



BUSINESS RULE GUIDANCE NOTE

Title: CANCELLATION OF TRADES MADE IN ERROR ON THE DERIVATIVES TRADING FACILITY

No: 3/02

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Purpose

The purpose of this Guidance Note is to remind Trading Participants of their rights and obligations under the Business Rules in relation to trading errors that occur when using the Derivatives Trading Facility. The Exchange is also providing guidance as to the circumstances in which a dispute concerning a trading error may be referred to the derivatives Trading Governors Committee for resolution.

Background

Increased activity in the options market during 2001 was accompanied by a significant increase in operator errors and requests for the Trading Governors Committee to rule on Disputes involving alleged erroneous trades. The increasing use of automated market making and arbitrage systems means market participants are quick to take advantage of any mispricing.

The introduction of Tailor-Made Combinations, which allows a non standard combination of up to four legs to interact with the central order book, could result in more than five (5) parties being involved in a trade. This will make the resolution of errors even more complex.

Furthermore a recent decision by the National Adjudicatory Tribunal has confirmed the jurisdiction of the Trading Governors Committee to cancel or amend transactions where the dispute concerned an erroneous trade.

There are a number of basic principles which are described in this Guidance Note that underpin the disputes resolutions process:

- Trading Participants are responsible for all their transactions and should not rely on the disputes resolution process as a substitute for ensuring adequately trained and diligent personnel or the implementation of appropriate automated filters.
- The Exchange believes it is in the interests of all market participants that traded prices properly reflect prevailing market prices and that market participants should not seek windfall profits from trading which is not fair and orderly.
- Any trade that would appear to any competent DTR to be outside prevailing market prices would be eligible for consideration by the Trading Governors Committee as a dispute.

The obligations of Participating Organisations to prevent errors are set out below. In relation to all the matters below, Trading Participants offering execution only services are subject to the same obligations and requirements as other Trading Participants.

Obligations in Options Markets

Trading Participants are reminded of their obligations under ASX Business Rule 7.5.2. In particular, Business Rules 7.5.2.1 and 7.5.2.2 state as follows:

7.5.2.1 Responsibility of Trading Participant

A Trading Participant is responsible for the accuracy of details, the integrity and bona fides, of all Trading Messages containing their unique identifier that is submitted into the Derivatives Trading Facility, regardless of whether a Designated Trading Representative of the Trading Participant was involved in their submission.

7.5.2.2 Knowledge of Trading Participant

For the avoidance of doubt, a Trading Participant's unique identifier embedded in a Trading Message is conclusive proof (for the purposes of these Rules) that the particular Trading Message was submitted into the Derivatives Trading Facility by or with the knowledge of the Trading Participant.

Cancellations in Options Markets

Transactions arising from erroneous orders may, with the consent of the counterparty, be cancelled in accordance with Business Rules 7.9.3.7. That Business Rule states as follows:

7.9.3.7 Errors resolved by agreement

If a Trading Participant becomes aware of any error in the entry of an order and an Option Transaction is effected in relation to the order:

- (a) The Trading Participant identifying the error must contact the Trading Participant with whom the transaction was effected and request the agreement of the Trading Participant to cancel the transaction;

- (b) If agreement is reached, both Trading Participants must as soon as possible after reaching agreement notify the Exchange of the
 - (i) error;
 - (ii) agreement to cancel the transaction; and
 - (iii) details sufficient to enable identification of the transaction to be cancelled.

After notifying the Exchange under paragraph (b), the Trading Participants must effect the cancellation by the end of that Trading Day.

The counterparty is under no obligation to agree to a cancellation.

Cancellation of an error in relation to one or more trades making up a Tailor-Made Combination will require that all trades making up that Tailor-Made Combination be cancelled. Hence it will be necessary for the Trading Participant to obtain the agreement of all counterparties prior to cancellation of the Tailor Made Combination.

Use of the Disputes process to resolve errors

As noted above, Trading Participants are obliged to correctly execute trades and so, as a general rule, the Exchange does not intervene to rectify errors that cannot be resolved by agreement. However, in some situations, a dispute arising from an erroneous trade may be dealt with under the disputes process in Business Rule 7.11.

Rule 7.11 deals with the powers of the Trading Governors Committee to consider and determine disputes between Trading Participants in relation to the Dealing Rules in the options market.

For the purposes of Rule 7.11.1, a “Dispute” is any “dispute arising in relation to the Dealing Rules and includes an objection by the Trading Participant that another Trading Participant has not complied with the Rules, the Procedures or practices of the Exchange relating to the making of markets, the placing of orders, the making of bids and offers or the entry into Options Transactions”.

Those errors falling within the meaning of “Dispute” may be dealt with in accordance with Business Rule 7.11.1. The Exchange will convene a Trading Governors Committee to determine a resolution of the Dispute as soon as practicable. The Exchange will use its best endeavours to have the Dispute resolved on the same day as it occurs.

It is noted that, under ASX Business Rule 7.11.1.9 and subject to Rule 7.11.2.4, the Exchange may take any action (or refrain from taking action) and give any directions it considers appropriate to give effect to a decision of the Trading Governors Committee including, without limitation, doing any or all of the following:

- (a) cancel or amend an Options Transaction;
- (b) restore an order which was executed to give rise to an Option Transaction cancelled under paragraph (a);

- (c) notify the Trading Participants and their Clearing Participants (if applicable) of the decision to cancel or amend an Option Transaction; and
- (d) Direct the Clearing House to amend or cancel the registration of an Open Contract arising from the Options Transaction amended or cancelled under paragraph (a).

Notwithstanding a decision of the Trading Governors Committee, either a Trading Participant or the Exchange may appeal to the National Adjudicatory Tribunal. The appeal process including timings for lodgement of an appeal and how an appeal will be conducted are detailed in Business Rule 7.11.2.

Errors that may be dealt with by the disputes process

Those errors that are inconsistent with the practices of the Exchange can trigger the disputes process in Rule 7.11. Errors that result in a price that is not consistent with the history of trading in the options and/or is not consistent with the history of trading in the underlying securities are seen to be matters that are contrary to the practices of the Exchange. These types of errors impact adversely on the fair operation of the market or are so obvious or manifest (because for example the price does not bear a relationship to fair market or intrinsic value) that they are not in the interests of the market.

Exchanges internationally have grappled with trying to specify what is an erroneous price. In most jurisdictions it remains a matter of subjectivity. The Exchange is not able to define the term “erroneous” so that it applies to all instances. Rather it will continue to rely on the interpretations of the Trading Governors Committee of the circumstances surrounding a particular incident.

Errors that will not be accepted as Disputes

Simple errors in order entry by Trading Participants as a result of carelessness may not trigger the Disputes process. These types of errors can only be resolved by agreement between all parties involved. Examples include:

- Rebooking of trades as a result of failing to trade in price / time priority on the Bulletin Board;
- Trading at market price a spread the wrong way around;
- Trading at market price when price / quantity have been entered the wrong way around;
- Trading the wrong series at market price;
- Trading the wrong series in the wrong class at market price;
- Buying in a single series when selling was the intention and vice versa;
- Trading more than once by entering the same order multiple times; or
- Incorrectly pricing a spread that trades at market price.

Failure to reach agreement means the options transaction stands.

The Exchange is not concerned with the reason the error was made but rather whether a competent DTR would regard the price or quantity of the resulting trades to be not achievable in normal trading circumstances.

Timing of Disputes

Business Rule 7.11.1.3 specifies that a Trading Participant who wishes to have a Dispute resolved must advise the Manager, Derivatives Market Control “immediately upon becoming aware of the matters giving rise to the Dispute”.

For Disputes involving erroneous trades the Exchange considers “immediately” to be before the close of trading or within 30 minutes of the transaction, whichever is the sooner. A Trading Participant that fails to adhere to these time limits may not be able to refer the dispute under Business Rule 7.11.

Contract Notes and Client Relations

It is the responsibility of Trading Participants to manage the relationship with their clients where a transaction has been cancelled.

In some instances clients may object to having a trade resulting from the error of another Trading Participant cancelled. ASX Business Rule 7.3.3.2 requires that, subject to Rule 7.3.3.2B, a Trading Participant must despatch immediately to each client a contract note (in writing or in another form permitted by the Exchange) of each Option Transaction entered into on the client’s instructions or on the client’s Discretionary Account, which includes a statement that the contract note is issued subject to:

- (i) the Rules, customs and usages of the Exchange and the Clearing House; and
- (ii) the correction of errors and omissions.

Clients may be confused by the cancellation of trades after they have been issued a contract note. Therefore, in circumstances where it is necessary to cancel a trade, either by mutual agreement or at the direction of the Exchange to give effect to a decision of the Trading Governors Committee, it is the responsibility of the Trading Participant to draw these conditions to the attention of the client.

Participants should review their Client Agreement Forms and Contract Note wordings to satisfy themselves that the client has been adequately advised that in certain circumstances options contracts appearing on a contract note can be cancelled or amended.

Role of DTRs

DTRs are reminded of their obligation to accurately enter orders into the DTF. The Exchange may take disciplinary action in cases of repeat errors. DTRs who repeatedly enter orders in error may be required to be retested.

Potential actions

The Exchange may take a range of disciplinary actions against a Trading Participant responsible for repeatedly entering erroneous orders into the market. These include, but may not be limited to, actions for:

- failure to maintain an orderly market;

- unsatisfactory professional conduct, where the conduct is such that it involves a substantial or consistent failure to reach reasonable standards of competence and diligence (“prohibited conduct”)
- in the case of errors arising from Automated Order Processing, failure to have appropriate automated filters.

Disciplinary action will generally be directed towards the Trading Participant responsible for entering the erroneous orders. However, it is possible that the circumstances of the transactions may require disciplinary action to be taken against both Trading Participants.

Qualification

ASX has published this note to promote commercial certainty and to assist Participants. Nothing in this note necessarily binds ASX in the application of the Rules in a particular case. In issuing this note ASX is not providing legal advice and market participants should obtain their own advice from a qualified professional person in respect of their obligations. ASX may replace this Guidance Note at any time without further express notice to any particular person. Readers should contact ASX to ensure they have the latest version.

Enquiries

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