



ASX Exchange Traded Options: Response to Consultation on Automatic-Exercise on Expiry Date & Approach for Exercise Errors

Table with 20 columns and 20 rows of alphanumeric codes (e.g., BBE, BPD, BTT, CAG, CCP, CFF, CHR, CLR, CNN, CPN, CSS, CUP, CXY, DDR, DMP, DUE).

Response to Market

26 August 2014

Table with 20 columns and 2 rows of alphanumeric codes (e.g., ESK, ESM, ESN, ESR, ESV, ETE, EUG, EUM, EVE, EVM, EVN, EVR, EVZ, EWC, EXA, EXC, EXE, EXG, EXM, EXR, EZA, EZL, FAC, FAN, FAR, FAS, FBU, FCN, FCR, FDC, FDC, FDC, FEL, FED, FFF, FFI, FGE, FGF, FGI, FIE, FIS, FKP, FKP, FLK, FLR, FLT, FMA, FMB, FMG, FML, FMM, FMN, FMS, FND, FNP, FNT, FOB, FOT, FOX, FOY, FPG, FPH).

Contacts

For general enquiries, please contact:

Mr Steven Ball – Senior Analyst, Trading
Operations & Development
T 02 9227 0820
E steven.ball@asx.com.au

Media enquiries, please contact:

Mr Matthew Gibbs – General Manager,
Media and Communications
T 02 9227 0218
E matthew.gibbs@asx.com.au

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Executive Summary

On 4 April 2014, ASX released for public comment a consultation paper entitled [ASX exchange-traded options: Consultation on automatic exercise on expiry date and approach for exercise errors](#) which examined the introduction of automatic exercise as the clearing house default position for all *in-the-money* cash settled and deliverable option contracts on expiry date. The consultation paper also sought feedback on ASX Clear's current approach in circumstances involving exercise errors where an option contract is inadvertently exercised, or where there has been an inadvertent failure to exercise an option contract.

ASX received 18 written submissions in response to the consultation paper (including 15 submissions on a confidential basis).¹

The consultation feedback provided strong support for the introduction of automatic exercise on expiry date for both cash settled and deliverable *in-the-money* options with the majority of respondents citing the economic rationality of doing so, the benefits relating to the mitigation of operational risk, market certainty and alignment with international market standards.

Accordingly, ASX Clear will introduce automatic exercise as the clearing house default position for all *in-the-money* cash settled and deliverable option contracts on expiry date, with the ability for a clearing participant to exclude automatic exercise for a specific position. The implementation will involve amendments to the ASX Clear Operating Rules and ASX is working towards a Q4 2014 rule implementation timeframe subject to regulatory approval. Until the introduction of automatic exercise as the clearing house default, clearing participants will need to continue with the current exercise and exercise amendment or withdrawal process.

In addition, ASX Clear will make changes to the ASX Derivatives Clearing System (DCS) which will allow a clearing participant to tailor supplementary automatic exercise criteria at an account level. This will allow a clearing participant to apply a minimum *in-the-money* threshold factor in order for automatic exercise to occur. ASX Clear intends to provide this functionality in a future Member Clearing Module (MCM) release targeted for Q2 2015 implementation. Further detailed information about the operation of the minimum *in-the-money* threshold factor will be communicated to clearing participants through ASX Clear and DCS business and technical documents.

The second key issue sought feedback with respect to ASX Clear's approach to Participant exercise errors at expiry. The majority of respondents supported the necessity for a fair, standardised and transparent error resolution policy.

However, feedback on the topic of error resolution was mixed in so far as some respondents were satisfied with ASX Clear facilitating direct private negotiations, others advocated for the clearing house to intermediate as a central counterparty on an anonymous basis, and a number of respondents were in favour of addressing exercise errors through a new structured and enforced error policy framework analogous to the ASIC Market Integrity Rules and existing cash market trade cancellation policies.

ASX has given serious consideration to all respondent feedback received in relation ASX Clear's current approach to exercise errors and has determined to continue with the current practice of facilitating direct negotiations between clearing participants.

ASX thanks those who have provided input on these matters through the consultation process.

¹ Submissions provided on a non-confidential basis are available at: <http://www.asxgroup.com.au/public-consultations.htm>

Automatic exercise on expiry date

Consultation feedback

1. There was strong support for the proposal that *in-the-money* cash settled and deliverable options contracts should be automatically exercised by default on expiry date. This was observed by respondents as being aligned with international market practice and would remove the risk of mistake by a clearing participant in failing to set up an account for automatic exercise as a default, or of an inadvertent failure to exercise a particular *in-the-money* position. Certain manual processes currently undertaken by clearing participants involving initial account set-up and expiry procedures would also be reduced.
2. The consultation also questioned that if ASX Clear were to implement the proposal for automatic exercise as the default position, would it be appropriate to provide the ability for clearing participants to exclude automatic exercise for a specific option position. All respondents overwhelmingly supported the need for the ability to exclude automatic exercise for specific positions.
3. Suggestions were put forward by several respondents that automatic exercise for an *in-the-money* position should also factor the cost of exercise against positive intrinsic value.

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4. ASX Clear will introduce automatic exercise as the clearing house default position for all *in-the-money* cash settled and deliverable option contracts on expiry date, with the ability for a clearing participant to exclude automatic exercise for a specific position.
5. The implementation of automatic exercise by default will occur at a **product** level within DCS. ASX will be making rule and procedure amendments to provide for automatic exercise of all *in-the-money* cash settled and deliverable contracts on expiry date, with the ability for a clearing participant to perform exercise exclusions for a specific position.
6. The rule amendments will include enhanced ASX powers to support the performance of ASX Clear's function in the exercise and settlement process. ASX is working towards a Q4 2014 rule implementation timeframe subject to regulatory approval.
7. Whilst ASX agrees that the cost of exercise may have an economic impact to an intrinsic value outcome, particularly equity options, it is the view of the clearing house that it would be inappropriate for ASX Clear to determine and apply a 'one-size-fits-all' threshold for automatic exercise.
8. However, ASX Clear is of the opinion that it would be beneficial to enhance DCS functionality so that a clearing participant would have the ability to apply a minimum *in-the-money* amount for automatic exercise (e.g. to reflect the cost of exercise) that will take priority over automatic exercise default criteria.
9. ASX Clear intends to make this functionality available in a future MCM release targeted for Q2 2015. Further information will be made available through ASX Clear and DCS business and technical documents. Rule amendments to support such minimum *in-the-money* criteria for automatic exercise will also need to be introduced at the same time.

Cash settled and deliverable option contracts

10. Unless a clearing participant performs an 'Exercise Exclusion' by the exercise cut-off time, or instructs a minimum *in-the-money* amount for automatic exercise (where that functionality is available), ASX Clear will automatically exercise any cash settled or deliverable option contract that is *in-the-money* on expiry date. This means that any options that are *in-the-money* **by any amount** on expiry night will be exercised. Any cash settled or deliverable option contract *at-the-money* or *out-of-the-money* will **expire** (i.e. be abandoned) on expiry night unless the Participant has specifically exercised that position.

11. ASX Clear will use the following test calculation to determine whether a cash settled or deliverable option contract is in-the-money and thus eligible for automatic exercise on expiry date:

[The difference between the underlying reference price and the strike price] x [Units per Lot]

12. Where the clearing participant has identified a minimum *in-the-money* amount for automatic exercise under the proposed new functionality, the *in-the-money* amount for the relevant option contracts determined under the above formula multiplied by the quantity of open contracts in that Series registered in the account of the clearing participant as Buyer must be equal to or greater than the minimum *in-the-money* amount identified by the clearing participant.

ASX Clear error resolution policy

Consultation feedback

13. ASX analysed what error resolution policies other market venues and clearing houses had in place. Through this analysis, ASX found that for most other markets the market rules and or clearing rules and procedures clearly provide that if default automatic exercise is not expressly overridden by the participant by the relevant exercise cut-off time, it is deemed to be binding and irrevocable.
14. Whilst a clearing participant does not have a right to have an exercise error addressed, and ASX Clear is not obliged to address any error, respondents were of the opinion that operational errors involving exercise and assignment had the potential for reputational damage to both the ASX ETO market and clearing participants alike. As such, there was broad support for ASX Clear to continue with its current approach to exercise errors at expiry. Respondents were also of the view that ASX Clear should publish clearly defined processes that set out when a clearing participant can request the redress of an exercise error and the approach that applies following such a request.
15. The consultation paper questioned whether ASX Clear should impose a notification cut-off time in order for a clearing participant to be able to seek that an erroneous exercise, or failure to exercise, be addressed. All respondents were of the opinion that any cut-off time should be no later than the opening of the market on the business day following the expiry date and, on balance, no later than 9:30am.
16. The final question posed in the consultation paper asked whether ASX Clear should identify the counterparty participant to the requestor seeking their error be addressed regardless of whether the counterparty participant has consented to their identity being revealed. The majority of feedback received from respondents to this question was largely in favour of ASX Clear not divulging the identity of the counterparty participant to a requestor seeking redress without prior consent.

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17. ASX Clear has determined to continue with the approach for exercise errors at expiry outlined in the consultation² and will impose a notification cut-off time of 9:30am (Sydney time) on the business day following the expiry date for the purposes of a clearing participant notifying ASX Clear that an exercise error has occurred and requesting the redress of its error.
18. Where a clearing participant notifies ASX Clear by the notification cut-off time about a failure to exercise or an exercise that has occurred as a result of an error and requests the redress of its error, ASX Clear will, where reasonably practical, contact the clearing participant(s) who are the sellers of the affected option contract and enquire as to whether the counterparty participant is willing to make arrangements for the error to be remedied.

² Refer paras. 16 – 24.

19. ASX Clear's policy on clearing participant exercise errors at expiry will be made available via a dedicated ASX Clear webpage on the ASX website. The policy will outline the circumstances and manner in which a clearing participant may request ASX Clear's assistance to address its exercise error and ASX Clear's approach where a Participant does so. Subject to regulatory approval, ASX will seek to introduce rule amendments reflecting this process in Q4 2014.
20. The ASX Clear exercise error policy will apply to both European and *American* style option contracts at expiry.
21. The ASX Clear approach to exercise errors will also apply to the early exercise of *American* style options.