CLEARING PARTICIPANT DEFAULT

AN OVERVIEW

Please note that this summary information is provided for guidance only and should be read in conjunction with the ASX Clear Operating Rules and ASX Clear (Futures) Operating Rules. It does not replace or vary those Operating Rules.

Background

The ASX group operates two Clearing Houses which provide central counterparty (CCP) clearing services in respect of Australia's main exchange traded markets:

- ASX Clear Pty Limited (ASXCL) provides CCP clearing services for the ASX market. This market is operated by ASX Limited and facilitates the trading of financial products including shares, debentures, bonds, ETFs and warrants (referred to as "cash market" products or transactions) and equity-related futures and options (referred to as "derivative market" products or transactions). ASXCL also provides CCP clearing services for the Chi-X market, on which ASX listed financial products are traded.

- ASX Clear (Futures) Pty Limited (ASXCLF) provides CCP clearing services for the ASX 24 market. This market is operated by Australian Securities Exchange Limited and facilitates the trading of futures and options on interest rate, equity index, energy and commodity products (also referred to as "derivative market" products or transactions).

Through a contractual process known as novation, the Clearing House becomes contractually accountable, as the "central counterparty", for completing all transactions on the relevant market[1]. Novation is deemed generally to occur at the point of trade, although it can be later for certain derivatives transactions. 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 the Clearing House and the clearing participant representing the buyer, and the other between the Clearing House and the clearing participant representing the seller (see Figure 1)

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 enables the netting of settlement obligations.

Through novation, the Clearing House provides protection to non-defaulting clearing participants (and, indirectly, their clients) from the inability of a defaulting clearing participant to meet its obligations.

The Clearing House 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 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 and funds are managed:

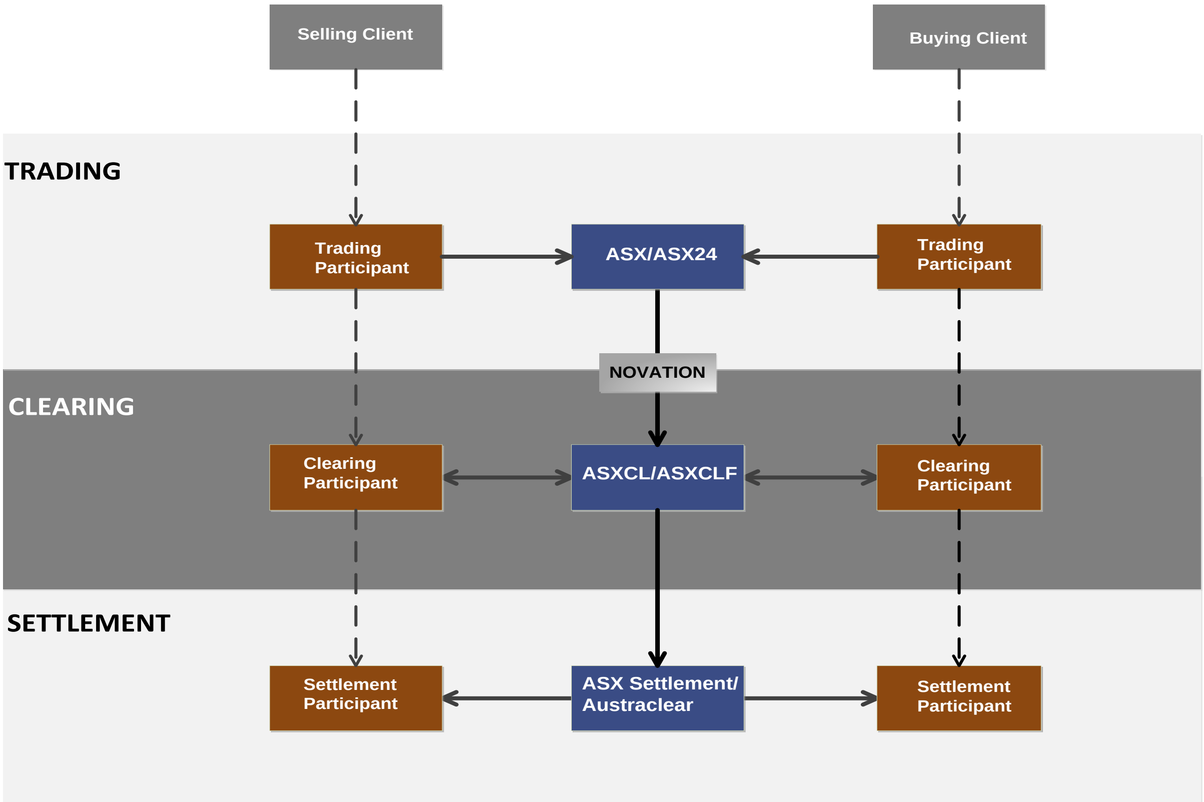
- between the client and their clearing participant – this is governed by the agreement between the client and their clearing participant, and applicable law (such as client money handling rules under the Corporations Act); and

- between the clearing participant and the Clearing House – this is governed by the operating rules of the Clearing House, with different arrangements applying for different categories of financial product transactions (refer to the explanation of different clearing account structures in this document).

[1] Transactions where the same clearing participant is buyer and seller (such as crossings) are not novated to ASXCL (the Clearing House for the cash markets operated by ASX Limited and Chi-X).

Positions maintained by a clearing participant at the Clearing House on behalf of clients are referred to in this document as "client positions". This term is intended to distinguish the proprietary (or "house") business conducted by a clearing participant with the Clearing House, from business conducted on behalf of clients. It does not mean that clients of a clearing participant have a right against the Clearing House to performance, or the continued maintenance at the Clearing House, of open client positions in the event of the clearing participant's default. A client's contractual relationship, in respect of their transactions, is with the clearing participant and not the Clearing House.

Figure 1: Trading, Clearing and Settlement Contractual Arrangements Arising from Novation



With dozens of participants trading in thousands of products and doing hundreds of thousands of trades a day in those products, the ability of the Clearing House to net all novated transactions contributes enormously to the efficiency of the settlement process and significantly aids the capital and operating effectiveness of Australian equities and futures markets. 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: each Clearing House, as the central counterparty, becomes exposed to the risk that the clearing participant on one side of a novated transaction does not perform its payment or delivery obligations in respect of the transaction.

The purpose of this document is to provide a high level overview of how ASXCL and ASXCLF manage this risk and the steps they can take in the event that a clearing participant fails to meet its obligations to the Clearing House.

Regulatory and legal context

The Clearing Houses are licensed operators of clearing and settlement facilities under the Corporations Act. As such, they have a number of statutory obligations including, to the extent that it is reasonably practicable to do so:

- to comply with the Financial Stability Standard 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 their services are provided in a fair and effective way.

The clearing and settlement facility operated by each Clearing House is also approved as a "netting market" for the purposes of the Payment Systems & Netting Act. The Act confers certain legal protections on the Clearing Houses in dealings with any clearing participant which may have gone into external administration, including in relation to the netting and termination of obligations and the receipt of money or other property pursuant to a margin call.

The conduct of the Clearing Houses and their respective clearing participants is governed by the operating rules of the relevant Clearing House, which operate as a contract between the Clearing House and its clearing participants. Among other things, these rules set out the circumstances in which the Clearing House may declare an "event of default" in respect of a clearing participant, and the steps that it may take as a consequence.

CCP Clearing Risk Management

One of the key requirements of the Reserve Bank's Financial Stability Standard for Central Counterparties[2] 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 clearing participant and its affiliates with the largest settlement obligations defaults on ASXCL and the two clearing participants and their affiliates with the largest settlement obligations defaults on ASXCLF.

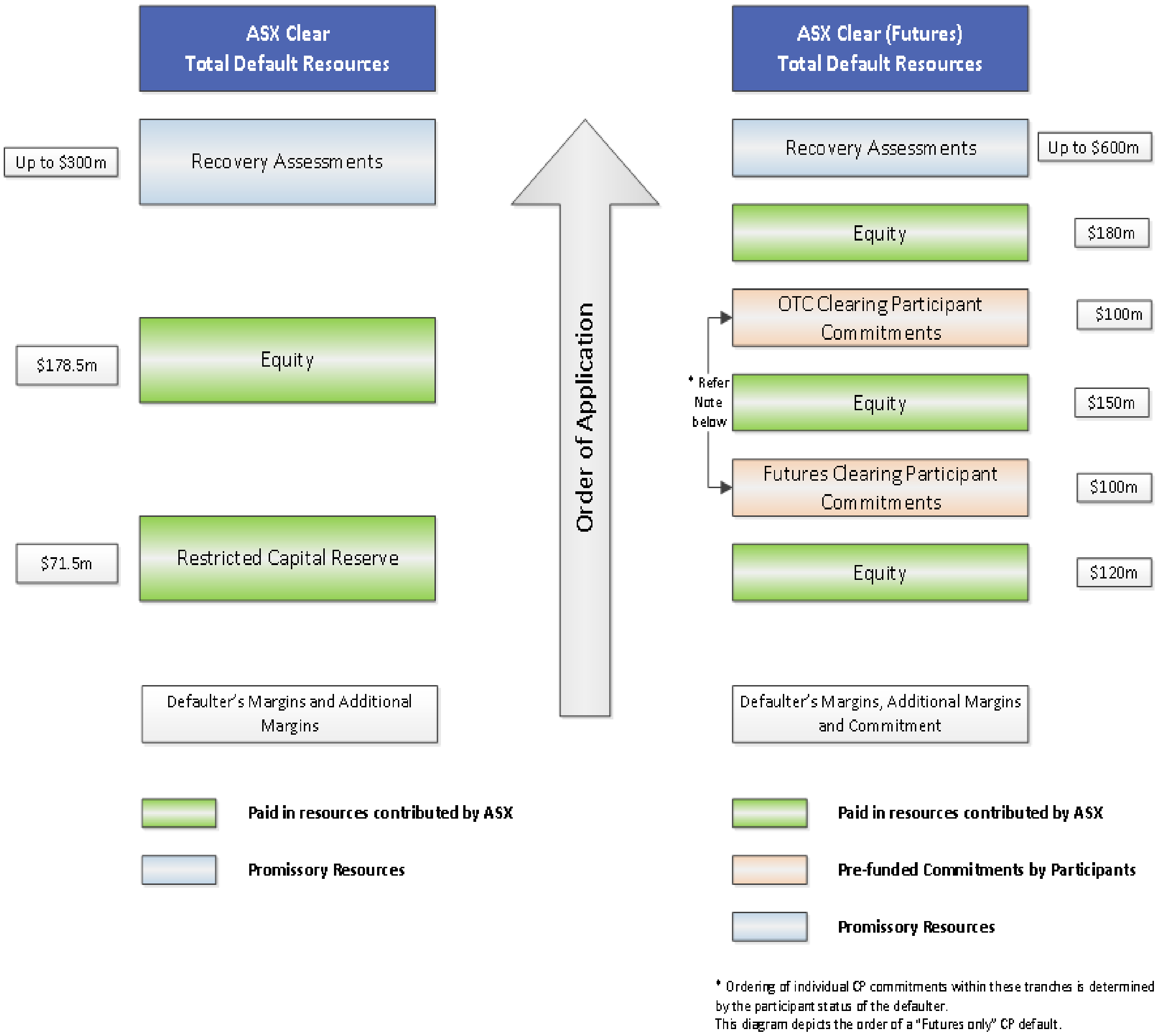
The Clearing Houses have layers of risk controls, which seek both to reduce the likelihood that a clearing participant will default and to manage the risk to the Clearing House if it does. Broadly stated, these include:

- minimum capital requirements for clearing participants, which are monitored through financial returns;
- end of day margining of clearing participants' cash market positions;
- end of day and, at times of high market volatility, intraday margining of clearing participants' derivatives market positions;
- 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; and,
- measures to ensure the adequacy of Clearing House resources, including daily stress testing of the amount and liquidity of Clearing House resources required to meet shortfalls arising from default of the clearing participant and its affiliates ASXCL and the two clearing participants' and their affiliates ASXCLF with the largest exposures under extreme but plausible market price move scenarios.

The level and order of application of the Clearing House resources is shown in Figure 2.

[2] These standards came into force on 29 March 2013.

Figure 2: The Level and Order of Application of Clearing House Resources[3]



Default Events

The operating rules of the Clearing Houses set out a number of events or circumstances which they may treat as an "event of default" by a clearing participant. These include:

- the clearing participant fails to meet any obligation to the Clearing House 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 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 the Clearing Houses may treat as an "event of default" is not restricted to financial failures. The Clearing Houses may, for example, declare an event of default where a clearing participant fails to meet its obligations to the Clearing House as the result of a serious operational failure.

[3] It should be noted that:
- ASX Clear resources also include any non-defaulter's Contributions held before Emergency Assessments are applied;
- For liquidity purposes, ASX Clear also has access to a $50m stand-by facility provided by ASX Limited; and,
- ASX Clearing Corporation (ASXCC) is the immediate Holding Company that fully owns ASX Clear and ASX Clear (Futures). ASXCC is fully owned by ASX Limited.

Default Powers

If either of the Clearing Houses declares an event of default in relation to a clearing participant, the Clearing House has the power to take a variety of steps, including:

- liquidating (or "closing out") the clearing participant's open positions by executing transactions that act to offset its net open derivatives market positions and net unsettled cash market transactions;

- where the defaulting clearing participant's proprietary ("house") and client positions are separately accounted for at the Clearing House, transferring the defaulting clearing participant's open client positions, either with or without any associated collateral, to another (non-defaulting) clearing participant; and,

- compulsorily settling (or "cashing out") the clearing participant's open derivatives positions at a price determined by the relevant market operator.

In choosing which of these powers to invoke, the Clearing House's priority will be to minimise the impact of the default on the market as a whole, in a manner consistent with the Clearing House's license obligations.

The conditions that the Clearing House may need to meet before seeking to transfer a defaulting clearing participant's open client positions include:

- where an administrator has been appointed to the clearing participant, receiving the administrator's written consent or court approval to perform such transfers; and,

- the pre-existence of alternative clearing arrangements for affected clients; and,

- receiving timely consent from the transferee clearing participants to receipt of the client positions to be transferred; and,

- confirmation that the potential margin impact of such a transfer on all parties involved (client, transferee clearing participant and the Clearing House[4]) is manageable.

The implications of different account structures

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

In broad terms, there are three main account structures adopted across the different exchange traded markets that are cleared by the Clearing Houses. In general, the lower the level of segregation of client positions and collateral provided by an account structure (and, consequently, the greater the netting and operational efficiency provided by the account structure), the less likely it is that in the event of a default of a clearing participant that the Clearing House can facilitate the transfer of client positions and collateral to an alternative clearing participant. Even where the clearing participant operates individually segregated client accounts with the Clearing House, in the event of that clearing participant's default a transfer of open client positions is not guaranteed and these may be closed out.

Irrespective of the account structure between the clearing participant and the Clearing House and how this is handled by the Clearing House if that clearing participant defaults, management of a client's account with that defaulting clearing participant remains the responsibility of that clearing participant (and most likely the Administrator appointed to that clearing participant).

Cash Market (ASXCL is the Clearing House)

A clearing participant has a single account for all house and client transactions. Clearing participants and clients benefit from maximum netting efficiency and client positions would not be transferred in a clearing participant default.

4 This is more complex in the case of an omnibus client account – as used on ASXCLF – since the Clearing House would not allow selective transfers of some client positions if that would lead to the de-netting of the client account position such that it resulted in an exposure beyond net margin held.

The defaulting clearing participant's net unsettled position in each cleared financial product class would be closed out on the market.

Futures Market (ASXCLF is the Clearing House)

A clearing participant has a single "omnibus" client account with the Clearing House that nets all client transactions into a single open client position per financial product class, and a separate house account for proprietary business.

This structure provides strong netting efficiency and lower costs by netting all client transactions in a single client omnibus account.

In a clearing participant default, the transfer of client positions referable to individual clients, with or without associated collateral, is made difficult by the fact that the Clearing House 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, the Clearing House holds net margin referrable to the aggregate of all client transactions). The Clearing House is more likely to close out the net client omnibus account exposures.

Exchange Traded Options Market (ASXCL is the Clearing House)

A clearing participant maintains individual client accounts with the Clearing House and a separate house account.

No netting efficiency across client accounts as individual client positions are retained and collateral managed at a gross level.

In a clearing participant default, this provides the best opportunity for the Clearing House to facilitate a transfer of client positions and collateral to an alternative clearing participant, if all necessary pre-conditions to transfer are satisfied. However, transfer is not a guaranteed outcome.

Shortfalls on close out

Broadly speaking, the Clearing House is able to apply the collateral[5] a defaulting clearing participant has lodged in its house account and client account(s), to cover shortfalls incurred by the Clearing House in closing out the defaulting clearing participant's open positions.

More specifically, ASXCL reserves the right to apply:

- the cash and non-cash collateral in a defaulting clearing participant's derivatives house account towards any shortfalls incurred by the Clearing House on closing out the positions on the clearing participant's house account and the net open positions across all the clearing participant's client accounts (whether they are unsettled cash market transactions or open derivatives positions);
- the cash collateral across all of the defaulting clearing participant's derivatives client accounts towards any shortfalls incurred by the Clearing House on closing out the net open positions across all the clearing participant's derivatives market client accounts; and,
- the non-cash collateral lodged in the derivatives client account of a particular client towards shortfalls incurred in connection with closing out the open derivatives positions in that client account.

ASXCLF may apply:

- the cash and non-cash collateral in a defaulting clearing participant's house account towards any shortfalls incurred by the Clearing House on closing out the open positions on that clearing participant's house and omnibus client account; and,
- the cash and non-cash collateral in a defaulting clearing participant's omnibus client account towards any shortfalls incurred by the Clearing House on closing out the open positions on that clearing participant's omnibus client account.

[5] Money or other property lodged by a clearing participant with the Clearing House is held as collateral to secure the clearing participant's obligations to the Clearing House. Money lodged as collateral is referred to as "cash collateral". Acceptable non-cash property lodged with the Clearing House is referred to as "non-cash collateral".

Any shortfall remaining after the defaulting clearing participant's collateral has been applied in this manner is satisfied out of the Clearing House's risk resources (as detailed above), as specified in the Clearing House's operating rules.

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.

Closure of client positions

In an event of default, where an administrator has been appointed to the clearing participant, the responsibility for managing the closure of client transactions in the books and records of the defaulting clearing participant rests with the administrators of the defaulting clearing participant and not with the Clearing House[6]. The Clearing House's role in this respect is to inform the administrators of the outcome of the process of managing its exposure to the defaulting clearing participant once the process of close out is complete. 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.

Further information for clients

A client of a defaulting clearing participant of ASXCL who suffers a loss because of its default may be able to make a claim for compensation on the National Guarantee Fund, administered by Securities Exchanges Guarantee Corporation (SEGC). Further information may be obtained from SEGC's website: http://www.segc.com.au/.

In limited circumstances, a client of a defaulting clearing participant of ASXCLF who suffers a loss because of its default may be able to make a claim for compensation on the SFE Fidelity Fund. Further information may be obtained from ASX's website:
http://www.asx.com.au/resources/compensation_arrangements_sfe.htm

[6] The client's relationship is with its clearing participant, which maintains on its books and records details of the client's individual transactions. The Clearing House does not manage those client transactions, but instead has a net position with the clearing participant representing the aggregate of all client transactions.