ASX Clear (Futures) Pty Limited

Clearing Participant Default

AN OVERVIEW

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

1. Background

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

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

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

Australian Securities Exchange Limited operates the ASX 24 market and facilitates the execution, through Trading Participants, of trades in futures and options on interest rate, equity index, and energy and commodity products (also referred to as "derivative" products, positions or transactions).

ASXCLF provides central counterparty clearing services for the ASX 24 market as well as for eligible OTC interest rate derivatives registered with ASXCLF. Clearing Participants are brokers authorised to clear trades through ASXCLF. Clearing Participants' margin obligations to ASXCLF on their derivative positions are settled through ASX's Austraclear system.

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

This document deals with ASXCLF, its Clearing Participants and their clients. The following sections outline the role of ASXCLF in reducing counterparty risk in the market, the way it manages that risk, particularly in the event of the default of a Clearing Participant, including the regulatory and legal framework and the implications for Clearing Participants and their clients.

2. Regulatory and legal context

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

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

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

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

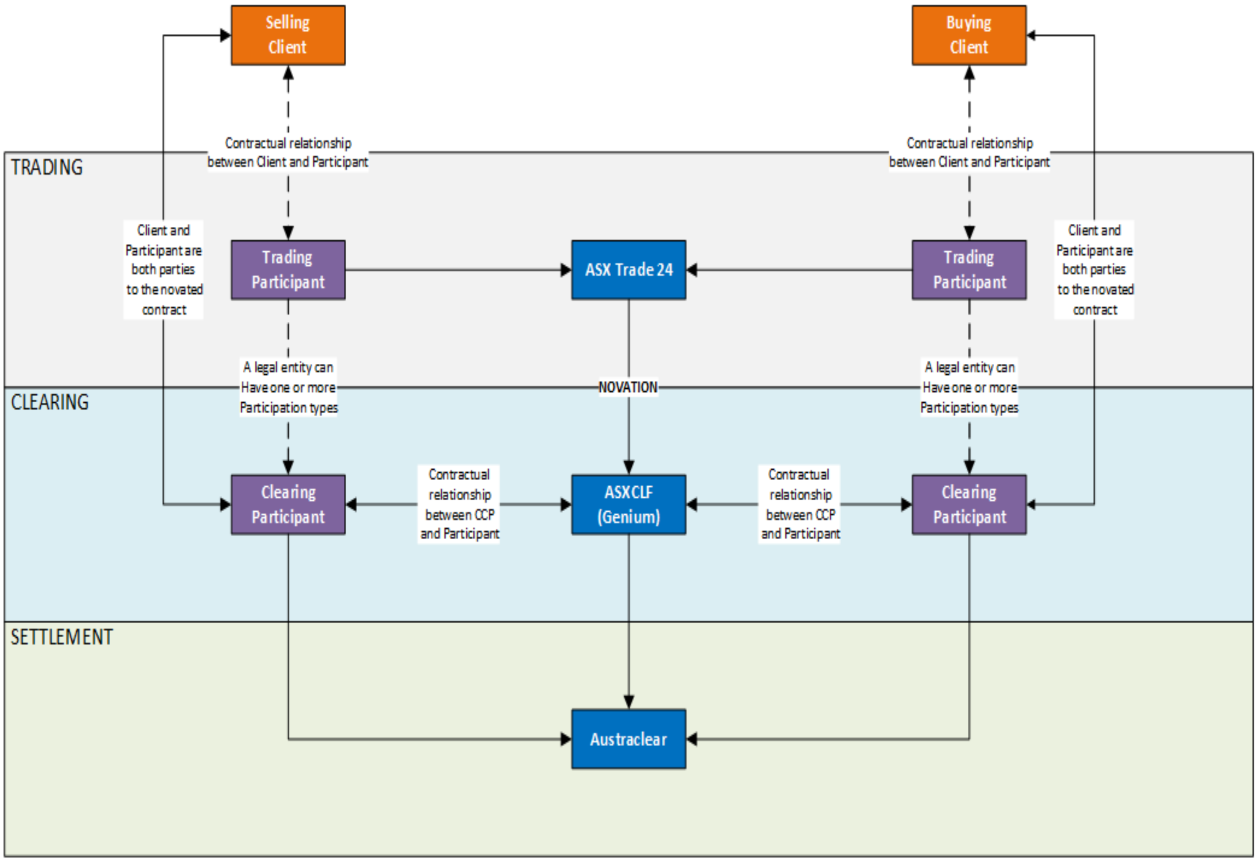
3. Contractual Relationships: ASXCLF, Clearing Participants and Clients

Through a contractual process known as novation, ASXCLF becomes contractually obligated, as the central counterparty, for completing all market and registered OTC transactions. Novation is deemed generally to occur at the point of trade or registration although it can be later for certain derivatives transactions.

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

Figure 1 illustrates this relationship for trades executed on the ASX 24 market. As noted above the Trading and Clearing Participant may be the same legal entity.

Figure 1: Trading and Clearing Contractual Arrangements Arising from Novation



Novation performs two important functions:

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

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

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

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

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

- between the client and their Clearing Participant – this is governed by the agreement(s) between the client and their Clearing Participant, and applicable law (such as client money handling rules under the Corporations Act); and

- between the Clearing Participant and ASXCLF – this is governed by the Operating Rules of ASXCLF, with different arrangements applying to different 'client account' options (refer to the explanation of the different clearing account types later in this document).

However, for Futures and OTC positions recorded in a client account, the client is, together with its Clearing Participant, also in a relationship with ASXCLF, governed by the Operating Rules of ASXCLF. This allows the client to require (for an individual account) or to request (for an omnibus account) ASXCLF to transfer positions in, and the collateral value for, that account from a defaulting Clearing Participant to a non-defaulting Clearing Participant.

ASXCLF Clearing Participants clear hundreds of thousands of trades a day in around one hundred and fifty products. The ability of ASXCLF to net all novated transactions contributes significantly to the capital and operating efficiency of the Australian futures market. As noted above, in acting as central counterparty, ASXCLF becomes the "buyer to every sell and seller to every buy". As such, at all times it has a "matched book" – a net zero position in every product and therefore zero market risk. The wholesale transfer of counterparty risk from multiple participants to a single well-regulated and well-capitalised Clearing House also helps to reduce systemic risk.

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

4. Central Counterparty Clearing Risk Management

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

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

- minimum capital requirements for Clearing Participants, which are monitored through the lodgement to ASXCLF of monthly financial returns;

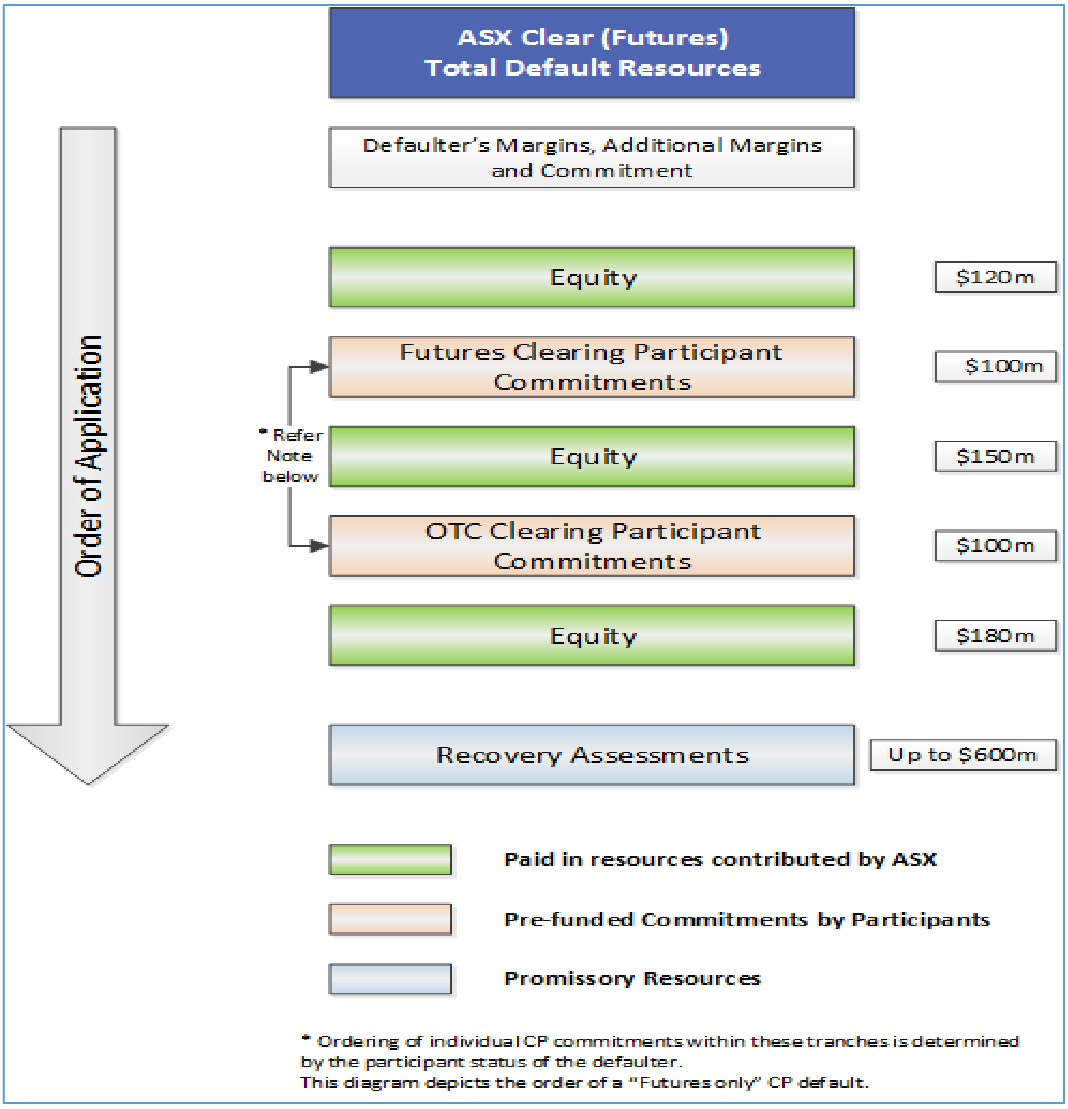
- end of day and routine intraday margining of Clearing Participants' positions; and

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

The level and order of application of ASXCLF's resources is shown in **Figure 2**. The first level is the defaulting Clearing Participant's margins and additional margins lodged with ASXCLF. These can be cash or eligible non cash securities. If these are insufficient to cover the losses and associated costs incurred by ASXCLF in managing the default and closing out the defaulter's open positions, it will draw on the $650 million of paid-in resources available to it.

Use of these funds is layered with $120 million of ASXCLF's capital used first, then, if needed, up to $100 million of Clearing Participant commitments, then a further $150 million of ASXCLF capital, the remaining $100 million of Clearing Participant commitments and finally the remaining $180 million of ASXCLF's capital. If these funds are insufficient, ASXCLF has powers under its Recovery rules to call Recovery Assessments from non-defaulting Clearing Participants up to a value of $600 million less the defaulting Clearing Participant's share.

Figure 2: The Level and Order of Application of ASXCLF Resources



Moreover, ASXCLF has additional powers available under the Recovery Rules to help manage a Clearing Participant default that exhausts the default resources outlined above. Under the Recovery Rules, ASXCLF has the power to reduce outgoing variation margin and daily settlement payments to all non-defaulting Clearing Participants ('payments reduction') and, as a last resort, terminate all open positions (not just the open positions of the defaulting Clearing Participant) and reduce settlement payments to Clearing Participants to the extent that they exceed ASXCLF's remaining default resources ('complete termination').

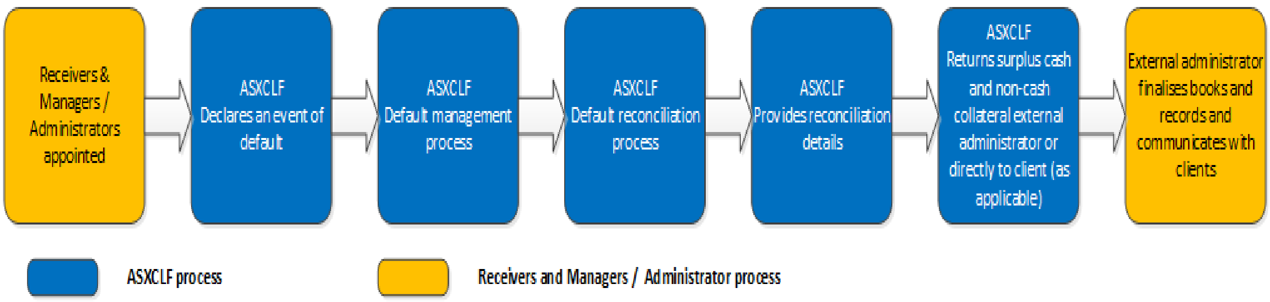
5. Default Events

ASXCLF's Operating Rules set out a number of events or circumstances which it may treat as an event of default by a Clearing Participant. These include[1]:

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

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

The diagram below illustrates the general phases which apply in managing the default of a Clearing Participant following, for example, the appointment of an external administrator or Receivers and Managers to a Clearing Participant highlighting in particular the implications for client positions. Similar phases also apply for an event of default which does not involve the appointment of an external administrator.



6. Default Powers

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

[1] ASX Clear (Futures) Operating Rule 71.3

- suspending the participation of the defaulting Clearing Participant;
- closing out the defaulting Clearing Participant's open positions through matching with other equal and opposite positions registered in an account of the Clearing Participant, executing market transactions that offset its net open exchange traded derivatives positions or through auctions with non-defaulting Clearing Participants for OTC positions; and
- where the defaulting Clearing Participant's client positions are individually accounted for at ASXCLF, transferring the defaulting Clearing Participant's open client positions, either with or without any associated collateral, to another (non-defaulting) Clearing Participant where the client has an existing contractual relationship.

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

7. Implications of the different account types

The different account types available for financial products cleared through ASXCLF are:

Product	Account type
Futures and OTC Interest Rate Derivatives	House account
	Omnibus client account
	Individual client accounts

The use of one type of account type over another involves assessment of both regulatory and commercial considerations.

In general, the lower the level of segregation of client positions and collateral provided by an account type:

- the greater the netting and operational efficiency provided by the account type; however
- the less likely it is that in the event of the default of a Clearing Participant that ASXCLF can facilitate the transfer of positions registered in the client account and associated collateral to an alternate non-defaulting Clearing Participant.

a. The collateral value of each client account

ASXCLF calculates a collateral value for each client account of a Clearing Participant. This is the amount which ASXCLF will transfer or return in respect of the client account in the event of the Clearing Participant's default.

The collateral value for an omnibus client account is the value of initial margin calculated by ASXCLF in respect of the omnibus client account as at the last end-of-day time at which the Clearing Participant settled its initial margin obligations prior to its default.

A client who elects to use an individual client account may request that the collateral which they provide to their Clearing Participant for their derivative contracts is passed through to ASXCLF and attributed to their account. This requires:

- the agreement of the Clearing Participant; and
- notice by the Clearing Participant to ASXCLF in respect of the collateral to be attributed to the client's account.

The collateral value for an individual client account is the greater of:

- the value determined by ASXCLF of all collateral (if any) attributed by ASXCLF to the client's account as at the time at which the client's Clearing Participant defaults; and
- the value of initial margin calculated by ASXCLF in respect of the client's account as at the last end-of-day time at which the client's Clearing Participant settled its initial margin obligations prior to its default.

b. Transferring client positions to an alternate Clearing Participant

Individual Client Accounts

Where Clearing Participants have established individual client accounts with ASXCLF, the netting efficiency is less than that of the omnibus model, however, ASXCLF is able to facilitate the transfer of positions registered in those accounts and associated collateral value to an alternate Clearing Participant if:

- the affected clients have alternative clearing arrangements; and
- timely consent is received from the alternate Clearing Participants to accept the client positions to be transferred; and,
- written consent for the transfer has been obtained from the affected clients.

Clients using an individual account have a limited period of time to have their transfer arrangements confirmed by their alternate Clearing Participant:

- up to twenty four hours for ASX 24 exchange traded derivatives[2]; and
- up to forty eight hours for OTC interest rate derivatives,

commencing from the time of ASXCLF's declaration of default

[2] The transfer period applicable to ASX 24 exchange traded derivatives that are accepted for portfolio margining with OTC interest rate derivatives is up to 48 hours.

If acceptance by the alternate Clearing Participant cannot be confirmed within the applicable time period, ASXCLF will terminate the client's positions as described below.

Omnibus Client Accounts

Client futures or OTC positions registered to the omnibus account provides strong netting efficiency and lower costs by netting all client transactions into a single open client position per financial product class. However, it is unlikely that a subset of those positions are able to be transferred in the event of a Clearing Participant default.

The transfer of individual client positions is made difficult as ASXCLF does not hold records of individual clients' transactions or the gross amount of margin that would be required for the transactions of individual clients (rather, ASXCLF holds net margin calculated on the aggregate of all client positions)[3]. Additionally, it is unlikely that an alternate Clearing Participant with whom all clients are satisfied, and who is willing to accept all clients in the omnibus account, can be found without delay. Accordingly, clients in an omnibus account should expect to have their positions terminated, as described below.

c. Termination of positions

Termination of futures positions that have not been transferred to non-defaulting Clearing Participants will occur in two steps. Firstly, long and short positions in the same contract are matched out across all client and house accounts. Any remaining net position in that contract will then be closed out on market. For example, if after positions in a particular futures contract have been matched-out there remains a net long position, the same number of contracts will be sold on market to close out that position.

The price at which identical futures positions of different clients are terminated by ASXCLF will be the same, irrespective of whether they are matched out with positions in the same account or other accounts or closed out on market. ASXCLF will advise the external administrator of the defaulting Clearing Participant of the termination prices applied by ASXCLF. However, the closure of client positions in the books and records of the Clearing Participant is a matter that will be determined by the external administrator and can be affected by the contractual arrangements between the Clearing Participant and its clients.

OTC positions (and any portfolio-margined ASX 24 exchange traded derivatives) that have not been transferred to non-defaulting Clearing Participants at the request of clients will be taken on by non-defaulting Clearing Participants under a competitive bid process prescribed by the Operating Rules (an "auction").

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

The Clearing Participant maintains on its books and records details of the client's individual transactions. ASXCLF does not manage the transactions between the Clearing Participant and its clients, the terms of which

[3] In the case of an omnibus client account, ASXCLF would not allow selective transfers of some client positions if that would lead to the de-netting of the client account positions such that it resulted in an exposure beyond net margin held.

are governed by the client agreement. Accordingly ASX cannot advise clients on the impact on their individual client positions of ASX's default actions.

The reconciliation information provided by ASXCLF to the defaulting Clearing Participant or their administrators about the close out of positions registered in client accounts will assist them in finalising the books and records of the defaulting Clearing Participant, including client account records. It is then a matter for the administrators to determine the manner in which client transactions in the books of the Clearing Participant are closed.

d. Shortfalls on close out

Broadly speaking, ASXCLF is able to apply the collateral[4] a defaulting Clearing Participant has lodged in its house account and client account(s), to cover shortfalls incurred by ASXCLF in closing out the defaulting Clearing Participant's open positions, and in the case of house account collateral to meet any further costs incurred in the default.

More specifically, ASXCLF reserves the right to apply:

- the cash and non-cash collateral in a defaulting Clearing Participant's house account towards any shortfalls incurred by ASXCLF on closing out the open positions on that Clearing Participant's house account, omnibus client account or individual client account, as well as any further costs incurred in the default;
- the collateral value for a defaulting Clearing Participant's omnibus client account towards any shortfalls incurred by ASXCLF on closing out the open positions on that Clearing Participant's omnibus client account, including positions of other clients in that omnibus client account; and
- the collateral value for a defaulting Clearing Participant's individual client account towards shortfalls incurred in connection with closing out the open derivatives positions in that client account; and
- the cash and non-cash collateral in excess of the aggregate collateral value of a defaulting Clearing Participant's client accounts (omnibus and individual client accounts) towards meeting any shortfalls incurred on closing out open positions on all that Clearing Participant's client accounts.

Any surplus cash or non-cash collateral remaining after positions have been closed out will be returned to the external administrator of the defaulting Clearing Participant (who will be responsible for determining and processing what funds need to be returned to clients) or to its clients directly asset out in the table below.

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

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[4] Money or other property lodged by a Clearing Participant with ASXCLF is held as collateral to secure the Clearing Participant's obligations to ASXCLF with regard to positions registered in the Clearing Participant's house, omnibus client or individual client accounts. Money lodged as collateral is referred to as "cash collateral". Acceptable non-cash property lodged with ASXCLF is referred to as "non-cash collateral".

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

e. Default reconciliation process

Following completion of the close out of all net open derivatives positions[5] registered in the accounts of the defaulting Clearing Participant, information will be provided to the external administrators by ASXCLF as to the default management process and account reconciliations, generally:

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

f. Return of surplus collateral

Surplus amounts of collateral held in respect of client accounts and house accounts will be returned to the external administrator or clients (as set out below) following the determination and deduction of costs incurred by ASXCLF on the default.

Product	Account	Surplus Collateral
Futures and OTC	House account	Surplus cash and non-cash collateral returned to external administrator.
	Omnibus client account	Collateral value[6] returned in cash (less applicable costs and losses) to external administrator to deal with in accordance with all applicable laws (including the Corporations Act) on behalf of clients entitled to the moneys.
	Individual client accounts	Collateral value returned in the form of actual or equivalent collateral attributed to the account (if any) or cash (less applicable costs and losses) directly to the client.

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

[5] Excluding open derivatives positions transferred to another Clearing Participant or which proceeded to expiry.
[6] ASXCLF will calculate 'collateral value' for a client account as outlined in Section 7(a) of this Overview.