



# Changes to the Exchange-Traded Option (ETO) Crossing Rules

Consultation Paper

28 August 2013

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## Invitation to Comment

ASX is seeking submissions on the issues in this paper by 25 September 2013.

Submissions should be sent to:

[greg.pill@asx.com.au](mailto:greg.pill@asx.com.au)

or

## Meeting with ASX

ASX invites parties interested in face-to-face consultation to contact us to arrange a suitable meeting time.

Please contact ASX on 61 2 9227 0696 if you wish to arrange an appointment.

ASX prefers to receive submissions in electronic form.

Submissions not marked as 'confidential' will be made publicly available on ASX's website. If you would like your submission, or any part of it, to be treated as 'confidential', please indicate this clearly in your submission.

ASIC will be given copies of all responses as part of the rule approval process.

## Executive Summary

ASX is proposing new Exchange-Traded Option (ETO) Crossing Rules that are designed to improve execution efficiency for end clients. The proposed new rules are intended to be easier to understand and less time consuming to use.

ASX proposes that:

- Crossings that are not of Special Size should be executed through the market on a price-time priority basis, instead of allowing them to be trade reported.
- The methodology for determining the Special Size Crossing threshold should be changed from premium-based to number of Contracts traded; except for Low Exercise Price Options (LEPOs), which will be linked to the underlying ASIC equity market block trade exemption levels relating to pre-trade transparency.
- The number of Contracts for Special Size should be a multiple of the ETO Market Maker's quoting obligation.

ASX is inviting interested parties to consider the proposals and provide comment to ASX by 25 September 2013.

## Background and Purpose

The ASX ETO Crossing Rules were created when ASX was formed in 1987 and, except for minor enhancements, have remained largely the same since.

ASX believes it is important to now update the ETO Crossing Rules to reflect current market practices and regulatory conditions, and to help strengthen the Australian ETO market.

The proposals contained in this paper seek to improve the attractiveness of using ETOs, including as an alternative to over-the-counter traded products, and help realise the growth potential of the ETO market.

In developing its proposal for ETO crossings, ASX assessed recent changes made to the cash equity market, consulted with various market user groups and examined ETO crossings rules at other global derivative exchanges. The proposals seek to balance the views and motivations of market users, and are guided by regulatory principles set out by the International Organisation of Securities Commissions (IOSCO) - in particular, Principle 35 of IOSCO's June 2010 *Objectives and Principles of Securities Regulation* report which said that "regulation should promote transparency of trading".

The proposed changes to ETO crossings, especially those which are not special size, will have implications for all ETO market stakeholders. In addition to technology changes, Market Makers will likely need to post more liquidity (price and size) on market to satisfy and participate in ETO crossings. The changes will also result in the removal of any guaranteed execution that currently exists for Market Makers and brokers. Instead, execution will be determined on a price-time priority basis, delivering best execution for the end client, whether they are retail or institutional. The proposed ETO Crossing Rules also aim to make the process of crossing options clearer, more efficient, and less time consuming for brokers.

## The ETO Crossing Rules Proposal

ASX is proposing to remove the trade reporting functionality for ETO Crossings that are below the Special Size threshold. That is, only Orders that meet the Special Size criteria can be reported as an ETO Crossing.

Orders that are below Special Size will now be required to occur on a price-time priority basis through the market.

This change will have the effect of removing the current categories from the ASX Operating Rule Procedure 4060 Part B:

- "Cross Single Series Function"
- "Cross with TradeMatch Function"
- "Crossing of Derivatives-Only Combinations that are Standard Combinations in TradeMatch"
- "Crossing of other Derivatives-Only Combinations" and
- "Crossing of Derivative/Cash Combinations".

These Crossing types will be replaced with a new procedure (see below).

Inadvertent Crossings, as specified under ASX Operating Rule Procedure 4060 Part B (9) "Crossing using Automated Processing", will remain.

ASX is aware that some Trading Participants facilitate client option orders and execute the underlying stock hedge of the trade before finalising the final option price with the client and reporting to market. We acknowledge that the proposed

ETO Crossing Rules offer no certainty for Trading Participants wishing to follow this practice for non-special size transactions. However, for ASX to remove this uncertainty the operating rules and procedures would need to allow for a crossing trade report function at any price regardless of size. This approach is contrary to the pre-trade transparency principles set out by IOSCO and would not provide best execution for the end client.

## ETO Special Size Crossing Thresholds

With the exception of LEPOs, Special Size Crossing thresholds are proposed to change from the current premium only methodology.

Special Size Crossing thresholds for all ETOs (except LEPOs) are currently set at a premium value of \$250,000 or \$500,000, depending on the ETO class category. It is proposed that new thresholds be set at 20 x the ETO market making requirement. For example, if the market making requirement for security XYZ is 100 contracts, the associated ETO Special Size threshold will be set at 2,000 contracts. The practical impact of such a change would be to encourage activity that is currently being transacted over-the-counter back on exchange, increasing liquidity and improving market quality.

- ASX is currently working with ETO Market Makers on increasing the minimum quote size for each ETO Class, as another element to enhance the quality of the ETO market. This change would flow through to the new block thresholds.

Special Size thresholds for LEPOs are to be aligned with the underlying cash equity product. For example, if the ASIC Market Integrity Rules Block Special threshold for security XYZ is \$200,000, the ASX Special Size threshold for the XYZ LEPOs will be \$200,000 of premium. Given the character of these products is closer to a cash market security than a traditional ETO product, it is appropriate to align the block threshold to that set by ASIC in the cash market. This change will have the practical effect of lowering the threshold for many LEPOs, other than those for the largest listed securities.

## New ETO Crossing Procedure for Non-Special Size Parcels

Under new arrangements, before an ETO Crossing can occur in the market, a Trading Participant looking to cross must ask for a Quote Request showing the full size of the potential crossing.

Market Makers, or if there is no obligated Market Maker, all Trading Participants, will have 15 seconds to reply to the Quote Request by putting their best price and quantity into the market.

A Trading Participant may elect to put in one side of the potential crossing into the market before asking for a Quote Request to gain priority at a particular price.

After the 15 second period following the initial Quote Request, the Trading Participant is allowed to enter the other side (or both sides if electing not to put in one side before the quote request) of the potential crossing into the market.

The Trading Participant has an additional 15 seconds after the initial 15 seconds (Quote Request time) in which to enter the other side or both sides of the Crossing Orders.

ASX is developing the technical capability to Quote Request into a combination product to help facilitate and simplify crossings in these instruments.

A participant would have a choice of two crossing methods to affect a crossing of ETO orders. They would operate as follows:

### Method 1:

- (a) The Trading Participant enters a Quote Request specifying the Contract Series/Combination code and quantity to be crossed.

- (b) A Quote Request for the total quantity sought to be crossed is automatically sent to Market Makers in the Contract Series/Combination or, if there is no obligated Market Maker, to all Trading Participants. The Trading Participant may proceed with the Crossing by entering each side of the Order into the market after waiting 15 seconds from making the initial Quote Request.
- (c) The entered Orders will then trade on a price-time priority in the market.

**Method 2:**

- (a) The Trading Participant enters one side of the Crossing Order for the Contract Series/Combination code into the market at the price at which they are trying to cross.
- (b) The Trading Participant **immediately** enters a Quote Request specifying the instrument code and quantity to be crossed.
- (c) A Quote Request for the total quantity sought to be crossed is automatically sent to Market Makers in the Contract Series/Combination or, if there is no obligated Market Maker, to all Trading Participants. The Trading Participant may proceed with entering the other side of the potential crossing after waiting 15 seconds from making the initial Quote Request.
- (d) The entered Orders will then trade on a price-time priority in the market.

## Review and Implementation

ASX will review the responses to this consultation paper following the closing of submissions on 25 September 2013 and expects to announce a final decision approximately one month later.

If ASX decides to change the ETO Crossing Rules, the market will be provided with a transition period sufficient to enable Trading Participants to make any required system changes.

ASX will also notify the market of any Operating Rule Procedure 4060 Part B changes that will need to be made in order to facilitate any changes to the ETO Crossing Rules.

Any rule changes that arise as a result of this initiative will require the normal regulatory clearance from ASIC.

### Your feedback

1. Do you support the proposed new Special Size Crossing thresholds? If not, what do you believe an appropriate threshold should be?
2. Do you support the new procedures proposed for affecting ETO Crossings? Please provide reasons and/or alternative suggestions.
3. What transitional period before the changes become effective would be required to enable participants to make any necessary systems changes?