

## ASX Clear Pty Limited

### Clearing Participant Default

#### AN OVERVIEW

*This summary information is provided for guidance only and should be read in conjunction with the ASX Clear Operating Rules. It does not replace or vary those Operating Rules. The document provides information on the powers of ASX Clear to manage the default of a Clearing Participant, the legal and risk framework supporting those powers and the implications for Clearing Participants and their clients.*

#### 1. Background

The ASX group operates two Clearing Houses which provide central counterparty clearing services to Australia's main exchange traded markets as well as for certain eligible OTC derivatives:

**ASX Clear Pty Limited**, and  
ASX Clear (Futures) Pty Limited.

The following information is provided with respect to ASX Clear Pty Limited (ASXCL). Equivalent information for ASX Clear (Futures) Pty Limited is provided in a separate Clearing Participant Default Overview document.

ASX Limited operates the ASX markets and facilitates the execution, through Trading Participants, of trades in financial products including shares, debentures, bonds, ETFs and warrants (referred to as "cash market" products, positions or transactions) and equity-related options (referred to as "derivative" products, positions or transactions).

ASXCL provides central counterparty clearing services for those ASX markets and also for the Chi-X market, on which ASX and Chi-X quoted financial products are traded, as well as for eligible Over the Counter (OTC) equity-related options registered with ASXCL. Clearing Participants are brokers authorised to clear trades through ASXCL.

The settlement of cash market transactions is conducted through ASX Settlement's Clearing House Electronic Subregister System (CHES) by settlement participants. Title to securities may be recorded in the CHES Subregister. Clearing Participants' margin obligations to ASXCL on their derivative and cash market positions are settled through ASX's Austraclear system.

A single legal entity typically acts as a Trading, Clearing and Settlement Participant but it is possible for an entity to specialise in trading or clearing or settlement or a combination of the three. For example, some specialist Clearing Participants, known as third party clearers, provide clearing services to trading-only participants. A client will have some form of contractual relationship with the participant(s) for all three services.

This document deals with ASXCL, its Clearing Participants and their clients. The following sections outline the role of ASXCL in reducing counterparty risk in the market, the way it manages that risk, particularly in the

event of a Clearing Participant default, including the regulatory and legal framework and the implications for Clearing Participants and their clients.

## 2. Regulatory and legal context

ASXCL is a licensed operator of a clearing and settlement facility under the Corporations Act. As such, it has a number of statutory obligations including, to the extent that it is reasonably practicable to do so:

- to comply with the Financial Stability Standards for Central Counterparties (FSS) published by the Reserve Bank of Australia and to do all other things necessary to reduce systemic risk; and
- to do all things necessary to ensure that its services are provided in a fair and effective way.

The clearing and settlement facility operated by ASXCL is also approved as a “netting market” for the purposes of the Payment Systems & Netting Act. The Act provides protection from reversal or invalidation under insolvency law for the termination, calculation and netting of obligations, payments and transfers of property to meet obligations and the enforcement of security by ASXCL. It also protects the movement by ASXCL of client positions and collateral to another (non-defaulting) Clearing Participant in the event of default of those clients’ Clearing Participant.

The conduct of ASXCL and its respective Clearing Participants is governed by the ASXCL Operating Rules, which operate as a contract between ASXCL and its Clearing Participants. Among other things, these rules set out the circumstances in which ASXCL may declare an “event of default” in respect of a Clearing Participant, and the steps that it may take as a consequence.

## 3. Contractual Relationships: ASXCL, Clearing Participants and Clients

Through a contractual process known as novation, ASXCL becomes contractually obligated, as the central counterparty, for completing all market and registered OTC equity-related option transactions<sup>1</sup>. Novation is deemed generally to occur at the point of trade or registration, although it can be later for certain derivatives transactions.

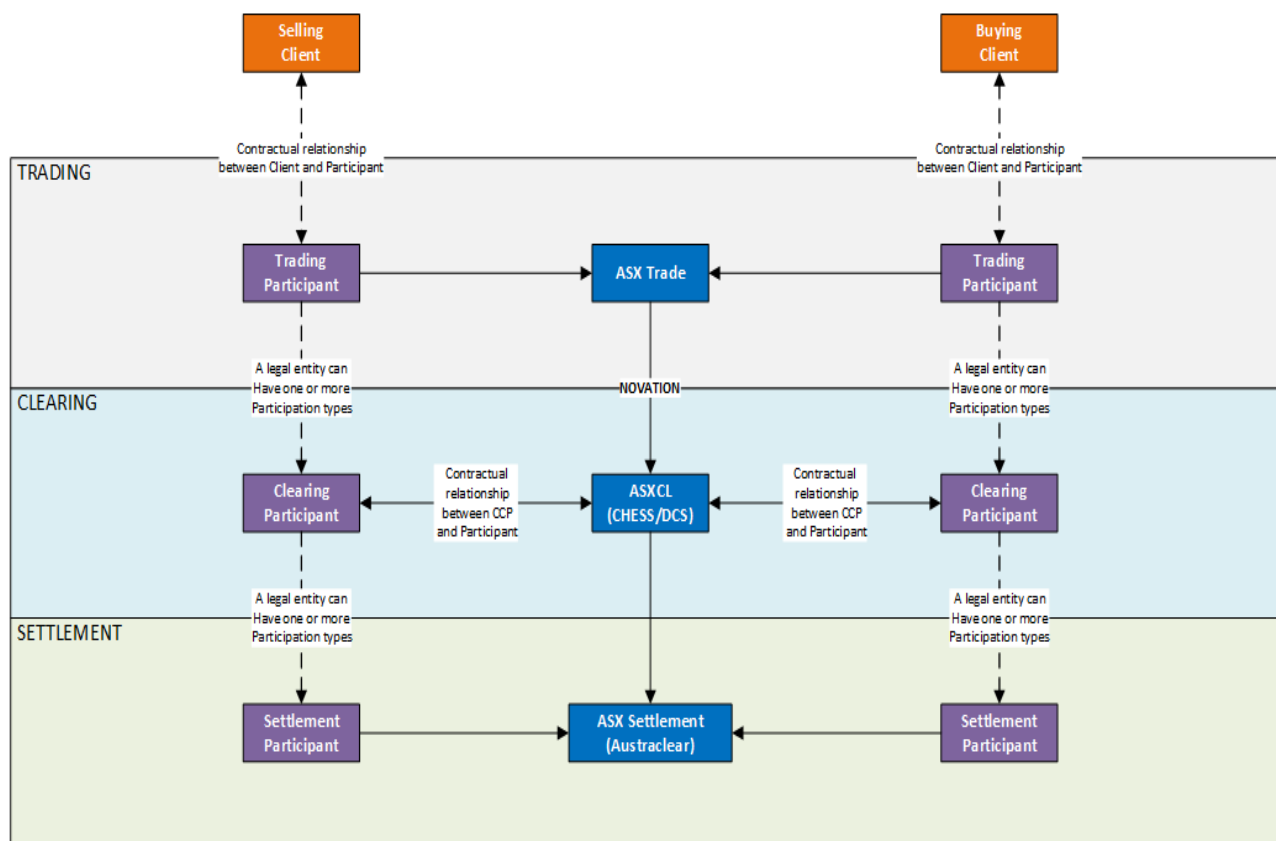
Through novation, the original market contract between the Trading Participant representing the buyer and the Trading Participant representing the seller is discharged and replaced with two new contracts: one between ASXCL and the Clearing Participant clearing for the Trading Participant representing the buyer, and the other between ASXCL and the Clearing Participant clearing for the Trading Participant representing the seller.

**Figure 1** illustrates this relationship for trades executed on the ASX market. Similar relationships apply for trades executed on the Chi-X market. As noted above the Trading, Clearing and Settlement Participant may be the same legal entity.

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<sup>1</sup> Transactions in cash market products where the same clearing participant is buyer and seller (such as crossings) are not novated to ASXCL.

**Figure 1: Trading, Clearing and Settlement Contractual Arrangements Arising from Novation**



Novation performs two important functions:

- it replaces the Clearing Participants' credit exposures to other Clearing Participants with whom they contract in cleared markets by substituting the Clearing House – an entity of known financial standing and subject to regulatory oversight – as the central counterparty for all novated transactions; and
- it maximises capital efficiency for Clearing Participants by permitting a single net exposure to be calculated and collateralised between the Clearing House and each Clearing Participant.

Through novation, ASXCL provides protection to non-defaulting Clearing Participants (and, indirectly, their clients) from the inability of a defaulting Clearing Participant to meet its obligations.

ASXCL is **not** interposed between a Clearing Participant and its clients (clients may include Trading Participants that have outsourced clearing functions to a third party clearer, and the clients of those Trading Participants).

Accordingly, novation does not change the counterparty risk exposure that clients have if their own Clearing Participant defaults and is unable to meet its obligations to them. Consequently, clients must understand and be satisfied with the creditworthiness and performance risk of their Clearing Participant.

In performing this assessment, clients of Clearing Participants should seek to understand and be satisfied with the manner in which their transactions, funds and any other assets are managed:

- between the client and their Clearing Participant – this is governed by the agreement(s) between the client and their Clearing Participant, and applicable law (such as client money handling rules under the Corporations Act); and
- between the Clearing Participant and ASXCL – this is governed by the Operating Rules of ASXCL, with different arrangements applying for different categories of financial product transactions (refer to the explanation of the different clearing account structures later in this document).

With dozens of participants trading in thousands of products and doing hundreds of thousands of trades a day in those products, the ability of ASXCL to net all novated transactions contributes to the capital and operating efficiency of the Australian Equities and Options markets. As noted above, in acting as central counterparty, ASXCL becomes the “buyer to every sell and seller to every buy”. As such, at all times it has a “matched book” – a net zero position in every product and therefore zero market risk. The wholesale transfer of counterparty risk from multiple participants to a single well-regulated and well-capitalised Clearing House also helps to reduce systemic risk.

However, these advantages come at a cost: ASXCL, as central counterparty, becomes exposed to counterparty risk – the risk that a Clearing Participant on one side of a novated transaction does not perform its payment or delivery obligations in respect of the transaction. If this occurs it means that ASXCL no longer has a matched book and takes on those obligations while continuing to meet its own obligations to non-defaulting Clearing Participants.

#### **4. Central Counterparty Clearing Risk Management**

One of the key requirements of the Reserve Bank’s FSS is that a central counterparty must have internal controls which provide it with a high degree of confidence that it will be able to settle its obligations in the event that the two Clearing Participants and their affiliates with the largest settlement obligations defaults. ASXCL meets this Standard.

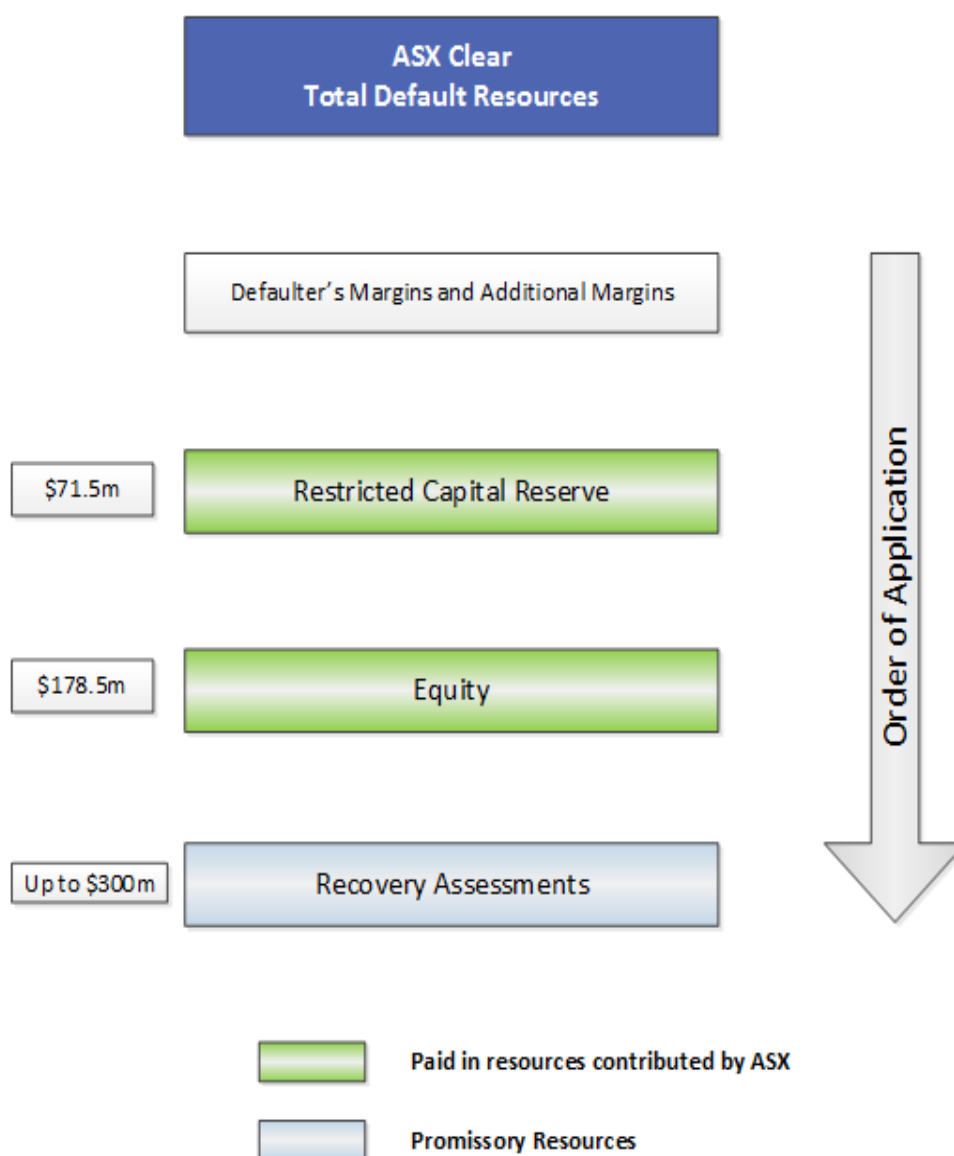
ASXCL has layers of internal controls, which seek both to reduce the likelihood that a Clearing Participant will default and to manage the risk if it does. Broadly stated, these include:

- minimum capital requirements for Clearing Participants, which are monitored through monthly financial returns;
- end of day margining of Clearing Participants’ cash market positions;
- end of day and ad hoc intraday margining of Clearing Participants’ derivatives positions; and

- additional margining of Clearing Participants where projected shortfalls that would arise from closing their positions in stressed market conditions, or the absolute size of their positions or margins, exceed pre-determined acceptable levels.

The level and order of application of ASXCL's resources is shown in **Figure 2**. The first level is the defaulting Clearing Participant's margins and additional margins lodged with ASXCL. These can be cash or eligible non cash collateral. If these are insufficient to cover the losses and associated costs incurred by ASXCL in managing the default and closing out the defaulter's open positions, it will draw on its own available resources (currently \$250 million). If these are insufficient, ASXCL has powers under its Recovery Rules to call Recovery Assessments from non-defaulting Clearing Participants up to a value of \$300 million.

**Figure 2: The Level and Order of Application of ASXCL Resources<sup>2</sup>**



<sup>2</sup> It should be noted that for liquidity purposes, ASXCL also has access to a \$150m stand-by facility provided by ASX Limited

Moreover, ASXCL has additional powers available under the Recovery Rules to help manage a Clearing Participant's default that exhausts the default resources outlined above. ASXCL's risk of loss continues until it finalises the close-out of the defaulting Clearing Participant's open positions and returns to a matched book. Under the Recovery Rules, ASXCL has the power to, as a last resort, terminate all open positions (not just the open positions of the defaulting Clearing Participant) and reduce settlement payments to Clearing Participants to the extent that they exceed ASXCL's remaining default resources ("complete termination").

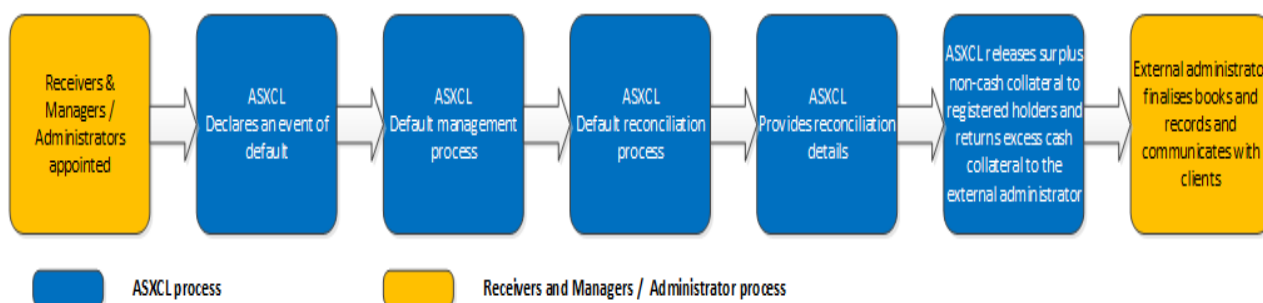
## 5. Default Events<sup>3</sup>

ASXCL's Operating Rules set out a number of events or circumstances which it may treat as an event of default by a Clearing Participant. These include<sup>4</sup>:

- the Clearing Participant fails to meet any obligation to ASXCL under a novated market contract, the Operating Rules or any other agreement (for example, failure to meet a settlement obligation or margin call);
- the Clearing Participant becomes an externally administered body corporate (for example, it has a liquidator, administrator or receiver appointed); or
- the Clearing Participant is suspended, expelled or terminated as a participant of any Australian or overseas exchange or is subject to any sanction imposed by an Australian or overseas regulatory authority.

The range of circumstances which ASXCL may treat as an event of default is not restricted to financial failures. An event of default may be declared, for example, where a Clearing Participant fails to meet its obligations to ASXCL as the result of a serious operational failure.

The diagram below illustrates the general phases which apply in managing the default of a Clearing Participant following, for example, the appointment of an external administrator or Receivers and Managers to a Clearing Participant highlighting in particular the implications for client positions.



## 6. Default Powers

ASXCL has the power to take a variety of steps if it declares an event of default in relation to a Clearing Participant, including:

<sup>3</sup> Refer to ASX Clear Guidance Note 5 Suspension and Termination of Participants

<sup>4</sup> ASX Clear Operating Rule 15.1.1

- suspending the participation of the defaulting Clearing Participant;
- closing out the Clearing Participant's open positions through matching with other equal and opposite positions registered in an account of the Clearing Participant or at ASX's discretion allowing certain derivative positions to expire or by executing market transactions that offset its net open derivatives positions and net unsettled cash market transactions; and
- where the defaulting Clearing Participant's client positions are individually accounted for at ASXCL, transferring the defaulting Clearing Participant's open client positions, either with or without any associated collateral, to another (non-defaulting) Clearing Participant where the client has an existing contractual relationship.

In invoking these powers, ASXCL's priority will be to minimise the impact of the default on the market as a whole, in a manner consistent with its licence obligations.

The conditions that ASXCL may need to be satisfied of before seeking to transfer a defaulting Clearing Participant's open client positions include:

- the pre-existence of alternative clearing arrangements for affected clients; and
- receiving timely consent from the new (receiving) Clearing Participants to accept the client positions to be transferred; and
- written consent for the transfer has been obtained from the client, together with the respective paperwork to facilitate the transfer of collateral; and
- confirmation that the potential margin impact of such a transfer on all parties involved (client, receiving Clearing Participant and ASXCL) is manageable.

## 7. Implications of the different account types

The different account types used for financial products cleared through ASXCL are:

| Product                             | Account type                                 |
|-------------------------------------|--|
| Cash Market                         | House account (known as cash market account) |
| ETOs and OTC equity-related options | House account                                |
|                                     | Individual client accounts                   |

### Cash Market

As Cash Market transactions are booked to a single house account for clearing and settlement, Clearing Participants benefit from maximum netting efficiency. As a consequence, however, unsettled novated client

positions would not be able to be transferred if a client's Clearing Participant defaults. ASXCL would ordinarily close out on market the defaulting Clearing Participant's net unsettled novated position in each cleared financial product class.

However, novated client and house positions may proceed to settlement with ASXCL's approval if the external administrator demonstrates an ability to meet the Clearing Participant's net settlement obligations on the relevant settlement date and the Clearing Participant remains operationally capable of participating in settlement.

Clients sponsored in CHESS by the defaulting Clearing Participant who wish to continue to maintain the registration of their shares on the CHESS subregister will need to appoint a new sponsoring broker for their CHESS holdings. If ASX Settlement receives a valid transfer request from a client's new sponsoring broker, ASX Settlement will effect the change of sponsoring broker for the client's CHESS holdings.

Clients who wish to have their CHESS holdings converted to issuer sponsored holdings will need to provide prescribed information to ASX Settlement.

#### [Equity related ETO and OTC options](#)

As client positions are typically booked to individual client accounts with ASXCL, there is no netting efficiency across client accounts, however in a Clearing Participant default this may enable ASXCL to facilitate a transfer of positions registered in client accounts and associated collateral to an alternate Clearing Participant, if all preconditions to transfer are satisfied. ASXCL will consider requests from clients for transfer on a case by case basis.

Where ETO and OTC equity-related option positions in an account do not meet the preconditions for transfer, ASXCL will seek to manage its exposure by closing out the net client and house account exposures. Close out can occur by matching long and short positions in a particular ETO or OTC series across all accounts (house and client) and then executing a trade equal and opposite to the remaining net position on market (or over the counter for OTC).

This approach applies also for positions that are subject to "specific cover". Specific covered positions (written call ETOs) are excluded from margining because they have the full quantity of underlying shares lodged as collateral against the position. However, in the event of the Clearing Participant's default, the positions, if not transferred as discussed earlier, will be included in the net position to be closed out on market. Similarly, no special rights attach to specific cover collateral which will be liquidated if required along with all other collateral. ASXCL will exercise discretion, however with respect to out-of-the-money positions which it may hold to expiry if the default occurs close to expiry.

The price at which identical ETO or OTC equity-related option positions of different clients are terminated will be the same, irrespective of whether they are matched out with positions in the same account or other accounts or closed out on market.



## 8. Close-out

### a. Closure of client positions

In the event of a Clearing Participant's default, the responsibility for managing the closure of client transactions in its books and records rests with the defaulting Clearing Participant or its administrators and not with ASXCL.

The Clearing Participant maintains on its books and records details of the client's individual transactions. ASXCL does not manage the transactions between the Clearing Participant and its clients, the terms of which are governed by the client agreement. Accordingly ASX cannot advise clients on the impact on their individual client positions of ASX's default actions.

Following the completion of the close out process ASXCL will promptly provide reconciliation information to the defaulting Clearing Participant or its administrators about the close out of positions registered in client accounts to assist them in finalising the books and records of the defaulting Clearing Participant, including client account records. It is then a matter for the defaulting Clearing Participant or its administrators to determine the manner in which client transactions in the books of the Clearing Participant are closed.

### b. Shortfalls on close out

Broadly speaking, ASXCL is able to apply the collateral<sup>5</sup> a defaulting Clearing Participant has lodged in its house account and client account(s), to cover shortfalls incurred by ASXCL in closing out the defaulting Clearing Participant's open positions, and in the case of house account collateral to meet any further costs incurred in the default.

More specifically, ASXCL reserves the right to apply:

- the cash and non-cash collateral in a defaulting Clearing Participant's house account (derivatives or cash market) towards any shortfalls incurred by it on closing out the house account positions and the net open positions across all the Clearing Participant's client accounts (whether they are unsettled cash market transactions or open derivatives positions), as well as any further costs incurred in the default; and
- the cash and non-cash collateral lodged in the derivatives client account of a particular client towards shortfalls incurred in connection with closing out the open derivatives positions in that client account.

Any excess cash remaining after positions have been closed out will be returned to the external administrator of the defaulting Clearing Participant (who will be responsible for determining and processing what funds need to be returned to clients). Any surplus non-cash collateral or surplus proceeds from the sale of non-cash collateral remaining after positions have been closed out will be returned to the registered holder of the non-cash collateral – further detail on this is provided in the table below.

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<sup>5</sup> Money or other property lodged by a Clearing Participant with ASXCL is held as collateral to secure the Clearing Participant's obligations to ASXCL with regard to positions registered in the Clearing Participant's house or individual client accounts. Money lodged as collateral is referred to as "cash collateral". Acceptable non-cash property lodged with ASXCL is referred to as "non-cash collateral".

Any shortfall remaining after the defaulting Clearing Participant's collateral has been applied in this manner is satisfied out of ASXCL's risk resources (as detailed above), as specified in its Operating Rules.

It should be noted that all clients of a Clearing Participant are potentially at risk of losing some or all of their collateral if the Clearing Participant defaults and shortfalls are incurred in closing out the Clearing Participant's client positions.

c. [Default reconciliation process](#)

Following completion of the close out of all net open derivatives positions<sup>6</sup> and net unsettled cash market transactions registered in the accounts of the defaulting Clearing Participant, ASXCL will provide information to the external administrators about the default management process and account reconciliations, generally:

- the positions that have been matched out and the close-out price;
- the market transactions (including price) that closed out net open derivatives positions and net unsettled cash market transactions;
- the market transactions (including price) that realised non cash collateral held in respect of the defaulting Clearing Participant's accounts; and
- reconciliations for the defaulting Clearing Participant's client related derivatives accounts, house accounts and cash market account, showing the net amount payable in respect of each account following close-out or expiry of net open derivatives positions in those accounts or close-out of net unsettled cash market transactions.

d. [Return of surplus collateral](#)

Following the determination and deduction of costs incurred by ASXCLF on the default, surplus amounts of collateral held in respect of client accounts and house accounts will be returned as set out below.

| Product     | Account       | Surplus Collateral  |
|-------------|---------------|---|
| Cash Market | House account | Surplus non-cash collateral released from ASX control to the registered holder's sponsoring broker.<br><br>Surplus cash collateral returned to the defaulting Clearing Participant or external administrator. |
| ETOs        | House account | Surplus non-cash collateral released from ASX control to the registered holder's sponsoring broker.   |

<sup>6</sup> Excluding open derivatives positions transferred to another Clearing Participant or which proceeded to expiry.

| Product | Account                   | Surplus Collateral   |
|---------|---------------------------|--|
|         |                           | Surplus cash collateral returned to the defaulting Clearing Participant or the external administrator.   |
|         | Individual client account | <p>Surplus non-cash collateral released from ASX control to the registered holder's sponsoring broker.</p> <p>Surplus cash collateral returned to the defaulting Clearing Participant or external administrator to deal with in accordance with all applicable laws (including the Corporations Act) on behalf of clients entitled to the moneys.</p> <p>Any surplus proceeds from the sale of non-cash collateral returned to registered holder of collateral, which will be the client or, if the collateral was lodged by a third party, the third party.</p> |

To facilitate payments of moneys to the defaulting Clearing Participant or external administrator in respect of client accounts, the defaulting Clearing Participant or external administrator will be requested to notify the details of the client trust account into which such moneys should be deposited.

## 9. Further information for clients

The ASXCL Client Frequently Asked Questions provides further information on the impacts and implications for clients of an ASXCL Clearing Participant default.