



12 February 2025

To: ASX Limited
(Attention: Alistair Wright)

Dear Sirs/Madams

Consultation on Amendments to ASX Clear Operating Rules to Introduce a Framework for Default Management Auctions of Cleared Cash Market and Derivatives Market Products

FIA¹ appreciates the opportunity to respond to the “Consultation on Amendments to ASX Clear Operating Rules to Introduce a Framework for Default Management Auctions of Cleared Cash Market and Derivatives Market Products” issued by ASX on 27 November 2024 (**the Consultation**). We support ASX’s initiative and would like to offer some feedback and requests for additional information.

Unless otherwise defined, capitalised terms used in this letter will bear the same meanings ascribed to them in the Consultation.

COMMENTS TO CONSULTATION QUESTIONS

Q1 - Do you have any suggestions on how to incentivize auction participants to bid in the auction?

In the CCP space, a common approach to incentivize auction participation is by adjusting a member's default fund (DF) contribution based on the quality of the bid they submit for a particular auction pool, either by seniorizing or juniorizing it. Juniorization should be applied when a participant is given the opportunity to bid. However, if the participant is not required to bid and does not voluntarily do so, they should not be juniorized. Seniorization is a powerful incentive to encourage fair bids, but this mechanism should also be applied when participation in the auction is mandatory.

¹ FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in London, Singapore and Washington, D.C. FIA’s membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry. FIA’s mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system, and promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA’s member firms play a critical role in the reduction of systemic risk in global financial markets. Further information is available at www.fia.org.



We therefore encourage ASXCL to reconsider the auction format choice. In situations where exchange close-out is inefficient due to low liquidity, there is a high likelihood that voluntary participation would also fail to close-out the defaulter's positions. This is because there is little incentive for participants to bid voluntarily during an auction if non-defaulting members are unwilling to absorb the defaulter's positions on the exchange.

To ensure effective participation, ASXCL could make auction involvement mandatory for clearing members capable of managing the defaulter's portfolio. In assessing a clearing member's ability, ASXCL could consider factors such as recent clearing activity (e.g., over the past 20 business days) and the scale of their clearing volumes (e.g., market risk sensitivities or notional).

Participation could be voluntary for those members who have not recently cleared similar products. For example, clearing members focused solely on cash products could opt out of auction pools involving stock options, and vice versa.

Additionally, ASXCL should introduce measures to incentivize clients. If ASXCL intends to offer the same treatment to clearing members and eligible clients for auction participation, it should provide financial incentives for clients, similar to the default fund contribution required from clearing members.

Requiring a financial contribution from clients who wish to bid in the auction would align incentives between clients and clearing members, creating a more level playing field. This contribution could be paid before the defaulter's portfolio is shared with the client and could be considered a fee collected by ASXCL to allow any interested client to review the portfolio. The fee could be used alongside the member-contributed default fund to absorb potential losses. The fee amount could vary across auction pools and be determined based on the liquidity the clients are expected to bring to the bidding process for the auction pool. This approach is already in place at ICE Clear Credit, providing an industry precedent.

Alternatively, clients can be invited to participate in the second round of the auction if the first round fails. In this case, clearing members would have already had the opportunity to bid, and a larger liquidity pool may be needed to successfully complete the auction, which clients could provide. If the second round also fails, recovery tools like VMGH or Partial Tear-Up may be used, which would directly impact client positions and serve as a strong incentive for clients to submit competitive bids.

In either case, client participation should be linked to an incentive, rather than providing a "free look" at the defaulter's portfolio, which could be misused or offer commercial advantage.



Q2 - Noting that ASXCL will determine auction pools with the intention of maximizing the likelihood of a successful auction, do you support ASX’s “all or nothing” approach?

We are supportive of the approach outlined by ASXCL. Once the defaulter's portfolio has been divided into homogeneous auction pools, participants should be required to bid on the entire pool. Auctions involve significant time and coordination between the CCP, expert groups, and participants. Allowing partial bidding within an auction pool would only complicate the process, leading to greater operational inefficiencies. This could hinder the goal of achieving a matched book as quickly as possible within the MPOR, thereby increasing the risk of residual default losses being mutualised through the default waterfall.

Bids from auction participants should therefore be structured as "All or Nothing" for the entire auction pool.

Q3 - What are the key attributes that you consider important in determining how the portfolio should be split into appropriate auction pools?

In general, the more granular the auction portfolio, the greater the likelihood of attracting a wider pool of participants.

Smaller auction pools must maintain internal homogeneity. To achieve this, the defaulter's portfolio should be split based on factors such as direction, size, maturity, and underlying characteristics, as outlined in the consultation.

Additional product-related factors, such as market capitalization for cash products and market risk sensitivities (e.g., tenor-based volatility, equity delta, gamma, and vega) for options, should also be considered.

Furthermore, ASXCL could consider grouping contracts that are frequently traded together as part of a spread or trading strategy—for example, pairing certain stocks with their corresponding index to create more of a hedged book.

Ultimately, ASXCL should maintain flexibility in selecting the parameters for splitting the portfolio, depending on the specific nature of the defaulter’s positions.

Q4 - Should ASXCL enter into “pre-auction hedges” in all possible instances to reduce the risk in each auction pool?

The decision to implement pre-auction hedges will depend on market conditions for each auction pool. This means the approach - ranging from full hedging to no hedging at all - could vary across different auction pools.

ASXCL should assess the advantages and disadvantages of hedging for each auction pool and determine the optimal level of hedging. While hedging can enhance the likelihood of a successful auction by mitigating potential losses on the defaulter’s portfolio, the CCP must also weigh the associated costs arising from hedging.

Furthermore, if hedging commences after the default has been declared or made public, the CCP must take measures to mitigate the risk of information leakage prior to executing any hedges. These measures could include seeking two-way bids, developing a hedging strategy before the formal default declaration, or engaging pre-selected hedging counterparties that are distinct from auction participants.

Q5 - Do you support the proposed approach for expressing an auction bid (i.e. that bids are to be expressed as a price in the auction currency specified in the DM auction terms)?

We support ASXCL’s approach of expressing auction bids as a price in the auction currency.

Q7 - Do you support the proposed approach that contemplates that ASXCL will provide information about the default portfolio directly to auction participants?

ASXCL should provide auction information directly to all participants, provided that a level playing field is already established.

As outlined in our response to Q1, information should be disseminated based on the financial incentives at stake. Specifically, if incentives apply to both eligible clients and clearing members, then all auction participants should receive the information directly from ASXCL. However, if no incentives are offered to eligible clients, they should only be involved in the second round of the auction.



FURTHER COMMENTS AND REQUESTS FOR CLARIFICATION

1 - Cap on Number of Auction Rounds
<p>It is understood that ASXCL has the option to re-auction in the event of a failed auction round. We recommend that ASXCL limit the number of auction rounds to a maximum of three. Each failed auction round increases market stress and leads to higher residual losses, which would then be subject to loss mutualization.</p>
2 - Reserve Price for Round 1 Only
<p>In general, we believe that pricing should be driven solely by the supply and demand dynamics of the contracts. This approach promotes the discovery of a fair market price and increases the likelihood of a successful auction.</p> <p>While we understand ASXCL's rationale intention to set a reserve price to ensure reasonable bids, this should be limited only to the first round of the auction. If the first round does not result in a successful outcome, the reserve price should be removed in subsequent rounds, as the market will likely face increased pressure to close the defaulter's portfolio.</p> <p>Accordingly, we strongly recommend that ASXCL refrain from setting a reserve price from the second round onward.</p>
3 - Clearing Participant Approval for Client Participation
<p>While the proposal permits client participation in auctions, we support the requirement for clients to obtain approval from the Clearing Participant before doing so.</p> <p>We also recommend that this approval be granted on an instance-specific basis rather than as a blanket authorization for the entire duration of the agency relationship. This approach would enable the Clearing Participant to make real-time decisions based on the client's credit quality at the relevant point in time.</p>
4 - Clarify Default Drill Procedures
<p>With the introduction of auctions, it is important to clarify how default drill practices will be refined from the current approach. We recommend that ASXCL incorporate these updates into the proposed rule changes.</p>

5 - Timing and Criteria for Auctions

If ASXCL chooses to close out a defaulter's position on the exchange, it should also clearly define the circumstances under which it may cancel the exchange closeout and proceed with an auction instead.

To provide clarity and preparedness, ASXCL should explicitly outline in its Rules and Procedures the scenarios in which it may opt to go directly to auction.

These measures are essential to ensure that clearing members are adequately prepared to support the auction process when needed and that the defaulter's portfolio is closed out within the MPOR.

6 - Expert group

To enhance transparency, we request that ASXCL provides advance disclosure of the following:

- The composition of the expert group, including the total number of members.
- Clear guidelines on the participation of clearing members within the group.
- The specific role and responsibilities of the expert group throughout the auction process.

We welcome the opportunity to work with ASX to address these comments and would also be happy to share relevant industry examples and global best practices where applicable.

Please feel free to contact me at bherder@fia.org or TzeMin Yeo at tmyeo@fia.org should you wish to further discuss.

Yours



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