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David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Re: "Financial Resources Requirements for Derivatives Clearing Organizations," 75 *Fed. Reg.* 63,113 (October 14, 2010); RIN 3038-AC98, 3038-AD02.

Dear Mr. Stawick:

Natural Gas Exchange ("NGX") appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("Commission") notice in the *Federal Register* entitled, "Financial Resources Requirements for Derivatives Clearing Organizations," 75 *Fed. Reg.* 63113 (October 14, 2010) ("Notice"). The Notice proposes rules implementing sections 725(c) and 805(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] to establish financial resource requirements for derivatives clearing organizations ("DCOs") to ensure that they are able to perform their functions in compliance with the Commodity Exchange Act ("Act") as amended by the Dodd-Frank Act.

The proposed rules seek to accomplish this goal by amending Core Principle B[2] and adopting new Rule 39.11 to require a DCO to possess financial resources that, at a minimum, (1) exceed the total amount that would enable the DCO to meet its financial obligations to its clearing members notwithstanding a default by the clearing member creating the largest financial exposure for the DCO in extreme but plausible market conditions, and (2) enable the DCO to cover its operating costs for a period of one year, as calculated on a rolling basis. Notably, a DCO under Proposed Regulation 39.11(b)(3) may allocate a financial resource, in whole or in part, to satisfy the requirements of either of these two requirements, but not both, and only to the extent the use of that resource is not otherwise limited by the Act, Commission regulations, the DCO's rules, or any of the DCO's contractual arrangements.[3]

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111-203, 124 State. 1376 (2010) ("Dodd-Frank Act").

[2] The core principles were added to the CEA by the Commodity Futures Modernization Act of 2000 ("CFMA").

[3] In addition, the proposed rules include Rule 39.29, which includes higher financial resource standards for systemically important DCOs ("SIDCOs") to reflect the importance of their role in the marketplace.

NGX

NGX operates a trading and clearing system for energy products that provides electronic trading, central counterparty clearing and data services to the North American natural gas, electricity and oil markets. On December 12, 2008, NGX was registered by the Commission as a DCO.[4]

Default Financial Resources

The Commission is proposing to require that a DCO possess financial resources that, at a minimum, exceed the total amount that would enable the DCO to meet its financial obligations to its clearing members notwithstanding a default by the clearing member creating the largest financial exposure for the DCO in extreme but plausible market conditions.[5] This requirement would enable the DCO to continue meeting its obligations to its clearing members whether or not a default has taken place. This standard is consistent with Core Principle B, as well as international standards.[6] The types of financial resources a DCO would be able to use to meet this requirement include: (1) the margin of the defaulting clearing member; (2) the DCO's own capital; (3) the guaranty fund deposits of the defaulting clearing member and non-defaulting clearing members; (4) default insurance; (5) if permitted by the DCO's rules, potential assessments for additional guaranty fund contributions on non-defaulting clearing members; and (6) any other financial resource acceptable to the Commission.[7]

Proposed rule 39.11(e)(3)(iii) provides that, to the extent a DCO relies on a guaranty fund, letters of credit would not be a permissible asset of the guaranty fund. NGX's guaranty fund is not mutualized; rather it is composed fully of NGX's own funds. NGX's guaranty fund currently relies in part on a letter of credit as an asset of the guaranty fund. This letter of credit provides for ready access by the Trustee to the funds, but on a next-day basis (if the demand is made before noon) rather than on a same-day basis. NGX's letter of credit is backstopped by insurance that is payable to NGX's parent if there is a draw-down on the letter of credit which causes NGX's parent to make a payment to the issuer of the letter of credit. We respectfully request that the Commission consider the acceptability of letters of credit as an asset of the guaranty fund and clarify in the final rule that letters of credit are acceptable as an asset of the

[4] NGX also operates as an exempt commercial market ("ECM"). NGX notified the Commission on November 5, 2002, of its operation as an ECM and has requested an extension to operate as an ECM for a period of one year following the effective date of the Dodd-Frank Act.

[5] Proposed Rule 39.11(a)(1).

[6] 75 *Fed. Reg.* at 63,114, fn. 11. Recommendation 5 of the Recommendations for Central Counterparties (which was prepared by the Committee on Payment and Settlement Systems ("CPSS") of the central banks of the Group of Ten countries and the Technical Committee of the International Organization of Securities Commissions ("IOSCO") in November 2004) requires similar standards for financial resources. *Id.*

[7] 75 *Fed. Reg.* at 63,114; Proposed Regulation 39.11(b)(1). The DCO would also be required to calculate the current market value of each of these financial resources on, at least, a monthly basis or more frequently as appropriate due to market fluctuations.

guaranty fund if: 1) the DCO is not mutualized, 2) the letter of credit is accessible in a short period of time, and 3) the letter of credit is backstopped with an alternative resource, such as that which backstops NGX's letter of credit or some other alternative resource acceptable to the Commission which backstops the letter of credit. NGX believes that in such circumstances, a letter of credit is a superior financial resource to default insurance and should be accepted as a permissible asset of the guaranty fund.

In a separate requirement, that the Commission also relates to default resources, the DCO's financial resources would be required to be sufficiently liquid to enable the DCO to fulfill its obligations as a central counterparty during a one-day settlement cycle.[8] Specifically, proposed rule 39.11(e)(1) would require every DCO to have capital in the form of cash to cover "the average daily settlement variation pay per clearing member over the last fiscal quarter." The unstated rationale of this provision is that if the DCO cannot collect daily variation margin from a defaulting member it will need liquid assets sufficient to enable it to nevertheless pay variation margin owed to non-defaulting members. This presumption holds true for a DCO with a typical margining system, but not all DCOs have such liquidity risks.

NGX trades and clears a number of different products, including physical contracts in natural gas. Physical contracts cleared by NGX are not margined in the same manner as is typical for futures contracts.[9] NGX does not conduct daily pays and collects associated with a daily settlement for its physical contracts. Rather, positive daily variation amounts are treated as gains that are recognized in the NGX risk system and in the overall calculation of margin requirements for a trader's portfolio. These gains on variation payments, however, are not realized until settlement, which for physical natural gas contracts is on the 25th day following the month of delivery. Thus, gains to a clearing participant accumulate in the clearing participant's account while the contract remains open and are used by the clearing participant in the final settlement, which is at full contract value. Where there is a negative variation payment, then the losses are recognized in the risk management system and if the clearing participant has insufficient collateral posted as a result of these declines, the clearing participant must pay to NGX an amount necessary to restore the account to an acceptable level. Thus, clearing participants with a declining portfolio value are required to top-up the margin on deposit when the value of the margin has eroded below the amount required to be maintained. Accordingly, NGX does not have liquidity risk arising from the need to make daily settlement payments to clearing participants that are owed variation settlement payments. We believe that the Commission's proposed liquidity requirement should be amended so that it applies only to contracts cleared by a DCO that provide for a daily variation pay and collect as part of their margin risk management systems. The proposed liquidity rule should not be applied to contracts that do not provide for a daily pay and collect because these contracts do not result in a liquidity exposure to the DCO.

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[8] Proposed Rule 39.11(e)(1).

[9] Some NGX contracts, however, are cleared using a conventional variation-margin model. NGX power contracts, for example, provide for a daily pay and collect with respect to variation adjustment to positions. The liquidity rule would apply to these contracts as proposed by the Commission and its application to power contracts does not raise the issue that is raised in connection with its application to physical contracts, such as NGX natural gas contracts.

We also request that the Commission reconsider the forms of financial resources that are permitted to satisfy the liquidity requirement under proposed rule 39.11(e)(1). This rule, as proposed would require that the DCO maintain sufficient financial resources to meet the average daily settlement variation pay per clearing member over the last fiscal quarter. As proposed, the DCO would be required to meet this requirement relying only upon cash. We believe that immediately accessible bank lines of credit should be an additional acceptable form of financial resource to cover this liquidity-related risk where the underlying commodity is itself traded in a liquid market. Where a clearing participant fails to make a margin payment as owed, the clearing house will respond to such a default by applying the defaulting participant's collateral to the shortfall and liquidating the defaulting participant's portfolio. Thus, the clearing house liquidity exposure is only for the time needed to liquidate the defaulting clearing participant's portfolio. Where the cash market for the commodity underlying the cleared contract is itself liquid, the period needed to liquidate the defaulting participant's portfolio should be brief, and the amount of the DCO's exposure will decline as the portfolio is realized. These facts support the DCO being able to make use of lines of credit as an additional liquidity resource. We therefore request that the Commission permit a DCO to be able to include as an acceptable form of financial resource committed lines of credit to meet the requirement under proposed rule 39.11(e)(1) that a DCO have financial resources to meet the average daily settlement variation pay per clearing member over the last fiscal quarter.

Finally, we request that the Commission clarify that the liquidity calculation applies to risk arising during the period when a contract is open and does not apply when trading has ceased and the delivery process is on-going. DCOs do not have same day, or even next-day exposures arising from the delivery process and the liquidity rule is therefore inapplicable to any exposures arising in connection with the delivery process.[10]

Approval of alternatives

Proposed rule 39.11(b) provides that the Commission may deem any other form of financial resource acceptable to meet the default-related requirement and/or the operating-cost requirement. There is significant variation among DCOs in the types of contracts that they clear and in their risk management systems. A DCO may have a number of arrangements which have not been considered fully in the proposed rule. When taken into account, these measures may support a finding that the overall risk management and guarantee arrangements of a DCO provide equivalent protections to those required by proposed rule 39.11. Accordingly, NGX respectfully requests that the Commission in the final rule make clear that it will interpret proposed rule 39.11(b)(1)(vi) and 39,11(b)(2)(ii) broadly so as to permit a demonstration, on a case-by-case basis, that a DCO meets the overall policies of the rule through a specific mix of financial resources.

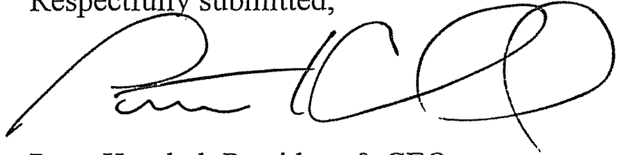
[10] NGX, acting as central counterparty, however, makes and takes delivery, including payment therefore. NGX does not have same-day, or even next day, liquidity risk arising from a delivery disruption or default because deliveries take place over a number of days and the contractual agreements to which clearing participants are bound include a multi-day cure period for default.

Conclusion

NGX recognizes the importance of maintaining sufficient financial default and operating resources and does not oppose the Commission's proposals to ensure that DCOs are capable of performing their functions in compliance with the Act. However, we believe that certain refinements of the proposed rule are necessary in order to address DCOs, such as NGX, that clear products other than traditional futures contracts. We believe that the refinements discussed above are reasonable in light of the different margining system used by NGX and satisfy the public interest concerns of ensuring that DCOs maintain sufficient financial resources to meet their obligations.

NGX appreciates the opportunity to comment on the Commission's Notice of Proposed Rulemaking. Please feel free to contact me at (403) 974-1705 or Peter.Krenkel@ngx.com with any questions.

Respectfully submitted,



Peter Krenkel, President & CEO

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