Derivatives Account Segregation and Portability

Market Discussion Document

October 2012

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1. Executive Summary

ASX is seeking market feedback on potential changes to the account structures it offers, and the means by which margins are calculated and held, under its central counterparty (CCP) services for clearing futures, options and other derivative financial products. These elements of the derivatives clearing service are central to the operation of the Australian market, affecting not only operational processes but also the distribution of risks and commercial returns between CCP clearing houses, Clearing Participants and their clients. ASX encourages all derivative market stakeholders to read this important document and assist ASX to ensure it continues to offer account structures and levels of segregation that both meet regulatory obligations and support the needs of all market stakeholders.

The potential changes considered here are driven by two main factors:

- Changes to Regulatory Standards

  This relates primarily to the proposed amendments to the Financial Stability Standards to which ASX's CCPs must adhere[1]. These proposals are consistent with the international CPSS-IOSCO Principles for financial market infrastructures ("PFMI") released earlier this year[2] and are designed to enhance systemic stability. *In particular, part of these approaches requires that a CCP's arrangements are structured in such a way that it is 'highly likely' to transfer client positions and collateral in the event of a Clearing Participant default (portability)*. In addition, ASX is keen to ensure that its CCPs' account structures facilitate collateral handling and client portability in such a way as to minimise new bank regulatory capital risk weightings.

- Demand for Client Clearing

  Major counterparty defaults observed during and subsequent to the Global Financial Crisis have demonstrated the risk management benefits of centralised clearing generally and of robust client protection specifically, and there has subsequently been increased demand for CCPs to assist in protecting clients in the event of a Clearing Participant default. This trend has been further encouraged by the growth of OTC derivatives clearing. In Australia, ASX Clear (Futures) will be introducing OTC interest rate swap clearing in 2013, including client clearing arrangements.

This initial discussion document seeks comment on several potential changes to CCP arrangements, including:

- The appropriate level of client protection benefits arising from the CCPs holding of client margin monies;
- Allowing clients of ASX Clear (Futures) Participants to elect to have their positions and margin held in new Individually Segregated Client Accounts ("ISCAs") or to remain pooled with other clients under the existing single client omnibus account structure;
- Whether cash margins should be held in trust rather than on the balance sheet of the CCP.

ASX is particularly interested in feedback on the likely impact on ongoing operational revenues and costs of these proposed changes, together with estimates of costs and timescales required for implementation. Suggestions for alternative approaches that efficiently achieve the same policy objectives and regulatory standards are especially welcome.

ASX requires submissions to be received by Friday 7th December. All responses should be sent to Joshua Everson at joshua.everson@asx.com.au. ASX intends to publish all responses unless you request that your submission, or a particular part of it, remains confidential. ASX will be holding a presentation and Q&A session on this paper, details of which will be circulated in due course, however please register your interest at rebecca.currie@asx.com.au in order to ensure that you receive an invitation. In addition, ASX management will be available to assist with any queries or arrange bilateral discussions with interested parties.

ASX will also be publishing a further consultation document in Q4 2012 on additional proposed changes to its clearing and settlement services in response to changes to the Financial Stability Standards (FSS) and the CPSS-IOSCO PFMIs. Consultation on cash equity market account segregation and portability will be included in this later document.

[1] http://www.rba.gov.au/media-releases/2012/mr-12-23.html
[2] http://www.bis.org/publ/cpss101.htm

2. Introduction

2.1 Structure of the Paper

This discussion document aims both to inform and to seek initial feedback from market stakeholders. In this section an introduction to key concepts is provided (portability and segregation). Section 3 outlines the need for change and Section 4 recaps on the existing account structures used by ASX's CCPs and the rationale for their use.

Section 5 puts forward several possible changes in order to achieve the policy goal of client portability, seeking comment on the impact and alternative suggestions. Finally, Section 6 seeks input on the impact of recent changes to bank regulatory capital weightings and also explores possible modifications to margin investment by ASX's CCPs.

While specific questions are posed throughout the document, ASX welcomes any additional feedback you may have on the topic. Readers may also find it useful to consult the recently published description of ASX's current default management processes when considering these questions[3].

2.2 Key Concepts

Before examining the alternative arrangements, it is important to introduce two inter-related, key concepts: portability and account segregation.

2.2.1 Portability

Under the CPSS-IOSCO PFMIs, portability is defined as 'the operational aspects of the transfer of contractual positions, funds, or securities from one party to another party'. Particular CCP account structures may be used to increase the likelihood of client position/collateral portability in the event of a Clearing Participant default, and there has been a broad international regulatory drive for CCPs to do so. However, even if a CCP offers an account structure which has a high degree of client position and collateral segregation, there are a number of factors which may still inhibit the portability of client positions, including:

a) *the current Australian insolvency law makes it difficult for CCPs to transfer client positions/collateral in a timely manner*

As highlighted by the Council of Financial Regulators (CoFR) in their recent *Review of Financial Market Infrastructure Regulation*[4], current Australian insolvency law is likely to impede the timely transfer of client positions in the event of a Clearing Participant default, as various permissions need to be secured by the CCP in order to transfer positions and/or collateral, but are unlikely to be forthcoming in the necessarily short timeframes post-default. Indeed, such a problem was encountered following the default of MF Global in 2011. CoFR is currently considering the legislative changes that could be made to improve the likelihood of client positions/collateral being successfully ported following a Clearing Participant default.

b) *a CCP obtaining timely agreement from the potential recipient Clearing Participant of the transferred client positions which in turn is driven by its administrative procedures, which may include the need to:*

   i) *conduct credit assessments;*

   ii) *formalise new client agreements;*

   iii) *comply with know your client and anti-money laundering requirements; and*

   iv) *collect client contact and banking details.*

It is important to note that even with the ideal regulatory regime and account structure in place, client position and collateral portability will never be guaranteed, as the time taken to undertake the transfer is limited to avoid the CCP, and therefore non-defaulting Clearing Participants and their clients, being exposed to unacceptable risks. In order to increase the likelihood that positions and collateral would be ported, clients would need to

[3] http://www.asx.com.au/documents/clearing/clearing-participant-default-an-overview.pdf
[4] http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2011/Review-of-Financial-Market-Infrastructure

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ensure that they have a clearing agreement with at least two Clearing Participants. Some overseas CCPs explicitly state that clients without back up clearing arrangements will have their positions automatically closed out in the event of a Clearing Participant default.

2.2.2 Segregation

In the PFMIs, segregation is defined as '*a method of protecting customer collateral and contractual positions by holding or accounting for them separately from those of the direct participant (such as a carrying firm or broker)*'.

Segregation operates at broadly two levels:

a) segregation at CCP-level: segregation of open positions between CCP and Clearing Participant, and related collateral held at the CCP, into positions and collateral balances referable to either the Clearing Participant's "house" (proprietary) or client business, as governed by the CCP's operating rules; and

b) segregation at Clearing Participant level: segregation of client money and property from that of the Clearing Participant and other clients in accordance with the Clearing Participant's statutory obligations prescribed by the Corporations Act. ASIC has recently consulted on those provisions. [5]

Although ASX's CCPs do not contract directly with clients, the account structures that the CCP provides to its Clearing Participants help facilitate appropriate client segregation of margin/collateral and open positions. Differing account structures create different counterparty risks for clients in the event of their Clearing Participant's or even the CCP's default – this topic is explored further in the following sections.

[5] See Treasury's latest consultation paper on the topic www.archive.treasury.gov.au/documents/2231/PDF/DP_Client_Monies_OTC.pdf

3. Main Drivers of Change

3.1 Regulatory Change

On 16 April 2012, *CPSS-IOSCO* released the *Principles for Financial Market Infrastructures* which apply to all FMIs including CCPs. Subsequently the RBA and ASIC[6] have both released consultations outlining the proposed local implementation of these Principles in the Australian market. The PFMI contain new, higher international standards for payment, clearing and settlement and also impose more onerous requirements on CCPs in terms of account segregation and client position portability. A key objective of CPSS-IOSCO and Australian regulators is for CCPs and their Participants to ensure it is "highly likely that client positions and collateral of a defaulting Clearing Participant will be transferred to one or more other Clearing Participants". While the circumstances surrounding each Clearing Participant default will inevitably be different, it is likely that, wherever possible, ASX would need to accommodate the transfer of client positions to other Clearing Participants under these new regulatory standards.

A CCP's ability to transfer client positions and margin following a Clearing Participant default would provide individual benefits for clients as well as broader market financial stability benefits. If client positions are able to be ported in the event of a Clearing Participant default then client positions would not need to be closed out by the CCP (i.e. forcibly bought or sold with the possible associated disturbance to the market and impacted clients). Importantly, client portability may prevent the forced breakage of existing client hedges, which has been highlighted as a key concern of market users, especially during periods of financial market instability.

On 25 July 2012, the Basel Committee released interim rules for *Capital requirements for bank exposures to CCPs*[7]. These rules require that bank Clearing Participants and bank clients of a Clearing Participant hold capital against their CCP trade exposures[8], posted collateral and, in the case of bank Clearing Participants, also against their exposure to CCP default funds. The Basel Committee intends to undertake further work on these rules throughout 2013.

In their August 2012 Discussion Paper: *Implementing Basel III capital reforms in Australia – counterparty credit risk and other measures*[9], APRA outlined its proposed approach to implementing the interim Basel Committee rules. APRA's proposal, due for implementation from 1 January 2013, is broadly consistent with the interim Basel Committee rules, although there are some key differences on the approach to capitalising exposures to CCP default funds.

While these rules will impose capital requirements for all bank exposures, the CCP account segregation model offered to and used by bank clients will have a significant impact on the applicable risk weights. Low risk weights are available for bank clients of a Clearing Participant where the account segregation approach:

- protects clients from the default of their Clearing Participant, CCP and other clients, and
- ensures that client position and collateral portability is highly likely.

3.2 Client Clearing

Demand for client clearing has grown significantly in response to significant corporate failures in the finance sector over the past five years and an expansion of CCP-cleared products, most notably to OTC products.

[6] http://www.asic.gov.au/asic/asic.nsf/byHeadline/12-221MR%20ASIC%20consults%20on%20amendments%20to%20clearing%20and%20settlement%20facilities%20guidance?opendocument
[7] http://www.bis.org/publ/bcbs227.pdf
[8] Trade exposures include the current and potential future exposure of a Clearing Participant or a client to a CCP arising from OTC services, exchange traded derivatives transactions or Securities Financing Transactions, as well as initial margin.
[9] http://www.apra.gov.au/adi/PrudentialFramework/Documents/APRA_Discussionpaper_BASEL3_CCR_FINAL_2.pdf

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3.2.1 Clearing Participant Defaults

Many derivatives market users have become more risk adverse as recent defaults and near-default events of broker/dealer organisations (e.g. Lehman Brothers, Bear Sterns, MF Global and PFG Best) have emphasised the need to carefully manage counterparty risk, even in centrally cleared markets. These events have often led clients to recalibrate their expectations regarding the possibility of large corporate failures, and have highlighted the potential client losses that could occur as a result. In the case of centrally cleared markets, the size of such potential losses is often linked to several key structural characteristics:

- 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 Clearing Participant;
- The extent to which clients may be exposed to other clients of a defaulting Clearing Participant; and,
- The location and form of client margin and the rights of clients to the return of those margins.

As a result there has been increasing end user (i.e. client) demand for CCPs to facilitate additional measures to protect client interests in the event of a Clearing Participant default. Whilst CCPs cannot provide complete client protection, available account structures and margin lodgment or pledge arrangements will have an important role to play. Furthermore, while certain models will likely assist in providing client protection, it is important to note that these protections are likely to impose greater costs on market users. The trade-off between cost and risk protection is therefore likely to be central to any choice of CCP client account structures.

3.2.2 OTC Derivatives Clearing

Another key driver for the market to examine the optimal use of accounts arises from the G20 mandate for the central clearing of certain OTC derivatives. This is likely to increase both the number of clients using CCPs and the size of the exposures that they run. Working with key market stakeholders ASX is currently developing an OTC interest rate derivative clearing service, and this market consultation will provide timely information to assist with the development of the service, especially in relation to client clearing. ASX is keen to receive feedback from potential clients of its OTC interest rate derivative clearing service in order to accommodate the risk protection needs of those users.

In addition, ASX is aware of developing overseas regulatory obligations on some market users, and is keen to ensure that its CCP services continue to meet such offshore requirements.

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?

4. Account Segregation Models

4.1 Key Characteristics

Before outlining the existing ASX account segregation structures, it is important to outline the key characteristics of CCP accounts and the associated segregation arrangements. The following three areas provide a breakdown based on the ways by which positions and margin are recorded, and cash collateral is received and invested by the CCP. Some combinations of the following characteristics are mutually exclusive (e.g. gross margin would not be calculated on net open positions).

Open Position Keeping: Gross v Net

While Clearing Participants must maintain accurate records in relation to client positions, the level of client details and position information recorded in a CCP's clearing systems can vary significantly across different account structures. Gross position keeping at the CCP level ensures that the CCP has visibility of the positions held by each client in addition to any Clearing Participant's proprietary positions. Net position keeping occurs where a CCP has access to only a single net client position across all of each Clearing Participant's clients.

Client Margining: Gross v Net

Gross client margining occurs where a CCP calls margin from a Clearing Participant by aggregating the margin requirements of each individual client's positions. Under this approach there is also no netting of house or client positions for margin calculation purposes. In some overseas CCPs, a hybrid approach exists although it is often also described as gross margining.

Net client margining occurs where a CCP imposes a margin requirement on the netted client positions. Under net client margining where Clearing Participants pass on margin, Clearing Participants will call more margin from their clients than is required to be lodged with the CCP[10]. Any surplus margin is held by the Clearing Participant (and typically invested by the Clearing Participant to generate interest income).

The total margin called by a CCP under a gross client margining model will therefore tend to be higher than that called under net client margining.

CCP Cash Margin Investment: Individual v Pooled

In this paper, pooled investment refers to a process whereby a CCP collects all cash margin posted by its Clearing Participants and commingles these funds in a pooled investment account. The funds are then conservatively invested by the CCP. In this situation it is not possible to specify which investment belongs to each individual Clearing Participant or client. Most, if not all, CCPs employ such an approach, with some, including ASX's CCPs, explicitly taking the counterparty and liquidity risk associated with the margin investment.

[10] Note that Clearing Participants may also receive more margin than they pass to a CCP where the Clearing Participant charges more margin than the rate set by the CCP. This applies to both gross and net margin arrangements.

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4.2 Existing ASX Account Structures

4.2.1 Background

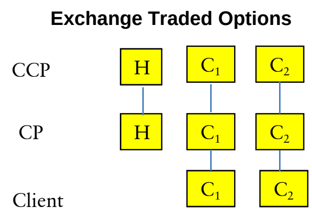
Through the novation process either ASX Clear or ASX Clear (Futures) becomes the counterparty to all trades between their Clearing Participants, and is therefore required to effectively 'guarantee' performance to other Clearing Participants. ASX currently uses a range of account segregation models in different exchange-traded markets. These models have arisen partly due to the inherent characteristics of each financial market (e.g. an emphasis on wholesale or retail customers), and partly due to the differing evolution of those markets over time.

4.2.2 Current Account Structures used by ASX's CCPs

The following Table summarises the key characteristics of each cleared market and further detail is provided below.

	Open Positions	Client Margining	Cash Margin Investment
ASX Clear			
Exchange Traded Options	Gross	Gross	Pooled
Futures	Net or Gross	Net or Gross	
ASX Clear (Futures)			
Futures and Options	Net	Net	Pooled
CFDs	Gross	Net	

Exchange Traded Option Market



Account Structure: House/Client segregated from each other. All open positions allocated to individual client level.

Margining: Gross i.e. calculated for each client and aggregated.

Margin Lodgement: Cash received from Clearing Participant and held on CCP balance sheet but client remains beneficial owner of lodged stock.

Why is the market structured this way?

- Significant number of retail customers but a lower number of trades compared to cash market.
- Permits lodgement of stock as collateral without exposing client to losses of other clients.
- Historically, client level systems functionality was provided to assist Clearing Participants set up costs when establishing the market.
- To assist Clearing Participants to meet their Corporations Act obligations in respect of client segregation.
- Client position portability potentially more likely compared with cash equity market.

Key Advantages

- Theoretically better chance of client positions being ported in the event of a Clearing Participant default.
- CCPs will hold more client margin and Clearing Participant defaults should be relatively easier to manage.
- Client positions are relatively transparent to the CCP.
- Client positions are segregated from the Clearing Participant's own trading and other client positions.

Key Disadvantages

- Clearing Participants will face a higher administrative burden given the need to maintain individual client accounts and are unable to generate as much interest revenue from client funds.
- Clients will probably face higher clearing costs as increased Clearing Participant costs are passed through and margin offsets cannot be applied across client portfolios or with other non-cleared positions.
- The CCP has the right to apply client cash collateral to deficits in any client account.
- CCP processing can be burdensome.

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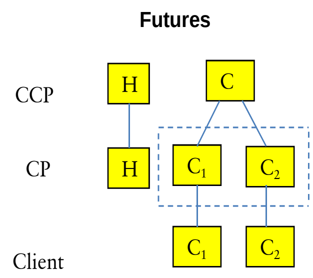
Futures Market[11]



Account Structure: House/Client segregated from each other. All open positions allocated to a single 'omnibus' client account at the CCP.

Margining: Net i.e. one net calculation for house and one for the omnibus client account. 'Surplus margin' from clients held at the Clearing Participant.

Margin Lodgement: Cash received from Clearing Participant and held on CCP balance sheet. Collateral ownership transferred to the CCP.

Why is the market structured this way?

- Market consists predominantly of wholesale clients.
- Lower CCP margin requirements are available through the significant position netting opportunities across clients.
- Extension of international futures market conventions at the time.

Key Advantages

- Costs to Clearing Participants are lower as a result of netting across client accounts.
- The client omnibus account lowers Clearing Participants' administration costs at the CCP in respect of client detail maintenance.
- Clearing Participants are able to generate interest revenue by investing surplus client margin.
- Bulk clearing and settlement systems and processes can be used by CCPs.

Key Disadvantages

- CCPs are much more likely to rely on closing out (net) client positions in the event of a Clearing Participant default.
- Non-defaulting client margin can be used to offset a defaulting client's losses.
- Single omnibus client account may add significant complexity to any potential transfer. In the event of a Clearing Participant default, the entire omnibus account may have to be transferred to a single other Clearing Participant in circumstances where total collateral value could be insufficient if client positions are un-netted by transferring to different Clearing Participants.

[11] The futures market account structure and margining approach described here refers to approach used on ASX Clear (Futures) for futures and options. There are, however, a small number of futures contracts cleared on ASX Clear such as the property index and ASX China Type wool contracts. These products are cleared either using the same account structure/margining methodology as that used for ETO contracts or the client omnibus structure as outlined in this section.

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ASX Listed CFDs

A hybrid approach is adopted.

Account Structure: House/Client segregated from each other. All open positions allocated to individual client level.

Margining: (a) Initial: Net i.e. one net calculation for house and one for the net positions across all individual client accounts. 'Surplus margin' from clients held at the Clearing Participant.

(b) Open Interest Charge: Calculated at an individual client account level.

Margin Lodgement: Cash received from Clearing Participant and held on CCP balance sheet. Collateral ownership transferred to the CCP.

Why is the market structured this way?

- Modification of the existing ASX Clear (Futures) conventions for the futures market to accommodate the need for client level open interest charge calculations inherent in the listed CFD product.

Key Advantages

- Costs to Clearing Participants are lower as a result of netting across client accounts.
- Clearing Participants are able to generate interest revenue by investing surplus client margin.
- Existing bulk clearing and settlement systems and processes can be used by CCPs.

Key Disadvantages

- Non-defaulting client margin can be used to offset a defaulting client's losses.
- Net margining may add significant complexity to any potential transfer. In the event of a Clearing Participant default, any potential transfer would likely require the entire omnibus account to be transferred to a single other Clearing Participant in circumstances where total collateral value could be insufficient if client positions are un-netted by transferring to different Clearing Participants.
- CCPs are much more likely to rely on closing out (net) client positions in the event of a Clearing Participant default.

5. Current ASX View

5.1 Objectives

ASX is seeking wide-ranging feedback on a variety of alternative account models and remains open-minded as to the eventual solution. However there are several core objectives which ASX believes should guide ongoing discussion:

- Clearly, ASX's CCPs must comply with their regulatory requirements, including those relating to portability and segregation. This will likely require amendment and/or extensions to the existing account segregation arrangements;
- Subject to sufficient demand, ASX CCPs should offer account structures that reflect the risk appetite of clients/end-users of ASX-cleared derivative markets in respect of the protections afforded them should their Clearing Participant default;
- ASX CCP account structures and their associated arrangements should be operationally and commercially viable for the CCPs, Clearing Participants and clients/end-users;
- ASX Clear (Futures) account structures must support OTC client clearing needs and the cross-margining of OTC and appropriate exchange-traded products;
- ASX CCPs should attain the required standards for and offer the appropriate means of, holding margin to ensure that regulatory capital risk-weightings are minimised;
- Clients and end-users should be made aware of the risks associated with the use of particular account structures.

ASX recognises that any changes to existing account structures potentially represent a significant change to market structure and associated operational processes. The current distribution of risks and commercial rewards between CCP, Clearing Participants and clients could therefore alter according to the structure adopted. For instance, by providing segregated individual client accounts that improve the likelihood of transfer in the event of a Clearing Participant default, the CCP is effectively providing a counterparty credit enhancement service to the client. Alternatively, if gross client margins are held at the CCP, Clearing Participants may not be able to rely upon interest earnings to effectively subsidise clearing fee savings to clients. A consequent impact on the pricing of clearing services is therefore likely according to the clients' choice of appropriate account structure.

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

5.2 Achieving Portability and Appropriate Segregation in the Derivatives Markets

In order to achieve portability through the timely transfer of client positions and collateral in the event of a Clearing Participant default, ASX believes that it would be necessary to:

- Ensure that the CCP has clear rights to transfer client positions and collateral from a defaulting Clearing Participant to another (non-defaulting) Clearing Participant.
- Record the positions, including details of each client, and hold the margin of each client at the CCP (i.e. adopt or maintain gross margining and position keeping).
- Strongly encourage and, in circumstances where a client is a significant user of the market, require that clients have a clearing agreement in place with an alternative Clearing Participant at all times.

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.

5.2.1 ASX Clear (Futures) – Futures and Options

Although permitted under the FSS, ASX Clear (Futures)' existing omnibus client account structure makes client portability, especially with margin, very difficult to accomplish in practice. In order to attain greater client protection in a Clearing Participant default, ASX Clear (Futures) would need to add an account type – individually segregated client accounts (ISCAs) - in addition to the current client omnibus account arrangement. Each client would be allocated an ISCA by their Clearing Participant unless that client chooses to opt out of the arrangement, having been presented with a standardised risk disclaimer to assist their understanding of the implications of such a decision.

Margin requirements would be calculated for each ISCA and passed from the Clearing Participant to the CCP (i.e. the ISCAs are gross margined). The CCP would only seek to use these margins to offset any losses arising from that specific ISCA should it be necessary for the CCP to close out the ISCA's positions following its Clearing Participant's default because transfer was not possible in the time available. Margins held from all house, client omnibus and ISCA accounts would continue to be commingled for investment purposes and invested on behalf of ASX Clear (Futures) under the existing very conservative investment mandate.

A client will continue to contract directly with their Clearing Participant irrespective of the account structure option they select. Whether or not an ISCA was chosen by the client, the Clearing Participant would continue to be responsible for the performance of the client's open positions and management of that client's collateral with the CCP. However, in the event of the Clearing Participant's default, the CCP would seek to transfer the client's positions and collateral (or equivalent value) to another (non-defaulting) Clearing Participant. The client would be responsible for securing the agreement of a recipient (non-defaulting) Clearing Participant within specified timeframes – probably no more than 2 business days after the default event. Should the client opt out of the ISCA and be cleared through a client omnibus account structure, ASX Clear (Futures) would expect to close out the (net) client position in the event of a Clearing Participant's default. At best, ASX Clear might be able to transfer client positions without collateral.

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.

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

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

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.

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?

5.2.2 ASX Clear (Futures) – CFDs

Unlike other products, ASX's listed (and centrally-cleared) CFDs currently operate on the basis of client-level position keeping but, for initial margin purposes, are treated as a net margined omnibus client account. Client level position keeping is required in order to calculate accurately the open interest charge. In light of widespread regulatory concern about ensuring appropriate client money protection for retail customers, especially in *OTC* CFDs, ASX is seeking to offer enhanced risk protections to clients on *ASX listed* CFDs. One means by which clients could have added security is for their margin monies to be held at ASX Clear (Futures) with an increased possibility of transfer in a Clearing Participant default by making the ISCA arrangements described in Section 5.2.1 available for CFD clients on an optional basis.

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.

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?

5.2.3 ASX Clear Exchange Traded Options

ASX Clear's existing individual account structure used for exchange traded options (ETOs) already assists with the portability and segregation of open client positions and non-cash collateral in the event of a Clearing Participant default. However, ASX Clear's Rulebook permits cash collateral lodged by the Clearing Participant in respect of the gross client margin requirement to be used to offset losses in any client account (i.e. the cash is pooled and at risk against losses from any of the defaulting Clearing Participant's client accounts). ASX Clear plans to amend the Rules to strengthen the segregation requirements in respect of clients' cash margin by restricting the ability of the CCP to offset client cash margin against losses arising from other client accounts. Furthermore, to assist with the operational aspects of portability, ASX Clear will require its Clearing Participants to maintain client details within the CCP's systems to more easily facilitate transfers.

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.

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?

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?

5.2.4 OTC Interest Rate Swap Clearing

ASX plans to extend the ASX Clear (Futures) clearing service to OTC interest rate swaps during the course of 2013. Given growing international and domestic demand, it is also ASX's intention to extend the OTC derivative clearing service to client clearing. In so doing, ASX Clear (Futures) is likely to need to examine several types of ISCA types in order to satisfy differing client/end user demands, and possibly differing overseas regulatory requirements. However it is anticipated that all client account arrangements will be individual in nature (i.e. there will be no omnibus client account structure under this clearing service). Therefore, as a key benefit of clearing both OTC and exchange-traded derivatives through a single CCP arises from the cost saving arising from margin offsets between the two product types, account types offered for listed futures and options on ASX Clear (Futures) will need to mirror those available to OTC clients.

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.

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5.2.5 General

In addition to the specific questions asked above, several general questions apply across ASX's CCP arrangements for holding cash margins.

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?

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?

6. Related Issues for Consideration

Capital requirements for bank exposures to central counterparties

In July 2012 the Basel Committee on Banking Supervision (Basel Committee) released interim rules on *Capital requirements for bank exposures to central counterparties*. The Australian Prudential and Regulatory Authority (APRA) intend to implement these rules and have released a discussion paper for consultation. ASX understands that the Prudential Standard, once finalised, will require that all banks regulated by APRA meet the final rules from the 1 January 2013. Banks that operate in Australia but which are regulated offshore (e.g. foreign bank branches operating in Australia) are anticipated to need to meet similar rules released by their domestic regulator.

ASX's view is that the regulatory risk weightings for bank CCP derivatives exposures in Australia will largely be determined by three key factors:

- whether a bank is a Clearing Participant or a client of a Clearing Participant;
- the account segregation model; and,
- the means by which margin is held.

The lowest risk weightings under the interim Basel Committee rules will generally be given to banks which act as Clearing Participants. We believe that Clearing Participant trade exposures[12] will be subject to a 2% risk weight. Collateral posted by the Clearing Participant will be subject to either a 0% or 2% risk weight depending on the custodial arrangements.

ASX's analysis has also found that where a bank is a client of a Clearing Participant, the applicable risk weighting will be lowest for account structures which provide the greatest degree of protection in the event of either the default of the Clearing Participant or the default of another client. Consequently it appears that bank clients of Clearing Participants which use the individual segregated client account will face a 2% risk weighting for all trade exposures and either a 0% or 2% risk weight on all posted collateral, depending on the degree of bankruptcy remoteness and beneficial interest in the lodged margin. In contrast, where the bank client of a Clearing Participants clears its transactions in an omnibus client account, it is anticipated that those banks may be subject to a much higher risk weight because of the greater risk clients using these models face to the default of their Clearing Participant and other clients. ASX understands that all bank clients of Clearing Participants which use either of these models will need to treat all trade exposures as a bilateral exposure and posted collateral as a bilateral trade.

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

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

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%?

[12] Trade exposures include the current and potential future exposure of a Clearing Participant or a client to a CCP arising from OTC derivatives, exchange traded derivatives or Securities Financing Transactions, as well as initial margin.

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ASX Margin Investment

Cash margins received from Clearing Participants on both of ASX's CCPs are held on the balance sheet of the CCP. ASX Clearing Corporation (ASXCC) invests these monies on behalf of the CCPs. These funds are operationally commingled and invested under a very conservative mandate with a focus on strict counterparty risk and liquidity risk management[13]. ASXCC assumes the counterparty risk of investing the funds. On both CCPs, all cash margin is held by the CCPs under their beneficial ownership.

Changes would be required to these arrangements to ensure that cash margins paid to ASX's CCPs are bankruptcy remote from the default of the CCP. Note that if a bank is a client of a Clearing Participant, the margin would also need to be bankruptcy remote from the Clearing Participant to attain full bankruptcy remoteness.

One alternative might be for the CCP to hold the margin monies in trust, probably pooled across clients but conceptually it could instead be at individual client level. Such a structure could also be accompanied by changes to the bearer of the investment counterparty and/or liquidity and the process by which the investment mandate is finalised would in such cases need to be re-visited.

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.

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?

[13] For further details please see page 62 of the 2012 ASX Annual Report http://www.asxgroup.com.au/media/PDFs/ASX_Full-Year_Annual_Report.pdf

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