Changes to Clearing Participant Minimum Core Capital Requirements Approach

RESPONSE TO CONSULTATION JANUARY 2017

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1. Introduction

ASX Clear (the CCP) sets minimum core capital requirements (MCCR) for its Clearing Participants (CP) which ensure that only CPs of robust financial standing use its service. The MCCR together with its other risk controls enable the CCP to promote systemic stability in ASX's markets.

A CP needs to have sufficient financial capacity to absorb financial and operational losses that may be suffered by the CP. MCCRs currently set by ASX for its CPs take into consideration the increased possibility for financial or operational losses arising having regard to the number of market participants that are cleared for by the CP. The current methodology therefore reflects, to a limited degree, the risk profile of each CP as it only varies according to the number of market participants clearing through the CP.

ASX has proposed a new methodology that reflects that the greater complexity inherent within a CP's business increases the probability of unexpected financial or operational shocks that could result in CP losses, which necessitates higher minimum core capital levels to be able to absorb them. This greater complexity includes the level of own account business activity, the extent of non-ASX business, and the degree of short option activity undertaken by clients of the CP. ASX intends to make changes to Schedule 1 of the ASX Clear Operating Rules ('Schedule 1') to reflect this change in MCCR approach.

Following a comprehensive consultation process which commenced in June 2016 with the release of the paper 'Changes to Clearing Participant Minimum Core Capital Requirements Approach' (which set out the proposed changes to ASX's MCCR approach – http://www.asx.com.au/documents/public-consultations/Changes-to-Clearing-Participant-Minimum-Core-Capital-Requirements-Approach.pdf) this paper now sets out:

- The new MCCR approach proposed to be incorporated in Schedule 1.
- Explanatory material which provides definitions of the three categories of activities together with examples of each, to support the new MCCR approach and to assist CP's with categorising their activities under the approach.
- The Business Activities Return, which requires business activity information from CPs to assist ASX with assessing CPs' own account and non-ASX activities for the purposes of MCCR determination.

ASX will consult on the proposed rule amendments and where appropriate, will update the market on the outcomes from the assessment of CPs' business activity information.

ASX received 15 responses from CPs and two industry associations (through written submissions, emails and feedback from consultation meetings held with CPs). The feedback has assisted with refining the final MCCR approach for the purposes of the rule amendments and defining the explanatory information required.

Following assessment of the feedback as described above and given the support from the majority of stakeholders, ASX has formed the view that client short ETO activity, CP own account business, non-ASX activity and the CP third party clearing activity, are reasonable and appropriate factors in determining a CP's MCCR.

Further, ASX does not consider it appropriate to provide MCCR exemptions for CPs clearing for related body corporates or subsidiaries of ADIs.

2. Overview

ASX will maintain the current base requirement for participation on ASX Clear (irrespective of whether a CP is a direct or general participant) of $5m. ASX will also continue to apply additional capital requirements based on the level of third party clearing activity undertaken by a general participant ($5m, $10m and $15m).

The amendments to Schedule 1 of the proposed MCCR approach are:

- Introduction of a risk reflective approach for determining MCCR, which considers three categories of CP activity: **client short ETO activity, own account business** and **non-ASX client activity**. This approach adds to the current approach which defines a set level of MCCR based on whether it is a direct or general participant.
- An additional capital requirement of **$2.5m** for CPs with client short ETO positions above a de-minimis level and where client short option activity is material, this additional requirement will be increased to **$5m**.
- An additional capital requirement of **$2.5m** for CPs undertaking any own account business in any financial products (other than de-minimis amounts) within their legal entity for which losses may be incurred by the CP. For CPs engaging in material own account business, this additional requirement will be increased to **$5m**.
- An additional requirement of **$2.5m** for CPs engaging in any activity (other than de-minimis amounts) that does not qualify as ASX-related execution, clearing or settlement activity. For CPs engaging in material non-ASX activity, this additional requirement will be increased to **$5m**.

In addition to the above amendments in Schedule 1, ASX will also provide participants with the following explanatory material (further described in section 4 of this paper):

- De-minimis and materiality levels for client short ETO activity. No de-minimis thresholds were provided in the original consultation.
- Expanded definition and extended range of activities that qualify as own account business. Limited definition and examples were provided in the consultation proposal.
- Expanded definition and extended range of activities that qualify as non-ASX activity. Limited definition and examples were provided in the consultation proposal.

Also, ASX has developed the Business Activities Return (as set out in section 5), which requires CPs to provide ASX with information relating to their business activities which will inform ASX's determination of whether a CP's own account business and non-ASX activity are de-minimis or material for the purposes of MCCR.

3. Feedback from Consultation

Categories of Clearing Participant Activities used to Determine MCCR

The consultation in 2016 proposed that Schedule 1 be amended to reflect that the MCCR for a CP of ASX Clear, will be based on three categories of CP activity (client short ETO, own account business and non-ASX activity), in addition to the degree of third party clearing undertaken by the CP.

This change was supported in-principle by the majority of stakeholders. One respondent disagreed with the approach suggesting that ASX's current risk management framework sufficiently captures and mitigates the risks associated with these activities. Another respondent indicated that the rationale for the increments in MCCR based on these additional activities was unclear. Two respondents suggested that ASX's current risk based capital requirements (Total Risk Requirement or TRR) adequately captures the risks associated with the activities described under the new approach.

Two respondents proposed exemptions for CPs clearing for related body corporates (RBC) or subsidiaries of ADIs on the basis that these CPs would be incorporated in the capital risk calculations of the related body corporate or ADI. A further CP proposed that ASX reflect the individual and relative (to those of other CPs) strengths and weaknesses of CP risk frameworks in its MCCR determination.

In assessing the feedback, ASX has formed the view that:

- The increments in MCCR based on these three categories of activities, which also take into account de-minimis and materiality thresholds, is appropriate and consistent with ASX's policy objective of maintaining appropriate MCCR standards.
- The MCCR is an important part of systemic risk management controls, and its role in the ASX risk control framework is to ensure, together with the TRR, that CPs have sufficient capital to support their business activities. As such, it is a key component of ASX's risk control framework, operating in conjunction with, and not as a substitute measure to ASX's other risk controls and TRR.
- A "carve out" for CPs who clear for RBCs or are RBC's of ADI's is not appropriate given the primary relationship is between ASX Clear and its CPs, and the MCCR is intended to give ASX the required visibility and comfort that a CP has the requisite minimum financial means to support its business activities.
- The bespoke nature of CP risk frameworks mean that it is impractical for ASX to conduct monitoring and assessment of these frameworks for the purposes of MCCR determination.

Additional Capital Requirements based on Client Short ETO Activity

The consultation in 2016 proposed that Schedule 1 be amended to introduce an additional capital requirement of **$2.5m** to the base requirement for CPs with client short ETO positions above a de-minimis level. Where client short option activity is material, this additional requirement will be increased to **$5m**.

While some respondents queried the rationale underlying the additional capital levels ($2.5m and $5m if material), the majority of responses focused on the need to specify de-minimis thresholds for this type of activity. More specifically:

- The majority of respondents suggested the lack of specific de-minimis thresholds could result in CP's with minimal client short ETO activity attracting a disproportionately high requirement.
- Most respondents commented that such thresholds should consider the size, level and risk associated with such activity.
- A number of respondents proposed that ASX take into consideration their current risk levels (capital based position limits or CBPL, total margin requirement after collateral and stress testing results) when assessing de-minimis levels of activity.

In addition to the above comments, two respondents suggested that thresholds should be kept as low and tight as possible, with one respondent opining that the $60m materiality threshold was too high. A number of stakeholders also requested ASX provide further clarity in respect of activities that qualified under this requirement.

The feedback above has been addressed as follows:

- ASX has introduced de-minimis thresholds for client short ETO activity that reflect CPs existing levels of risk with ASX Clear - as measured by their initial margin to capital ratios. ASX has also included specific examples of trading strategies that qualify as client short ETO positions (see section 4).
- ASX has reviewed the current materiality threshold level and reduced it (see section 4).

Additional Capital Requirements based on Own Account Business

The consultation in 2016 proposed that Schedule 1 be amended to introduce an additional capital requirement of $2.5m to the base requirement for CPs with own account business above a de-minimis level. Where this activity is material, this additional requirement will be increased to $5m. Own account business, which relates broadly to types of business activities, where those activities directly place the CP's own funds at risk of a loss due to credit events or market movements, is of concern to ASX as such activity could increase the risk of a default event and/or the size of losses given default of the CP.

While some respondents were broadly supportive of the additional capital requirement based on own account business, most respondents suggested there was lack of clarity in respect of the types of activities that qualify as own account business with one respondent specifically suggesting that ASX exclude underwriting activity where a third party sub-underwriter is used from the definition of own account business. Most respondents also sought further clarity on ASX's approach to the categorisation of a participant's own account business as de-minimis or material.

The feedback above has been addressed as follows:

- ASX has provided further definitions and examples of own account business in section 4 of this paper.

- ASX has developed the Business Activities Return (as set out in section 5), which requires CPs to provide ASX with information relating to their business activities which will inform ASX's determination of whether a CP's own account business is de-minimis or material for the purposes of MCCR.

ASX will however continue to include underwriting activity where a third party sub-underwriter is used under own account business given the impracticality of assessing each underwriting arrangement for the purpose of setting the MCCR.

Additional Capital Requirements based on non-ASX Activity

The consultation in 2016 proposed that Schedule 1 be amended to introduce an additional capital requirement of $2.5m to the base requirement for CPs with non-ASX activity business above a de-minimis level. Where this activity is material, this additional requirement will be increased to $5m. Non-ASX Activity relates broadly to types of business activities which are not ASX related secondary market execution, settlement and clearing activities.

ASX received arguably the highest level of interest in respect of this consultation proposal. The majority of respondents sought further clarity on ASX's approach to the categorisation of a participant's non-ASX activity as de-minimis or material. ASX had provided limited examples and had not specified the approach in respect of determining de-minimis and material activity in the consultation proposal. Several respondents sought clarity on the treatment of transactions executed through other exchanges and third party execution and clearing of international products.

ASX has responded to the feedback as follows:

- Provided further definitions and examples in section 4 of this paper.
- ASX has developed the Business Activities Return (as set out in section 5), which requires CPs to provide ASX with information relating to their business activities which will inform ASX's determination of whether a CP's non-ASX activity is de-minimis or material for the purposes of MCCR.

Also, two respondents suggested that capital requirements for activity carried out in different markets, should be adjusted to reflect the complexity, structure and rating of the particular market together with the nature of the products transacted. One respondent noted the importance of ASX monitoring and validating CP reporting of non-ASX activity. While ASX acknowledges the benefits associated with both comments, it would be impractical for ASX to undertake the detailed assessment and validation suggested under each proposal given the breadth, range and bespoke nature of non-ASX activities undertaken by participants.

4. Explanatory Material to Support Schedule 1 Amendments

Client Short ETO Activity Definitions, Examples and Thresholds

Client short ETO activity relates to all non-specific covered short positions in ASX Clear cleared options (i.e. covered calls are excluded), held by clients of the participant (which include positions from executing participants). This includes trading strategies such as:

- Shorts from selling a call covered with a different underlying stock to that of the option.
- Shorts from selling a call covered with a bought call.

Given that Initial Margin on ETOs is predominantly driven by short options, ETO Initial Margin will be used as a proxy for the level of short ETO activity for the purposes of setting thresholds.

The proposed thresholds for client short ETO activity are as follows:

- De-minimis:
  A CP with average Initial Margin (client/segregated account total) over the previous 12 months less than **$2.5m** will not attract the client short ETO capital requirement of $2.5m.
- Material:
  CP average Initial Margin (client/segregated account total) over the previous 12 months greater than **$40m** is deemed material and attracts an additional $5m to the base requirement.

Own Account Business Definitions and Examples

Own account business relates broadly to types of business activities, where those activities directly place the CP's own funds at risk of a loss due to credit events or market movements. Examples of own account business are:

- Participation/Underwriting (irrespective of whether the activity is mitigated by sub-underwriters), lead manager or deal arranger for corporate transactions.
- Market making.
- All CP house activity, irrespective of the exchange the transactions are executed on or the CCP through which the transactions are cleared.

For example, own account business would not include principal trading/investments conducted by related entities of the CP (provided they are not funded by the CP) or error trades.

Non-ASX Activity Definitions and Examples

Non-ASX activity relates broadly to types of business activities which are not ASX related secondary market execution, settlement and clearing activities and comprises:

- Client execution on other exchanges not cleared through ASX Clear or ASX Clear (Futures).

- Client clearing through a CCP other than ASX Clear or ASX Clear (Futures).
- Client non exchange traded products (other than those cleared by ASX Clear and ASX Clear (Futures)).

Examples of non-ASX activity include:

- Market execution, settlement and clearing activities in international stocks and derivatives.
- CFDs.
- Corporate finance.
- Stock and margin lending.
- Debt and foreign exchange activities.

For the purposes of the MCCR, the following are not included as non-ASX activities:

- "Administrative" type activities e.g. portfolio administration, superannuation.
- Provision of paid services where the CP is not exposed directly to financial risk e.g. research, financial planning.

5. Business Activities Return

In assessing whether a CP's own account business and non-ASX activity are de-minimis or material for the purposes of MCCR, ASX is proposing to use an approach which considers a wide range of individual CP specific factors relating to these activities (e.g. revenue and turnover, risk limit utilisation), rather than narrowly focusing on one or two factors. In order to allow ASX to carry out this assessment, the Business Activities Return (which accompanies this paper) has been developed which requires CPs to provide ASX with information relating to their own account business and non-ASX activity. ASX will take individual CPs through the application of this approach (on request and on a bi-lateral basis), in order to provide them with clarity on the MCCR categorisation, and related rationale, of their own account business and non-ASX activity.

ASX attaches the initial Business Activities Return with this paper and requests all non-bank CPs to complete this return for the December 2016 quarter. Participants have until 17 February 2017 to provide the requested information. The format of the return may be amended following assessment of the initial information received from CPs. ASX intends to send this return to CPs on a quarterly basis going forward.

ASX will notify CPs of subsequent rule changes and any additional procedures (if required) related to this assessment approach following the receipt and review of CP responses to the Business Activities Return.

6. Timeframe for Implementation of MCCR

ASX will allow for a transitional period of up to 12 months for CPs to meet any increased MCCR that will apply to the CP upon the introduction of the changes.

ASX consulted on a phased 12 month transitional period for compliance with the new requirements, and received mixed feedback with some respondents comfortable with a non-phased 12 month (or less) transitional period and other respondents proposing longer periods ranging from 18 months to 5 years, both phased and non-phased. Most respondents in the latter group were of the opinion that a shorter period would prejudice smaller CPs and that changes to the core capital are long term decisions for any business.

Following assessment of the responses, ASX has formed the view that a non-phased 12 month period for implementation is appropriate and reasonable, and does not prejudice any participant as it allows CPs sufficient time to make necessary changes to meet the new requirements.

Schedule 1 will be amended to specify that the MCCR applicable to each CP will be reviewed on at least an annual basis (or more frequently if the Business Activities Return or ETO data monitored regularly by ASX indicate significant shifts in a CP's risk profile) with CPs required to meet any increases to their MCCR within a period of up to 6 months thereafter (except for increases for General Participants arising from clearing for additional market participants which will need to be met prior to starting clearing for that additional market participant).

ASX received little feedback on the proposal for an annual MCCR review cycle and 6 month compliance period (post transition). As such, ASX will not change either proposal.

7. Meeting Shortfalls in Core Capital

ASX will no longer permit Participants who do not hold sufficient core capital to satisfy any portion of their core capital requirement by (a) providing cash to ASX Clear or (b) through a subordinated debt facility.

ASX received only one response to this proposal. The respondent was not supportive of the proposal on the basis that the ability to meet shortfalls with cash or sub-debt provide participants with flexibility in respect of meeting their MCCR obligations. ASX has formed the view that it is inappropriate to allow CPs to meet their shortfalls with cash or subordinated debt given ASX's policy objective of maintaining appropriate MCCR standards.

There are no CPs currently using either cash or subordinated debt to meet their MCCR.

8. Other Stakeholder Comments

In addition to specific feedback received in relation to the new approach, ASX also received a number of general comments from a range of stakeholders.

Appendix A provides this feedback and ASX's response to each.

APPENDIX A: Summary of General Feedback from Consultation Proposal

Feedback	ASX has formed the view
What is the rationale for the MCCR change now?	This enhancement provides further stability in respect of ASX Clear's clearing arrangements. Continuous improvement of the CCP's risk controls is in line with ASX's policy objectives and risk appetite, and consistent with ongoing regulatory expectations and is important to the long-term health of the Australian financial markets.
The proposed MCCR changes will restrict participation and concentrate participation in fewer larger institutions.	The MCCR approach is intended to reduce the probability of a CP default irrespective of the size of the CP. ASX considers client short ETO activity, own account business and non-ASX activity higher risk activities that require higher capital to support, and these higher requirements mitigate a default event. Given the relatively low volume of CPs impacted ASX does not expect there to be concentration consequences related to capital changes.
Provide further detail on how the six international CCPs stipulate their minimum core capital requirements based on the proposed categorisation of the activities identified in the consultation paper.	While ASX is cognisant of the approaches of other CCPs, ASX considers the risk reflective nature of the proposed approach a valid enhancement to ASX's current approach, and a more developed approach to that of most other international CCPs.
The proposed changes do not address the risk of failure of key service providers to the clearing process nor do the changes reflect the impact any such failure would have on participants.	Reflecting the risk of failure of key service providers is beyond the scope of the MCCR changes.
What is the rationale for imposing capital requirements based on the number of market participants the CP clears for (an additional $5m, $10m, and $15m on the base MCCR).	The additional requirements for number of participants is not a new requirement and reflects ASX's view that a CP's core capital must support the additional risk undertaken by the participant in clearing for entities that are exposed to potentially significant market risks.
This approach may lead to participants restricting activity in their ASX participant which could lead to potential issues with related parties.	The aim of this approach is to reduce the probability of a CP default, which promotes the financial health and stability of the Australian market.