

## FinfraG / Financial Market Infrastructure Act

### A new challenge for derivatives market participants



In the aftermath of the financial crisis in 2009, the governments of the G20 countries agreed that regulation would be necessary to enhance the resilience and transparency of the derivatives markets. In reaction, the United States passed the Dodd-Frank Act in 2010, and the European Market Infrastructure Regulation ("EMIR") came into force in the EU in 2012.

In Switzerland, the Financial Markets Infrastructure Act (FMIA), also known as "FinfraG", was adopted by the Parliament in June 2015 and is expected to come into force beginning of 2016. It will align the derivatives trading regulation with the international standards, and address key changes in the infrastructures of the financial markets, such as trading platforms and central clearing counterparties.

#### What is FinfraG?

The main requirements for market participants in derivatives trading can be categorised under four headings: the **reporting obligations** of derivatives transactions, the **clearing obligations** of OTC derivatives, the **platform trading obligations**, and the duty to **mitigate risk**, including the bilateral margining requirements.

#### Reporting obligation

- Transaction data reporting to a recognised Trade Repository
- Must be done T+1 at the latest

#### Clearing obligation

- Eligible OTC contracts need to be settled through a recognised clearing counterparty
- Direct or indirect clearing access to the CCP

#### Risk mitigation

- Timely confirmation
- Dispute Resolution
- Portfolio reconciliation
- Portfolio compression
- Daily Valuation
- Margin requirements

#### Platform Trading

- Eligible derivatives must be traded via recognised trading venues or organised trading facilities

#### Reporting obligation

Under the reporting obligation, all derivatives transaction data, including OTC and exchange-traded derivatives, will have to be reported to a trade repository recognised by FINMA.

Unlike EMIR, but similar to Dodd-Frank, the FinfraG reporting obligation is "single-sided", meaning that only one of the counterparties will have to report the transaction to the repository. This reporting duty will follow a **"cascade" principle**, where a certain hierarchical order determines which counterparty will report.<sup>1</sup>

In 2014, SIX has announced that it will establish a trade repository for the Swiss financial market based on FinfraG. The reporting obligation is expected to follow a phase-in approach, starting with financial counterparties, a few months after FinfraG comes into force.

Concretely, to satisfy the reporting obligation, counterparties will need to connect to a **recognised trade repository**, and be able to transmit the required derivatives transaction data in the specified format within the given deadline (T+1). Alternatively, market participants may also choose to delegate their reporting duty to either trade counterparties or third parties.

#### Clearing Obligation

Eligible OTC contracts, will have to be settled through a Central Clearing Counterparty (CCP) that has been **recognised and authorised by FINMA**.

To comply with this requirement, large counterparties must set-up contractual and operational clearing frameworks. They will have to establish a clearing capability/relationship either on a clearing member level, ensuring appropriate segregation of the accounts; or indirectly, by opening a client clearing account with a clearing broker, which implies negotiation of client clearing documentation.

Acting at an early stage, assessing exposure and impact of the FinfraG requirements will provide useful insights, and facilitate compliance when the regulation comes into force.

<sup>1</sup> Financial counterparties will report when trading with non-financial counterparties. Large entities will report when trading with small counterparties. For trades between counterparties of the same classification, the selling entity will report.

Market participants will have to implement new tools and processes, establish connectivity with clearing brokers, central counterparties, and trade repositories

**Risk mitigation**

Derivative contracts that are not traded on a recognised exchange, and not centrally cleared, are subject to the risk mitigation obligation. These measures aim to reduce counterparty and operational risks. The risk mitigation techniques are: dispute resolution; timely confirmation of contractual terms; portfolio reconciliation and compression; the obligation of daily valuation of outstanding transactions; and finally, the requirement to exchange appropriate collateral.

Counterparties will thus have to put policies and procedures in place in order to comply with the different mitigation measures.

**Margin Requirements**

The collateral exchange obligation will require that counterparties of non-clearable OTC derivatives have contractual agreements in place to exchange **appropriate levels of financial guarantees** reflecting potential future exposure (Initial Margin) and current exposure (Variation Margin). Market participants should ensure that **proper collateral management procedures** are in place to ensure the **appropriate evaluation and segregation** of the collateral.

**Trading via trading venues and organised trading facilities<sup>3</sup>**

Large counterparties must trade eligible derivatives via trading venues or an operator of an organised trading facility (OTF) authorised or recognised by FINMA.

Similar to the clearing obligation, FINMA will decide whether a derivative class will fall under the trading venue requirement, according to the degree of standardisation and liquidity of the class.

**Who will FinfraG impact?**

FinfraG will affect all participants in the derivatives market, financial and non-financial counterparties alike. However, not all the requirements apply to all counterparties on the market in the same way.

FinfraG distinguishes between financial (FC) and non-financial (NFC) entities, both divided into large and small counterparties, resulting in four different counterparty classifications. A counterparty is defined as being large if its gross positions in **relevant outstanding OTC derivatives transactions**, calculated as a rolling average over a period of 30 working days, is above the threshold defined by the Federal Council.

As shown in Figure 1, the reporting obligation applies to all counterparties except for trades between two small non-financial counterparties, whereas the requirement to settle via a central clearing counterparty, and via a recognised trading platform, only apply to trades involving two large counterparties. The risk mitigation measures, apply to all counterparties, except the daily valuation requirement that only applies to trades between large entities, and the collateral exchange and portfolio reconciliation obligations that do not apply to trades with small non-financial counterparties.

**How will FinfraG impact market participants?**

As we have seen, FinfraG will have significant impact on derivatives market participants. Participants will have to implement new tools and processes, establish connectivity with clearing brokers, central counterparties, and trade repositories. They will need to adapt legal contracts and collateral management frameworks to meet the new requirements.

The obligations addressed by FinfraG will be deemed satisfied if the market participants are in compliance with foreign equivalent legislation that has been recognised as equivalent by FINMA. Market participants will need to go through a detailed assessment of the scope of this exemption addressed by FinfraG and their internal systems to identify potential overlap in the applicable legislations, such as EMIR, with respect to derivative transactions.

Figure 1. Overview of the FinfraG obligations according to the Counterparty classification<sup>2</sup>

	FC+	FC-	NFC+	NFC-
Reporting	✓	✓	✓	✗
Clearing	✓	✗	✓	✗
Risk mitigation	✓	✓	✓	✓
Portfolio reconciliation	✓	✓	✓	✗
Daily valuation	✓	✗	✓	✗
Collateral exchange	✓	✓	✓	✗
Platform trading	✓	✗	✓	✗

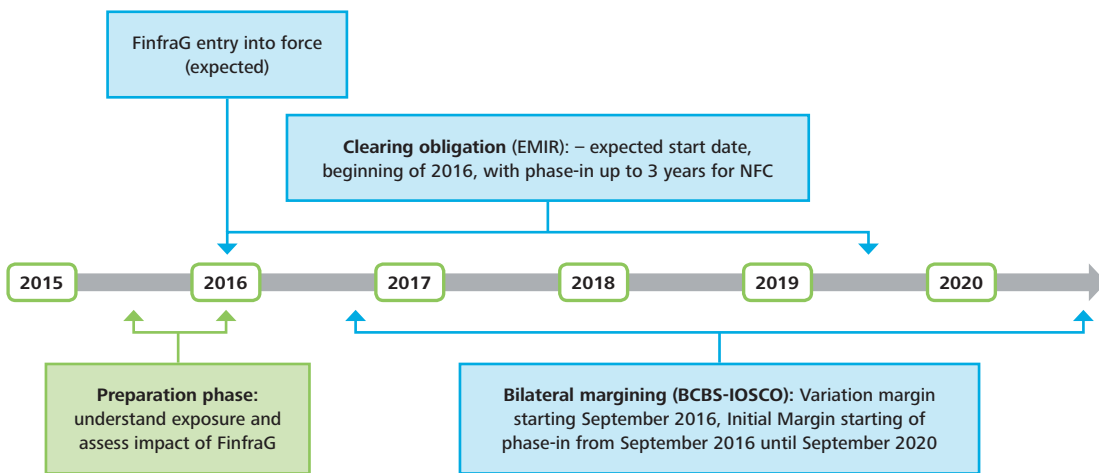
2 In the table, the EMIR terminology is used. A "+" designates counterparties above the threshold that is thus large, and a "-" designates small counterparties below the defined threshold.

3 This obligation only applies when both counterparties of the trade are large counterparties.

**What do you need to do next?**

You will need to review your product range and assess the effect on the profitability of your services. Compliance with this new regulation that increases the complexity of the derivatives markets is a challenge. Acting at an early stage, assessing exposure and impact of the FinfraG requirements will provide useful insights, and facilitate compliance when the regulation comes into force.

FinfraG, introducing new rules for derivatives markets, will come into force beginning of 2016



**How can we help?**

We can assist you facing this new regulatory challenge, from the assessment of your exposure to the implementation of tools and systems in order to achieve compliance.

Deloitte Derivatives Advisory Services offers specific operational and technical solutions to achieve compliance with the FinfraG requirements as outlined below.

Regulatory assessment and gap analysis	Derivatives documentation management	Collateral management	Implementation
<ul style="list-style-type: none"> <li>• Determine your exposure to FinfraG and its impact on your organisation.</li> <li>• Gap analysis of current processes and systems.</li> <li>• Compliance assessment regarding cross-border trades: the overlaps, gaps and equivalences with other applicable legislations: EMIR and Dodd-Frank.</li> </ul>	<ul style="list-style-type: none"> <li>• Set-up and negotiation of contractual framework and documentation for central counterparty clearing and client clearing.</li> <li>• Contractual framework for trade repository reporting.</li> <li>• Update bilateral contracts to include new margin requirements for non-clearable trades.</li> </ul>	<ul style="list-style-type: none"> <li>• Capital efficiency analysis.</li> <li>• Collateral optimisation: Initial and Variation Margin across cleared and non-cleared derivatives.</li> <li>• Data review &amp; data extraction.</li> </ul>	<ul style="list-style-type: none"> <li>• Assistance with the implementation of operational, technical and documentation solutions required for the new central clearing, transaction reporting and margin requirements.</li> </ul>

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**Deloitte Derivatives Advisory Services** concentrates global expertise in implementing into the business area of the new reporting, clearing and risk mitigation requirements combined with the large documentation expertise to ensure efficient technical integration as well as full compliance with the new regulatory landscape. We help our client to build efficient internal systems to achieve straight through processing, reduce operational risk and access additional liquidity.

Our **flexible resourcing model** offers wide-range solutions to process-intensive challenges generated by regulatory complexity, financial innovation and re-positioning of the trading activities.

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