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19th December 2012

Mr Joshua Everson
Australian Securities Exchange
Exchange Centre
20 Bridge Street
Sydney NSW 2000

Dear Mr Everson,

Citigroup Global Markets Australia Pty Ltd (Holder of AFSL No. 240992, "**CGMA**") welcomes the opportunity to comment on the proposals that have been put forward by the ASX Clear Corporation (**ASX**) in the consultation paper entitled "Derivatives Account Segregation and Portability" (**discussion paper**). We are pleased to share the following comments with ASX.

CGMA welcomes the enhanced transparency and counterparty risk mitigation that the mandatory central clearing of eligible Over the Counter (**OTC**) derivatives will provide pursuant to the implementation of the G-20 commitment of Pittsburgh, 2009. CGMA has over 60 years of clearing experience, and was among the first major institutions to organise as a global, multi-asset OTC non-participant clearing service, undertaking these changes beginning in 2008 and starting active clearing in December 2009.

Since that time, CGMA has provided its clients "agnostic" connectivity to their choice of viable central clearing counterparties (**CCPs**), and has been working with industry participants, CCPs, and global regulators in the design of efficient central clearing processes to ensure that systemic risk is mitigated to the greatest extent possible. CGMA recognises the strategic importance of central clearing and has worked throughout the world to promote consistency in all central clearing designs as a means of minimizing the possibility of regulatory arbitrage.

CGMA continues to analyse alternative arrangements for enhanced segregation and will work with industry participants to explore associated costs, risks and regulatory capital implications of any model proposed. In addition to robust segregation, CGMA strongly believes that a successful clearing regime hinges upon seamless portability, whose resilience is closely related to the design of risk waterfalls. Clearing houses must not compete on "risk", and in the context of central clearing, risk is best mitigated by striking the appropriate balance amongst accurate pricing of the underlying via variation margin, initial margin and the guarantee fund. In addition to ensuring that the combined financial safeguards package is robust enough to adequately withstand systemic shocks, further thought must be given to the size and structure of each of these pools. We believe, therefore, that central clearing could be further strengthened through

regulation that requires standardisation of the relationship between initial margin and the guarantee fund.

Internationally, there has been discussion on the matter of portability and segregation. The recent adoption by the CFTC of the Legally Separated, Operationally Co-mingled (**LSOC**) model illustrates that Regulators globally are recognising the need for further stability.

Ultimately the protections against default should be balanced against the mitigation of the risks associated with trading and clearing. LSOC provides a fundamental change in how clear swaps customer positions and related collateral are treated. It does strike a balance between clients who have full legal protection of collateral in a Clearing Participant (**CP**) default and the concerns expressed by CPs that implementing a model of full segregation would result in significant additional costs.

LSOC is not the only model that could be contemplated. As discussed further in our comments, there are other options available to clearing customers that will offer the protections against default whilst mitigating risks. The benefit of overseas market experience can allow CCPs and regulators to make better informed decisions.

Under the new proposals, CPs would still remain responsible for the performance of client's open positions and management of their collateral with the CCP. This Discussion Paper notes that current laws are a hindrance to the CCP's being able to transfer client position/collateral in a timely manner. Although the proposal does go on to suggest that there be a time limit (T+2) for collateral transfer, unless there is a consistent approach to portability, the hindrance may continue as different segregation methods create more administration of accounts.

Another key to successful clearing design is to ensure that regulation enables industry participants to achieve appropriately risk-managed capital efficiencies. Central clearing is expected to significantly reduce systemic risk, and represent a net benefit to clients. However, central clearing does impose additional costs on clients that were not present in the bilateral, uncleared construct. These costs include the requirement to post higher levels of initial margin, and to exchange, on a daily basis, variation margin without thresholds or minimum transfer amounts. Additionally, limitations on acceptable collateral by clearing houses further impact the cost inflation associated with central clearing.

With the above points in mind, CGMA makes the following comments to the questions posed in this discussion paper.

Q1: Are there any additional high-level drivers or aspects of the drivers cited above that ASX should consider when examining the optimisation of portability and segregation arrangements?

Lessons learned from Lehman Brothers, Bear Sterns, MF Global and PFG

The consultation raises that the lessons from Lehman Brothers, Bear Sterns, MF Global and PFG lead to an examination of the following:

- The scope of the CCP's role in protecting clients, which often centred on an inaccurate assumption that the CCP acts as direct counterparty to the client, and will ensure ongoing performance of the contract even after the default of the client's CP;
- The extent to which clients may be exposed to other clients of a defaulting CP; and,
- The location and form of client margin and the rights of clients to the return of those margins.

While these issues should certainly be considered, we believe the closer examinations that should arise from those examples are...

- An examination of the investment policies pertaining to client margin permitted under the CCP rules or by regulation;
- Extraterritorial implications of futures clearing member bankruptcy; and
- Increasing transparency of client segregated assets and verification of such.

Appropriateness of initial margin and default waterfalls in supporting portability

CGMA strongly supports a “defaulter pays” model. In this model, initial margin is set at a level which, at a high confidence interval in a default scenario, independently mitigates the gap risk between mark to market movements and prior variation margin calculations without reliance on the guarantee fund or the clearing house contribution to the financial resources. The “defaulter pays” model therefore allows the guarantee fund to be set at a correspondingly lower level, and a guarantee fund that is transparent, replicable, and of appropriate (small) size will prevent portability from breaking down as counterparty conditions deteriorate in a dislocated market.

For example, in a situation where a replacement clearing member is asked to accept the transfer of a fully collateralized portfolio of a non-participant in a pre- or post-default situation, if the additional guarantee fund requirement of accepting this new client is too burdensome, the clearing member's ability and desire to accept the portfolio will be constrained—especially as the market further dislocates. There are two elements associated with the guarantee fund cost. First, the replacement clearing member must fund the guarantee fund, typically during a period of market dislocation. This funding requirement and the associated increase to regulatory capital must be considered carefully. Additionally, the guarantee fund—by its nature—is subject to loss mutualisation.

Although CGMA is supportive of the alternate segregation models for OTC derivatives, the potential for such guarantee fund mutualisation is higher under LSOC or individual segregation regimes, than under the legacy futures “baseline” model because viable client collateral is removed from the default waterfall. Further thought must be given to ensure that CCPs do not seek to compensate for this potential shortfall by increasing the CP default fund contributions in isolation to their own contributions.

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Regulatory standards requiring the appropriate balance between initial margin and the guarantee fund could offset the commercial pressure on CCPs to have lower initial margin than their competitors.

This equilibrium can be struck in a number of ways. Firstly, regulation may require that the guarantee fund size of the members must be tied to the contribution of the CCP. CGMA acknowledges that ASX currently contributes a significant amount to the default waterfall, but given the intention of adding significant OTC clearing risk to this, we would hope that ASX maintains their percentage allocation to the default waterfall as new risk is added.

A second approach could be the capping of the size of the guarantee fund. Any stress losses that exceed these proposed guarantee fund caps could then be attributed back to participants and non-participants in the form of initial margin concentration charges based on individual portfolios. This can be accomplished in the context of LSOC segregation. The “defaulter pays” approach, therefore, ensures that industry participants “pay” for their own risk and is the most conducive to seamless portability. Any breakdown in portability will, in turn, have adverse consequences on systemic risk.

In a deteriorating market, replacement CPs asked to accept the most sizeable portfolios with the largest accompanying guarantee funds will potentially encounter difficulty raising additional capital during the portability process. A failure to fund the additional guarantee fund requirement could expose the portfolio to liquidation in accordance with CCP rules and applicable regulation. Based on the forgoing, CGMA encourages regulators to consider rules that would require the standardisation of the relationship between initial margin and the guarantee fund through the adoption by clearing houses of the “defaulter pays” model.

Definition of the term “client position and collateral portability is highly likely”

Given the importance of achieving preferable risk weighting status for the segregation models, we would suggest that guidance from regulators be provided to define what models would meet the requirement of the term “client position and collateral portability is highly likely”.

Transparency

CGMA advocates increased transparency of location and investment style of client asset holdings from CCPs and CPs. CGMA’s Client Money Segregation portal, accessible via Citi Velocity® gives clients access, from a central location, to segregated balances, trust bank distributions and related regulatory reporting. This portal allows clients to see the daily amounts of client funds in Segregated, Secured, and Sequestered accounts. It also provides their respective breakdowns of securities and cash. In Europe, clients are provided transparency into CGMA’s client money trust bank distributions. CGMA’s reporting portal has been received favourably by U.S. Congressional staff, Regulators, and most importantly, our clients.

Further analysis and certainty of cross margining futures and OTC derivatives

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CGMA supports CCPs looking to maximise collateral efficiency, but careful consideration of the issues involved in cross margining futures and OTC derivatives needs to be performed and tested against bankruptcy law and risk considerations. All existing futures CPs should be consulted on any proposed offering and be actively involved in any decision to change the existing structure

Q2: Please provide your views on the proposed core objectives, identifying any additional major objectives if necessary.

CGMA is supportive of providing its clients with robust segregation in accordance with regulation and governing bankruptcy code. Accordingly, CGMA has been a market leader in its support of enhanced client protections and has publicly commented in support of the LSOC segregation. This proposed rule has now been finalised and is entitled "Protection of Cleared Swaps Before and After Commodity Broker Bankruptcies" for cleared OTC derivatives. CGMA notes that this model has also been embraced by functioning CCPs in Europe, and we believe that Australian adoption of this model and the resulting synchronisation of the global segregation design for OTC derivatives would be positive for the markets.

We believe that any consultation on segregation models should include a consideration of the LSOC model as an option for clients.

Q3: Do you believe that ASX's CCPs will need to undertake any other activities to facilitate client portability in the derivatives markets? Please consider any domestic or overseas regulatory requirements, if appropriate. ASX is keen to establish the whether any additional complexities arise under prime brokerage arrangements.

As raised in this discussion paper, it is important that any proposed solution is consistent with international standards for CCPs and takes into account potential requirements for recognised status by foreign regulators. Further to this, and as previously mentioned, CGMA re-iterates the view that given the importance to achieving preferable risk weighting status for the segregation models- guidance from regulators be sought to define what models would meet the requirement of the term "client position and collateral portability is highly likely".

While we agree that record keeping of gross positions and margin should be required information reported by clearing members to the CCP, we do not agree that this necessitates gross margining. Increased transparency, combined with consistency of segregation models with bankruptcy law, should in of itself assist in the case of a member default.

Q4: Do you agree with the suggested approach? Please explain your rationale for the answer and whether the proposal meets any overseas regulatory requirements you may have.

We have a number of suggestions arising from the ASX's suggested approach and are detailed below.

- CGMA recommends that the holding of client assets on the ASX balance sheet be resolved before considering structures that look to limit mutualisation of assets. Without this clients are still ultimately mutualised at the ASX.
- CGMA questions why ISCA be offered as a default, with clients being able to opt out to omnibus. Given that the omnibus structure is the existing segregation model, and our client feedback has been that this structure would remain their preferred option, we would recommend that this be the default account structure. Clients could then have the option to opt into alternate account structures.
- While this consultation has contemplated member default we believe a detailed discussion of client asset protection in the case of an ASX default should be fully elaborated as part of the consultation.

Q5: What would be the impact on Clearing Participants and/or their clients of the introduction of ISCA's by ASX Clear (Futures)? Please provide feedback on your likely implementation timelines and costs.

Clearers would need to rebuild reconciliations with new logic that would cover both ISCA's and omnibus account. Including UAT this could take 3-6 months (potentially longer given the flexibility required). Clearers would need to reengineer GMI, or equivalent, to direct trades to the correct accounts to allow for reconciliation against the exchange (either ISCA or Omnibus logic); the initial set up would be 3-6 months

- with the added impact of ongoing maintenance/additional set up requirements for each new client.
- There would be a requirement to re-document clients. The legal burden on the industry to complete this would be significant in terms of cost and time although this is difficult to quantify.
- Our initial cost analysis on ISCA accounts, leads us to believe, taking into account increased cost of cash movements as well as loss of interest revenue from the CP to the ASX, that there is likely to be a significant increase in clearing fees.

Q6: Do you foresee any issues with the implementation of this approach? If so, how do you recommend that ASX should address them?

No comment

Q7: Do you believe that the choice of account type – ISCA or omnibus – should be available to all market users or even be mandatory in some cases? Please consider categories such as market-makers, retail clients and overseas users when answering.

There should be the choice of segregation model open to all clients. One key consideration is who is considered the client for the purposes of making those decisions. By way of example, could the decision be made by an investment manager on behalf of its funds under management- or should the funds themselves be directly responsible?

Q8: Should it be compulsory for ISCA holders to have concurrent clearing agreements with at least two Clearing Participants? If so, should this apply to all or just a particular category of clients?

Clients should be informed of the possible benefits to porting of having more than one clearing agreement but ultimately the decision should be left to the client.

Q9: Do you believe that the introduction of individual segregated client accounts for ASX's listed CFDs would add value to the ASX product offering? In your answer please note your view of the advantages and any disadvantages with such an approach.

No comment

Q10: Should the ISCA approach be compulsory for all ASX listed CFD users or should an omnibus client account be retained for margin purposes on an optional basis?

No comment

Q11: Do you believe that any other changes should be made to the account structures facilitating the clearing of exchange traded options by ASX Clear? In answering, please consider the large number of individual client accounts and the potential impact on the CCP's operations in a Clearing Participant default.

Clients should be awarded the same choice of account structure across all ASX clear products.

We would request that ASX review the current framework for clients using stock as collateral on ASX. Our key concern with the current construct is that CPs are not afforded priority to that collateral in the case of a client default.

Q12: Should ASX Clear also introduce a client omnibus account on ASX Clear akin to that on ASX Clear (Futures)? If so, should the type of client permitted to use this account be limited in any way?

Clients should be awarded the same choice of account structure across all ASX clear products.

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Q13: Do Clearing Participants foresee any factors that would prevent their maintenance of up-to-date client account information in ASX Clear's DCS system?

No comment

Q14: Do OTC market participants (either as potential clients or Clearing Participants of the ASX Clear (Futures) OTC clearing service) have any specific preferences or requirements for client account structures in OTC clearing? In answering, please consider any overseas regulatory obligations that may be placed upon your organisation and/or those of your clients.

As stated in the answer to Question 2 above- CGMA is supportive of providing its clients with robust segregation in accordance with regulation and governing bankruptcy code. Accordingly, CGMA has been a market leader in its support of enhanced client protections and has publicly commented in support of the Legally Segregated, Operationally Commingled (LSOC) segregation model outlined in the Commodity Futures Trading Commission (CFTC) proposed rule, since finalized, entitled "Protection of Cleared Swaps Before and After Commodity Broker Bankruptcies" for cleared, OTC derivatives. CGMA notes that this model has also been embraced by functioning CCPs in Europe, and we believe that Australian adoption of this model and the resulting synchronisation of the global segregation design for OTC derivatives would be positive for the markets.

Further to this we believe clients should be given the choice of account structure and that choice should include the option of margining on either a gross or net basis.

Q15: Where a Clearing Participant calls margin from an individually segregated client account in excess of that called from the Clearing Participant by the CCP, should the Clearing Participant be required to pass the additional margin to the CCP? If not, what alternative approaches would provide the client with protection in the circumstances of a Clearing Participant default?

We believe that client should be given the choice of posting excess with a CP or the CCP. Excess funds held with the CCP or CP should be afforded the same bankruptcy protection as assets held to cover margin.

Q16: Where an institution stands as an intermediary between the ultimate client and the Clearing Participant, and those positions are held in an individually segregated client account, should the Clearing Participant be required to allocate each underlying client's positions to a specific individual account? If not, are additional or alternative measures required to ensure the appropriate level of client protection?

This is best answered by our clients, as the decision on whether or not they would want to extend this option to their clients is theirs. CGMA would suggest that ASX perform a detailed legal analysis of the issues concerning looking through intermediaries to end investors

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especially in the case that the intermediaries are located in another jurisdiction. Any ambiguity around these issues could delay porting of positions and defeat the purpose of providing individual physical segregation.

Q17: Do you agree with ASX's interpretation of the interim Basel Committee rules? Please outline any difference of views.

We would ask that ASX expand on their analysis to include the potential capital treatment under LSOC.

Q18: What steps should ASX take to minimise the regulatory capital weightings for banks centrally cleared transactions?

Affording bank clients the option of omnibus, LSOC or full physical segregation allows all participants to make their own choice on what is the best balance of cost and risk mitigation.

Q19: Taking into consideration the likely additional custodian costs, do bank clients believe that ASX should seek put in place arrangements that reduce the capital weighting on margins from 2% to 0%?

Please refer to our response to Q18

Q20: What, if any, changes do bank users of ASX's CCPs, either as Clearing Participants or clients, believe ASX should make to its margin investment approach to ensure appropriate risk protections in the event of the default of the Clearing Participant and/or the CCP? Please note the benefits that you believe such a change would provide to the market and any additional risks to such a change. In answering, please consider client protection and, if you are a bank, any regulatory capital implications.

As already discussed, CGMA recommends that the holding of client assets on the ASX balance sheet be resolved before considering structures that look to limit mutualisation of assets. Without a solution, CPs and their clients are still ultimately mutualised at the ASX.

Further to this we believe that transparency of ASX investments would give comfort to the owners of those assets.

Q21: It may be possible for each individual client's margin to be lodged with a CCP and invested into a specific security or account according to a variety of investment risk thresholds to satisfy a range of user expectations on investment returns and risk appetites. Do you believe that there is demand for such a service? What would be the impact?

We believe that the adoption of a program similar to that offered at the CME through their 'Specialized Collateral Programs' would be beneficial for market participants.

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In conclusion, CGMA is extremely supportive of robust segregation and seamless portability. International regulatory consistency in the application of clearing requirements and segregation models is beneficial to all market participants. It is important that clients be given a range of choices of account classes and complete transparency of the risks and costs of each account option. We believe that a detailed market wide cost benefit analysis should be performed on any proposed account structure(s) so that market participants are able to make informed choices on the balancing of cost versus the level of protection they require.

CGMA encourages the ASX to critically assess the interplay amongst the basic determinants of portability, namely initial margin, variation margin, and guarantee fund requirements. CGMA strongly believes that the conjugation of these elements provide for a dynamic, secure and forward looking regime for the Australian futures and OTC clearing markets.

Whilst the discussion paper does focus on client protection in the case of default, there should also be a discussion around the monitoring of client positions by the CCPs. ASX 24 currently receives a DBOR report which details positions at client level. This could be used by the CCP to establish a threshold of reporting whereby those clients that accrue large positions are possibly at risk of default. This could be utilised as an added level of protection against the risk of client default. .

Should you have any queries in relation to the information provided by CGMA, please do not hesitate to contact CGMA directly.

Sincerely,

Ian Nissen

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