



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

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

Invitation to comment

ASX is seeking submissions on this consultation paper by Monday 19 May 2014. Submissions should be sent to:

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Attention: Ms Diane Lewis – Senior
Manager, Regulatory & Public Policy

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.

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Executive summary

ASX is consulting market participants, clearing participants and interested stakeholders on the ASX Clear procedural framework for the automatic exercise of *in-the-money* cash settled and deliverable option contracts.

The consultation also seeks feedback on ASX Clear's approach in circumstances where an option contract is inadvertently exercised, or where there has been a failure to exercise an option contract when the intention was to do so.

ASX is exploring ways to improve operational risk management and efficiency for its customers and align its procedures with global best practice.

Automatic exercise on expiry date

International benchmark review of automatic exercise

1. ASX has performed an international benchmark review of derivative markets across major global exchanges and option clearing houses on the use of 'automatic exercise' on expiry of option contracts. The market venues and clearing houses reviewed all provide for the 'automatic exercise' of cash settled option contracts and certain deliverable option contracts as the default position, provided that they are *in-the-money* on expiration.
2. Generally, option contracts *at-the-money* and *out-of-the-money* are not subject to automatic exercise and will expire worthless, unless exercise is expressly requested. However, certain cash settled products are automatically exercised *at-the-money* in addition to *in-the-money*.
3. The automatic exercise thresholds employed by most market venues and clearing houses typically operate on a basis of 0.01 (local currency) or more *in-the-money*, or a percentage threshold that is either fixed or set as prescribed from time to time. The clearing houses that use a percentage criterion for *in-the-money* automatic exercise typically calculate the percentage as being the difference between the strike and fixing (reference) price as a percentage of the strike price.
4. No clearing houses were found to automatically allocate exercise notices in respect of *in-the-money* option contracts by default on a day other than on expiry day.
5. All clearing houses reviewed provide that if default automatic exercise is not expressly overridden by the participant by the relevant exercise cut-off it is binding and irrevocable pursuant to the relevant clearing rules and procedures.
6. The clearing house systems covered by the review all provide for automatic exercise to be set at either a product or account level or both.

International benchmark constituents

Market venue	Clearing house	Auto-exercise at expiration date	Auto-exercise in-the-money	Auto-exercise at-the-money ¹	Auto-exercise out-of-the-money	Auto-exercise override ability
London Stock Exchange Derivatives Market	LCH.Clearnet	✓	✓	✗	✗	✓
Chicago Board Options Exchange	The Options Clearing Corp.	✓	✓	✗	✗	✓
Hong Kong Stock Exchange	SEHK Options Clearing House	✓	✓	✗	✗	✓
Tokyo Stock Exchange	Japan Securities Clearing Corp.	✓	✓	✗	✗	✓
Eurex Exchange	Eurex Clearing	✓	✓	✗	✗	✓

¹ For a limited number of cash settled products, automatic exercise at-the-money was also provided for.

Current automatic exercise features supported by ASX Clear

7. In contrast to other derivative market venues and option clearing houses, ASX Clear does not provide for the automatic exercise of *in-the-money* cash settled and deliverable products as the default position in the first instance. However, clearing participants have the choice to elect and manage automatic exercise upon expiry at an account level through ASX Clear's Derivatives Clearing System (DCS).
8. The table below sets out the current DCS parameters available to an ASX Clearing Participant in relation to the exercise of option contracts at expiry. The relevant DCS parameters must be set by the exercise cut-off time (generally 19:00) on the date of expiry in order to achieve the desired exercise outcome.

Priority	Mechanism	Initiated by...	Operates at...	Used to...	Overrides
1	Manual exercise exclusion	Participant	Position level	Exclude a position from auto-exercise	Account auto-exercise
N/A	Manual exercise	Participant	Position level	Notify a position to be exercised	The expiry of an in-the-money, at-the-money or an out-of-the-money option position that may otherwise occur
2	Account auto-exercise	Participant	Account level	Apply a default setting for auto-exercise of in-the-money positions to an account	N/A

Proposal

Cash settled option contracts

9. ASX Clear proposes to provide for the automatic exercise of all *in-the-money* cash settled option contracts (e.g. XJOs) on the expiry date as the default position. It is proposed that a clearing participant will have the ability to manually override the automatic exercise of a specific option contract through the DCS system.
10. If a clearing participant does not manually override the automatic exercise on an option contract prior to the exercise cut-off time ASX Clear will deem the exercise binding and irrevocable pursuant to the relevant clearing rules and procedures.
11. The table below sets out the proposed DCS parameters that would be available to ASX Clear and an ASX clearing participant in relation to the exercise of cash settled option contracts at expiry. For the purposes of the table, automatic exercise for all *in-the-money* cash settled option contracts would be set by ASX Clear as the default position for all new and existing products. 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.

Priority	Mechanism	Initiated by...	Operates at...	Used to...	Overrides
1	Manual exercise exclusion	Participant	Position level	Exclude a position from product default auto-exercise	Product default auto-exercise
N/A	Manual exercise	Participant	Position level	Notify a position to be exercised	The expiry of an in-the-money or an out-of-the-money option position that would otherwise occur
2	Product default auto-exercise	ASX Clear Operations	Product level	Apply a default setting for auto-exercise of in-the-money positions at product level	N/A

Consultation questions

- 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.
- 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 ability for clearing participants to **exclude automatic exercise** for a specific option position? Please set out your reasons.

Deliverable option contracts

12. ASX Clear proposes to provide for the automatic exercise of all *in-the-money* deliverable option contracts (e.g. stock options) on the expiry date as the default position. It is proposed that a clearing participant will have the ability to manually override the automatic exercise of a specific option contract through the DCS system.
13. If a clearing participant does not manually override the automatic exercise on an option contract prior to the exercise cut-off time ASX Clear will deem the exercise binding and irrevocable pursuant to the relevant clearing rules and procedures.
14. The table below sets out the proposed DCS parameters that would be available to ASX Clear and an ASX clearing participant in relation to the exercise of deliverable option contracts at expiry. For the purposes of the table, automatic exercise for all *in-the-money* deliverable option contracts would be set by ASX Clear as the default position for all new and existing products. 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.

Priority	Mechanism	Initiated by...	Operates at...	Used to...	Overrides
1	Manual exercise exclusion	Participant	Position level	Exclude a position from product default auto-exercise	Product default auto-exercise
N/A	Manual exercise	Participant	Position level	Notify a position to be exercised	The expiry of an in-the-money or an out-of-the-money option position that would otherwise occur
2	Product default auto-exercise	ASX Clear Operations	Product level	Apply a default setting for auto-exercise of in-the-money positions at product level	N/A

Consultation questions

- 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.
- 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.

Error in option exercise

Other market venues and clearing houses

15. ASX's review of market venues and clearing houses did not identify rules or procedures dealing with error resolution policies. However, the review did find clearing rules and/or procedures that 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.

ASX Clear approach for exercise errors

16. The ASX Clear Operating Rules do not provide for remedy of exercise errors in the event where an option contract is inadvertently exercised, or where there has been a failure to exercise an option contract by the exercise cut-off time on the expiry date when there was an intention to do so. Accordingly, a clearing participant does not have a right to have an exercise error addressed, or to have any particular process followed if they request their error be addressed, and ASX Clear is not obliged to take steps to address the error.
17. However, if a clearing participant contacts ASX Clear about a failure to exercise or an exercise as a result of a clearing participant oversight, ASX Clear may, at its discretion, agree to take steps which may facilitate the error being addressed. Set out below is a high level description of the approach generally followed by ASX where it agrees to take such steps.
18. If ASX Clear agrees to take steps to seek to address the error, ASX Clear will contact the relevant clearing participants who are sellers of the affected option contract and who have been allocated or not allocated an exercise notice as a result of the exercise error ('counterparty participants'), and enquire whether the counterparty participant agrees to facilitate the error being addressed - e.g. in the case of a deliverable option contract, the delivery of the relevant underlying security or the non-delivery of the underlying security dependant on the nature of the exercise error. At this initial point of contact ASX may divulge the identity of the requesting clearing participant (to which the requestor will be deemed to have consented when contacting ASX Clear to seek to have the exercise error addressed).
19. ASX Clear will not divulge the identity of the counterparty participant(s) to the requesting clearing participant unless the counterparty participant agrees to facilitate the error being addressed or the counterparty participant otherwise agrees to such disclosure.
20. The counterparty participant is not obliged in any way to consider a corrective course of action, and any agreement by the counterparty participant to enter into an arrangement to facilitate the error being addressed is on a voluntary basis.
21. 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.
22. In relation to *American* style deliverable option contracts for which an exercise event (e.g. Corporate Action) may occur prior to the expiry date, ASX Clear may also facilitate the approach described above, or may also facilitate position adjustment where appropriate.
23. The approach outlined in this consultation paper in relation to exercise errors is not intended to address the scenario where a clearing participant is experiencing technical problems in the transmission of clearing messages before the exercise cut-off time. Under these circumstances, a clearing participant may contact ASX Clear before exercise cut-off and request emergency assistance to address such circumstances pursuant to ASX Clear Operating Rule 6.9.

Consultation questions

- 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.
- 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.
- 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.
- 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.