In conversation with Euronext: European Equity Options

With regulation set to bring widespread changes across the European markets, The Trade Derivatives speaks to Euronext's Adam Rose, head of Financial Derivatives, about how this will drive execution decisions in the equity options market in the next decade.

Q: With regulation transforming the interest rate derivatives space, how has the equity options market changed?

The equity options market continues its own revolution which has picked up pace in the last year. The drivers are largely the same as in other asset classes: new liquidity providers, increased focus on capital use and competition between trading venues.

The previous iteration of market structure, with a fluid OTC service for institutional clients, has been challenged by new liquidity sources which are more able to compete in a centrally cleared world. We remain some distance from a full central order book market, for good reason, but there is much more automation in price formation. We are focusing on the new landscape: what are the key drivers for decision makers and how venues can provide solutions to the challenges ahead.

Adam Rose

Q: In what ways are exchanges looking to keep up and innovate?

Exchanges now offer a much broader set of products: this is a function of increased demand to trade through an exchange and clear centrally. In the largest European underlyings it is now generally possible to trade maturities onscreen from one day to five years.

Trade reports with bespoke strike prices, broken expiry dates, European or American style, cash or physical settlement are commonly accepted and clear alongside existing positions in instruments with a central order book. Standardisation will create more efficiency for market makers in management of their portfolio but with many end clients used to the flexibility of OTC, trading venues and liquidity providers are generally comfortable to facilitate this expansion.

The boundary for product expansion will come with CCP risk management: so long as a CCP is comfortable to risk manage new products we can expect more bespoke variations to be added.

Q: How will market structure changes affect trade execution for clients?

For small orders in a vanilla option or simple strategies the central order book is efficient: clients can often expect to find liquidity inside a quoted spread. The broadest cross-section of participants will have the ability to interact and ensure a solid execution. Conversely, trading a complex structure is likely to remain the domain of those few firms able to accurately

FACT: 32% of AEX-Index® options volume is in either weekly or daily expirations

understand and manage the risk, as this is much harder to automate.

Q: Will we see the emergence of a new type of liquidity provider?

The middle ground is ripe for development. In a parallel to cash equity markets we can expect trading venues to innovate and find solutions to get clients the best price. MiFID II will create a level playing field in areas such as block size and delayed publication, meaning exchanges can compete on more positive aspects such as execution solutions. Increased automation, including RFQ platforms, is enhancing the ability of independent market makers to participate in what were previously phone-brokered markets. Their price competition should bolster value for clients, with the increase in transparency post MiFID II leading to a more level playing field for these firms in terms of available information.

LCH S.A.'s launch of DIME (Derivatives Initial Margin Enhancement) in April 2016 has seen required initial margin reduce by an average of 28% on Euronext stock options and futures overnight

FACT: Market Makers trade over 60% of their onscreen activity on Euronext stock options inside their quoted spread

Q: What impact will clearing have on market activity?

Once a function of trading activity, clearing has grown in prominence. Market makers who are able to manage their capital use efficiently are better positioned to facilitate clients. High capital charges on OTC trading coupled with the introduction of OTC margin will further enhance the proposition of venues connected to CCPs. CCPs in turn have developed. The ability to offset margin across underlyings and between standard and flexible positions creates significant benefit. Being long a standard option on one exchange and short flex on another will impact collateral requirements.

Another area of opportunity is the sourcing of eligible collateral by both market makers and buyside. Developments in margin funding cost will change the overall value of an options strategy so we can expect more platforms in this space to help facilitate efficient collateral transformation, unless rules on capital charges against such activity OTC are relaxed.

Q: Is this now decision time for clients?

Choosing how and where to execute used to be formulaic. Momentum towards exchange trading and central clearing has created an environment where exchanges can enhance their offering and expect to attract clients, though not overnight. MiFID II best execution requirements will mean each firm needs to have a clear understanding of what is best for their clients.

Expect trading venues to continue to develop their offering to facilitate trading in more efficient ways such that the value of European equity options markets is secured for the long term. ■

Keep an eye out for developments on Euronext equity options over the coming months

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