



20th December 2012

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

By email: joshua.everson@asx.com.au

Dear Mr Everson

Derivatives Account Segregation and Portability – ASX Market Discussion Document

Thank you for the opportunity to make comments in response to the matters raised by ASX in the discussion document.

AFMA understands that ASX has not reached a concluded view on the issues in the paper and is seeking genuine market feedback on the most effective way to structure clearing and settlement arrangements in a manner that meets regulatory expectations and allows market users, including clearing participants, to manage their risks and resources in an efficient way.

As you would be aware, AFMA has an ongoing dialogue with the ASX, the Government through the members of the Council of Financial Regulators, and with other market participants about clearing and settlement in the Australian market more broadly, including in relation to central clearing of OTC derivatives, trade reporting, and the prospect of the entry of new providers of clearing and settlement services.

It is in the interests of our members for AFMA to take a holistic view of developments in clearing and settlement. These developments cannot be considered in isolation and we need to have a better understanding of what the regulatory landscape will be, who the providers will be, and how that will affect the business operations of our members. Accordingly, while we have some comments at this stage in response to the issues raised in the consultation paper, we are not sufficiently informed about likely developments in the future to express any view at this time that should be taken as our final view on a particular issue. Our strong preference is continue to actively engage with ASX as the regulatory regime becomes clearer, changes are made to the existing clearing & settlement facilities, and ASX looks to introduce new services.

1

On that basis, we would like to provide the following comments in response to the issues raised in the discussion document.

General observations

The regulatory environment is fluid

There are a number of consultation processes underway in relation to clearing and settlement that are likely to result in significant regulatory changes, and consequently, significant operational changes for CCPs and industry participants. There are currently no express regulatory requirements compelling ASX to implement the proposals in the discussion paper. ASX should make it abundantly clear that it has not decided upon particular structural reforms and rule changes, and is genuinely open to all suggestions from industry and will consider those suggestions, notwithstanding any preferred approaches within ASX or elsewhere.

In particular, we encourage ASX to consider all other potential models for holding client margins, rather than focussing on the individually segregated client account model. Our members are of the view that an environment that offers flexibility and choice for clients in the clearing services they receive (including the level of protection of assets and the costs associated with that) is the optimal outcome for the Australian market.

Individually segregated client accounts (ISCAs)

While there are some obvious investor protection benefits that flow from the ISCA model, AFMA members are concerned about the possible negative impacts within clearing participants, and the likely flow-on effects to underlying clients. The ISCA model has the potential to create significant operations, technology, legal and compliance burdens, increase costs, and potentially reduce overall efficiencies of both clearing participants and potentially the wider market.

There are other models which can provide the kind of outcomes ASX seeks, and that will be less onerous for clearing participants to implement. These other options should be fully explored before a final decision is made.

Insolvency law

We understand from comments made at the ASX forum held on 28th November 2012 that there are possible solutions to the issues in insolvency law that have existed for some time but were magnified by the MF Global matter, and that these solutions are currently being considered by the Council of Financial Regulators and the Government. It is difficult to comment on this without any information about what those solutions might be, how they will be implemented and in what timeframe. In addition, we do not know whether CCPs and clearing participants will be required to do anything to give effect to those solutions, which adds a further layer of uncertainty.

Market participants would like to know what the proposed solution is and how it will be implemented before any final decision on adoption of the ISCA model or any other model is made. We have not conducted any analysis as to what changes are required to Australian insolvency laws in order to overcome the kind of roadblocks in porting client positions that were brought to the fore as a result of the MF Global situation. In our view, the policy makers should provide that analysis as part of a public consultation process.

End clients

The issues in the discussion paper raise significant issues for end clients, not the least of which is the likely increase in the overall cost of clearing if an ISCA model is adopted. It needs to be clearly understood in the marketplace that the added protection of individual segregation of client accounts will come at a cost that cannot be reasonably expected to be absorbed by clearing participants.

It would be helpful in this process if ASX could provide clarity as to who is a “client”, for the purposes of an omnibus account and individually segregated client accounts.

We recommend that ASX, to the extent that it embarks on any change in its account and margining structure, drafts appropriate public documents for consumption by clients of clearing participants in relation to the operation and effect of such a model. Clients should also be provided with more detailed information about the CCP’s investment of client collateral.

We recommend that ASX provide appropriate transitional arrangements in relation to any of the proposed changes referred to in the discussion paper.

Responses to questions in the discussion paper

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

- Developments in the OTC space will drive the amount of collateral posted against margin/exposure significantly, and industry participants will devote more time and energy to decreasing/optimizing the margin they post.
- Any solution needs to analyse conflicts of law issues and in particular those arising from the operation of different insolvency regimes upon the failure of foreign clearing members. Clear rules on porting and segregation backed up by regulatory/legislative protections would help address these legal risk issues.
- Another key driver is the requirement for ASX to attain recognition in Europe under EMIR Article 25 (if it is to continue to attract European banks as members) which would involve scrutiny of ASX risk management arrangements by ESMA against CPSS-IOSCO standards on portability amongst other things, or compliance with the regime in Australia (the FSS) that imports these standards.
- Does ASX know who will be assessing the CCP against the CPSS-IOSCO standards for FSS and Basel III purposes in Australia? There needs to be a level of certainty that whatever model is ultimately adopted by ASX will satisfy the “highly likely” portability requirement and other legal and regulatory requirements.
- A failure to comply with CPSS-IOSCO standards on portability/segregation will also impact ASX’s Qualifying CCP status under Basel III which would result in punitive capital treatment of clearing participants’ exposures to ASX and default fund commitments (funded and unfunded) – i.e. not just a loss of the standard CCP 2% risk weighting.

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

- Some customers may not want to pay all of the increased costs of a move towards an increasingly operationally segregated model. ASX should ensure an approach which allows for the clearing participant to have flexibility in their offering to customers allowing for the cost to drive the customer decision. Pre-funding models may need to be considered if the model moves to complete segregation.

- Another objective should be legal certainty with respect to default management arrangements – i.e. porting.
- ASX should be strongly encouraged to do more analysis around risk issues relating to cross margining between OTC and futures segments. Using the same default management processes, waterfalls and funds may not be the most desirable solution for either segment, even though collateral efficiencies are generally desirable.

Q3. *Do you believe 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 whether any additional complexities arise under prime brokerage arrangements.*

- At a point of considerable stress in the market, clearing participants may not be willing to take in portfolios without having time to review and understand the risk in the portfolio. It would be useful if ASX can look at building a tool that helps clearing participants review a portfolio quickly, utilising all the information the CCP has available to it that a clearing participant would not have access to.
- AFMA members are some distance away from supporting a requirement that a client should have a second clearer in the event that the primary clearing participant defaults or is otherwise not able to meet their obligations. At a minimum it is not appropriate for ASX to propose the imposition of these kinds of requirements. This is a policy issue which should be properly debated. There are significant costs involved in this kind of back-up arrangement, which also give rise to additional risk issues for the back-up clearer that merit further detailed consideration. It may be that the appropriate way to incentivise back-ups for financial institutions is under the capital rules around portability.
- With respect, the three bullets in section 5.2 on page 12 of the discussion paper oversimplify the key requirements. "Gross margining" is an unhelpful term in this context without further detail.
- Any portability framework may ultimately require legal or regulatory support to ensure that the rules of the CCP have primacy upon the insolvency of any foreign or domestic clearing participant. ASX should investigate the structures (including statutory trust) structures used in other jurisdictions to support portability.

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.*

- Whilst the approach sounds broadly palatable and workable within the current principal to principal structure at ASX, significantly more detail is required to reach a conclusion either way. There are many variants on the spectrum of options between traditional futures omnibus and full legal segregation that need to be considered - ISDA have done work on this in the US and EU that may be informative for ASX.
- Individual segregation should be presented as something that clients can choose to opt into (as is the case on EUREX for example) rather than having to ask clients if they want to "opt out" of individual segregation. Omnibus should still be the default at the very least in the futures context.
- If ISCA is implemented, it should be accompanied by a change of the revenue sharing arrangements between the exchange and clearing participants, given the substantial shift of cash holdings from member to the ASX that would be expected. The ISCA structure, whilst providing improved risk terms to clients, does not alter the risk exposure of clearing members and the combination of higher overheads, lower revenues and increased capital requirements may cause some entities to question the cost/benefit equation for clearing ASX24. The increase in concentration risk that might

eventuate if there were fewer clearing participants is something that regulators should not take lightly.

- It is not clear whether the proposal envisages a mechanism by which the clearing participant passes information to the ASX, which notifies them how much margin the ISCA is holding. Will there be one for one settlement per ISCA between ASX and the clearing participant?

Q5. *What would 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.*

- It is difficult to assess the impact and timelines as, without more specific detail as to the final structure, IT providers cannot provide reliable assessments. Based on past experience, it is assumed that systems will require an upgrade to support ISCA with software costs of approx. EUR 100k, internal work effort costs of another EUR 100k and an estimated 3-6 months to implement. It would also be expected that the management of additional exchange level accounts would generate additional staff overhead. We would request ASX to sponsor any external IT provider costs to minimize the cost to existing clearing members.
- The optionality of ISCA (once elected by clients) could significantly disrupt current market structures that tend to rely in the futures context on omnibus margin and netting across client accounts (across multiple exchanges).

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

- At a big picture level, clearing members will lose the benefit of net margin impact and will have to fund increasing amounts of margin on behalf of the customers due to the timing between when margin calls are made with ASX and when the clearing member receives margin from customers.
- Will ASX also be considering moving to a pre-funding model?
- ASX must establish an account opening process for ISCA's to enable effective STP of transactions. It is not outlined how ASX would achieve this, but the process must be sufficiently optimal to enable efficient and timely processing of new accounts.
- In addition, the ASX **must** be able to support via its execution API clients confirming the ISCA on execution so unallocated trades are margined under the ISCA, not under the clearing members house account as it is currently. The clearing member cannot be disadvantaged if a client holding an ISCA does not provide timely allocations which may generate intraday margin calls for which the clearing member is liable. Failure to address this would fundamentally defeat the object of the exercise of the ISCA intraday.
- ASX must keep payment volumes to a minimum to reduce staff overhead and EXIGO costs. It is unclear how ASX would look to manage the margin calls with the ISCA structure, but indications are that margins calls would have to be at ISCA level and hence cash payments / receipts made at this level in EXIGO thereby increasing operational overhead and risk. We would be seeking some form of automation around this process and reduced Exigo fees to keep costs at or below current levels.
- ASX must provide TD+1 trade, position and cash files/reports to clearing members at both ISCA and consolidated levels. Most clearing members will still reconcile the consolidated trade, position and cash position so if ASX cannot provide this data at consolidated level, the overhead in performing the reconciliation will increase substantially, again increasing the costs to clearing members.

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.

Whilst investor protection initiatives are broadly supported, mandatory requirements for any class of client or clearing member are not supported. This should be genuine choice for clients and clearing members who have to price the costs. The ISCA and omnibus models should be priced differently due to the operational burden and the funding drag of the ISCA. Customers can make a choice based on their willingness to pay the higher costs.

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

- A mandatory requirement is not currently supported. In the OTC clearing space, these arrangements present difficult risk issues which the market is only now getting fully to grips with. From a clearing member perspective, back up clearing facilities would need to be subject to conditions that allow the clearing member to take account of a broad range of time sensitive factors before agreeing to accept ported positions – upfront guaranteed arrangements are not going to be widely available.
- Clients already have the option to do this voluntarily. Mandating this would increase the work effort for clearing members to on-board clients for a 'worst case scenario' and with a zero revenue expectation. Client on-boarding is an involved process with considerable costs and we would be unlikely to find a viable business case to take these accounts on.

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 comments at this time.

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 comments at this time.

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.

No comments at this time.

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?

No comments at this time.

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 comments at this time.

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.

A detailed legal analysis of the options available in both OTC and futures context is required. AFMA would be willing to assist ASX with this. At a high level, the regulatory and capital outcomes should be broadly the same across OTC and futures although there may be different ways of achieving those outcomes due to different existing market structures and client expectations etc.

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 do not support the imposition of a requirement of the type described in the question. This should be left to customer choice/pricing. Segregation of excess margin at a third party custodian or the clearing house implies additional costs for the client in return for altering their risk profile. Clients should be able to choose the balance they want to achieve between costs and risks.

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?

Again no requirement should be imposed. Further work and analysis needs to be done to ensure that the ASX has the optimum segregation and portability outcome that deals with the complexities inherent in global net margining arrangements involving clients acting through (potentially) multiple brokers (subject to different client protection regimes) across multiple exchanges, currencies and collateral types. If a client wants to receive one margin call across all exchanges that it trades from a single source global broker, then that flexibility needs to be built into the model at a local exchange level.

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

- Broadly acceptable in that the key benefit for a bank client here is to be able to "look through" their clearing member to get the preferential risk weighting and the look through treatment requires "highly likely" portability.
- If ASX is not compliant with CPSS-IOSCO standards then it will be a non-Qualifying CCP and bank clearing members will suffer a punitive capital treatment for exposures as well as default fund obligations.

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

We refer you to the latest BCBS 227 guidance.

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%?

It would be useful for this sort of structure to be available (as a choice) from a capital management perspective, but more information is required about how bankruptcy remoteness would be achieved to properly assess this and the resulting costs.

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.

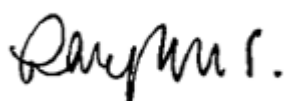
Further legal analysis on the options available is needed.

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?

Providing a framework similar to the CME's IEF2 & IEF5 programs would be a value-add for ASX.

I hope these comments are of assistance. Please contact me on 02 9776 7997 or tlyons@afma.com.au if you have any queries about this submission.

Yours sincerely



Tracey Lyons
Director, Market Operations & Retail