

5 April 2013

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ASX OTC Interest Rate Derivatives Clearing consultation paper on Draft Operating Rules

The International Swaps and Derivatives Association, Inc. (“**ISDA**”)¹ welcomes the opportunity to provide comments on the Australian Securities Exchange (“**ASX**”) *Draft Operating Rules* (“**Consultation paper**”) released on 21 February 2013.

Our response to the consultation paper is derived from these efforts and from consultation with ISDA members operating in Australia and Asia. Individual members will have their own views on different aspects of the Consultation paper, and may provide their comments to the ASX independently.

General observations

Before we address the questions posed in the Consultation paper, we would like to make a few general observations.

One of the key points we would like to address is the need for more clarity and granularity of the default management process, the auction process and the cross margining of Futures and over-the-counter (“**OTC**”) contracts. The proposed operating rules are fairly broad and do not provide the necessary details regarding the default management process and auction process to enable the market to assess ASX’s OTC Interest Rate Derivatives Clearing rules (“**OTC clearing rules**”). Additionally, we seek confirmation that the current clearing model as it pertains to the Futures contracts remains unchanged after the addition of the OTC clearing rules, i.e., the timings of margin calls, cash flow settlement amounts etc. remain unchanged.

We are very concerned about a single default fund. Although there may be potential cost savings achieved from cross-margining, we are not convinced that one single default fund is advisable or

¹ ISDA’s mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. For more information, visit www.isda.org.

² Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, April 2012.

necessary. We believe ASX should set up a separate default fund while still making cross-margining available. We are concerned with the need for OTC Clearing Participants to bid on both a Futures and OTC portfolio in the auction process. We believe the benefits from cross-margining will only benefit those institutions that take advantage of it, resulting in other participants subsidizing this benefit. Greater clarity on how the default management will work in such an instance and careful consideration should be given to future scenarios in which ASX has a larger number of OTC Clearing Participants that may not be large or active players in the futures market. Additionally, we request more details on the margining process for a cross-margined portfolio.

We believe the auction process requires further clarity and details as well. In particular, the loss allocation in the auction process needs to be clearly defined, particularly if the commitment of a non-defaulting OTC Clearing Participant has been used by ASX. Another point of concern is the juniorisation of a Clearing Participant's Commitment for a "bid that is unrepresentative of the market value"². We seek clarity on the logic and method ASX will use to determine if a Clearing Participant's bid is unrepresentative of the market value. When a Clearing Participant defaults and an auction is held, the market would be in a phase of uncertainty and stress. Under such an instance, spreads usually widen in a market. Hence, it is possible that the bids submitted for an auction may indicate an extremely wide spread and is simply a reflection of the market and not an unrepresentative bid of the market value.

We believe greater clarity is needed in the default management process. We seek clarity on the default waterfall, particularly after the second level commitments have been utilized. A Clearing Participant has the ability to decline a further Commitment, consequently, if ASX is still suffering losses after all the second level Commitment has been utilized, we believe the steps ASX takes in such an instance should be clearly stated in the operating rules. For the default management process to work, it is essential that the Australian bankruptcy regime allows ASX to transfer the defaulting Clearing Participant's portfolio to a non-defaulting Clearing Participant. The assets held by ASX should not be used in the resolution of the defaulting Clearing Participant. The defaulting Clearing Participant's assets should be easily transferred to the counterparty of the trade in the event of a close-out or to the non-defaulting Clearing Participant in the event of an auction or transfer of portfolio. We hope ASX would be able to provide a legal opinion that enforces this as well as for other jurisdictions in which a Clearing Participant may be incorporated. Conflicts with the bankruptcy regime of other jurisdictions may occur and certainty is needed that the defaulting Clearing Participant's portfolio may be closed-out, auctioned or transferred to a non-defaulting Clearing Participant.

We believe governance should be given more consideration and the impact this will have on Clearing Participants. If one group of Clearing Participants have a greater vote based on the services used in ASX, this would raise significant governance issues for those Clearing Participants that only clear either OTC contracts or Futures contracts. It should be considered that Clearing Participants with large positions in ASX should be given a platform to voice their concerns as they would most likely be the larger contributors to the default fund and consequently have more "skin in the game". Additionally, the role of the DMG within the

² Australian Stock Exchange, *Consultation on Draft Operating Rules*, February 2013, Schedule 4, Page 25.

governing structure should be enhanced so that the necessary expertise and skill in managing the risks of the CCP will be handled by those whose contributions are at risk.

We would also like to highlight the need for a longer consultation period due to the limited resources available, given all the regulatory and compliance changes occurring in the US and EU.

Response to specific questions

The remainder of this letter sets out our comments in relation to the specific questions posed in the Consultation paper. The questions used below correspond to the questions used in the Consultation paper.

QUESTIONS

Rule Section	Stakeholder Question	Feedback
OTC Rules – Key Provisions		
2 – Participation and General		
2.2	(A) Are there any admission or general conduct requirements that it would not be appropriate to apply to OTC Clearing Participants?	No comments.
2.3(a)	(B) For Phase 1 (Dealer-to-Dealer), is the jurisdictional nexus appropriate? Should it be broader or narrower – why?	It should be broader and not limited to only an Australian Bank as defined in the Corporations Act as this would also include credit unions as seen in the list of ADIs published by APRA ³ . While a credit union would need to satisfy its ability to participate in the default management process, it does not preclude them from becoming an OTC Clearing Participant. It may be prudent to widen the conditions to include corporations; financial institutions (other than Australian banks); or foreign branches of foreign banks with a history of financial, business standing and repute. As different banks may have different methods for

³ <http://www.apra.gov.au/adi/Pages/adilist.aspx>, Australian Prudential Regulation Authority (APRA), *List of Authorized Deposit-taking institutions*, last updated 1 March 2013.

		<p>booking and managing their trades, a bank with an Australian branch may have a booking system that books their trades to their London branch as opposed to its Australian branch. Under the current Clearing Participant eligibility criteria, only the Australian branch of a foreign bank will be eligible as a Clearing Participant and the parent company or foreign branch of that foreign bank would have to clear their trades as a client. These trades should not be considered client trades and should be part of the house account of the Clearing Participant. Additionally as client clearing is unavailable at this time, ASX may wish to consider a solution that enables a foreign branch of a foreign bank to be clear its trades via its Australian branch as part of the house account of the Clearing Participant.</p> <p>It is extremely important that all OTC Clearing Participants have the ability and skills to participate in the default management auction process. For a robust auction process, all Clearing Participants must have the capability of participating in the auction process and the ability to handle a potentially large portfolio of OTC contracts. This would enable the auction price to reflect the market price as active market participants would be determining the price of that particular contract type.</p>
2.10 and 4.2	(C) For Phase 1 (Dealer-to-Dealer), is the scope of the trades that are acceptable for submission appropriate? If not – why not?	No comments.
2.3(c)	(D) Are there other ways in which ASX could ensure that an OTC Clearing Participant is able to bid on a portfolio comprising portfolio margined ASX 24 Futures?	<p>ASX may want to take into account an OTC Clearing Participant’s ability in making a market in the product class that is being auctioned and its operational capacity and financial ability to bid on a large portfolio of OTC and Futures contracts.</p> <p>We do not believe it is prudent to mandate a Clearing Participant to bid on a combined portfolio of both Futures and OTC contracts and consequently must be able to clear both OTC and Futures contracts. This may be applicable to some firms which wish to utilize the cross-margining provided by ASX or are currently large</p>

		<p>Futures participants. However, not all Clearing Participants, depending on the structure of their portfolio, will be large Futures participants nor would they want to gain a large Futures portfolio.</p> <p>A single default fund would be unpalatable for Clearing Participants who only clear either Futures or OTC contracts as their commitments will, ultimately, still be at risk. It is preferable to have separate auction pools and default funds rather than a mandate to bid on a large combined portfolio. In the event one clearing service runs into difficulties, it will not adversely affect the other if the default funds are kept separately. Furthermore, ASX should consider the scenario whereby one clearing service may need to close down and having two separate default funds would ensure continuity of the other clearing service.</p> <p>If a Futures contract has been nominated for cross-margining, then this Futures contract should be “moved” to the OTC clearing service and be auctioned with the OTC contracts in the event of a default. As you are aware, swap yields and futures move in diametrically opposite directions in times of severe stress. This may cause a situation in which the default fund would be inadequate if cross-margining is allowed.</p> <p>By mandating a Clearing Participant take on a defaulting Clearing Participant’s Futures and OTC positions, the non-defaulting Clearing Participant may be forced into taking on a Futures position in which it is not an active or large participant. This may be mitigated if the Clearing Participant is allowed to abstain from bidding on this portfolio in the auction process. However, this Clearing participant will be penalized in the auction process if its bid is considered an outlier. On the other hand, for the auction process to work, it requires as many Clearing Participants as possible to be part of the bidding process.</p>
2.14 and Handbook	(E) Do you consider that the mandate and procedures of the Product Committee are	We would like to seek clarification on what it means to be “acceptable to ASX Clear (Futures) in its reasonable discretion” ⁴ . If ASX is not obliged to adopt the Product Committee’s recommendations, we believe there should

⁴ Australian Stock Exchange, *Consultation on Draft Operating Rules*, February 2013, ASX OTC Handbook, Schedule 5, Section 2.1(b), Page 40.

	appropriate?	be strict governance model around service enhancement; additional products for clearing; etc. We believe there is a need for the Product Committee to have a “veto” power over ASX’s suggested course of action.
3 - Commitments and Financial Requirements (see also Schedule 2)	(F) Is the proposal to set the fixed commitment for OTC Clearing Participants at \$5m appropriate?	Yes, we believe this is reasonable.
	(G) Is the proposal for transitional arrangements for variable commitments a reasonable step up to the steady-state? If not- why not?	<p>Clarity is needed on what constitutes “sufficient use of its OTC Clearing Service to warrant an increase in the OTC Commitment”⁵. There should be a grace period to enable OTC Clearing Participants to source the extra funds needed for an increase in the OTC Commitment. We support ASX Clear (Futures) in notifying and consulting with the Risk Commitment prior to its proposed determination.</p> <p>There should be a minimum number of Clearing Participants before the service should be started. This would ensure that during the Transitional Period, the OTC commitment of \$12,500,000 per OTC participant is sufficient.</p>
	(H) Is the steady state of \$100m a reasonable amount for OTC Clearing Participants to contribute for Phase 1? If not – why not?	The total guarantee fund needs to be risk based and dynamic rather than in a “steady state” as the market is unlikely to be in a continuous “steady state”. Accordingly, the Variable Commitment, whilst subject to a cap, should be risk related, i.e., the Variable Commitment should be proportional to the amount of margin required. By modeling hypothetical scenarios and position sizes in times of market stress, the CCP should be able to determine if \$100 million is sufficient. For example: more than a 25 basis point shock on a portfolio with a DV01 of \$4 million will produce a DV01 loss of more than \$100 million. In such a scenario, the steady-state of \$100 million as proposed in the Consultation

⁵ Australian Stock Exchange, *Consultation on Draft Operating Rules*, February 2013, ASX OTC Handbook, Schedule 2, Section 3.1, Page 6.

		<p>Paper would be insufficient.</p> <p>Currently, the Variable Commitment is proportional to the volume of business cleared⁶. Initial Margin is calculated by reference to trade volume rather than the aggregate risk of the cleared OTC contracts. We believe the Variable Commitment should be based on the aggregate risk of the cleared OTC contracts instead of trade volume as the Variable Commitment should be proportional to risk. We also believe the calculation period used to calculate the Variable Commitment should be monthly and not quarterly.</p> <p>From an operational perspective, we seek clarity on process for the final settlement cash flows for the variation margin, i.e., will margin be incorporated as part of the cash flow settlement amount and one payment made to ASX or will margin and cash flow settlement be two separate payments to ASX?</p>
3.3 and Handbook	(I) Are the Financial Requirements for OTC Clearing Participants appropriate? If not – why not?	An additional test ASX may consider is an OTC Participant’s capital should be more than a certain percentage of the average monthly figure of its initial margin requirements.
	(J) Are the reporting requirements for OTC Clearing Participants appropriate? If not – why not?	No comments.
4 – Registration 4.5 and Handbook	(K) Do you support ASX’s proposed enhanced “futures style” novation approach?	It is crucially important there is certainty an OTC contract will be accepted for registration with ASX Clear (Futures). The ability of ASX Clear (Futures) to defer acceptance removes this certainty to some extent. If ASX Clear (Futures) chooses to defer acceptance, it should be for a very short time period only. There are associated costs if an OTC contract is rejected by ASX Clear (Futures) and the market moves between the time the OTC contract was submitted for registration and the time

⁶ Australian Stock Exchange, *Consultation on Draft Operating Rules*, February 2013, Schedule 4, Rule Section 3(ii), Page 21.

		<p>it took to reject the OTC contract. Parties to the OTC contract would need to determine who will bear the loss incurred from the OTC contract not being cleared and any associated hedges of the transaction. Under the Dodd-Frank Act, if a CCP is a derivatives clearing organization (“DCO”), it would be required to accept/reject an OTC contract as quickly as technologically practicable if fully automated systems were used. This would be “done in a matter of milliseconds or seconds, at most, a few minutes, not hours or days”⁷. While we recognize there are technological issues to be worked out to attain this level of acceptance/ rejection, if ASX chooses to register as a DCO under the CFTC, it would need to comply with this regulation as well.</p> <p>If no check is performed pre-trade to ensure a Clearing Participant has sufficient collateral, there is a possibility that the CCP and its other Clearing Participants may be exposed to unsecured risk. To alleviate this concern, we suggest a margin “buffer” to be put in place for Clearing Participants.</p>
	<p>(L) Is novation sufficiently certain to meet Clearing Participants requirements?</p>	<p>Assuming the conditions to registration is set out in the OTC Rules are satisfied, the OTC contract will be processed by ASX and will send a response via MarkitWire with a message confirming registration. There exists some uncertainty regarding the length of time it takes for ASX to determine if the conditions for acceptance are met. Would the length of time taken for acceptance be similar to the 60 second time limit as seen in the CFTC regulations?</p> <p>Rule 4.5 of the ASX OTC Handbook⁸ refers to the capability of ASX to “defer registration” in certain circumstances. We seek clarity on the process and time limits in such an instance. As submissions of registrations of OTC contracts may only occur between 6 a.m. and 9 p.m. Sydney time, we seek clarity on the</p>

⁷ <http://www.gpo.gov/fdsys/pkg/FR-2012-04-09/pdf/FR-2012-04-09.pdf>, Federal Register, Vol. 77, No. 68, Part III, Commodity Futures Trading Commission, 17 CFR Parts 1, 23, 37, et al., *Customer Clearing Documentation, Timing of Acceptance of Clearing, and Clearing Member Risk Management; Final Rule*, Part III(C)(3), page 21285.

⁸ Australian Stock Exchange, *Consultation on Draft Operating Rules*, February 2013, ASX OTC Handbook, Rule 4.5, Page 7.

		<p>procedure and process for OTC contracts submitted outside of these hours.</p> <p>Rule 4.5(b) of the ASX OTC Handbook⁹ refers a risk-based limit check, we would like to clarify if there will be separate limits for OTC contracts and the Futures contracts.</p>
4.11-4.15 and Handbook	(M) Are there Operational Processes that have not been included in the OTC Rules and Handbook which you think should be covered? If so – what are they and why should they be covered?	<p>We support the functions of back loading, re-bilateralisation, transfer of OTC Open contracts and OTC portfolio compression.</p> <p>We seek clarity on the operational aspect of a transfer of OTC Open contracts, such as the handling of fees, margin etc.</p> <p>We support and applaud the benefit of a voting process for the OTC portfolio compression. However, we seek clarification on the practical implementation of the OTC portfolio compression process. For example: if the Clearing Participants disagree with the results of the portfolio compression cycle, will there be another portfolio compression cycle? Would another round of votes be needed in such an instance? If the date for the OTC portfolio compression needs to be moved from the agreed date, would this require another voting process? Would Clearing Participants be able to select the contracts for trade compression? Would ASX be using a 3rd party service provider such as Tri-Optima or would they be using their own in-house service?</p>
5 – Accounts and Margins 5.2	(N) During the dealer-to-dealer phase of ASX’s service, is it sufficient for a Clearing participant to have a single House Clearing Account for both its OTC and Futures proprietary business? Do you foresee any issues with such an approach?	<p>If cross-margining of certain Futures contracts and OTC contracts are allowed, then the house account should be split to reflect the portfolio of Futures and OTC contracts that have been cross-margined from the rest of the dealer’s non-cross margined Futures contracts, i.e., the cross-margined Futures contracts will placed in the “OTC contracts pool” and will follow the OTC default rules.</p> <p>As portfolio margining of both OTC contracts and Futures contracts is not compulsory and Clearing Participants may choose to cross-margin some of their</p>

⁹ Australian Stock Exchange, *Consultation on Draft Operating Rules*, February 2013, ASX OTC Handbook, Rule 4.5(b), Page 7.

		<p>Futures contracts, we believe separate accounts would be necessary. In the event a Clearing Participant elects not to portfolio margin, will it be able to make its margin and settlement payments separately for its Futures contracts and its OTC contracts?</p> <p>We seek clarity on the settlement timing for Intra-Day Margin. Rule 5.6 of the ASX OTC Handbook states that “such calls may be made at any time during normal ASX operating times for cash settlement on a Business Day. Each OTC Intra-Day Margin call must be met by the OTC Participant within two hours of it being made”¹⁰. As such, we seek confirmation that payment of Intra-Day Margin has to be made within two hours after an OTC Intra-Day Margin call has been made on that Business Day.</p>
5.3-5.4 and 5.8 (see 5.7 and 5.9 which are not intended to be implemented for Phase 1)	(O) If ASX were to hold Initial Margin on trust (as contemplated in draft rules 5.7 and 5.9) would this achieve “bankruptcy remoteness” under Basel III (APRA Prudential Standard 112)? What other steps, if any, do you think ASX would need to take to ensure “bankruptcy remoteness”? Please comment on the relative importance of bankruptcy remote collateral holding arrangements as compared with other service features planned for introduction in	<p>Consideration should be given to the bankruptcy regime of other jurisdictions and the possibility of conflicting laws with regards to initial margin and “bankruptcy remoteness”. For collateral to receive a 0% risk weight, the collateral posted should be held by a custodian¹¹, and is bankruptcy remote from the central counterparty (“CCP”)¹².</p> <p>The function of initial margin is to offset the losses of a defaulting Clearing Participant. Hence, it is important that the monies are available to ASX to be used in the event of a Clearing Participant’s default to ensure the continuation of the CCP as well as to mitigate the losses of the non-defaulting Clearing Participants.</p> <p>For the risk weight of 2% or 0% to be applied to collateral, under Basel III requirements, a CCP needs to be a qualifying CCP (“QCCP”) and compliant with the</p>

¹⁰ Australian Stock Exchange, *Consultation on Draft Operating Rules*, February 2013, ASX OTC Handbook, Rule 5.6, Page 10.

¹¹ Basel Committee on Banking Supervision, *Capital Requirements for Bank Exposures to Central Counterparties*, July 2012, page 6, footnote 10: “...the word “custodian” may include trustee, agent, pledgee, secured creditor or any other person that holds property in a way that does not give such a person a beneficial interest in such property and will not result in such property being subject to legally-enforceable claims by such persons creditors, or to a court-ordered stay of the return of such property, should such person become insolvent or bankrupt”.

¹² Basel Committee on Banking Supervision, *Capital Requirements for Bank Exposures to Central Counterparties*, July 2012, page 6.

	Phase 2.	<p>CPSS-IOSCO Principles for Financial market Infrastructures¹³ (the “PFMIs”). Accordingly, 3.1.9 of the PFMIs states that “the legal basis should support the enforceability of the participant-default rules and procedures that an FMI uses to handle a defaulting or insolvent participant, especially any transfers and close-outs of a direct or indirect participant’s assets or positions...An FMI should have a high degree of certainty that such actions taken under such rules and procedures will not be voided, reversed, or subject to stays, including with respect to the resolution regimes applicable to its participants”¹⁴.</p> <p>It may be prudent for ASX to have defined investment parameters to protect the Clearing Participants’ collateral and to ensure ASX does not take unnecessary investment risks of the Clearing Participants’ collateral. The primary aim behind investment of collateral should be to reduce interest rate, investment and credit risk but still maintaining liquidity. Principle 16 of the PFMI states that “an FMI should safeguard its own and its participants’ assets and minimize the risk of loss on and delay in access to these assets. An FMI’s investments should be in instruments with minimal credit, market, and liquidity risks”¹⁵.</p> <p>The house collateral should also be adequately segregated from the CCP’s own assets. This would ensure the Clearing Participants’ rights to the return of their collateral upon insolvency of the CCP are not impaired, particularly for initial and “excess” margin of the Clearing Participants’ held by the CCP.</p> <p>As the OTC contracts will be market netting contracts¹⁶, it infers that the interest created for the cash initial margin under rule 5.7 of the ASX OTC Handbook will</p>
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¹³ Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, April 2012.

¹⁴ Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, April 2012, page 24.

¹⁵ Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, April 2012, page 3.

¹⁶ Australian Stock Exchange, *Consultation on Draft Operating Rules*, February 2013, ASX OTC Rulebook, Rule 4.16, Page 13.

		<p>be excluded from section 8(e)(iii) of the Personal Property Securities Act 2009¹⁷ (“PPS Act”) under the market netting contract (“market netting contract exclusion”). As such, the interest will form part of the market netting contract. However, as there is no case law to confirm how the courts will interpret the market netting contract exclusion, it may be beneficial to ASX and Clearing Participants to ensure that express reference to rules 5.7 and 5.9 of the ASX OTC Rulebook¹⁸ are made in the market netting acknowledgement such that it is beyond a doubt that the parties intended those rules to be an elemental part of the market netting contract.</p>
5.12 and Handbook	(P) Do you agree with the proposed methodology for calculating PAI as set out in the OTC handbook? If not – why not?	No comments.
5.5 and Handbook	(Q) Do you have any comments on ASX’s approach to portfolio margining ASX 24 Futures and OTC Derivatives?	<p>In the event of an OTC-only Clearing Participant, the default waterfall applied will be that of Scenario 2 in Schedule 1 of the consultation paper¹⁹. In such an instance, would the first level and second level of commitment be sufficient to cover the potential losses of an OTC-only Clearing Participant, given that the other Clearing Participants may be cross-margining some of their Futures and OTC contracts.</p> <p>At this stage, as only Dealer-to-Dealer clearing is proposed, the assumption is that these Dealers would trade in both Futures contracts and in OTC contracts. It is unlikely at this time that the scenario described in the above paragraph will occur. However, as the market develops and more players start clearing, it would be prudent to take into account all possible scenarios, particularly where client clearing is involved.</p>

¹⁷ http://www.austlii.edu.au/cgi-bin/sinodisp/au/legis/cth/consol_act/ppsa2009356/s8.html?stem=0&synonyms=0&query=market%20netting, Personal Property Securities Act 2009, Section 8.

¹⁸ Australian Stock Exchange, *Consultation on Draft Operating Rules*, February 2013, ASX OTC Rulebook, Rule 5.7 and Rule 5.9, Page 15-16.

¹⁹ Australian Stock Exchange, *Consultation on Draft Operating Rules*, February 2013, Section 1: Default Waterfall for Futures and OTC, Page 17.

		<p>It is important that the Futures contracts that are allowed to be cross-margined with the OTC contracts are limited. They should be limited to Futures contracts that are natural hedges to the OTC contracts only. If a wide range of Futures contracts are allowed to be cross-margined with OTC contracts, this will be an issue for the auction process. In the auction process, a Clearing Participant will only need to bid if it has an open position in that product. If the list of eligible Futures contracts increases, the probability of an OTC Clearing Participant having no position in a particular Futures contract increases. In such an instance, would this OTC Clearing Participant be exempt from bidding on the defaulter’s cross-margined portfolio?</p> <p>We seek further details on the margin calculation, in particular, the SPAN methodology used to calculate margin. There exist margin calculation methodologies, other than SPAN, that may be more optimal for margin calculation. It should be noted that some of the other CCPs employ a margin methodology based on filtered historical stimulation to calculate both the OTC portfolios and the cross-margined (OTC and Futures) portfolio. We seek further details on the risk parameters ASX will use in its margin calculation. For example: will the margin calculation be based on a 99 percentile for 5 business days or if a liquidity element will be incorporated into the margin calculation. Would ASX be providing a margin calculator such as the one provided by CME?</p> <p>In the event of a close-out, we seek details on the close-out process, in particular, the timing of such a close-out event as OTC contracts typically take up to 5 days to close out as compared to 1 day for Futures contracts.</p> <p>We believe more clarity and detail is required in determining the default water fall process, the auction process and the margin calculation of a cross-margined portfolio. The proposed Operating rules do not address these issues in sufficient details.</p>
6 – Default	(R) Are there other events that should be expressly	Some of the events of Default seem fairly widely drafted, for example: if ASX is of the opinion that a Clearing

6.3-6.4	contemplated as events of default for an OTC Clearing participant?	Participant is “in default under the terms of any agreement” ²⁰ , it would be considered an event of Default. An event of Default should be based on some type of materiality test and should not be based on a subjective test.
6.2 and Schedule 3	(S) Do you consider that the procedures of the DMG are appropriate? Are there other matters on which ASX should seek the input of Clearing Participants in the event of a default?	<p>We believe there should be only be one DMG. Rule 1.5 of Schedule 3 of the ASX OTC Rulebook²¹, infers that ASX Clear (Futures) may choose to convene a meeting in the event of a Default. We believe a DMG meeting should always be convened when a Default occurs.</p> <p>ASX should not have the ability to “maintain the ultimate decision on whether and under what terms and conditions the DMG proposals are implemented or not”²². The function of the DMG is to provide the needed expertise and market knowledge in the handling of a defaulted OTC Clearing Participant’s portfolio. If ASX neither consults nor chooses to use the advice provided, it defeats the purpose of having a DMG. If ASX decides to maintain the ultimate decision on whether to follow the DMG’s expert advice, then any losses should first be met with the CCP’s own capital instead of the Clearing Participants’ default fund contributions.</p> <p>ASX in consultation and with the assistance of the DMG should have the ability to split the defaulted portfolio into smaller auction portfolios to increase efficiency and reduce the risk associated with the auction process. Portfolio splitting should not be mandatory but should be an option in the default management process. Following the portfolio splitting, ASX and the DMG should then neutralize the risk by hedging ASX’s exposure to the defaulting OTC Clearing participant’s exposure before running the auction process. Participation in the auction process should be mandatory for all Clearing Participants with an open position in a particular contract class. ASX should not have the ability to waive the requirement for a Mandatory OTC Participant to participate in the auction</p>

²⁰ Australian Stock Exchange, Consultation on Draft Operating Rules, February 2013, ASX OTC Handbook, Rule 6.4 (b), Page 20.

²¹ Australian Stock Exchange, *Consultation on Draft Operating Rules*, February 2013, ASX OTC Rulebook, Schedule 3, Page 39.

²² Australian Stock Exchange, *Consultation on Draft Operating Rules*, February 2013, ASX OTC Rulebook, Page 40.

		<p>process.</p> <p>The DMG should also advise upon the construction of the relevant Liquidation Groups and be under a duty to act in the collective interests of the Clearing Participants.</p> <p>We believe greater clarity and detail is required on the default management process.</p>
	<p>(T) Are there other obligations that should be imposed on a non-defaulting OTC Clearing Participant in connection with a defaulter? If so – what are they?</p>	<p>We support the concept of participating in an auction only if the Clearing Participant has an open position in that contract class. There should be a minimum of 3 Clearing Participants for the auction process to occur.</p> <p>As seen in our response to Question (CC), ASX may consider the option to state that all payment obligations by ASX to Clearing Participants will be subject to a haircut to enable ASX to conserve limited resources in the event of a Default. However, the haircutting process should be subject to a cap and this should be clearly stated to Clearing Participants in the ASX rules. If a cap is not stated, Clearing Participants face the risk of unlimited liability in the default process.</p>
6.6 and 6.7	<p>(U) Are the matters ASX proposes to take into account in calculating the termination value of a defaulter’s contracts appropriate?</p>	<p>In determining if Open contracts should be terminated and the termination value, ASX should consult and seek the assistance of the DMG prior to making that decision.</p> <p>A default will often coincide with periods of extreme market stress. Determination of termination value should take into account stresses, the increase in volatility and the impact on valuation and pricing.</p>
	<p>(V) Do you foresee any operational or legal issues arising if ASX terminates all obligations under OTC Open Contracts of a defaulting Clearing Participant?</p>	<p>There exists the possibility of conflicting insolvency regimes and actions, particularly in cross border situations, in which, the Clearing Participant may be an Australian branch of a foreign bank.</p> <p>The OTC Rules seem to contemplate that upon a default of a Clearing Participant, ASX will either termination their OTC Open contracts or proceed to an auction process. In the rules of both the London Clearing House (“LCH”) and Hong Kong Exchange (“HKEx”), both CCPs have the power to novate any contracts from the defaulted Clearing Participant to a non-defaulted</p>

		Clearing Participant who is willing to take on such a position. ASX rules currently do not specifically address this issue and ASX should consider adding this to their OTC Rules as an additional option in the event of a default of a Clearing Participant.
OTC Handbook		
Schedule 4	(W) Are there matters which ASX's default management auction rules should cover which are not already covered?	<p>Yes, the loss attribution of ASX following the completion of all auction(s) and if ASX has utilized any of the non-defaulters' contributions. When ASX has utilized the non-defaulters' contributions, there needs to be certainty as to how these losses will be allocated to the remaining non-defaulters' default contribution. Clearing Participants would want clarity on whether they would be required to either top-up their default fund contribution or the amount of losses they will need to absorb in the event of another Clearing Participant defaulting.</p> <p>We do not believe auction units and permissible spreads are necessary. These auction terms will unnecessarily complicate the auction process at a time of market stress. If one of the eligibility criteria of an OTC Clearing Participants is its ability to bid and manage a large portfolio of contracts, then the need to specify auction units is no longer relevant. There is no need to specify the permissible spreads as the auction bidder should have the necessary expertise to price this into their auction bid. There should also be no reserve price for a DM auction as this would not be a reflection of the market price and would simply be an arbitrary price set by ASX. This defeats the concept of an auction.</p> <p>We believe more details and clarity is required on the default management auction procedures.</p>
	(X) Do you agree with ASX's proposed approach to auctioning of OTC Derivatives and portfolio-margined ASX 24 Futures together?	No, we believe the cross-margining and mandatory bidding on a cross-margined portfolio requires more details and clarity.

	<p>(Y) Do you agree with ASX’s proposed ‘no positions, no participation’ policy?</p>	<p>Yes, we agree with this.</p>
	<p>(Z) Do you agree with this mechanism for determining whether a Clearing Participant’s Commitment should be juniorised? What other incentives could be used to encourage competitive bidding by Clearing Participants in default auctions?</p>	<p>We believe as a market maker, OTC Clearing Participants would have sufficient incentive to bid on a portfolio if they believe this portfolio will enhance their current positions.</p> <p>While we recognize the need to incentivize all Mandatory OTC Participants to place a competitive bid, we believe juniorisation of a Clearing Participant’s Commitment requires greater details. Consideration should be given to a scenario in which a Mandatory OTC Participant is unable to take on the auction portfolio due to the current portfolio position it holds. The auction process would cause the Mandatory OTC Participant to take on a position that may worsen its market position.</p> <p>If juniorisation is imposed, there should be a defined/capped amount that an OTC Clearing Participant will be subject to as this “loss” will be factored into their auction price. Additionally, clarity is needed on the factors/grounds in which ASX determines a bid to be unrepresentative of the market value. As you may know, there will always be outliers to every auction, hence, how ASX determines whether a bid is “unrepresentative of market value” and is not a reflection of the wide market spreads, at a time of stressed market conditions, is crucial. For example, under the HKEx rules, there are three separate tranches whereby bidders are juniorised to a greater or lesser degree depending on their bid vis-à-vis the successful bidder.</p> <p>We request ASX to provide further clarity and details on the juniorisation process.</p>
<p>Schedule 4</p>	<p>(AA) Do you agree with a winner-takes-all approach or do you think a different approach is preferable? If so, why?</p>	<p>We believe the DMG should have some discretion on this point.</p>

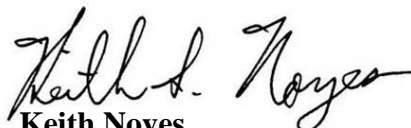
Futures Rules – Significant amendments only		
<p>6 – Withdrawing of Clearing Participant Commitment</p>	<p>(BB) Does the proposed resignation regime provide adequate certainty of exposure for resigning Clearing Participants?</p>	<p>Yes, although we believe 30 days would be a more appropriate timeframe for the Clearing Participant’s resignation to be effective.</p> <p>If a default occurs during the time a Clearing Participant resigns and the end of a quarter, there should be a cap on the losses the Clearing Participant will suffer as it already has resigned from ASX and should no longer be liable for ASX’s losses, particularly if it no longer has any Open contracts.</p>
<p>7 – Satisfaction of Obligations of ASX Clear (Futures) 7.1-7.9</p>	<p>(CC) Is the proposal order of application of financial resources as illustrated in Schedule 1 appropriate?</p>	<p>There are some additions ASX may consider adding to their default waterfall. One option may be to state that all payment obligations by ASX to Clearing Participants will be subject to a haircut to enable ASX to conserve limited resources in the event of a Default. However, the haircutting process should be subject to a cap and this should be clearly stated to Clearing Participants in the ASX rules. If a cap is not stated, Clearing Participants face the risk of unlimited liability in the default process.</p> <p>Under LCH rules, this “haircutting” operates and continues until either (i) the defaulting Clearing Participant’s contracts are successfully auctioned and transferred or (ii) the pre-agreed cap on haircut losses for Clearing Participants is reached.</p> <p>The ninth step in the default waterfall states that “any other monies or assets available to ASX Clear (Futures)”, we seek clarity on what these “monies and assets” mean as the default waterfall would almost fully utilize by this stage.</p> <p>We also seek further clarity in the Rules of ASX Clear (Futures) when a Clearing Participant defaults before the completion of a previous default and auction process of a previous Clearing Participant.</p> <p>In the event an OTC Participant, Participant A, does not have any futures positions but the other six OTC Participants have both futures and OTC contracts. If one of the other 6 OTC Participants defaults, Participant A would follow the default waterfall as if it had no futures positions?</p>

		We seek more clarity on the default of an OTC Participant and Futures Participant.
7.6	(DD) Is it sufficiently clear that no Clearing Participant has a legal obligation to replenish at any time?	Yes. If all the monies in the default fund have been used up, and ASX is still suffering losses and the remaining Clearing Participants chose not to submit additional commitments, it is unclear what steps ASX will take in such an instance. In such an event, will ASX go into insolvency and how will the remaining non-defaulted contracts be handled?
11 – resignation, termination and Change in Control 11.1	(EE) Does this resignation regime provide adequate clarity and certainty around the resignation process?	Yes. We seek clarity on the impact of a default during the time a Clearing Participant resigns to the point its Commitments are returned and the losses it may suffer during that time. The issue of a multiple defaults during a resignation process should also be considered and a limit on the losses suffered by the resigning participant should be considered.
11.1A	(FF) Is there any reason why ASXCLF should not adopt a similar approach to registration for the purpose of termination?	No comments.
14 – Amendment to Rules	(GG) Is the proposed approach to granting a vote per authorization appropriate in light of the matters the subject of a vote?	If the Clearing Participants consist of a very diverse range of membership and risk participation, we believe it would be undesirable for Clearing Participants with a small portfolio and risk profile to have equal representation. Accordingly, we agree with the proposal that there should be one vote per authorization.
	(HH) Are there other matters in connection with the default waterfall on which Clearing Participants should be entitled to vote?	We believe Clearing Participants should be able to vote on replenishment of the Commitment for each Clearing Participant. If a Clearing Participant has resigned but its resignation is not effective, it would still be liable for any replenishment during that period. Consequently, a shorter resignation period is necessary to minimize the risk a Clearing Participant faces of multiple replenishment requirements.

<p>Part 7A – Termination with respect to ASX Clear (Futures)</p>	<p>(II) Will the inclusion of this rule assist ADIs in gaining concessional risk weightings on netted trade exposures?</p>	<p>No comments.</p>
<p>20 – Risk Committee 20 and Schedule 5</p>	<p>(JJ) Do you consider that the mandate and procedures of the Risk Committee are appropriate?</p>	<p>The Risk Committee should be consulted on membership approvals, positions and liquidity limits of all Clearing Participants. The Risk Committee should also be consulted on the model used to calculate margin and the start of the default process following a Fore Majeure event. As the Risk Committee will consist of Futures Participants, we believe a quorum of 3 Clearing Participants is too low given the large number of Futures Clearing Participants and the differing risk profiles of an OTC contract versus a Futures contract.</p>

Yours sincerely,

For the International Swaps and Derivatives Association, Inc.


Keith Noyes
Regional Director, Asia Pacific


Cindy Leiw
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