3rd March 2023

Vicky Saporta
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

Sasha Mills
Bank of England
Threadneedle Street
London
EC2R 8AH

Dear Ms Saporta,
Dear Ms Mills,

In December, ISDA wrote to you to recommend making permanent the UK EMIR temporary exemption for certain equity options from exchanging initial and variation margin, which is due to expire on 4 January 2024. We would like to set out in more detail why ISDA, the Investment Association, the Alternative Investment Management Association (AIMA), and their respective members consider this recommendation a priority.

The equity options market

Single stock equity options and index equity options ("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, and use in share buy-backs by companies. Equity options may also be used to allow UK investors access to equity markets that are closed to direct investment from UK investors (*e.g.*, certain emerging markets), and allowing UK pension funds to diversify their portfolios. Equity options also play a key role in supporting convertible bond issuance by UK 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 derivatives in H1 2022**. BIS data also shows that in H1 2022, 64.60% (in notional amount outstanding) of equity-linked contracts (which include forward/swaps and options) had a maturity of up to 1 year. Only 5.11% (in notional amount outstanding) of equity linked contracts had a maturity over 5 years in H1 2022, compared to 22.36% of notional amounts outstanding in OTC derivative interest rate contracts.

[1] CL2016R2251EN0040010.0001.3bi_cp 1..1 (europa.eu)
[2] BIS Statistics Explorer: Table D5.1

Why to permanently exempt equity options from the Margin RTS

The original temporary exemption was introduced to avoid market fragmentation, to ensure a level playing field across jurisdictions, and to avoid scope for regulatory arbitrage. This rationale remains valid, and since the exemption was reintroduced, there has not been a material change to the international position.

The US is the largest market for equity options[3], 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 for the SEC non-cleared margin rules. They fall outside of Title VII of the Dodd Frank Act as they are not defined as "swaps" or "security-based swaps". Rather, equity options are treated as securities in the US. There is therefore no prospect of these contracts being subject to the US margin rules, in fact it would require a change of law (.e. Act of Congress) to make such options subject to Dodd Frank requirements.

Without a permanent exemption from the UK margin rules (1) **UK clients will face a competitive disadvantage when trading underlyings with US dealers compared to US clients** knowing US dealers will have to reflect funding costs in their pricing and (2) **UK dealers will also face a clear competitive disadvantage compared to US dealers when dealing with most non-UK clients** (including US insurers and hedge funds). These non-UK clients are likely to cease trading with UK dealers upon expiry of the exemption.

By way of example, **UK firms offering products such as call spreads, for which counterparties commonly seek "equity accounting" treatment, will be negatively impacted.** Pursuant to the accounting guidance, one of the conditions to obtaining equity accounting treatment is that such transactions are not collateralized. A call spread is a pair of call options that are often used by convertible bond issuers to hedge the option embedded in a convertible bond. These transactions facing FCs and NFC+ counterparties can be booked today to UK (or EU) firms in reliance on the current options relief. If the option relief expires, pricing such products from a UK entity will be uncompetitive relative to US dealers. There is an expectation that the business would simply be lost to non-UK dealers or otherwise migrated to non-UK legal entities where firms have the capabilities to do this, though this is not economic for all firms to pursue.

Imposing margin requirements in relation to equity options will also have a **disproportionate impact for smaller counterparties**, potentially leading UK 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-UK clients – discouraging them from entering into equity options transactions with UK 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 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.**

[3] BIS Statistics Explorer: Table D5.1

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 UK market participants (including pension and insurance institutions and other funds, as well as banks and dealers).

The need for early communication to industry participants

We urge the UK authorities to communicate its intentions **as soon as possible** to mitigate against the damaging effects of a cliff-edge on 4 January 2024. The process for firms to implement arrangements for margin requirements can be significant and need to begin. Without further clarification the industry risk wasting effort at a time when they have many priorities and demands on their change capabilities and financial resources. If the authorities believe that a public consultation is required on changes to the rulebook, or more time is required to consider a permanent exemption, we urge a targeted extension of the derogation– of at least 2-3 years – to allow for this to be addressed. This could also then be considered as part of the broader review of EMIR in the UK via the Future Regulatory Framework review process.

We thank you for taking the time to consider our views on these issues. We look forward to discussing them with you at your convenience.

We have copied a version of this letter to Richard Knox, Director of Financial Services at HM Treasury.

Yours sincerely,

Scott O'Malia
CEO
International Swaps
and Derivative Association

Chris Cummings
CEO
The Investment Association

Jack Inglis
CEO
Alternative Investment
Management Association

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.

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 set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 250 members that manage US$800 billion of private credit assets globally. 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).

About The Investment Association

The IA champions UK investment management, supporting British savers, investors and businesses. Our 250 members manage £10 trillion of assets and the investment management industry supports 114,000 jobs across the UK. Our mission is to make investment better. Better for clients, so they achieve their financial goals. Better for companies, so they get the capital they need to grow. And better for the economy, so everyone prospers. Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital.

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks and shares ISAs. The UK is the second largest investment management centre in the world, after the US, and manages 37% of all assets managed in Europe.