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March 21, 2011

Filed Electronically

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

Re: "Risk Management Requirements for Derivatives Clearing Organizations," 76 *Fed. Reg.* 3698 (January 20, 2011); RIN 3038-AC98.

Dear Mr. Stawick:

Natural Gas Exchange Inc. ("NGX") appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("Commission") notice in the *Federal Register* entitled, "Risk Management Requirements for Derivatives Clearing Organizations," 76 *Fed. Reg.* 3698 (January 20, 2011) ("Notice"). The Notice proposes rules implementing section 725(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1] The Commission is proposing rules to implement the core principles with which registered Derivatives Clearing Organizations ("DCO") must comply initially and on a continuing basis.

Among these requirements, the Commission is proposing in Rule 39.15(c)(1) to prohibit DCOs from accepting letters of credit as initial margin. The Commission in Rule 39.13(h)(5)(i)(A) is proposing that a DCO must require its members to maintain current written risk management policies and procedures and under proposed Rule 39.13(h)(iii) that a DCO must review the risk management policies, procedures and practices of its members on a periodic basis. These particular proposed implementing rules are in excess of the requirements of the applicable core principles as expressed in the Commodity Exchange Act, 7 U.S.C. §1 *et seq.* (the "Act") and do not take into account the unique attributes of NGX.

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,

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

electricity and oil markets. On December 12, 2008, NGX was registered by the Commission as a DCO.[2]

NGX offers a unique, non-intermediated clearing model. All participants on the NGX trading platform self-clear on NGX DCO. Both the NGX market and the DCO are non-intermediated. None of the participants in NGX DCO clear for customers. In addition, NGX is non-mutualized. Accordingly, clearing participants are not required to contribute to the guaranty fund which NGX DCO finances through its proprietary funds.

A significant component of the participants in the NGX market are commercial end-users. These participants typically make or take delivery on a routine basis in the cash markets. Moreover, among the contracts traded on NGX and cleared by NGX DCO are forward contracts in the physical commodity. Reflecting its focus on commercial end-user participants, unlike other clearing houses which may step out of the settlement process, NGX DCO sees its role as central counterparty ("CCP") as including guaranteeing completion of the settlement process. Accordingly, NGX as CCP arranges for deliveries and settlement payments to be made. NGX DCO ultimately stands behind the settlement process, and in case of default, will complete the delivery process to the non-defaulting party.

Prohibition on Letters of Credit as Initial Margin

The Commission is proposing to prohibit DCOs from accepting letters of credit as initial margin. This is intended to implement Core Principal F, "Treatment of Funds," which provides in part that, "Each derivative clearing organization shall hold member and participant funds and assets in a manner by which to minimize the risk of loss or of delay in the access by the derivatives clearing organization to the assets and funds." The Commission explained that in its view, proposed Rule 39.15(c)(1) is intended to limit the assets that the DCO accepts as initial margin to those that have minimal credit, market, and liquidity risks. Proposed rule 39,15(c)(1) leaves to the discretion of the DCO the types of assets that it will accept as initial margin, with the exception of letters of credit. The Commission explained that the proposed blanket prohibition on letters of credit is "because they are unfunded financial resources with respect to which funds might be unavailable when most needed."[3] This rationale is not supported when applied to the NGX DCO model.

Congress in the Dodd-Frank Act instructed the Commission to be flexible when considering the margin methodologies for OTC markets. Specifically, Section 4s(e)(3)(D) of the Act provides that the financial regulators shall establish comparable capital requirements and minimum initial and variation margin requirements, *including the use of non cash collateral*, for-swap dealers. Accordingly, Congress recognized that commercial end-users make use of non cash collateral in their credit support arrangements with their dealer counterparties and determined that such practices should be incorporated in the new regulatory framework. Similar to practice in the OTC markets, NGX permits non cash collateral (in the form of letters of credit)

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[2] 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.

[3] 76 Fed. Reg. at 3710.

to its participants. Commercial participants thus are able to make use of OTC-style non cash collateral on a trading platform and clearing house for contracts that would otherwise trade in the OTC market. Clearing OTC transactions is the essential legislative goal of the Dodd-Frank Act. NGX meets that legislative purpose today. In so doing, NGX DCO provides its CCP guarantee while aligning with certain OTC practices, including the use of non cash collateral in the form of letters of credit. Under section 4s(e)(3)(D) of the Act swap dealers will continue to be able to offer commercial end users OTC instruments based on non cash collateral initial and variation margin. It would be contrary to the express goals of the Dodd-Frank Act and to the larger public interest if the Commission, by prohibiting the use of letters of credit as initial margin by NGX DCO, pushes OTC business that is currently being cleared by NGX DCO back to the non-cleared, bi-lateral markets. This is the likely outcome if NGX is prohibited from accepting letters of credit from its participants.[4]

Moreover, the non-intermediated nature of NGX DCO supports the acceptability of letters of credit. In an intermediated clearing model, the clearing member brings a large number of customers to the clearing house, each with a different risk profile. This accentuates and reinforces the need for immediate access to initial margin funds. Any one customer may present a default risk to the member and in turn to the clearing house. In a non-intermediated model, the clearing house is dealing with a reduced number of risk profiles, all of which are known to it. Given its familiarity with its participants, the clearing house can exercise a degree of discretion in accepting letters of credit without the same challenges to risk management faced by a typical, intermediated clearing house.

The very concept of core principle regulation is that the regulated entity is able to use a degree of discretion in meeting the regulatory requirement. The Commission's substitution of the absolute prohibition on letters of credit is contrary to that concept. NGX has accepted irrevocable letters of credit which comply with NGX requirements regarding timing and acceptable institutions for many years and has drawn on letters of credit with no issue of lack of immediacy or non-compliance by the bank upon which the letter of credit was drawn. The letter of credit is appropriate to the scale of NGX's clearing operations, its replication of financing arrangements in the OTC markets and to its non-intermediated nature. The Commission, if it adopts this prescriptive rule, may encourage participants back to the non-cleared bi-lateral markets where non cash collateral is specifically permitted and countenanced by the Commodity Exchange Act. Such a result would be a significant loss for NGX DCO and a major set-back to achieving the goals of the Dodd-Frank Act.

Mandate to DCO to require participants to maintain risk management policies

Proposed Rule 39.13(h)(5)(i)(A) would mandate that a DCO require its members to maintain current written risk management policies and procedures. Furthering that requirement, proposed Rule 39.13(h)(iii) would mandate that a DCO review the risk management policies, procedures and practices of its members on a periodic basis. The Commission explains that in its view, "in order for a DCO to adequately manage its own risk, it must ensure that its clearing

[4] To the extent that NGX members are commercial end-users, they are eligible for an exemption from the mandatory clearing requirement and are likely to revert to non-cleared bi-lateral transactions if that is the only venue under which they can margin using non cash collateral.

members also have adequate risk management policies and procedures."[5] The requirement that members of a DCO have and follow risk management policies is a sensible requirement in the context of the typical, intermediated clearing house. In the intermediated clearing model, a member or participant brings customers to the clearing house whose positions put the clearing house at risk. In a mutualized clearing house, all of the members share that risk and, depending upon the segregation model, the customers of a single clearing member may be exposed to risk in the event of a shortfall in the member's segregated customer funds. Because of these risks, the clearing house must ensure that all members follow minimum risk management policies. This protects members from a fellow member with clearly deficient risk management policies and protects each member's customers from suffering unexpected losses due to a default.

In a non-intermediated model, however, the rational for a clearing house mandating that its members have risk management guidelines is less persuasive. In the case of NGX, many clearing participants are commercial end users, trading and clearing for their own account. Although such entities do in fact have internal risk management policies, they are not required to share such policies with their swap dealer or forward contract counterparties and are not subject to on-site audits by their counterparties. Yet, the Commission's proposed rules would require NGX DCO to subject its members to such requirements. There is little or no justification for requiring such measures; none of the clearing participants is exposed to the default risk of any other member or to fellow customers of a member.

The proposed rule overlooks the differences in risks that exist in the non-intermediated model and the context in which NGX DCO operates. The rules as proposed, if applied to NGX will have the unintended consequence of favoring the non-cleared, bi-lateral markets in which such a requirement does not exist over a successful clearing model. This is contrary to the public interest, the goals of the Dodd-Frank Act and to enlightened regulatory policy.

For these reasons, NGX DCO respectfully requests that the Commission modify the final rule to require that intermediated clearing houses are required to require their members to have written risk management policies. If the Commission declines to do so, we ask that the Commission provide guidance that a non-intermediated clearing house would not be required to conduct on-site audits of participants and that in the case of self-clearing participants, the clearing house meets its obligations to review such policies if it does so on a for-cause basis only.

Conclusion

NGX recognizes the importance of maintaining strong clearing houses 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 rules are necessary in order to address DCOs, such as NGX, that follow a non-intermediated model and clear products other than traditional futures contracts. We believe that changes to the proposed rules are reasonable and will satisfy the public interest concerns of ensuring that DCOs maintain sufficient financial resources to meet their obligations. We further believe that if the Commission does not modify the proposed rules as we suggest, the over-all

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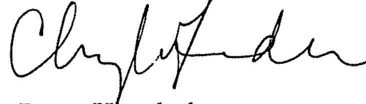
[5] 76 *Fed. Reg.* 3707.

effect of the rules will be to push volume of certain OTC transactions that is currently being traded and cleared on NGX back to the bi-lateral, non-cleared contracts.

NGX appreciates the opportunity to comment on the Commission's Notice of Proposed Rulemaking. Please feel free to contact Cheryl Graden, NGX Chief Legal Counsel at (416) 947-4359 or our outside counsel, Paul M. Architzel of Wilmer Cutler Pickering Hale and Dorr, at (202) 663-6240 with any questions.

Respectfully submitted,



per Peter Krenkel
President and CEO, NGX

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