

SETTLEMENT RISKS FOR PARTICIPANTS WHERE FINANCIAL PRODUCTS ARE CONTROLLED BY THIRD PARTIES

The purpose of this Guidance Note	<ul style="list-style-type: none"> To assist clearing participants understand the potential settlement risks when acting for clients whose financial products are subject to a security interest in favour of a margin lender or other financier or otherwise controlled by a third party
The main points it covers	<ul style="list-style-type: none"> The principal nature of a clearing participant's obligations to ASX Clear Settlement risks where clients have given security over financial products Settlement risks where financial products are lodged as collateral with ASX Clear Settlement risks on release of cover for an exercised call option Steps a clearing participant should take to mitigate these settlement risks
Related materials you should read	<ul style="list-style-type: none"> None

History: Guidance Note 11 amended 25/03/19. Previous versions of this Guidance Note were issued in 04/14 and 06/15 and under the ACH Clearing Rules as Guidance Note 17 in 05/08.

Important notice: ASX has published this Guidance Note to assist participants to understand and comply with their obligations under the ASX Clear Operating Rules. It sets out ASX's interpretation of the ASX Clear Operating Rules and how ASX is likely to enforce those rules. Nothing in this Guidance Note necessarily binds ASX in the application of the ASX Clear Operating Rules in a particular case. In issuing this Guidance Note, ASX is not providing legal advice and participants should obtain their own advice from a qualified professional person in respect of their obligations. ASX may withdraw or replace this Guidance Note at any time without further notice to any person.

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1. Introduction

This Guidance Note is published to assist clearing participants understand the potential settlement risks when acting for clients whose financial products are subject to a security interest in favour of a margin lender or other financier or otherwise controlled by a third party.

2. The principal nature of a clearing participant's obligations to ASX Clear

Under the ASX Operating Rules, the matching of trading messages in the ASX trading platform results in a contract being formed between the trading participants whose trading messages are matched:

- in the case of cash market transactions, for the sale and acquisition of the relevant cash market products at the price and volume matched; and
- in the case of derivatives market transactions, on the terms of the relevant contract series and at the price and volume matched.¹

Each trading participant acknowledges, however, that the clearing obligations owing to it or by it in respect of that transaction will be performed as principal obligations of the clearing participant responsible for those obligations.²

Under the ASX Clear Operating Rules:

- cash market transactions submitted to ASX Clear Pty Limited (ASX Clear) by an approved market operator are immediately novated to ASX Clear if the delivering PID and receiving PID relate to two different legal entities;³ and
- derivatives market contracts entered into on the ASX market are novated to ASX Clear at the time the derivatives market transaction to which it relates is registered with ASX Clear.⁴

Upon novation, a cash market transaction is discharged and replaced with two "cash CCP transactions" and a derivatives market contract is discharged and replaced with two "derivatives CCP contracts." Under the novated arrangements:

- the obligations owed by the seller to the buyer are replaced by obligations in the same terms owed by the seller's clearing participant to ASX Clear, and obligations owed by ASX Clear to the buyer's clearing participant; and

¹ ASX Operating Rule 4040.

² ASX Operating Rule 4041. The relevant clearing participant may be the trading participant, if it is also a clearing participant, or a third party clearing participant with whom the trading participant has a clearing agreement. Each trading participant is required to have in place and maintain adequate arrangements for the clearing of all market transactions entered into by it on the ASX market (ASX Operating Rules Schedule 1 Rule 1.1000).

³ If the delivering and receiving PIDs relate to the same legal entity, the cash market transaction is not novated to ASX Clear but is simply notified by ASX Clear to the participant as having been registered under ASX Clear Operating Rule 12.1.1.

⁴ ASX Clear Operating Rule 12.2.1.

- the obligations owed by the buyer to the seller are replaced by obligations in the same terms owed by the buyer's clearing participant to ASX Clear, and obligations owed by ASX Clear to the seller's clearing participant.⁵

This results in ASX Clear effectively being interposed between the seller's clearing participant and the buyer's clearing participant as a central counterparty. This facilitates the netting of the delivery and payment rights and obligations of each clearing participant (as those rights and obligations are now owed by or to ASX Clear as central counterparty), bringing significant efficiencies to, and substantially reducing risk in, the settlement process.

The rights and obligations under cash CCP transactions and derivatives CCP contracts between the relevant clearing participant and ASX Clear are owed by and to those parties as principals to each other, even where the clearing participant may be acting as agent for another person.⁶ Consequently, the clearing participant for a client must perform its obligations to ASX Clear regardless of whether the client performs its obligations to the clearing participant.

3. Settlement risks where clients have given security over financial products

A clearing participant who accepts the clearing obligation on a contract to sell financial products entered into on an approved market operator and who is not the controlling participant in ASX Settlement for those financial products needs to be aware of the potential settlement risks it faces in that scenario, particularly if the products are subject to a security interest in favour of a margin lender or other financier.

Margin lenders and other financiers who take security over financial products will typically make arrangements to protect their security interest in ASX Settlement. This will usually involve having the financial products sponsored and controlled by the margin lender/financier (if it is a settlement participant in ASX Settlement) or by a related or associated settlement participant (if it is not).

It will usually be a term of the security that the client may not dispose of the financial products without the consent of the margin lender/financier. Amongst other circumstances, a margin lender/financier will typically refuse to consent to a disposal of financial products if the client is in breach of a margin call or if the disposal would cause its loan to valuation ratio (LVR) to be exceeded.

The risk of this happening is heightened during periods when market prices are under downward pressure, when there is a greater risk of LVR requirements being breached and of margin calls being made. This risk is all the more acute where the margin lender/financier holds security over a single financial product or financial products in a single market sector.

Other factors in addition to downward price movements may lead to LVR requirements being breached and margin calls being made – for example if a margin lender/financier reduces its LVR for a particular financial product or removes that product from its approved list, effectively reducing the LVR for that product to zero.

Where a clearing participant has delivery obligations and is not the controlling participant in ASX Settlement for those financial products, it should be aware that there may be a risk that the controlling participant will not provide the necessary instructions to allow the financial products to be applied to meeting its settlement obligations. This could occur, in particular, if the controlling participant is, or is associated with, a margin lender or other financier who is not prepared to release the financial products from its security.⁷

If this happens and the clearing participant cannot source the financial products required to meet its settlement obligations from elsewhere, it will face a settlement failure and contravene its obligations under the ASX Clear Operating Rules. This may have enforcement consequences for the participant and has the potential to adversely affect other participants, the clearing and settlement facility and the wider financial system.

⁵ ASX Clear Operating Rule 12.2.2.

⁶ ASX Clear Operating Rule 12.2.3.

⁷ As mentioned above, this could occur because the client is in default on a margin call or the release of the financial products from the margin lender's or financier's security would cause its LVR to be exceeded.

4. Settlement risks where financial products are lodged as collateral with ASX Clear

Under the ASX Clear Operating Rules, ASX Clear may require a clearing participant to provide cover for its margin obligations under cash CCP transactions or derivatives CCP contracts.⁸ Cover can be provided in the form of cash or collateral and, if collateral, in the form of approved financial products.⁹

All collateral is subject to a security interest in favour of ASX Clear to secure the performance by the relevant participant of its obligations to ASX Clear. That security interest has priority over the interest and ownership rights of any other person claiming an interest by way of security in the collateral.¹⁰

ASX Clear will only accept lodgement of financial products as collateral if they are CHESSE sponsored and meet the collateral eligibility criteria.¹¹ Amongst other things, this requires that the financial products are not subject to any third party security interest (whether legal, equitable or statutory) at the time they are provided to, or at any time while they are held by, ASX Clear as collateral unless the parties to that security interest have agreed between themselves in writing that ASX Clear's security interest in respect of the financial products has priority over that security interest and the parties hold the benefit of such agreement on trust for the benefit of ASX Clear, or ASX Clear has agreed otherwise in the circumstances set out in the Procedures.¹²

Financial products held as collateral for a participant's margin obligations will only be released by ASX Clear if replacement cover is provided.¹³

This may cause problems for a clearing participant responsible for settling a sale of financial products executed on an approved market operator who expects to use financial products held as collateral by ASX Clear to meet its settlement obligations. As stated above, those financial products will only be released by ASX Clear when replacement cover is provided. If the client is not in a position to provide replacement cover to the participant in a timely manner so that the participant can then lodge that cover with ASX Clear, the participant could find itself obligated as principal to meet its settlement obligations to ASX Clear but not be able to access the financial products held as collateral by ASX Clear to meet those obligations.

As noted in section 3 above, even where the client provides replacement cover, if the clearing participant is not the controlling participant of those financial products in ASX Settlement, there may still be a risk that the controlling participant will not provide the necessary instructions to allow the financial products to be applied to meeting the settlement obligations of the clearing participant.¹⁴

5. Settlement risks on release of cover for an exercised call option

Where ASX Clear allocates an exercise notice submitted by the buyer of a call option over an underlying financial product to a seller of the call option, the relevant options CCP contract is discharged and a new cash CCP

⁸ ASX Clear Operating Rule 14.6.1. Note that under ASX Clear Operating Rule 14.8.1 a clearing participant must not use cash or collateral that belongs to a client for the purpose of meeting the clearing participant's margin obligations in connection with that cash CCP transaction.

⁹ ASX Clear Operating Rules Procedure 14.6.1. In the case of an options CCP contract, it is not necessary that the financial products provided as cover are the same as the underlying financial products for the contract (for example, NAB shares may lodged as collateral for a CBA options contract). If they are the same, however, and they have been lodged by the clearing participant of a seller of a call option, the financial products can be designated as "specific cover" for the participant's margin obligations under that call option: see ASX Clear Operating Rules Procedures Annexure 1 clause 3.3.

¹⁰ ASX Clear Operating Rule 14.6.7. Thus, if the participant commits an event of default under the ASX Clear Operating Rules, ASX Clear has rights to deal with the collateral, including to sell it and apply the proceeds towards satisfying amounts due by the participant to ASX Clear.

¹¹ ASX Clear Operating Rules Procedures Annexure 1 clause 3.2.

¹² ASX Clear Operating Rule 14.6.3. Note that under the corresponding Procedure ASX Clear has grandfathered those arrangements involving third parties holding second-ranking security interests over financial products that it agreed to in writing prior to 1 March 2019. These agreed arrangements include certain margin lender priority deeds.

¹³ ASX Clear Operating Rules Procedures Annexure 1 clause 3.4.

¹⁴ See note 7 above.

transaction arises under which the seller agrees to deliver the underlying financial products and the buyer agrees to pay the exercise value under the contract.¹⁵

The discharge of the options CCP contract results in the termination of the margin obligations owed in respect of that contract and, consequently, the need for the clearing participant to provide cover for those margin obligations.

ASX Clear will ordinarily release financial products provided by a clearing participant as collateral for an options CCP contract upon the discharge of that contract, provided it receives the necessary instructions to do so¹⁶ and the participant is not otherwise in default of its obligations to ASX Clear (and would not be as result of the release of the collateral).

Where financial products have been lodged as cover for a call option, the participant with the obligation to deliver the financial products upon exercise may therefore be expecting to use those financial products to meet that delivery obligation.

Again, however, if the clearing participant is not the controlling participant of the financial products in ASX Settlement, there may be a risk that the controlling participant will not provide the necessary instructions to allow the financial products to be applied to meeting the delivery obligation of the clearing participant on exercise.¹⁷

6. Steps a clearing participant should take to mitigate these settlement risks

To help mitigate the settlement risks noted above, if a clearing participant is not the controlling participant of a client in ASX Settlement, it should have appropriate contractual arrangements in place with the client and the controlling participant, which:

- require the client to disclose to the clearing participant if any financial products the client intends to dispose of are the subject of a security interest in favour of a third party;
- require the controlling participant to disclose to the clearing participant if any relevant financial products it controls on behalf of the client are or become the subject of a security interest in favour of the controlling participant or a related body corporate; and
- clearly set out when the clearing participant can require the controlling participant to deliver the client's financial products to it or in accordance with its instructions.

¹⁵ ASX Clear Operating Rule 20.3.2.

¹⁶ Where the clearing participant is also the controlling participant in ASX Settlement, these instructions are given to ASX Settlement as CHES message 029 *Options Cover Removal Request* and, where the clearing participant is not the controlling participant in ASX Settlement, as CHES message 103 *CP Collateral Removal Authorisation*: see ASX Clear Operating Rules Procedures Annexure 1 clause 3.6.

¹⁷ See note 7 above.