



23rd May 2014

Ms Diane Lewis
Senior Manager, Regulatory and Public Policy
ASX Limited
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Sydney NSW 2000

By email: regulatorypolicy@asx.com.au

Dear Ms Lewis

ASX exchange traded options: Consultation on automatic exercise on expiry date and approach for exercise errors

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on proposals contained in the Consultation Paper dated 4 April 2014 titled *ASX exchange traded options: Consultation on automatic exercise on expiry date and approach for exercise errors*.

To that end, please find below responses to the consultation questions posed in the paper.

Q1 Do you agree that ASX Clear should change its current policy and provide for automatic exercise as the default position for all *in-the-money* cash settled option contracts on the expiry date? Please set out your reasons.

A1 AFMA is aware of differing opinions amongst market participants regarding this point.

Specifically, there appears to be consensus that there are risks attached to non-automatic exercise of in-the-money options. However, there is not unanimity as to whether the optimal method to manage such risks is via ASX Clear setting automatic exercise as the default, or continuing to allow clearing participants to mitigate this risk by contracting with their clients coupled with using the automatic exercise facility at an account level through ASX Clear's Derivative Clearing System (DCS) at expiry.

We also ask ASX Clear to note that there may be a significant cost implication to market participants if they need to change policies, procedures, and documentation to reflect automatic exercise as the default option set by ASX Clear.

Whilst being mindful of the divergence in opinions regarding automatic exercise as the default position for in-the-money cash settled options on balance, AFMA is supportive of this proposal, as:

- automatic exercise of cash settled options is an economically rational decision; and
- the certainty of automatic exercise as the default position may provide confidence to market participants.

Q2 If ASX Clear were to implement the proposal for automatic exercise as the default position for all **in-the-money** cash settled options contracts, do you support ASX Clear providing the for clearing participants **to exclude automatic exercise** for a specific option position? Please set out your reasons.

A2 AFMA supports this proposal, as:

- it is consistent with our response to Q4; and
- consistency across cash settled and deliverable options is desirable as it will assist to reduce operational risk for clearing participants.

Q3 Do you agree that ASX Clear should change its current policy and provide for the automatic exercise as the default position for all **in-the-money** deliverable option contracts on the expiry date? Please set out your reasons.

A3 In the context of our response to Q1, AFMA supports this proposal, as:

- in most cases it is an economically rational decision to exercise ITM deliverable options; and
- the certainty of automatic exercise as the default position may provide confidence to market participants.

Q4 If ASX Clear were to implement the proposal for automatic exercise as the default position for all **in-the-money** deliverable options contracts, do you support ASX Clear providing the ability for clearing participants **to exclude automatic exercise** for a specific option position? Please set out your reasons.

A4 AFMA supports this proposal for a number of reasons including:

- an underlying may have moved up/(down) through a strike price where the option holder may not wish to exercise the calls/(puts) and therefore buy/(sell) the amount of underlying equal to the number of contracts multiplied by the multiplier;
- details of corporate actions may influence the decision to exercise;
- stock borrow availability is a consideration;
- non-exercise of an OTC hedge will influence the decision; and
- movements in dual listed stocks after the domestic close may be important.

Further, the definition of an option is that it gives the holder “.....the right but not the obligation...”. Though an option seller may assert they could have been expecting to be exercised upon ITM options and a lack of automatic exercise introduces uncertainty, by definition the seller has sold the right to certainty.

Q5 Do you agree that ASX Clear should change its current approach to addressing participant exercise errors notified to ASX Clear? Please set out your reasons.

- A5** AFMA notes that as outlined in paragraph 16 of the Consultation Paper, ASX Clear is currently not obliged to take any steps to address an error. However we further note that in paragraph 17, ASX Clear “.....may at its discretion, take steps which may facilitate the error being addressed...”.

In the interests of promoting an efficient, honest, and fair market for all participants, AFMA supports ASX Clear formalising the process outlined in paragraphs 17 -20 where it will in all circumstances take these actions, rather than at its discretion.

However, paragraph 21 says (emphasis added):

“If the counterparty participant agrees to facilitate the error being addressed, the terms of such an agreement are a matter to be negotiated directly between the relevant clearing participants, and any steps taken to address the error should occur directly between those parties *outside of the exercise and allocation process undertaken by ASX Clear* (which occurs automatically post the relevant exercise cut-off time based on exercise information at that time). Accordingly, *ASX Clear and DCS records will not reflect any arrangement agreed between the relevant clearing participants.*”

AFMA understands this to mean the erroneous option exercises will stand and result in stock trades occurring at the strike price. As such, we suggests ASX includes in the proposal how an error may be rectified between counterparty participants. If this proposal includes “...position adjustment...” as mentioned in paragraph 22, we ask ASX Clear to make details of this process available to the market.

- Q6** Should ASX Clear change its current approach so that it does not in any circumstances take steps which may facilitate the correction of exercise errors? Please set out your reasons.

- A6** AFMA does not support this approach as the lack of a mechanism to correct errors does not lend itself to efficient markets.

- Q7** Should ASX Clear impose a notification cut-off time in order for a participant to be able to seek that an erroneous exercise or failure to exercise be addressed, and if so what time should apply? Please set out your reasons.

- A7** Yes, there should be a clear cut off time. Whilst AFMA is aware of some market participants differing slightly as to the exact time, consensus says that it should be no later than the next trading day. Some participants would prefer the flexibility of a cut-off time being market close on the next trading day, however concern has also been expressed to AFMA that having the ability to correct errors on the day following expiry may be open to abuse.

We suggest ASX Clear give careful consideration to the cut-off time for a participant to seek to have an erroneous exercise or failure to exercise addressed.

Given that it is not intended that a counterparty participant must agree to facilitate an error bring addressed, on balance AFMA suggests a cut-off time no later than thirty minutes before the start of trading on the day following expiry.

Adopting this approach would allow:

- time for clients to be consulted or notified;

- time for position and/or risk systems to be corrected; and
- prevent the additional complication of executing transactions related to the error.

Q8 Should ASX Clear identify the counterparty participant to the requestor regardless of whether the counterparty participant has consented to their identity being revealed? Please set out your reasons.

A8 No, AFMA does not support this as:

- the counterparty participant did not make the error;
- there may be reputation risk involved in having the name of the counterparty participant divulged to the requestor; and
- if executed on behalf of a client the decision to cancel lies with the client, who may have given instructions not to assist in the reversal of an error.

Further comments

In addition to the questions posed in the Consultation Paper, AFMA would like to make the following observations:

(a) Regarding exercise cut off time, paragraph 14 of the Consultation Paper states:

“A clearing participant seeking to achieve a different exercise outcome (from that of automatic exercise on expiry) will need to manually override the automatic exercise through the DCS system by the exercise cut-off time which is generally 19:00 on the expiry date.”

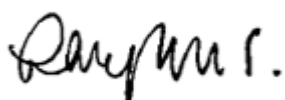
AFMA suggests ASX gives consideration to making the cut-off time explicit and final, not general. This would have the benefits of:

- removing any ambiguity;
- allowing clearing participants to develop policies and procedures to cater for exercise of options;
- allowing market participants to better manage exposures by using related instruments, including dual listed companies; and
- allowing market participants to respond to a change in market conditions between the market close and the cut-off time.

(b) Whilst the Consultation Paper considers circumstances where a clearing participant makes an error, AFMA would like to suggest ASX Clear uses this opportunity to make clear to all market participants what the approach would be in the unlikely event of an option exercise error caused by ASX.

If you have any queries about this submission, please contact me on 9776 7997 or tlyons@afma.com.au.

Yours sincerely



Tracey Lyons
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