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30 April 2020

Dear Executive Vice-President Dombrovskis,

Dear Chairman Maijoor,

Dear Chairman Campa,

Dear Chairman Bernardino,

EMIR – Time-limited derogation under the Margin Regulatory Technical Standards (Margin RTS) for equity options and indexes

The International Swaps and Derivatives Association (ISDA), the Alternative Investment Management Association (AIMA), the European Association of Co-operative Banks (EACB), the European Banking Federation (EBF), Invest Europe, the Managed Funds Association (MFA) and the Nordic Securities Association (NSA, comprising the Danish Securities Dealers Association (Børsmæglerforeningen), Finance Finland (Finanssialan Keskusliitto), the Norwegian Securities Dealers Association (Verdipapirforetakenes Forbund) and the Swedish Securities Dealers Association (Svenska Fondhandlareföreningen)) – hereinafter referred to as 'the associations' - welcome the European Supervisory Authorities' (ESAs') proposed amendments to the Margin RTS to extend by one year the current deferred application of the margin requirements for single-stock equity options or index options, meaning that once the amendments come into effect these transactions would be out of scope of the Margin RTS until 4 January 2021. However, the associations also strongly agree with the ESAs' statement that, three years after the entry into force of the Margin RTS, the reasons for deferring application of the margin requirements to these transactions have not materially changed.

As a result, we urge the European Commission and the ESAs to consider amending the Margin RTS to permanently exempt these transactions, or else to significantly extend the period of deferred application ('temporary derogation') to allow further observation of developments in other jurisdictions and to avoid an unlevel playing field for EU market participants engaged in global derivatives markets.

We would also urge the European Commission to make any amendments as soon as possible during the first half of 2020 to avoid potentially damaging uncertainty for market participants, as it is difficult for firms to plan and prepare for implementation of the Margin RTS (and support their clients through the implementation process) where derogations are extended for short periods of time, particularly if the extension is granted only shortly before the expiry of the current temporary derogation.

A permanent exemption, or a further extended derogation from the Margin RTS for equity options and index options, is necessary

Article 38 of the Margin RTS provides for a three-year derogation from the margin obligation in respect of all non-centrally cleared OTC derivatives which are single-stock equity options or index options. This temporary derogation was necessary to avoid market fragmentation and to ensure a level playing field for EU counterparties on a global level, because in some jurisdictions (e.g. the US) single-stock options and equity index options are not subject to equivalent margin requirements. The temporary derogation was intended to allow time for monitoring of regulatory developments in other jurisdictions.

However, as the ESAs comment in their Final Report on amendments to the Margin RTS, three years after entry into force of the Margin RTS, the situation has not materially changed and many jurisdictions either have not implemented margin requirements for single-stock equity options or index options or have also introduced temporary derogations for these contracts.

As the situation has not materially changed and does not seem likely to change materially in the future, the associations would ask the European Commission and the ESAs to amend the Margin RTS to exclude these contracts from the margin requirements permanently or, failing that, to extend the temporary derogation for a significant period of time (e.g., a further three years beyond the current proposed data of expiry, to 4 January 2024) to allow time to continue to monitor regulatory developments in other jurisdictions.

If the Margin RTS are not amended to exempt equity options or to provide for a lengthier derogation, the ESAs should consult separately (and as soon as possible) on the expiry of the equity options derogation

If the European Commission and ESAs do not amend the draft revised Margin RTS to exempt equity options and index options or to further extend the temporary derogation, we urge the ESAs to (as soon as possible) conduct a full public consultation addressing whether or not the equity options derogation should be extended. We believe that the ESAs should also, at that point (and certainly no later than 30 June 2020), make a statement to the effect that national competent authorities should not prioritise their supervisory actions, and should apply their risk-based supervisory powers in day-to-day enforcement of margin requirements for equity options and index options in a proportionate manner until after this consultation has run its course and sufficient time has passed to either effect any legislative changes deemed appropriate, or to give market participants time to put in place necessary infrastructure and documentation to apply this requirement should the consultation conclude that it is appropriate for the derogation not to be extended.

We believe that such a statement would be necessary as it seems unlikely that the ESAs could – at this stage – hold a consultation and draw conclusions from that consultation sufficiently early to give market participants adequate time to comply with the requirement to apply margin requirements to equity options and index options by 4 January 2021.

We believe it would be unusual for such an impactful requirement to be applied to market participants without any formal consultation having been held as to its appropriateness. We observe that the ESAs have not consulted on the derogation at any point since the adoption of the Margin RTS in 2016.

Approach currently taken in other jurisdictions

As mentioned above, in many other jurisdictions these transactions are either out of scope of the margin rules or benefit from a permanent or temporary exemption. For example, in the US, equity options are not addressed within the scope of Dodd Frank Title VII, and regulatory margin requirements do not in practice apply to swap dealers under US regulation. Aside from the EU, the US is the largest market for equity options[1], so alignment with the US in this regard will be important to avoid disruption of cross-border business. In particular, EU banks – which have until now been among the market leaders in equity options business - will face a clear competitive disadvantage when dealing with non-EU clients (including US insurers and hedge funds) which are likely to cease trading with them upon expiry of the exemption under EMIR.

In Singapore, the Monetary Authority of Singapore has released guidelines exempting equity options and equity index options from the scope of its margin rules entirely[2].

[1] https://stats.bis.org/statx/srs/table/d8?f=pdf

[2] https://www.mas.gov.sg/-/media/MAS/Regulations-and-Financial-Stability/Regulations-Guidance-and-Licensing/Securities-Futures-and-Fund-Management/Regulations-Guidance-and-Licensing/Guidelines/Guidelines-on-Margin-Requirements-for-NonCentrally-Cleared-OTC-Derivatives-Contracts-11-Feb-2020.pdf

FINMA Guidance regarding the Swiss margin rules[3] provide for a temporary exemption for single-stock options and equity basket options until 4 January 2021 (and the Swiss regulator has the power to exempt additional categories of equity derivatives).

Similar temporary exemptions also apply in Hong Kong[4] (in relation to both the HKMA and SFC margin rules) and South Korea[5].

Real economy benefits of the equity option derogation and importance for smaller counterparties

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 European investors (*e.g.*, emerging markets), allowing EU pension funds to diversify their portfolios. Equity options also play a key role in supporting convertible bond issuance by European corporates, but their usage in this context would no longer be viable if margin requirements were to be applied to them.

Imposing margin requirements in relation to equity options will have a disproportionate impact for smaller counterparties coming within the scope of the Margin RTS, potentially leading EU entities that currently use equity options for hedging and risk mitigation to cease trading these products due to the cost increase, and – in the case of non-EU clients – incentivizing them to avoid dealing with EU counterparties in equity options.

For relatively small counterparties, that nevertheless exceed the initial margin threshold of aggregate average notional amount of uncleared derivatives of €8 billion or over, a significant burden would arise from the requirement to post initial margin on a daily basis (assuming there has been any change in the netting set the previous day). This collateral has to 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 is a legally and operationally complex task.

If the derogation is allowed to expire without further relief from the ESAs and the European Commission, global market fragmentation and stability of the OTC equity options market is likely to result, impacting liquidity, causing inefficiencies and higher costs for derivatives market participants as well as ultimately increased systemic risk. EU market participants, for example, may find it more difficult to hedge their risks in the market through equity options, leading to market fragmentation (with EU firms finding it more difficult to access hedges with non-EU firms).

[3] FINMA Guidance 04/2019 – Financial Market Infrastructure Ordinance: exchange of collateral / extension of transitional period for equity option, 13 December 2019

[4] Paragraph 7(e) of Part III of Schedule 10 to the Code of Conduct (Appendix A of the Consultation Conclusions published in December 2019), single-stock options, equity basket options and equity index options are out of scope until 3 January 2021

[5] Text available at http://www.fss.or.kr/fss/kr/law/guide_view.jsp?seqno=20190305145314802&no=2&s_title=&s_kind=&src

Apart from the increased collateral demands and costly operational uplift associated with expiry of the derogation, the erosion of hedging liquidity would further inhibit cross-border derivatives business, to the significant disadvantage of European market participants (including pension and insurance institutions and other funds, as well as banks and broker dealers) that use these products for hedging and risk mitigation reason, compared to entities in other jurisdictions (particularly US) who are not required to collect or post margin in relation to these products.

ISDA estimates that as many as 1100 counterparties and 9400 relationships will come into scope for Phase 5 and 6 margin initial margin requirements, with a significant proportion of those clients trading OTC equity options. It is very likely that a high proportion of these clients, who currently use these products for critical hedging and risk mitigation functions, will stop trading these products altogether due to the increased cost of utilizing them.

We thank you for your consideration of this letter, and would be happy to discuss this issue further at your convenience.

Yours sincerely,

Scott O'Malia,
CEO,
ISDA

Adam Jacobs
Managing Director,
AIMA

Herve Guider,
Managing Director,
EACB

Wim Mijs,
CEO,
EBF

Martin Bresson,
Public Affairs Director,
Invest Europe

Jakob Legård Jakobsen,
Executive Director,
Danish Securities Dealers Association,
(current Presidency of NSA)

Michael Pedroni
Executive Vice-President
& Managing Director,
International Affairs,
MFA

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 73 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.

About AIMA

AIMA is the global representative of the alternative investment industry, with more than 1,900 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in 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 programs 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 100 members that manage $350 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 specialized educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

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 28 member 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 4,050 locally operating banks and 58,000 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 210 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 79 million members and 749,000 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, uniting **32 national banking associations** in Europe that together represent some **3, 500 banks** – large and small, wholesale and retail, local and international – employing about **two million people**. **Website: www.ebf.eu**

About Invest Europe

Invest Europe is the world's largest association of private capital providers. We represent Europe's private equity, venture capital and infrastructure investment firms, as well as their investors, including some of Europe's largest pension funds and insurers. Invest Europe's members take a long-term approach to investing in privately-held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps create healthy and sustainable companies across Europe, securing millions of jobs and delivering strong returns for leading pension funds and insurers whose members depend on them for their retirements.

About MFA

MFA represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

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 the Danish Securities Dealers Association (Børsmæglerforeningen), Finance Finland (Finanssiala), the Norwegian Securities Dealers Association (Verdipapirforetakenes Forbund) and the Swedish Securities Dealers Association (Svenska Fondhandlareföreningen). Website: www.nsa-securities.com