Exemption from the margin requirements for single stock equity options and index equity options

Single stock equity options and index equity options ('equity options') play a significant part in the real economy. Imposing variation and initial margin requirements on these instruments would increase funding costs and operational complexity and could result in smaller EU counterparties ceasing to use equity options for hedging and risk mitigation purposes. In addition, given some major jurisdictions (e.g. the US) are permanently exempting equity options from margin requirements, EU market participants would face a clear competitive disadvantage when dealing with non-EU counterparties. Given the very small size of the equity option market compared to the overall OTC derivatives market and also the short maturities of such instruments, a permanent exemption from margin requirements would not add material risks to financial stability.

A recital should be introduced in EMIR 3 recognising that in some major jurisdictions equity options are not subject to equivalent margin requirements and that to avoid market fragmentation and to ensure a global level playing field it is appropriate to permanently exempt these contracts from the margin requirements.

The equity options market

Equity options play a significant part in the real economy and are used for multiple purposes aside from transactions between dealers, including hedging exposure to the purchase price in the context of an M&A transaction, use in share buy-backs by companies and use in private equity transactions as well as for stake building in preparation for takeover bids. Equity options may also be used to allow EU investors access to equity markets that are closed to direct investment from EU investors (e.g. certain emerging markets), allowing EU pension funds to diversify their portfolios. Equity options also play a key role in supporting convertible bond issuance by EU corporates, but their usage in this context would no longer be viable if margin requirements were to be applied to them. Finally, certain equity option strategies allow shareholders to hedge the market risk on the shares they own and increased margin requirement could make investing in shares economically unattractive.

The equity options market is very small compared with the overall OTC derivatives market and most of these contracts have a short maturity. The impact on financial stability of exempting these contracts from the Margin RTS[1] is therefore marginal. **According to BIS data[2], equity options represented 0.55% of notional amount outstanding of all OTC derivative contracts in H1 2022**. BIS data also shows that in H1 2022, 64.60% (in notional amounts outstanding) of equity linked contracts (which include forward/swaps and options) had a maturity of up to 1 year. Only 5.11% (in notional amounts outstanding) of equity linked contracts had a maturity over 5 years in H1 2022, compared to 22.36% of notional amount outstanding in OTC derivative interest rate contracts.

The current EMIR regime for equity options

Article 38 of the Margin RTS provides for a derogation until 4 January 2024 from the margin obligation in respect of all non-centrally cleared OTC derivatives which are equity options. This temporary derogation was introduced to avoid market fragmentation and to ensure a level playing field for EU counterparties on a global level, given many jurisdictions either have not implemented margin requirements for equity options (US, Singapore,) or have also introduced temporary derogations (Hong Kong[3], Switzerland[4], UK[5]) for these contracts. The temporary derogation was intended to allow time for monitoring of regulatory developments in other jurisdictions and has already been extended twice. However, the situation has not materially changed.

Why to permanently exempt equity options from the Margin RTS

The EU legislators' original rational for exempting equity options from the Margin RTS – to avoid market fragmentation and to ensure a level playing field – remains valid.

The US is the largest market for equity options[6], so alignment with the US in this regard is particularly important to avoid disruption of cross-border business. In the US, equity options are not in scope of Title VII of the Dodd Frank Act and there is therefore no prospect of these contracts being subject to the US margin rules. Without a permanent exemption from the margin rules: (1) **EU clients will face a competitive disadvantage when trading EU underlyings with US banks/dealers compared to US clients** knowing US banks/dealers will have to reflect funding costs in their pricing and (2) **EU banks/dealers will also face a clear competitive disadvantage compared to US banks/dealers when dealing with most non-EU clients** (including US insurers and hedge funds). These non-EU clients are likely to cease trading with EU banks/dealers upon expiry of the exemption under the current Margin RTS.

Imposing margin requirements in relation to equity options will also have a **disproportionate impact for smaller counterparties**, potentially leading EU entities that currently use equity options for hedging and risk mitigation purposes to cease trading these products due to the funding cost increase, and – in the case of non-EU clients – discouraging them from entering into equity options transactions with EU counterparties.

For relatively small counterparties, which nevertheless exceed the initial margin threshold of aggregate average notional amount of non-centrally cleared derivatives of €8 billion due to their use of equity options for risk mitigation purposes, a significant burden would arise from the requirement to prepare

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[1] CL2016R2251EN0040010.0001.3bi_cp 1..1 (europa.eu)
[2] BIS Statistics Explorer: Table D5.1
[3] https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CR-G-14.pdf
https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/Code_of_conduct_05082022_Eng.pdf?rev=0fd396c657bc46feb94f3367d7f97a05
[4] https://www.fedlex.admin.ch/eli/cc/2015/854/en
[5] https://www.handbook.fca.org.uk/techstandards/EMIR/2016/reg_del_2016_2251_oj/chapter-iv/042.html
[6] BIS Statistics Explorer: Table D5.1

for and to post regulatory initial margin on a daily basis. This collateral must be held in bankruptcy-remote, segregated accounts with no right of re-use. As a result, this would **increase funding costs for these relatively small counterparties**, and would also create opportunity costs (as the assets could not be put to other productive use, such as financing real economy activities). Establishment of segregated initial margin accounts, regulatory initial margin credit support documentation and an initial margin calculation method and governance are **legally and operationally complex tasks.**

Apart from the increased collateral demands and costly operational uplift associated with expiry of the derogation, **global market fragmentation and erosion of hedging liquidity would further inhibit cross-border derivatives business,** to the significant disadvantage of EU market participants (including pension and insurance institutions and other funds, as well as banks/dealers).

Proposed amendment to EMIR

A recital should be introduced in EMIR 3 that recognises that in some major jurisdictions equity options are not subject to equivalent margin requirements and that to avoid market fragmentation and to ensure a global level playing field it is appropriate to permanently exempt these contracts from the margin requirements.

This will give the mandate to the European Supervisory Authorities to amend the Margin RTS to exclude these products from the margin requirements.

About AIMA
The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than US$2.5 trillion in hedge fund and private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org

About EACB
The European Association of Co-operative Banks (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 27member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 2,700 locally operating banks and 52,000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 223 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 85million members and 705,000 employees and have a total average market share of about 20%. Website: www.eacb.coop

About EBF
The European Banking Federation is the voice of the European banking sector, bringing together national banking associations from across Europe. The federation is committed to a thriving European economy that is underpinned by a stable, secure and inclusive financial ecosystem, and to a flourishing society where financing is available to fund the dreams of citizens, businesses and innovators everywhere.

About EFAMA
EFAMA is the voice of the European investment management industry, which manages over EUR 30 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors.
Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities. EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the authoritative EFAMA Fact Book.
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About ISDA
Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 79 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

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Managed Funds Association (MFA), based in Washington, DC, New York, and Brussels, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 150 member firms, including traditional hedge funds, crossover funds, and private credit funds, that collectively manage nearly €1.9 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

About NSA
The Nordic Securities Association (NSA) is a Nordic cooperation that works to promote a sound securities market primarily in the Nordic region. The NSA is formed by Capital Market Denmark (Kapitalmarked Danmark), Finance Finland (Finanssiala), the Norwegian Securities Dealers Association (Verdipapirforetakenes Forbund) and the Swedish Securities Markets Association (Svensk Värdepappersmarknad), NSA - Nordic Securities Association (nsa-securities.eu). Nordic Securities Association's public ID number in the Transparency Register is: 622921012417-15