ASX
AUSTRALIAN SECURITIES EXCHANGE

Financial Stability Standards Implementation

The Way Forward

Cash Equity Market Account Segregation and Portability, and Rescheduled Settlements

A. Executive Summary

In December 2012 the Reserve Bank of Australia (RBA) released new Financial Stability Standards (FSS) for Financial Market Infrastructures. These were a response to the new international standards for the regulation and conduct of Clearing and Settlement facilities developed by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organisation of Securities Commissions (IOSCO). They form part of a global tightening of financial markets regulation in the wake of the Global Financial Crisis.

The new FSS took effect on 29 March 2013. They apply to licensed clearing and settlement facilities, including ASX Clear, ASX Clear (Futures), ASX Settlement and Austraclear.

ASX has received transitional relief until 31 March 2014 for central counterparty (CCP) requirements for the new standards relating to Segregation and Portability, and Liquidity Risk. The RBA Payments System Board, in granting this relief, acknowledged the significant industry-wide changes needed to implement certain elements of these standards. This consultation paper now seeks industry feedback on those changes - recognising that compliance with the new FSS is mandatory for ASX Clear.

This is ASX's second consultation[1] resulting from the new regulatory requirements. We are seeking feedback on the new regulatory requirements including the choice of cash equity market account structures. ASX would particularly like feedback on the likely benefits as well as establishment and additional ongoing operational and settlement costs of the different choices. We have also put forward a proposal which will remove the need to reschedule cash equity market settlements in the event that a Clearing Participant is not able to meet a payment obligation.

We are not seeking comments on FMI Recovery and Resolution arrangements. The current international framework for FMI Recovery and Resolution is yet to be finalised and the RBA has provided all FMIs under its supervision with transitional relief until 31 March 2014. Once both the international and domestic FMI recovery and resolution requirements crystallise, ASX will consider seeking market feedback on the ASX FMI recovery and resolution arrangements.

ASX would also like feedback on the impact of these proposals on operational costs, together with estimates of costs and required timescales for implementation. Suggestions for alternative approaches that efficiently achieve the same policy objectives and regulatory standards are specifically sought.

ASX requests submissions to be received by Wednesday 4th September 2013. 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 is available to answer any queries you may have regarding this paper.

We will be holding a presentation and Q&A session on this paper on Monday 26th August 2013 at 4:30pm. Please register your interest at rebecca.currie@asx.com.au.

1 A previous ASX consultation was released on Derivatives Account Segregation and Portability in October 2012.

B. Cash Equity Market – Account Structures and Portability

New Standards

Standard 13 of the new FSS covers Segregation and Portability and requires that "*a central counterparty should have rules and procedures that enable the segregation*[2] *of positions of a participant's customers and the collateral provided to the central counterparty with respect to those positions*". Guidance to Standard 13 emphasises that "customer's positions and collateral should be segregated from those of the participant through which the customers clear".

In addition, Sub-standard 13.2 of the new FSS for central counterparties states that:

> *"A central counterparty should employ an account structure that enables it readily to identify positions of a participant's customers and to segregate related collateral. A central counterparty should maintain customer positions and collateral in individual customer accounts or in omnibus customer accounts, or equivalent."*

The Guidance to the FSS in 13.2.1 relating to this sub-standard encourages CCPs to take a number of factors into account:

> *"In considering the appropriate account structure, including the level of segregation and the basis for margin collection (that is, gross or net), a central counterparty should take into account stakeholders' views and assess the important benefits of individual customer protection alongside all relevant legal and operational factors. Such factors might include applicable insolvency regimes, costs of implementation and operational implications (for example, operational challenges associated with maintaining and managing individual customer accounts)."*

Current Practice

The clearing of cash equity market transactions by ASX Clear is currently structured in such a way that the CCP operates a single house account with each Clearing Participant that comingles and nets all proprietary (house) and client unsettled novated transactions. Use of this single house account benefits both Clearing Participants and their clients by maximising netting efficiency[3] and therefore minimising funding costs. As a practical matter, the use of a single account and the short three day settlement cycle make it extremely unlikely that client positions can be ported to an alternative Clearing Participant in the event their Clearing Participant defaults.[4] See "Cash Market Overview" below.

Australia is not unique in operating a single house account at a Clearing Participant level within the CCP with other countries[5] whose clearing arrangements have evolved from settlement systems often functioning in a similar manner (e.g. NSCC, USA). Conversely, other jurisdictions where CCPs (e.g. LCH Clearnet Ltd, UK) have moved into cash equity market clearing from futures

2 Under the FSS segregation refers to "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)."

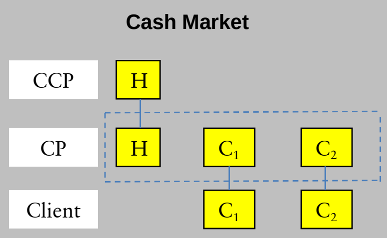
3 Single accounts are able to maximise netting efficiency because offsetting positions can be found between house and client positions and also among the positions of different clients clearing through the same Clearing Participant. This structure helps to lower funding costs because margins calculated by the CCP are based on the net positions within an account.

4 An assessment of ASX's approach in a default is more widely covered in "Clearing Participant Default: An Overview" http://www.asx.com.au/clearing/default-management.htm

5 Cash equity markets in Canada and Hong Kong also use the single house/client account model for clearing and settlement.

clearing activities, have tended to extend existing house and client omnibus account structures for central clearing of the cash equity market.[6]

Cash Market Overview



Account Structure:
Single house account for all (house and client) novated transactions.
Margining:
Net/Net i.e. net of house and all client transactions. Not able to be passed on to clients.
Margin Lodgement:
Cash received from Clearing Participants and held on CCP balance sheet and pledged collateral (beneficially owned) from Clearing Participants.

Why is the market structured this way?
- To maximise settlement efficiency.
- Reflects the evolution of the CHESS settlement mechanism.
- Large number of retail customers.
- No expectation of portability for unsettled client transactions.

Key advantages
- Both Clearing Participants and clients benefit from maximum netting efficiency for margin and settlement purposes.
- No need for transaction allocation by Clearing Participants at the CCP.
- Minimises the number of settlement transactions and settlement costs.

Key disadvantages
- Shortfalls on the house account could potentially be covered by client assets.
- Unable to pass through client collateral to the CCP.
- Unsettled novated obligations are extremely unlikely to be ported in the event of a Clearing Participant default. The net outstanding unsettled novated T+3 transactions would be closed out by the CCP on market.
- No CCP transparency of client transactions.

Proposal for Comment

Stakeholders are asked to consider and provide feedback on the existing structure and two further options which ASX views as potential solutions to ensure ASX Clear meets the new regulatory requirements. These potential solutions could either replace or be provided as additional choices to the existing structure for Clearing Participants and their clients.

1) Single house account (maintain the status quo)

Under this option, ASX Clear would continue to support a single house account containing all unsettled, novated house and client equity market transactions. The only non-cash collateral a Clearing Participant could provide against this account would be stock that is beneficially owned by the Clearing Participant. As a result, ASX Clear would continue without any direct oversight of client transactions.

[6] The single account and client omnibus account structures discussed in this paper limit a CCP's ability to trace the end client. The Individually Segregated Client Account significantly enhances a CCP's ability to trace client funds due to the individual segregation of client positions. (Please note ASX Clearing Corporation pools all cash collateral for investment purposes).

There are some specific client protection disadvantages associated with the existing single house account. Under the present arrangements, in the event of the default of their Clearing Participant and close out of positions in the account, any assets in the account relating to client positions can be used to cover any shortfalls in the account relating to house positions. Another disadvantage is that the lack of segregation between house and client positions makes margin pass-through to clients unworkable.

ASX is conscious of the feedback received on proposed CHESS amendments (released in 2008) where there was strong opposition to any measures that increased operational costs due to the 'un-netting' of settlements and created significant conversion costs. Below is a summary of the feedback received to the proposal for consultation in 2008.

> *The proposed separation of house and client cash market obligations via the introduction of a client omnibus account received limited support. While one respondent saw the separation of house/client business as a fundamental protection that should be extended across all markets, a number of respondents argued that there were valid reasons for different account structures in the cash market. In comparison to the options or futures market, the differing risk and margin requirements, different settlement periods, anonymous trading preferences and client documentation required in the cash market were listed as major factors that make maintaining the current account structure appropriate in the view of those respondents.*
>
> *Other comments suggested that the operational complexity of Clearing Participants maintaining and funding two separate entrepot accounts would reduce efficiency by requiring gross coverage of two separate obligations, with no perceived reduction in counterparty risk. A further technical issue was raised around the CHESS settlement process and potential loss of efficiency. No respondent addressed the potential default management advantages of the proposed cash market account structure.*

The requirements contained under FSS Sub-standard 13.2 would strongly suggest that the existing single house account structure as a stand-alone solution will not be an acceptable option for the cash equity market. ASX is keen to receive updated (from 2008) stakeholder feedback in relation to any major concerns that may arise from either replacing or extending the range of available account structures with client omnibus and/or individually segregated client account structures. Such factors might include the cost of implementation and ongoing operational and settlement cost implications relative to any improvements in client protection. Another factor is that it may preclude trading orders that combine house and client business. Comprehensive feedback will enable ASX to share with regulators a fully informed view of the implications of moving away from the existing account structure.

2) Introduce a client omnibus[7] account

This alternative would require all Clearing Participants to designate each trade as either a client transaction or a house transaction. There are three possible options for achieving this outcome:

a) At the time of entering the order at a trading facility (e.g. ASX Trade or Chi-X) each Trading Participant would designate their order as either a client or house order. CHESS would then facilitate netting at both a house and client level. This would then require Clearing Participants to maintain separate Accumulation and Settlement entrepot accounts in order to ensure that there is no comingling of house and clients assets.

[7] References to omnibus account in this paper include an Accumulation account and Settlement entrepot account at either a house or client level.

b) All executions not designated as client or house at the time of order entry will be classified as house intraday. Clearing Participants would then have up until the netting process commences on T+1 to change the designation to client if required. CHESS would then facilitate netting at both a house and client level. Clearing Participants would be required to maintain separate Accumulation and Settlement entrepot accounts in order to ensure that there is no comingling of house and clients assets. Note – that in the event of a Clearing Participant intraday default, any position not designated as client would be deemed to be house positions.

c) Each Clearing Participant could operate two Clearing Participant IDs (PIDs) resulting in all client transactions being settled through one Clearing PID and all house positions being settled through the other Clearing PID. CHESS currently supports this model as Accumulation and Settlement entrepot accounts are allocated at the PID level.

A client omnibus account structure would provide a number of benefits to clients. This structure separates house and client transactions (and margins) so that, in the event of a default, shortfalls arising from the Clearing Participant's default on the house positions with the CCP could not be offset against balances held on the client omnibus account. ASX considers that the likelihood of portability[8] under these account structures would be very low because of the short cash equity market settlement cycle.[9]

Compared to the single house account option, a client omnibus account would also have a number of disadvantages. The separation of house and client accounts is likely to raise the margin[10] requirement for Clearing Participants and would require a change to the way CHESS performs its netting. This separation will result in a loss of any position netting efficiencies for Clearing Participants with house positions as these positions would no longer be able to be netted against the client account and may lead to higher overall margin requirements.

The number of settlements is likely to increase as client positions would not be comingled with house positions for settlement purposes. It would be necessary to have one net settlement for client business and another net settlement for house business (where applicable).This is likely to result in an increase in the number of transactions requiring settlement and increased settlement related costs.

Under the client omnibus account structure, clients would be exposed to the default of their Clearing Participant's other clients in the event that the defaulting client and available Clearing Participant collateral is insufficient to cover the client loss. Any transition to a client omnibus account structure is expected to have a relatively minor impact on Clearing Participants who have limited or no house activity.

3) Introduce an Individually Segregated Client Account

Another alternative would require all Clearing Participants to allocate the trades of each client to an individual client account while house positions would be allocated to a single house account.

This structure has the benefit of separating house and client transactions (and margins) so that, in the event of a default, shortfalls arising from the Clearing Participant's default on the house positions with the CCP could not be offset against balances held in individual client accounts. The

[8] Under the FSS portability refers to "The operational aspects of the transfer of contractual positions, funds or securities from one party to another party.

[9] An overview of the existing ASX Clearing Participant Default arrangements can be found at the following link http://www.asx.com.au/documents/clearing/clearing-participant-default-an-overview.pdf

[10] Please note that the client omnibus account would be margined on a net basis.

individual segregation of each client's position would also protect against the default of fellow clients.

While this structure would provide some enhanced client protections (such as removing fellow client risk), there remains a significant likelihood that the porting of client positions and collateral will be impractical in the event of a Clearing Participant default because of the short cash equity market settlement cycle.

The Individually Segregated Client Account (ISCA) would significantly increase the total level of margins which would need to be posted to ASX Clear by Clearing Participants compared with the single house account and client omnibus options. This is because netting of positions and margin would only take place at the individual client account level.

Assuming that either a client omnibus or an ISCA were implemented, the legal and rulebook changes required to permit the passing on of cash market margins to clients and the use of client funds and collateral to offset these margin obligations would include at a minimum:

a) ASX Clear Operating Rules: remove the rule that precludes Clearing Participants passing on cash market margin requirements to clients; and

b) Corporations Act/Regulations: amend legislation to enable client money held by the Australian Financial Service (AFS) licensee (i.e. the Clearing Participant) to be used to meet cash market margin requirements of a licensed Clearing and Settlement facility.[11]

Clearing Participants would also need the ability and system capacity to pass on margins to clients in an equitable, appropriate and proportionate way to underlying clients. It is likely this could be more easily achieved with an ISCA than with a client omnibus account structure. Other changes may also be required although ASX has not undertaken a full scoping exercise at this stage.

The feedback ASX has received to date suggests an ISCA model would be operationally burdensome for both the Clearing Participant and their clients. We would welcome any comments on whether this structure could be appropriate including whether ASX Clear should offer a choice to participants and their clients to use either a client omnibus account or an individual account.

ASX is anticipating that the increase in settlement transactions and settlement fee implications under the ISCA would be consistent with the increase anticipated under the client omnibus option. This is because ASX is proposing that one net settlement would be required for client business and another net settlement for house business (where applicable). Another possibility could be that a Holder Identification ID (HIN) could be used to allow settlement to occur on a per client account basis. This would be more operationally complex for ASX Clear and Clearing Participants.

[11] The Corporations Act currently expressly permits client money to be withdrawn to only meet derivatives margin requirements.

Summary of ASX cash equity market account segregation options

	Single house account	Client Omnibus	ISCA
Exposure to fellow client risk	Yes	Yes	No
Exposure to Clearing Participant default	Yes	Client positions and collateral are separate from house business but clients are still exposed to other clients and CP operational risk	All client positions are segregated from house and other clients but clients are still exposed to CP operational risk
Degree of netting efficiency	High	Medium – client positions can be netted against offsetting positions of other clients	Low – only offsetting positions in the same client account can be netted against each other
Likelihood of Portability	Extremely Low	Very Low	Low
Potential Cash Market margin payable to ASXCL	Moderate	Medium	High
Likelihood of margin pass-through from clients to ASX Clear assuming the implementation of the necessary Corporations Act and rulebook changes	Not possible	Not likely	High

Questions:

Q1: Which method do you prefer and why?

Q2: Should any other alternatives be considered?

Q3: Are there any other factors that should be taken into account?

Q4: Are there any other impacts or benefits of either model on Clearing Participants or their clients that should be taken into consideration?

Q5: What, if any, would be the implementation impact on Clearing Participants?

Q6: Should Clearing Participants be able to offer any of the options outlined to their clients?

Q7: Do you believe a gross margin client omnibus account structure should be considered in order to facilitate margin pass-through?

Q8 Under the ISCA proposal, do you believe that final settlement should occur on a per client account basis or as one single settlement across all clients?

ASX strongly encourages Clearing Participants to complete the confidential Request for Clearing Participant Information in Attachment A. This information will allow ASX to assess the expected costs and benefits associated with moving to either of the two suggested cash equity market options. Any data received will be treated as confidential and used on an anonymous basis for the purpose of aggregation across the market.

C. Rescheduled Settlements

Current Practice

One of the objectives of ASX CCPs is to manage their liquidity exposures conservatively and be able to settle CCP obligations prior to on-market close-out on a timely basis in the event of a Clearing Participant default. ASX CCPs currently calculate their liquidity requirements based upon an assessment of maximum requirements in normal market conditions and additional liquidity needed in the event of default in extreme but plausible circumstances. To meet this requirement, both CCPs ensure sufficient funds are held in liquid form to inject within a two hour period, if required.

Under some very extreme cash market Clearing Participant default scenarios, ASX Clear relies upon the powers of the ASX Settlement Operating Rules to reschedule some or all of the unsettled novated equity payment obligations in the CHESS batch to a subsequent day. This enables ASX Clear to better manage its liquidity needs by netting against future cash inflows. To achieve this ASX Clear relies on a 'backout algorithm' applied by ASX Settlement that seeks, through an impartial iterative process, to select sufficient transactions to reschedule to ensure that a defaulting Clearing Participant's net payment amount is reduced to zero (or a small receive). This ensures orderly settlement and so minimises systemic risk in such circumstances but results in some Settlement Participants not receiving cash on time for stock which has been presented for settlement on the scheduled settlement date. For more information on the existing settlement arrangements in the event of an ASX Clear Participant default please see the 'Example of the offsetting transaction' section below.

The main benefit of ASX Clear's ability to reschedule payment obligations in the event of a Clearing Participant default is that in extreme default scenarios ASX Clear is able to manage more efficiently its liquidity requirement during the settlement cycle. ASX Clear currently operates with a $300 million default liquidity requirement. Without the ability to reschedule payment obligations for extreme default scenarios, the current required default liquidity would be closer to $1.5 billion. During 2008, at the height of the global financial crisis, the default liquidity requirement without rescheduling would have been over $3 billion.

New Standards

ASX Clear will need to meet the requirements of the Liquidity Sub-standard 7.3 which states that:

> *"A central counterparty should maintain sufficient liquid resources in all relevant currencies to settle securities-related payments, make required variation margin payments and meet other payment obligations on time with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would generate the largest aggregate payment obligation to the central counterparty in extreme but plausible market conditions…."*

The Liquidity Sub-standard 7.9 also states that:

> *"A central counterparty should establish explicit rules and procedures that enable the central counterparty to effect same-day and, where appropriate, intraday and multi-day settlement of payment obligations on time following any individual or combined default among its participants. These rules and procedures should address unforeseen and potentially uncovered shortfalls and aim to avoid unwinding, revoking or delaying the same day settlement of payment obligations. These rules and procedures should also indicate the central counterparty's process to replenish*

any liquidity resources it may employ during a stress event, so that it can continue to operate in a safe and sound manner."

ASX Clear has the ability to reschedule payment obligations and assumes usage of this power in the most extreme default liquidity scenarios. The new liquidity standard will mean ASX Clear can no longer retain rules that enable rescheduling of payment obligations. Rules that ensure settlement on the intended settlement day are therefore required.

The current use of rescheduling has been an effective tool to cover liquidity shortfalls during the equity settlement cycle in the unlikely event of a Clearing Participant default. The new standards also anticipate that liquidity arrangements to cover unforeseen and potentially uncovered liquidity shortfalls could exist between the central counterparty and its participants (see Liquidity Standard 7.9 Guidance below):

"….If a central counterparty allocates potentially uncovered liquidity shortfalls to its participants, the central counterparty should have clear and transparent rules and procedures for the allocation of shortfalls. These procedures could involve a funding arrangement between the central counterparty and its participants, the mutualisation of shortfalls among participants according to a clear and transparent formula, or the use of liquidity rationing (for example, reductions in payouts to participants)….."

The proposal for comment below has been designed to enable ASX Clear to meet both Sub-standards 7.3 and 7.9. It is ASX Clear's intention that ASX Settlement will continue to be able to reschedule settlements which are caused by stock shortfalls.

Proposal for Comment

ASX seeks comments on the proposed approach outlined below. This will assist ASX with the scoping exercise for identifying potential rule changes and will allow ASX Clear to comply with Sub-standards 7.3 and 7.9.

Given the new regulatory requirements, ASX is proposing to amend the existing rescheduling arrangements that would be used in certain circumstances. Specifically, ASX is proposing to amend the ASX Settlement Operating Rules to give effect to a set of transactions that enable the CCP to settle its payment obligations on the intended settlement date in the event of a Clearing Participant default. This will occur through an arrangement with non-defaulting Clearing Participants to whom ASX Clear has payment obligations which offsets the underlying settlement obligations for the transaction with a separate "offsetting transaction arrangement[12]" - also referred to as a stock repurchase arrangement.[13]

It is not intended that the offsetting transaction arrangements would apply to stock delivery obligations that ASX Clear has to non-defaulting Clearing Participants. These obligations are still intended to be rescheduled to the next settlement business day in accordance with current practice, if required.

Where ASX Clear has an obligation to make a payment to a non-defaulting Clearing Participant for the purchase of stock from that Clearing Participant, ASX Clear intends to fund that payment obligation through an offsetting transaction arrangement. Namely, under the first leg of the offsetting transaction arrangement ASX Clear would, in effect, redeliver the stock to the non-defaulting Clearing Participant in return for payment equal to the amount of the payment

[12] Such offsetting transaction arrangements are used in other jurisdictions.

[13] Although the example below only includes a single default scenario we intend that this solution would also apply in the unlikely event of a multiple CP default (including the default of CP affiliates).

obligation of ASX Clear to that Clearing Participant. These arrangements would see ASX Clear agreeing to repurchase the stock the next business day under the final leg of the offsetting transaction.

This offsetting transaction arrangement would thus be used to fully offset delivery and payment obligations of the non-defaulting Clearing Participant and ASX Clear (respectively) under the initial transaction. This would facilitate settlement of ASX Clear’s payment obligations on the intended settlement date under the initial transaction as required by Liquidity Sub-standard 7.9 and avoid the delay of that settlement obligation.

Both the first and final leg of the offsetting transaction are for the same units and dollar values as the delivery and payment obligations of the non-defaulting Participant and ASX Clear under the initial transaction.

As set out in the example below, subsequent offsetting transactions may also be entered into until settlement of the on-market close out of ASX Clear’s exposure under the initial transaction is achieved.

This proposal will achieve the same economic and operational outcome as existing rescheduling arrangements. Rather than being the deferral of settlement, this mechanism reflects completion of the original settlement obligation and entering into a new offsetting transaction. The proposed solution provides certainty for the original transaction and creates a structured basis for the refinanced transaction. This proposal also ensures the benefits of the current approach are retained and provides greater market transparency of the liquidity support being provided by Clearing Participants in the event of a significant default.

ASX Clear has $300 million of available funds to help manage liquidity needs in the event of a Clearing Participant default. Under the current arrangements if liquidity needs in the event of a default were likely to exceed $300 million, ASX may reschedule settlements.

Under the proposed solution, if a Clearing Participant defaults ASX Clear would use the existing $300 million of available funds prior to using the proposed refinancing arrangement to facilitate settlement of the original transactions of non-defaulting Clearing Participants. If ASX Clear were to inject only a portion of the required liquidity in the event of a Clearing Participant default (i.e. in the event that the liquidity need is greater than $300 million), the existing ASX back out algorithm would determine the transactions to be settled through the injected ASX funds and those settled using the offsetting transaction arrangement. In selecting the transactions which should be settled in the ASX Settlement batch this algorithm promotes a specific settlement scenario which seeks to maximise all settlements in the ASX Settlement batch. This proposed arrangement will have the same economic effect as the current approach which reschedules settlements. This is illustrated in the example below.

This proposed arrangement does not require changes to CHESS messages but will require ASX rulebook changes in order to come into effect.[14]

[14] ASX is not intending to make any changes to individually executed contracts.

Example of the offsetting transaction

Assumptions:

Clearing Participant A is due to deliver 100 BHP shares for settlement at T+3 and Clearing Participant B is scheduled to make a payment of $3,300 ($33 per share). Assume this is the only trade scheduled to settle in the CHESS batch. On T+3 Clearing Participant B's payment provider rejects the payment obligation and under these circumstances ASX Clear declares Clearing Participant B to be in default. For the purpose of this example it is also assumed that ASX Clear has no available liquidity facilities.

Step	Time	Current Arrangement	Proposed Arrangement
1	T+3	If ASX Clear does not inject the required liquidity this settlement will be rescheduled to the next day.	The original contract will settle along with an offsetting transaction (i.e. ASX Clear will provide 100 BHP shares and Clearing Participant A will pay ASX Clear $3,300 ($33 per share)). This trade is the first leg of the offsetting transaction. Given the offsetting nature of both trades – no movement of funds or stock would occur.
2	T+3	ASX will instruct its default close-out broker/s to sell 100 BHP shares (for the purpose of this example the price for this sale was $30 per share). This trade will settle in 3 days time. The original transaction will be rescheduled to the next day.	Note: ASX instructs its close-out broker to sell 100 BHP shares on ASX Clear's behalf (the price for this transaction is the market price at T+3 ($30 per share in this example)). This trade will settle in 3 days time.
3	T+4	The original transaction will be rescheduled to the next day.	The second leg of the offsetting transaction occurs - ASX buys 100 BHP shares at the same price as the original transaction (i.e $33 per share) with Clearing Participant A to deliver 100 BHP shares*. As there is only one trade for settlement a new offsetting transaction will be entered into with the 2nd leg to settle at T+5 for the full amount (the net impact is no movement of stock or cash at T+4 - the transactions due to settle at T+4 do so as offsetting transactions).
4	T+5	The original transaction will be rescheduled to the next day.	As there is only one trade in the batch a new offsetting transaction will be entered into to settle at T+6* for the full amount (the net impact is no movement of stock or cash at T+5 - the transactions due settle at T+5 do so as offsetting transactions).
5	T+6	At T+6 the close-out and rescheduled transactions settle. The following transactions occur: 1. a) ASX Clear receives funds from the market ($3,000) b) ASX Clear delivers 100 shares to the market 2. a) Clearing Participant A delivers 100 BHP shares to ASX Clear b) ASX pays $3,300 to Clearing Participant A Note: ASX will fund the required $300 shortfall required to complete settlement from available liquid resources.	At T+6 the close-out and offsetting transactions settle. The following transactions occur: 1. a) ASX Clear receives funds from the market ($3,000) b) ASX Clear delivers 100 shares to the market 2. a) Clearing Participant A delivers 100 BHP shares to ASX Clear b) ASX pays $3,300 to Clearing Participant A Note: ASX will fund the required $300 shortfall required to complete settlement from available liquid resources.

Note: Existing CHESS processing and messaging will continue un-changed.
* Depending on the positions in the batch (i.e. net receipts and deliveries of BHP stock) this trade could fully or partially settle on this day.

Other key considerations

The example above is a simplification of the likely settlement scenarios which would occur in the event that a Clearing Participant was unable to meet a payment obligation.

Illiquid stock

It is possible that a Clearing Participant's payment failure may relate to an illiquid stock delivery. This situation would require flexibility in the solution outlined above as ASX Clear's trade instruction to its default broker may take more than a day to fill due to the absence of a liquid market in the particular stock/s. In such situations ASX Clear will need to roll over the offsetting transactions each day until the position can be closed out in the market. As a result final settlement could occur at a point beyond the T+6 example provided.[15]

Other solutions considered by ASX

There are some other possible alternative approaches which could be used by ASX Clear to address the new requirements. These would potentially involve ASX Clear establishing either third party committed liquidity and/or stock lending facilities of $1.5 billion or more to manage the orderly default of the largest Clearing Participants and their affiliates over the settlement cycle (at significant cost to both ASX Clear and the broader market). In addition to the cost burden, ASX Clear is also concerned that the reliability of such arrangements would be questionable at times of significant financial market stress when they are most likely to be required.

Q9: Are there any comments on the proposal, especially on the operational impact?

Q10: Are there any other changes required to the Clearing Participant/client arrangements to facilitate the operation of the offsetting transaction arrangements?

Q11: Are there any suggestions for alternatives that achieve the same regulatory requirement, particularly drawing on overseas experience?

[15] It is important to note that general liquidity in the cash equity market may also decrease in response to a Clearing Participant default.

Attachment A – Request for Clearing Participant Information

ASX would appreciate if Clearing Participants submit the requested information below as an excel worksheet. Submissions can either be attached to responses to the Consultation Paper or alternatively can be sent as a stand-alone document to joshua.everson@asx.com.au.

	Cash equity market client clearing option					
	Client omnibus account			Individually segregated client account		
	House	Client	Total	House	Client	Total
Forecast change (+ or (-) %) in the annual dollar value of cash equity market positions traded on ASX Trade						
Forecast change (+ or (-) %) in the annual dollar value of cash equity market positions cleared on ASX Clear						

Current house positions as a proportion of total clear positions on ASX Clear (%)	
How long will it take you to make the necessary changes to provide client omnibus account or ISCAs?	

	Client omnibus account	Individually segregated client account
Estimated internal development cost required to offer new cash equity market account structure ($)		
Estimated increase in annual operating costs to provide new cash equity market account structure ($)		