ASX 24 Exchange Traded Derivatives and OTC Interest Rate Derivatives Client Clearing Service

Second Consultation on Draft Operating Rules

October 2013

Contents

Invitation to comment

ASX is seeking submissions on the draft Operating Rules canvassed in this paper by 15 November 2013

Submissions should be sent to:

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or

Office of General Counsel
ASX Limited
20 Bridge Street
Sydney NSW 2000

Attention: Ms Catherine Eakin

ASX prefers to receive submissions in electronic form

Submissions not marked as 'confidential' will be made publicly available on ASX's website

If you would like your submission, or any part of it, to be treated as 'confidential', please indicate this clearly in your submission.

ASX is available to meet with interested parties for bilateral discussions on the draft Operating Rules

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Executive Summary

This is the second of two Consultation Papers in which ASX seeks stakeholder input on draft Operating Rules related to the introduction of its Client Clearing Service for ASX 24 Exchange Traded Derivatives and OTC Interest Rate Derivatives. The first Consultation Paper, released in August 2013, focused on client account segregation and portability features of the service. This Consultation Paper focuses on certain aspects of ASX's default management processes. The draft Operating Rule amendments covered by this Consultation Paper are intended to do three things:

- refine the existing default management process for OTC Interest Rate Derivatives and portfolio-margined ASX 24 Exchange Traded Derivatives, in particular by:

    - confirming ASX's power to combine House and non-ported Client portfolios of one or more defaulting Clearing Participants for the ultimate purpose of disposal either through sale or auction to non-defaulting Clearing Participants; and

    - providing greater clarity on the auction formats that ASX may utilise for default management purposes.

  These changes are relevant to ASX's OTC Dealer Clearing Service (launched on 1 July 2013) as well as the Client Clearing Service (to be launched in phases during the first half of 2014);

- introduce rules for allocating to House and Client accounts of one or more defaulting Clearing Participants the losses, costs and expenses incurred by ASX in closing out their House and non-ported Client OTC and portfolio-margined ETD positions – a method for allocating such losses is necessitated by the introduction of the Client Clearing Service; and

- refine the existing rules for 'juniorisation' of OTC Commitments to enhance the incentives for OTC Clearing Participants to bid competitively in default auctions – these refinements are proposed in compliance with the requirements of Australian regulatory agencies and are not directly related to the Client Clearing Service.

Stakeholder responses to this Consultation Paper should be submitted to ASX by 15 November 2013.

Introduction

Purpose

ASX is building a world class financial market infrastructure that is tailored for the Australian financial markets. ASX's central counterparty client clearing services for ASX 24 Exchange Traded Derivatives and OTC Interest Rate Derivatives (together the "**Client Clearing Service**") are key components of that infrastructure. In August 2013, ASX released the first of two Consultation Papers seeking stakeholder input on draft Operating Rules related to its Client Clearing Service. The first Consultation Paper focused on client account segregation and portability features of the service. In this second Consultation Paper ASX seeks comment on draft amendments to the Operating Rules that refine certain aspects of ASX's default management processes.

The draft Operating Rules and related procedures can be found at http://www.asxgroup.com.au/public-consultations.htm The amendments at this link are marked-up against the draft Operating Rules that accompanied the first Consultation Paper (August 2013). All amendments (related to both Consultation Papers) remain subject to regulatory clearance.

Scope

The draft Operating Rule amendments covered by this Consultation Paper contain refinements to certain aspects of ASX's default management processes that relate to OTC Interest Rate Derivatives and ASX 24 Exchange Traded Derivatives that are selected for portfolio margining with OTC Interest Rate Derivatives. Default management processes related to porting Client positions were covered in the first Consultation Paper (August 2013) and are not repeated here. A number of miscellaneous amendments to default management related Operating Rules are also included in this Consultation Paper.

Who should read this document?

ASX encourages Clearing Participants, their existing Clients and Clients who have an interest in using ASX's Client Clearing Service, and ASX's OTC Foundation Customers, to read and respond to this Consultation Paper.

Responses should be submitted to ASX by 15 November 2013. Consultation questions on which ASX has a particular interest in stakeholder feedback are included in this Consultation Paper.

Frequently used terms

Terms that are frequently used in this Consultation Paper are defined below.

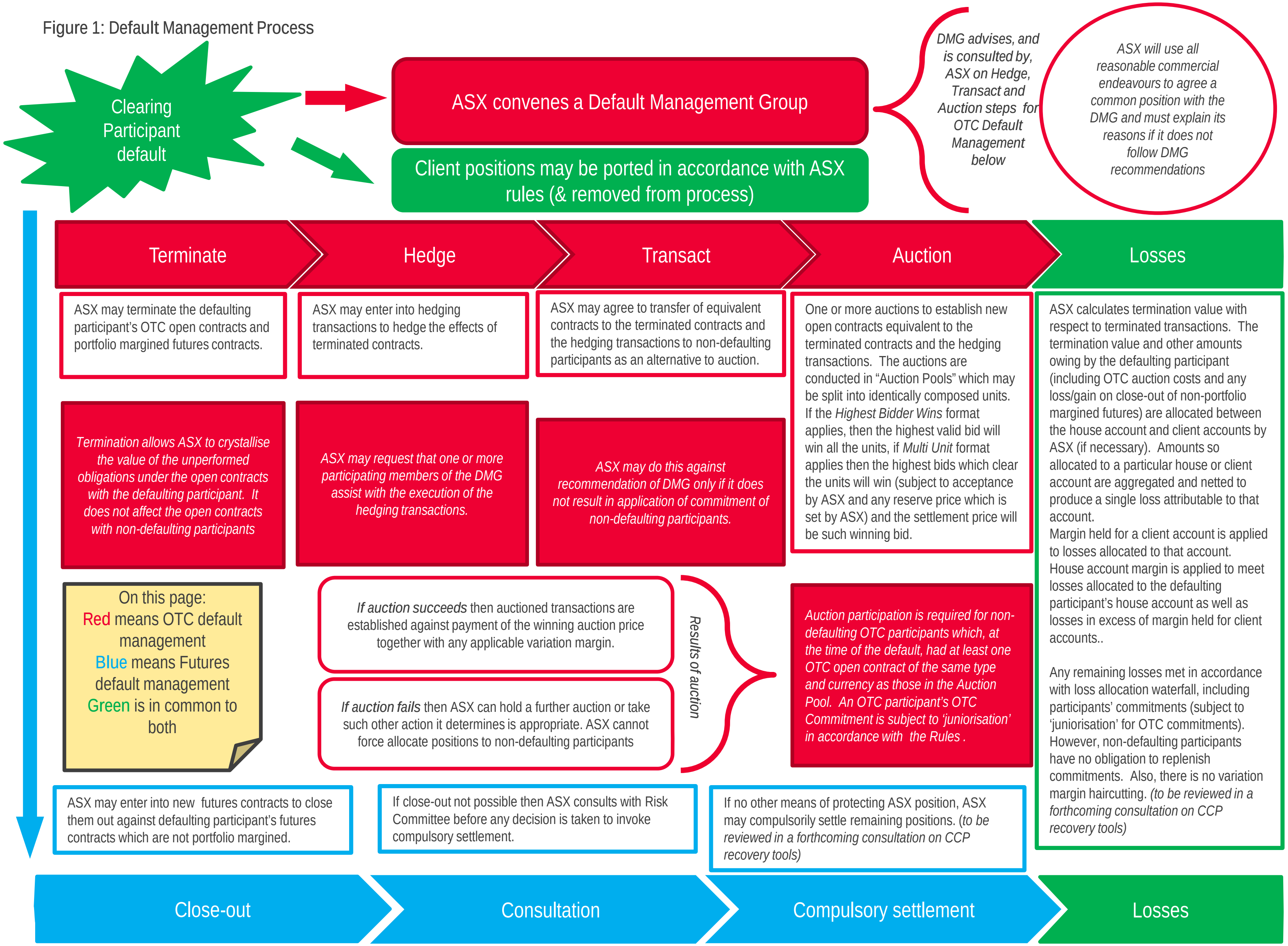
Term	Meaning
ASIC	Australian Securities and Investments Commission
ASX	ASX Clear (Futures) Pty Limited
ASX 24 Exchange Traded Derivatives	derivatives traded on the ASX 24 market
Clearing Participant	a participant in the clearing and settlement facility operated by ASX
Client	a person on behalf of whom a Clearing Participant acts in respect of cleared transactions
Default Management Process	the process that ASX follows upon the default of a Clearing Participant

Term	Meaning
Default Management Group or DMG	the group comprising representatives of OTC Clearing Participants that will advise and assist ASX with respect to the Default Management Process as it relates to OTC and portfolio-margined ETD transactions
Default Portfolio	the portfolio of OTC and portfolio-margined ETD transactions of a defaulting OTC Clearing Participant that is to be either sold or auctioned by ASX in accordance with the Default Management Process; the portfolio includes Client transactions that have not been ported successfully within the porting window and hedging transactions entered into by ASX following the default
ETD	ASX 24 Exchange Traded Derivatives (see above)
ICA	an Individual Client Account; comprising open positions of only one Client
Omnibus	a single Omnibus Client Account; comprising open positions of multiple Clients
OTC	OTC Interest Rate Derivatives (see below)
OTC Commitment	an OTC Clearing Participant's default fund contribution in respect of OTC clearing
OTC Interest Rate Derivatives	Over-the-counter interest rate derivatives that are eligible for clearing through the clearing and settlement facility operated by ASX
RBA	Reserve Bank of Australia

Default Management Process: overview

ASX's Default Management Process for a Clearing Participant default in relation to all cleared financial products, incorporating the refinements to the Operating Rules that are covered by this Consultation Paper, is diagrammatically expressed in Figure 1 below.

Figure 1: Default Management Process



The steps taken by ASX as part of the Default Management Process, as it relates to OTC and portfolio-margined ETD transactions (the red and green sections of Figure 1), are summarised as follows:

1. Declare default
2. Terminate obligations under positions of defaulting Clearing Participant
3. Hedge portfolio of defaulting Clearing Participant's positions (prior to hedging, ASX may combine House and non-ported Client portfolios of defaulting Clearing Participant to take advantage of available offsets, thus minimising hedging costs) to make the combined Default Portfolio
4. Consider disposal strategy: direct sale or auction of the combined Default Portfolio?
5. If direct sale, enter into transactions to sell Default Portfolio
6. If auction, consider auction format ('Highest Bidder Wins Auction Format' or 'Multi-Unit Auction Format')
7. Consider breaking up Default Portfolio into smaller auctionable portfolios (Auction Pools), and (for 'Multi-Unit Auction Format') split Auction Pools into identical Auction Units
8. Assign a "risk" (or incentive) rating to each Auction Pool, if there is more than one Auction Pool
9. Conduct auction(s) and settle Auction Pools with winning bidder(s)
10. Allocate disposal losses, costs and expenses to House and Client accounts; residual initial margin (if any) associated with Client accounts that have not successfully been ported is returned by ASX to Clients (ICA) or Clearing Participant (Omnibus)
11. Losses in excess of defaulting Clearing Participant's initial margin and default fund contribution are applied against mutualised default resources contributed by ASX and non-defaulting Clearing Participants, in accordance with 'default waterfall', with OTC Clearing Participant's OTC Commitments juniorised according to ranking of bidders in each Auction Pool

In formulating its Default Management Process, ASX has taken into account the approaches of various international OTC clearing houses.

The draft Operating Rule amendments covered by this Consultation Paper relate specifically to:

- confirming the authority of ASX to combine House and non-ported Client OTC and portfolio-margined ETD positions of one or more defaulting Clearing Participants into one or more portfolios for the ultimate purpose of disposal, either through sale or auction to non-defaulting Clearing Participants, as referred to in Step 3 above;

- providing greater clarity on the auction formats that ASX may utilise for default management purposes: 'Highest Bidder Wins Auction Format' or 'Multi-Unit Auction Format', as referred to in Step 6 above;

- introducing rules for allocating to House and Client accounts of one or more defaulting Clearing Participants the losses, costs and expenses incurred by ASX in closing out their House and non-ported Client OTC and portfolio-margined ETD positions, as referred to in Step 10 above; and

- refining the existing rules for 'juniorisation' of OTC Commitments to enhance the incentives for OTC Clearing Participants to bid competitively in default auctions, as referred to in Step 11 above.

Minor changes to the Default Management Process as it relates to non portfolio-margined ETD (the blue sections of Figure 1) are also proposed (refer "Matching out" in Miscellaneous amendments, below).

Client default

This Consultation Paper focuses exclusively on the default of Clearing Participants. There are no changes proposed in this paper to the draft Operating Rules dealing with the default of Clients that accompanied the first Client Clearing Service Consultation Paper published in August 2013.

Composition of the Default Portfolio

The transactions to be sold or auctioned by ASX in the event of an OTC Clearing Participant default – the Default Portfolio – must be determined prior to disposal. The Default Portfolio will comprise all OTC and portfolio-margined ETD transactions of the defaulting OTC Clearing Participant in its own name ('House' transactions) together with Client transactions that have not been ported successfully within the porting window, and hedging transactions entered into by ASX following the default. ASX reserves the right to sell or auction the Default Portfolio either as one lot or in portions comprising either or both House and Client transactions in accordance with the Default Management Process. The ability to combine and dispose of a defaulting Clearing Participant's House and Client portfolios together allows ASX to reduce risk across the Default Portfolio, by taking advantage of available offsets, and therefore reduce hedging costs. The loss allocation methodology set out later in this Consultation Paper is designed to ensure appropriate allocation of disposal losses, costs and expenses amongst House and Client accounts of the defaulting OTC Clearing Participant(s).

Additionally, in the case of multiple contemporaneous or near-contemporaneous defaults, ASX may further combine into a single Default Portfolio House and non-ported Client transactions of multiple defaulting OTC Clearing Participants. If this occurs then the loss allocation methodology is to be used to allocate losses between the defaulting OTC Clearing Participants and their respective House and Client accounts.

Key Operating Rules:

OTC Rule 6.8 and Schedule 3 (Default Management Process) permit ASX to combine House and Client transactions so that they are treated as part of one or more portfolios for sale or auction in accordance with the Default Management Process.

Consultation Questions:

A1: Do you agree with ASX's approach to the composition of the Default Portfolio? If not, why not?

Default auction process

What is the default auction process?

A default auction represents the final stage of the risk mitigation process undertaken by ASX in the event of an OTC Clearing Participant default. As part of the Default Management Process, the default auction is followed by allocation of losses, costs and expenses and default fund application – see Default Management Process overview above.

The design of the default auction should be finalised during the Default Management Process in order to achieve the following objectives:

- move risk (inherited from the defaulting OTC Clearing Participant) from the balance sheet of ASX to the surviving OTC Clearing Participants at a price at which the winning bidder(s) is (are) willing to transact;
- ensure that this transfer takes place in a manner that minimises the impact on the prices of the underlying product(s) comprising the Default Portfolio; and
- ensure that any risk transfer with respect to the remaining OTC Clearing Participants occurs with due regard to the risk of triggering subsequent or 'knock-on' defaults.

ASX's proposed refinements to the default auction process

The Operating Rules framework for default auction design must be flexible enough for the default auction process to be a useful tool when it is needed in an OTC Clearing Participant default scenario. ASX's proposed refinements to the existing Operating Rules framework seek to maintain this flexibility whilst providing greater clarity in relation to the auction formats most likely to be utilised.

ASX must take many factors into account in designing an auction for a given default scenario, including market circumstances at the time of default of an OTC Clearing Participant and other elements such as the size and composition of the Default Portfolio. ASX will consult with the DMG in relation to these matters.

The series of decisions ASX considers will be required to determine auction design with respect to an OTC Clearing Participant default are identified in Appendix 1. In the draft Operating Rule amendments, ASX has clarified the rules for two specific auction formats: Highest Bidder Wins and Multi-Unit (also known as 'Modified Dutch Auction'). The differences between these formats are also outlined in Appendix 1. These formats are the two most likely to be used in the event of an OTC Clearing Participant default. However ASX reserves the right, in consultation with the DMG, to utilise other auction formats in order to most appropriately mitigate risk and recover value in the event of an OTC Clearing Participant default.

Key Operating Rules:

OTC Rules Schedule 3 (Default Management Process), clause 4 (DM Auctions) sets out the proposed default auction process. This is supplemented by OTC Handbook Schedule 4 (Default Management Auction Procedures):

- The two most likely default auction formats are specified in OTC Handbook Schedule 4, clauses 8.3 and 8.4 covering Highest Bidder Wins Auction Format and Multi-Unit Auction Format respectively;

- ASX has the discretion to use other auction formats (OTC Handbook Schedule 4, clause 8.1).

Consultation Questions:

B1: Do you agree with the proposed refinements to the default auction process in the Operating Rules? If not, why not?

Allocation of default losses

Following the successful completion of a direct sale or auction of the Default Portfolio, ASX must allocate all losses, costs and expenses incurred by ASX in closing out the OTC and portfolio-margined ETD transactions comprising the Default Portfolio to the House and Client accounts of the defaulting OTC Clearing Participant to which those transactions were referable.

Figure 2 in Appendix 2 illustrates the method of calculation of termination value for terminated OTC and portfolio-margined transactions following a default auction (the same principles apply to a direct sale). Termination allows ASX to crystallise the value of the unperformed obligations under the open contracts with the defaulting Clearing Participant. It does not affect the open contracts with non-defaulting Clearing Participants. The determination of ASX's losses on disposal of the Default Portfolio, at sale or auction, will be based on these calculations. The draft Operating Rule amendments do not change this method, but add rules for allocating the calculated loss to the House and Client accounts of the defaulting OTC Clearing Participant to which the terminated transactions were referable.

The principle of loss allocation is to reflect profit and loss movements in the Default Portfolio (following any combination of House and Client positions) on the basis of the risk of the constituent House and Client portfolios at the time of combination. The risk measure used will be the initial margin relating to each portfolio at the time of combination. Prior to any combination, variation margin movements can be used to reflect profit and loss movements in respect of constituent portfolios.

By using this method, any losses incurred by combined portfolios, after the time of combination, are apportioned in proportion to the relative riskiness of the individual portfolios at the time of combination. (Combination of portfolios is discussed in the section "Composition of the Default Portfolio" above.) A similar method will be used to allocate losses between multiple defaulting OTC Clearing Participants and their respective House and Client accounts, where ASX chooses to combine the defaulting OTC Clearing Participants' House and non-ported Client transactions into a single Default Portfolio.

ASX will maintain records to ensure full attribution and reconciliation i.e. initial margin and variation margin account details at each key moment in time, at end of day and each intraday (including ad hoc) revaluation.

A worked example of loss allocation in a default scenario involving an OTC Clearing Participant's House Account and three Individual Client Accounts (which were not successfully ported) is set out OTC Handbook Schedule 6 (Allocation of Loss Worked Example).

<u>Key Operating Rules:</u>

OTC Rule 6.8 sets out the rules for loss allocation and is complemented by OTC Handbook Schedule 6 which contains a worked example.

<u>Consultation Questions:</u>

C1: Do you agree with ASX's proposed approach to allocation of losses, costs and expenses? If not, why not?

OTC Commitment juniorisation

What is juniorisation?

Juniorisation is the process whereby OTC Clearing Participants are incentivised, through potentially accelerated exposure to losses in the default waterfall, to submit 'good quality' bids in any auction of a defaulting Clearing Participant's Default Portfolio. A good quality bid means a bid which minimises the difference between:

(a) total consideration settled between ASX and the winning OTC Clearing Participant bidder(s) in any default auction; and
(b) an objective measure of the market value to ASX of the Default Portfolio, taking into account the most recent margined value of the portfolio.

Under current market practice among OTC CCPs internationally, juniorisation typically involves creating a retrospective tranching across all OTC Clearing Participants' default fund contributions (OTC Commitments) so that those OTC Clearing Participants submitting higher (or sufficient) quality bids for the Default Portfolio are afforded more seniority within the OTC Commitment tranche of the waterfall than those OTC Clearing Participants that bid less favourably (or that bid below an absolute threshold of quality).

Under the existing Operating Rules, a limited form of juniorisation applies to OTC Commitments in that OTC Clearing Participants that are required to bid in a default auction but fail to do so will have their OTC Commitments applied ahead of other OTC Clearing Participants; those OTC Clearing Participants that are required to bid and do so (or are not required to bid) will have their OTC Commitments applied without reference to the amount of their bids. ASX provided commitments to ASIC and RBA to implement a form of juniorisation of OTC Commitments that incentivises OTC Clearing Participants to bid competitively in default auctions.

Key principles of juniorisation design

The key principles that have guided ASX's OTC Commitment juniorisation design are summarised as follows:

1. Clearly define all direct financial penalties and/or rewards surrounding auction bids and associated juniorisation rules, as well as all potential or indirect liabilities, faced by all OTC Clearing Participants;

2. Ensure all non-defaulting OTC Clearing Participants that are required to participate in the default auction do so actively and meaningfully;

3. Realise an auction value of the Default Portfolio as close as possible to the estimated market value, recognising the value of margin cover available; and

4. Minimise losses via the waterfall to ASX and all non-defaulting Clearing Participants arising from the auction process.

ASX's proposed approach to OTC Commitment juniorisation

ASX's proposed approach to OTC Commitment juniorisation is explained in a series of principles set out in Appendix 3. Worked examples of OTC Commitment juniorisation are set out in proposed Schedule 5 of the OTC Handbook published with this Consultation Paper.

The proposed juniorisation mechanism affects only the ranking of OTC Clearing Participants' commitments within the OTC Commitment tranche of the default fund. It does not affect the size of OTC Commitments or the ranking of OTC Commitments relative to other tranches of the default fund. Accordingly, the proposed Operating Rules amendment to implement juniorisation is not subject to a Clearing Participant ballot.

Consultation undertaken and feedback received

ASX has undertaken an extensive consultation process with OTC Foundation Customers, the RBA and ASIC on the juniorisation design. ASX's proposed juniorisation approach incorporates feedback received in the course of those consultations. This approach has been presented to and accepted in principle by OTC Foundation Customers. RBA and ASIC have accepted the approach in principle for the purposes of this consultation. Stakeholders are asked in this Consultation Paper to provide feedback on the draft Operating Rule amendments that give effect to OTC Commitment juniorisation.

<u>Key Operating Rules:</u>

OTC Rules Schedule 3 (Default Management Process), clause 5 (Juniorisation) sets out the rules for juniorisation of OTC Commitments. Consequential amendments to the order of application of OTC Commitments prescribed by the default waterfall are included in Futures Rule 7.5(e).

<u>Consultation Questions:</u>

D1: Do you have any comments on the draft Operating Rule amendments that give effect to OTC Commitment juniorisation?

Miscellaneous amendments

OTC Handbook Schedule 3: Default Management Group Procedures

The Default Management Group Procedures set out in the OTC Handbook Schedule 3 have been amended for the following purposes:

- to clarify that there will be one DMG per product type;
- to clarify that the number of OTC Clearing Participant representatives participating in a DMG will be up to 10, with rotational participation where the number of OTC Clearing Participants exceeds 10;
- to clarify that ASX may not nominate a member to the DMG but will have a facilitative role in relation to meetings of the DMG;
- to clarify that DMG members may not be individuals who have previously been sanctioned for misconduct;
- to require DMG members and their nominating OTC Clearing Participants to observe and comply with ASX's DMG Dealing Code of Conduct and DMG Terms of Reference (ASX will provide those documents to all OTC Foundation Customers).

Futures Rule 72.1(a): Matching out

Amendments to Futures Rule 72.1(a) are proposed to confirm ASX's authority to 'match out' opposite ETD positions within and between the House and Client accounts of a defaulting Clearing Participant. This process will take place in respect of non portfolio margined ETD positions that are recorded in the House account of the defaulting Clearing Participant or in a Client account that are not successfully ported. The purpose of the amendment is to ensure that, for each ETD contract class, ASX is able to close out on market a net position across all accounts of the defaulting Clearing Participant. This will minimise the costs and market impact of the close out process.

The price at which transactions within each ETD contract class are matched out will be determined by ASX based on the settlement price at the time at which the defaulting participant last met its margin obligations and the price at which remaining transactions in the ETD portfolio of the defaulting Clearing Participant are closed out on-market. The price determined by ASX will be applied to all transactions closed out, regardless of whether they were closed out on-market or through the matching out process.

Futures Rules 72.3 & 72.4: Calculation of net amounts

Amendments to Futures Rules 72.3 and 72.4 are proposed to further apply the segregation afforded by the Client Protection Model to the netting of due and payable amounts calculated by ASX in the event of a Clearing Participant default. The amendments are intended to provide that any Client sub-accounts will be separately netted.

OTC Rule 4.5: Acceptance for registration

Amendments to OTC Rule 4.5 are proposed to allow ASX to accept transactions that do not satisfy its registration requirements. ASX may wish to accept such transactions in the case of a default, for example, where such transactions are risk-reducing in respect of the Default Portfolio but do not strictly satisfy the registration requirements because the OTC Clearing Participant was in default at the time at which the transactions were received by ASX.

OTC Rules 6.2(b)&(c): Participant obligations

Amendments to OTC Rules 6.2(b) and 6.2(c) are proposed to clarify the obligations placed upon non-defaulting OTC Clearing Participants in the event of a default. These amendments are intended to ensure that ASX is treated fairly in the circumstances of default, particularly when executing DM Hedging Transactions.

Next steps

ASX seeks stakeholders' views on the draft Operating Rules. Submissions should be made by 15 November 2013. ASX seeks market feedback by this date in order to give Clearing Participants and their Clients certainty regarding the Operating Rules that will apply from the commencement of the OTC Client Clearing Service from the end of Q1 2014 and is accordingly seeking to obtain the required regulatory clearances by the end of 2013.

ASX welcomes the opportunity to discuss the draft Operating Rules with interested parties (see Contacts on page 3).

Appendices

Appendix 1: Decisions required to determine auction design

The series of decisions (to be made by ASX in consultation with the relevant Default Management Group) that will be required to determine auction design in relation to a specific OTC Clearing Participant default are as follows:

1. What is the hedged Default Portfolio?

The hedged Default Portfolio will comprise all House transactions of a defaulting OTC Clearing Participant together with Client transactions that have not been ported successfully within the relevant porting window and hedge transactions executed by ASX (in consultation with the Default Management Group) in order to mitigate the risk associated with the existing House and Client transactions.

House and Client transactions may be combined into a single portfolio in order to assist in minimising costs associated with the default management process, as well as minimising the risk to ASX and surviving Clearing Participants.

If there are multiple defaulting OTC Clearing Participants, ASX may combine the Default Portfolios into a single portfolio for the purposes of hedging or holding a successful default auction.

2. Can the hedged Default Portfolio be auctioned as one lot?

The hedged Default Portfolio would first be considered as to its appropriateness to be sold as one Auction Pool. Some factors to consider would be the total size of the Default Portfolio, the delta neutrality of the Default Portfolio, the tenor of the Default Portfolio, the state of the OTC market at that moment in time, the size of participation at similar tenor points along the curve of the Default Portfolio and the total number of trades comprising the Default Portfolio.

If a consideration of the above factors leads ASX to reasonably expect that it can be auctioned as one Auction Pool, then the auction would proceed using the Highest Bidder Wins auction format. This is the equivalent of having one Auction Pool and one auction unit.

3. Does the hedged Default Portfolio need to be split into multiple Auction Pools?

If the hedged Default Portfolio is considered to be of a such a size, or is considered to contain such a variety of risks, that would reasonably lead ASX to believe that a better outcome could be achieved if the Default Portfolio split into multiple Auction Pools, then the hedged Default Portfolio may be broken down into smaller or diverse Auction Pools to facilitate appropriate participant bidding.

4. Can the hedged Default Portfolio be auctioned off in one auction, but only by using multiple units?

If the hedged Default Portfolio is deemed to be of a shape with respect to delta neutrality, tenor and other factors that it could be auctioned off in one auction, but the size of the Default Portfolio (by size of risk) gives rise to ASX having concern as to the transferability of the Auction Pool, then ASX may auction the hedged Default Portfolio as one auction, but using multiple auction units (referred to as 'Multi-Unit Auction Format').

5. Auction incentive weightings

It is at this point the concept of auction incentive weightings in respect of different Auction Pools might be utilised. While it is expected that any Default Portfolio will be split into Auction Pools in such a way as to make each Auction Pool attractive to surviving OTC Clearing Participants, there may be a need to provide some further stimulus to the bidding process through the use of an auction incentive pool scheme, which is a tool used to attribute greater or lesser risk of juniorisation to one or more Auction Pools. The principles relating to this process are outlined below in Appendix 3 and a worked example is provided in OTC Handbook, Schedule 5.

6. Requirement to Bid

In accordance with the proposed Operating Rules, mandatory bidders will be identified by reference to the type and currency of open positions they have at the time of default of the OTC Clearing Participant.

ASX considers that all OTC Clearing Participants are better able to manage all or some of a Default Portfolio than would ASX on an ongoing basis. ASX also considers that all existing OTC Clearing Participants would be in a position to manage all OTC trade types currently eligible for clearing.

7. Minimum Bid Size

Under a single unit winner-take-all auction (the “Highest Bidder Wins” format), the minimum bid size is simply the total size of the Auction Pool. Where there are multiple units in an auction (“Multi-Unit” format), two components must be clarified in advance of the auction; minimum bid size and the process for the determination of auction winner(s).

It is proposed that in this circumstance ASX would follow an approach in use elsewhere, whereby the number of units required to be bid on at an auction is defined in accordance with the initial margin of the bidding OTC Clearing Participant attributed to that Auction Pool by ASX relative to the initial margin of all other non-defaulting OTC Clearing Participants attributed to that Auction Pool by ASX. This is set out in a worked example in OTC Handbook, Schedule 5.

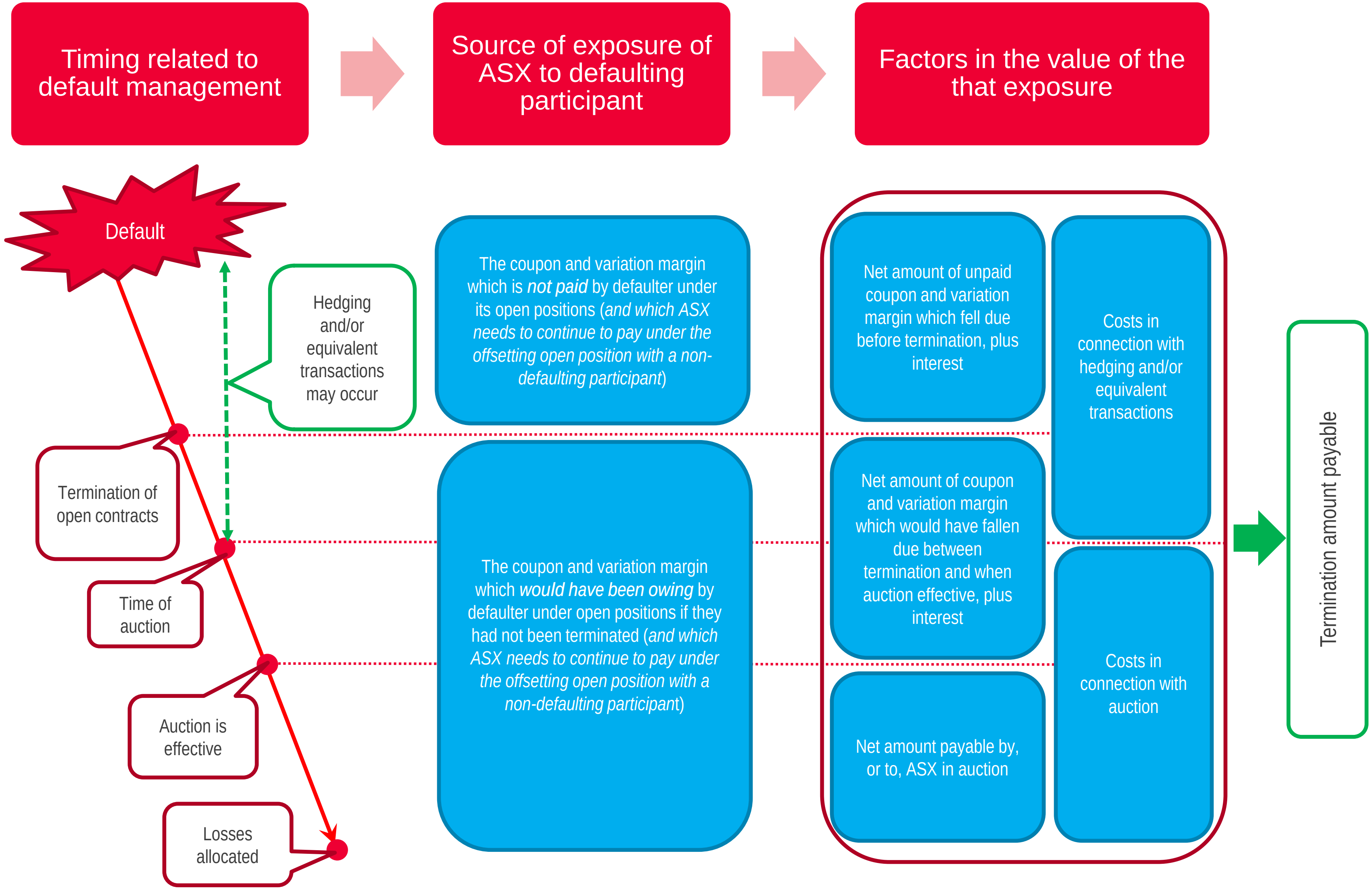
OTC Clearing Participants may bid for a number of units greater than the minimum bid size. The lowest bid price submitted by each OTC Clearing Participant will be used in order to determine the ranking for the purposes of juniorisation of their OTC Commitment for that auction.

8. Winners in a multi-unit auction

The bids submitted by all OTC Clearing Participants for each Auction Pool will be ranked from highest to lowest. Each successive bid (beginning with the highest) will then be allocated the number of auction units attached to that bid until such time as the auction units are exhausted.

Appendix 2: Calculation of the termination value for terminated transactions

Figure 2: Calculation of termination value for terminated transactions



Appendix 3: Principles of OTC Commitment juniorisation

Principle 1:

Determine a juniorisation process that assumes the Default Portfolio can be broken down in size into Auction Pools and then further into homogeneous units

This is important to the Australian environment as there is a concentration of larger players in the market. Finding an OTC Clearing Participant bidder of a size big enough to be able to take on the risk of a Default Portfolio at close to market price may prove to be difficult in times of market turmoil. Therefore to eliminate as much market risk as possible and reduce losses it may be advantageous to break down the Default Portfolio so that all remaining OTC Clearing Participants can actively participate in the Default Management Process. A juniorisation process should factor in this scenario.

Principle 2:

The OTC Commitment tranche of the default waterfall must be apportioned across the Auction Pools based on the relative risk of those Auction Pools

It is important to incentivise bidding in the riskier Auction Pools so that if ASX is left with a shortfall it will at least be less risky on a relative basis.

Principle 3:

Identify a price for each portfolio that would indicate an “economic bid”. Bidders who submit an “uneconomic bid” are treated at the same level as non-bidders with respect to the specific Auction Pool being auctioned

This would deter OTC Clearing Participants from submitting a bid deliberately designed to avoid winning the auction at the same time as avoiding any penalty for not submitting a bid. Further it will ensure that bids received will be reasonably close to the actual market prices relating to the relevant Auction Pool.

Principle 4:

Non bidders and uneconomic bidders are juniorised first and lose their portion attributable to the individual Auction Pool ahead of economic bidders

This goes to the purpose of juniorisation during a default auction.

Principle 5:

Losing bidders are treated as the second lowest tranche for each Auction Pool. Each losing OTC Clearing Participant bid for each Auction Pool is ranked according to price. The order of ranking then directly determines the waterfall for losses attributed to that auction

Ranking the bidder OTC Clearing Participants provides for a direct competition against each other as their pre funded OTC Commitment default contributions will be at risk of loss according to their bid ranking.