the Swiss margin rules do not allow to switch between a model- and a statutory approach, once chosen.

### 4.3 REQUIREMENTS FOR EXCHANGE OF MARGIN

The obligation to exchange **initial margin (IM)** will only apply to amounts of more than CHF 50 mio., as calculated pursuant to the methodology specified in the FMIO.

The same assets qualifying as eligible collateral assets for VM purposes may also be posted as IM.

Unlike for purposes of the VM calculation, the **FX haircut** percentage of 8% will apply to **cash and non-cash IM**, to the extent that it is denominated in a currency other than the **termination currency** applicable to the relevant party.

No IM must be exchanged for the currency component of a **currency swap**.

### 4.4 SEGREGATION OF MARGIN

All IM (but not VM) that a party posts to its counterparty must be **segregated** and parties must enter into an agreement regarding such segregation.

Moreover, according to the FMIO Amendment, IM provided in cash must be deposited with a **third party bank**, which must not be a party to the transaction. However, IM provided in a form other than cash may be held by the receiving party or the receiving party may hold it on custody with the posting party or a third party mandated by the receiving party.

Obligations to provide IM between the parties **must not be offset**.

Cash IM may be **reinvested** under the conditions specified in the FMIO Amendment.

### 4.5 NEW DOCUMENTATION

The IM requirements will require entering into further **collateral arrangements in addition to those entered into for VM compliance**. For ISDA Master Agreements governed by English law, a **Credit Support Deed** published by ISDA may be used, as amended to ensure compliance with the FMIA margin requirements. To the extent that the services of Euroclear or Clearstream as third party custodians are used, the documentation published by these custodians jointly with ISDA may be used.

## 5 CROSS-BORDER TRANSACTIONS

### 5.1 SCOPE

The Swiss margin requirements also apply in a **cross-border** context, except where:

a) the foreign counterparty, if it was incorporated or domiciled in Switzerland, would not have to post or collect margin under the Swiss margin rules; or

b) the foreign rules are equivalent to the FMIA margin rules (as determined by FINMA) and they do not provide any requirement to post or collect margin.

### 5.2 SUBSTITUTED COMPLIANCE

The Swiss margin rules allow **substituted compliance**

pursuant to the rules of EMIR for cross-border transactions on the basis that FINMA has recognized the rules of EMIR as equivalent to the Swiss margin rules. However, as regards other jurisdictions, this is not yet the case.

### 5.3 NON-NETTING JURISDICTIONS

In line with the EMIR RTS, the FMIO Amendment introduces a rule that the Swiss party is not obliged to post margin, where the **netting or collateral arrangements** or the arrangements regarding the **segregation of collateral** are **not enforceable** in the relevant foreign jurisdiction (**non-netting jurisdiction**). However, the Swiss party must nevertheless collect margin for its exposure on a gross basis. To the extent that collection would not be enforceable or possible on a gross basis, there would be no such collection requirement either, provided that the ratio of

such transactions does not exceed **2.5%** of all outstanding OTC derivatives transactions, as calculated pursuant to the methodology specified in the FMIO Amendment.

As regards transactions with counterparties in non-netting jurisdictions, the documentation will have to be amended accordingly to take these regulatory requirements into account.

### 6 STATE OF PLAY

The credit support documentation used for OTC derivatives transactions will have to be reviewed for FMIA compliance before the 1 September 2017 VM compliance date. In addition, for parties falling into the scope of IM requirements, the relevant IM credit support documents will have to be put in place.

## Contacts

The content of this Newsletter does not constitute legal or tax advice and may not be relied upon as such. Should you seek advice with regard to your specific circumstances, please contact your Schellenberg Wittmer liaison or any of the following persons:



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