

# FUNDS AND INSURERS ENTERING INTO DERIVATIVES

## A SUMMARY OF YOUR OBLIGATIONS

If you are a fund, insurer or other non-bank financial entity and you enter into derivatives, regulatory obligations may apply to you, as a Financial Counterparty (FC), under EU and UK regulation. In this briefing we give an overview of these obligations.<sup>1</sup>

### 1. The main obligations are:

- (a) reporting trades to an authorised repository;
- (b) clearing trades unless you determine you fall below certain thresholds; and
- (c) taking specific steps to mitigate risk, including exchanging margin, reconciling portfolios periodically and agreeing dispute resolution procedures.

### 2. Are you impacted?

When entering into derivatives other than on an exchange (OTC derivatives), you become a counterparty subject to regulation, even for simple trades like interest rate swaps. Funds and insurers are, like banks, treated as Financial Counterparties (FCs) and subject to more requirements than Non-Financial Counterparties.

This briefing flags key issues for funds, insurers and other FCs as buy-side derivatives counterparties trading with banks.<sup>2</sup> The regulatory requirements are complex and must be considered on a case-by-case basis.<sup>3</sup>

### 3. Reporting

You are required to report details of each of your OTC derivative transactions to an approved trade repository.

### 4. Clearing

You are required to clear certain types of standardised OTC derivative contracts, unless you perform annual calculations that show you fall below the clearing thresholds and are therefore categorised as a small financial counterparty (SFC). Omitting to perform the calculations means you will be treated, like large banks, as being above the clearing thresholds.

To determine whether a FC's OTC contracts exceed the clearing threshold, the FC needs to calculate the value of all OTC contracts (cleared and uncleared) entered into by that FC or entered into by other entities within the group regardless of whether the contracts are for hedging purposes. The aggregate month-end average group position in OTC derivative contracts in each asset class for the previous 12 months is used for these

purposes. For UCITS and AIFs, positions need to be calculated at the level of the fund.

There are separate clearing thresholds for each asset class. If an FC's derivatives activity is below each of these clearing thresholds then the entity is a SFC. If an FC exceeds one or more of the clearing thresholds, it will be subject to the clearing obligation (such entities are generally referred to as FC+).

The calculation needs to be repeated every 12 months. If an FC chooses not to undertake the calculation, it cannot be treated as an SFC and will be subject to the clearing obligation. Where an FC calculates that it exceeds the threshold and becomes an FC+ (and even where an FC chooses not to calculate its positions) the FC must immediately notify the competent authority (the FCA in the UK) and must establish clearing arrangements within four months of notification for all its in-scope OTC derivatives contracts.

Note that exemptions to the clearing obligation may apply. Intragroup transactions can be exempt, provided certain conditions are met and an application is made to the competent authority to benefit from the exemption.

### 5. Margining

All FCs, i.e. both SFCs and FC+s, are subject to mandatory margining requirements.

All FCs are required to exchange variation margin on a daily basis, with specific requirements applying to the way in which this can be exchanged.

Initial margin requirements only apply if your portfolio (according to the aggregate average month-end notional amount (AANA) of non-cleared derivatives transactions for a party on a consolidated group basis) exceeds the relevant threshold (€8bn) in a prescribed period.

As is the case with the clearing threshold, this calculation must be performed in a specific manner and special attention must be paid to how the AANA threshold is applied when dealing with AIFs and UCITS – some funds will be treated as independent entities for the AANA determination, and special consideration must also be given to multimanager funds.

<sup>1</sup> We do not discuss pension-specific regulatory requirements/exemptions in this briefing.

<sup>2</sup> Different requirements apply where trading is with Non-Financial Counterparties.

<sup>3</sup> This briefing is not intended to be comprehensive – it does not include all the details relating to the requirements and their application.

## 6. Daily mark-to-market valuation

FCs are required to carry out mark-to-market valuations of non-cleared OTC derivatives on a daily basis and are required to report updates to valuations and collateral, as often as daily if relevant.

## 7. Timely Confirmation

All counterparties are subject to a timely confirmation obligation which means the terms of non-cleared OTC contracts must be confirmed where available, by electronic means, as soon as possible and within prescribed timeframes. Formalised processes (which are robust, resilient and auditable) must be in place for such timely confirmation. Financial counterparties must have procedures in place to report, on request, the number of unconfirmed OTC derivative transactions that have been outstanding for more than 5 business days.

## 8. Portfolio Reconciliation and Compression

All OTC derivative contracts need to be reconciled on a periodic basis, with frequency depending on the number of OTC derivative trades with a counterparty. For funds, the trade count and therefore portfolio reconciliation frequency should apply at the fund level or sub-fund level and not the level of the fund manager.

## 9. Dispute Resolution

FCs are required to report to the competent authority any disputes with their counterparties about an OTC contract (including in relation to valuation) and the exchange of any collateral in respect of the contract. The requirement applies when a dispute is for an amount or value higher than €15 million. The FCA requires reporting of disputes that are outstanding for at least 15 business days.

## 10. Change Ahead

Market participants using derivatives will be keen to keep an eye on any potential changes to their regulatory obligation going forward. Proposed UK reforms may include:

- Alignment of the timing for the compliance cycle for initial margin with global standards.
- IM requirements ceasing to apply to existing derivative transactions once one of the parties falls below the AANA threshold.
- Partially aligning the AANA calculation for the purposes of the clearing threshold with the AANA calculation for the purposes of initial margin.

## 11. Readiness for regulatory compliance

Should you require any assistance in relation to regulatory compliance for your derivative contracts, or if an informal discussion about any of the points in this briefing would be of interest, please contact a member of our team.

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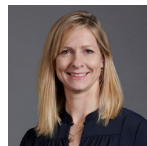
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