

## **EXPLANATORY STATEMENT for ASIC CLASS RULE WAIVER [CW 15/0384]**

Prepared by the Australian Securities and Investments Commission

*ASIC Market Integrity Rules (Competition in Exchange Markets) 2011*

The Australian Securities and Investments Commission (**ASIC**) makes this instrument under subrule 1.2.1(1) of the *ASIC Market Integrity Rules (Competition in Exchange Markets) 2011* (the **Competition Rules**).

Under subrule 1.2.1(1), ASIC may relieve any person or class of persons from the obligation to comply with a provision of the Competition Rules.

Unless otherwise indicated, capitalised terms in this Explanatory Statement refer to defined terms in the Competition Rules.

### **1. Background**

*The Competition Rules*

On 29 April 2011, ASIC made the Competition Rules which form part of the regulatory framework for competition between exchange markets.

The Competition Rules apply to:

- (a) the activities or conduct of a Market;
  - (b) the activities or conduct of persons in relation to a Market; and
  - (c) the activities or conduct of persons in relation to Financial Products,
- as specified in each Chapter, Part or Rule.

Chapter 4 of the Competition Rules relates to Pre-Trade Transparency. Chapter 4 applies to:

- (a) Equity Market Operators and CGS Market Operators;
- (b) Equity Market Participants and CGS Market Participants; and
- (c) Orders and Transactions in Equity Market Products and CGS Depository Interests.

Currently the Financial Markets to which the Competition Rules apply include the financial markets operated by ASX Limited (ACN 008 624 691) (**ASX**) and Chi-X Australia Pty Ltd (ACN 129 584 667) (**Chi-X**).

*Pre-trade transparency exceptions*

Subrule 4.1.1(1) of the Competition Rules provides that, subject to subrule 4.1.1(2), a Participant must not enter into a Transaction unless the Transaction is entered into by matching of a Pre-Trade Transparent Order (being an Order for which information such as price and volume is made available before execution) on an Order Book.

Subrule 4.1.1(1) reflects the importance of pre-trade transparency to the price formation process, liquidity and to fair, orderly and transparent markets.

Subrule 4.1.1(2) of the Competition Rules lists the exceptions to the requirements of subrule 4.1.1(1). A Participant is not required to comply with subrule 4.1.1(1) in relation to:

- (a) Block Trades;

- (b) Large Portfolio Trades;
- (c) Trades with Price Improvement;
- (d) Permitted Trades during the Post-Trading Hours Period;
- (e) Permitted Trades during the Pre-Trading Hours Period; and
- (f) Out of Hours Trades.

*ASIC Class Rule Waivers [CW 12/1710] and [CW 13/680]*

On 13 December 2012, ASIC made ASIC Class Rule Waiver [CW 12/1710]. Class Rule Waiver [12/1710]:

- (a) withdrew Class Rule Waivers [11/1103] and [12/233];
- (b) provided relief from the Pre-Trade Transparency obligations in Rule 4.1.1(1) of the Competition Rules for:
  - (i) "ETF Special Trades";
  - (ii) "Crossings of a Derivative/Cash Combination"; and
  - (iii) Crossings based on the Best Available Bid or the Best Available Offer.

On 24 May 2013, ASIC made ASIC Class Rule Waiver [CW 13/680] which withdrew [CW 12/1710] but continued, refined and extended the relief previously provided in [CW 12/1710]. In particular, paragraph 7 of [CW 13/680] extended the relief in [CW 12/1710] from Rule 4.1.1(1) of the Competition Rules, to certain Transactions on the Market operated by Chi-X arising from:

- (a) Market Pegged Orders;
- (b) Primary Pegged Orders; and
- (c) Mid Point Orders.

This relief applied from 26 May 2013 to 26 September 2013.

On 17 April 2014, ASIC made ASIC Class Rule Waiver [CW 14-0322] which varied ASIC Class Rule Waiver [CW 13/680] to extend the relief provided. Relief was extended to circumstances where a Participant enters into a Transaction in an Equity Market Product as a result of a "derived order" generated as part of a "tailor made combination order". For more information concerning the concepts of "derived order" and "tailor made combination order", please see the explanatory statement to [CW 14-0322].

## **2. Purpose of this Class Rule Waiver**

This Class Rule Waiver varies [CW 13-680] to create an additional circumstance in which a Participant is relieved of the obligation to comply with the pre-trade transparency obligation in subrule 4.1.1(1) of the Competition Rules.

It enables a Participant to enter into a Transaction in an Equity Market Product that is part of a Contingent Equity Transaction (**CET**), without being required to comply with subrule 4.4.1(1).

A CET is a single transaction consisting of two components or 'legs', namely:

- (a) an off-market transaction in an Equity Market Product (the **Equity Leg**) which is subsequently reported to the Market; and
- (b) one or more over-the-counter (**OTC**) options transactions (the **Option Leg**).

As both the Equity Leg and the Option Leg are transacted simultaneously, the parties to the CET agree on a net price for the CET rather than pricing individual legs separately.

The Equity Leg of the CET will be negotiated off-market and subsequently reported to the market. Accordingly, in the absence of this Class Rule Waiver, the Equity Leg will contravene the pre-trade transparency requirement of subrule 4.1.1(1). Furthermore, the Equity Leg of the CET may not fall within any of the Pre-Trade Transparent exceptions in subrule 4.1.1(2).

#### *Reasons for granting the Class Rule waiver*

The policy rationale for subrule 4.1.1 does not apply to CETs.

This is because CETs are negotiated off-market and on the basis of a net price as explained above. Accordingly, pre-trade information concerning the price of the Equity Leg may not provide useful and meaningful information to the market.

In addition, ASIC considers that CETs have a number of benefits which would contribute to fair, orderly and transparent markets.

CETs are a legitimate hedging strategy, providing a delta hedge. Delta hedging is an options strategy that aims to reduce or hedge the risk associated with price movements in the underlying security by offsetting bought and sold positions. The change in the price of the option for each basis-point change in the price of the underlying security is the 'delta'. CETs offer the ability to lock in a 'delta'. This will reduce the risk associated with price movements in the underlying security as they are offset by the Equity Leg position.

Also, the simultaneous pricing of the two legs in the CET facilitates market efficiency as it removes the need to renegotiate pricing of the Option Leg in response to each movement in the underlying equity. This renegotiation is otherwise cumbersome and time consuming. In times of market volatility, this sort of hedging may not be possible in the absence of a mechanism similar to a CET.

As the Equity Leg will be reported to ASX, post-trade transparency of the Equity Leg will be available using the "OC" trade report condition code. The "OC" code reports off-market equity trades that are reported as part of an OTC deal.

Furthermore, it is expected that the number of CETs will be low, so the overall effect on pre-trade transparency will be negligible.

ASIC therefore considers that there are considerable market innovation and market efficiency benefits afforded by CETs. We do not consider that there is a practical regulatory detriment in waiving the pre-trade transparency requirements for these transactions.

### **3. Operation of this Class Rule Waiver**

Paragraph 4 of the Class Rule Waiver inserts a new paragraph 7B into ASIC Class Rule Waiver [CW 13/680]. The new paragraph 7B of [CW 13/680] provides relief for a Participant from the obligation to comply with Rule 4.1.1(1) of the Competition Rules, in the case where a Participant enters into a Transaction in an Equity Market Product that is part of a CET.

This Class Rule Waiver will apply for a period of approximately 12 months.

### **4. Consultation**

ASIC did not formally consult on this Class Rule Waiver, however discussions were held with ASX acting on behalf of Participants who potentially would use CETs. ASX advised that these Participants were supportive of a new ASX clearing service of which CETs are an important part.

**Statement of Compatibility with Human Rights**

A Statement of Compatibility with Human Rights is included in this Explanatory Statement at Attachment A.

## ATTACHMENT A – Statement of Compatibility with Human Rights

*Prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011.*

### ASIC CLASS RULE WAIVER [CW 15/0384]

This Legislative Instrument is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Unless otherwise indicated, capitalised terms in this Statement refer to defined terms in the *ASIC Market Integrity Rules (Competition in Exchange Markets) 2011 (the Competition Rules)*.

#### 1. Overview of the Legislative Instrument

This Legislative Instrument amends ASIC Class Rule Waiver [CW 13/680]. It provides relief to Participants of the Market operated by ASX Limited (ACN 008 624 691) (**ASX**) from subrule 4.1.1(1) of the Competition Rules in the case where the Participant enters into a Transaction in an Equity Market Product that is part of a Contingent Equity Transaction (**CET**). Subrule 4.1.1(1) of the Competition Rules provides that, subject to certain exceptions in subrule 4.1.1(2), a Participant must not enter into a Transaction unless the Transaction is entered into by matching of a Pre-Trade Transparent Order (being an Order for which information such as price and volume is made available before execution) on an Order Book.

A CET is a single transaction consisting of two components or ‘legs’, namely:

- (a) an off-market transaction in an Equity Market Product (**the Equity Leg**); and
- (b) one or more over-the-counter (**OTC**) options transactions (**the Option Leg**).

As both the Equity Leg and the Option Leg are transacted simultaneously, the client agrees on a net price for the CET rather than pricing individual legs separately.

The Equity Leg of the CET is negotiated off-market and therefore will not meet the pre-trade transparency requirement of subrule 4.1.1(1). A Participant that enters into a CET may therefore breach subrule 4.1.1(1) without this Class Rule Waiver.

#### *Reasons for granting the Class Rule waiver*

The policy rationale for subrule 4.1.1 does not apply to CETs.

This is because CETs are negotiated off-market and on the basis of a net price as explained above. Accordingly, pre-trade information concerning the price of the Equity Leg may not provide useful and meaningful information to the market.

In addition, ASIC considers that CETs have a number of benefits which would contribute to fair, orderly and transparent markets.

CETs are a legitimate hedging strategy, providing a delta hedge. Delta hedging is an options strategy that aims to reduce or hedge the risk associated with price movements in the underlying security by offsetting bought and sold positions. The change in the price of the option for each basis-point change in the price of the underlying security is the ‘delta’. CETs

offer the ability to lock in a 'delta'. This will reduce the risk associated with price movements in the underlying security as they are offset by the Equity Leg position.

Also, the simultaneous pricing of the two legs in the CET facilitates market efficiency as it removes the need to renegotiate pricing of the Option Leg in response to each movement in the underlying equity. This renegotiation is otherwise cumbersome and time consuming. In times of market volatility, this sort of hedging may not be possible in the absence of a mechanism similar to a CET.

As the Equity Leg will be reported to ASX, post-trade transparency of the Equity Leg will be available using the "OC" trade report condition code. The "OC" code reports off-market equity trades that are reported as part of an OTC deal.

Furthermore, it is expected that the number of CETs will be low, so the overall effect on pre-trade transparency will be negligible.

ASIC therefore considers that there are considerable market innovation and market efficiency benefits afforded by CETs. We do not consider that there is a practical regulatory detriment in waiving the pre-trade transparency requirements for these transactions.

## **2. Human rights implications**

This Legislative Instrument does not engage any of the applicable rights or freedoms.

This Legislative Instrument is compatible with human rights as it does not raise any human rights issues.