



Peter Krenkel
President and CEO
Natural Gas Exchange Inc.
2330, 140 – 4 Avenue SW
Calgary, Alberta T2P 3N3
T (403) 974-1705
F (403) 974-1719
peter.krenkel@ngx.com

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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:

The Commodity Futures Trading Commission (“CFTC” or “Commission”) recently re-opened the comment period¹ on a number of proposed rules in order to provide the public with an opportunity to comment on the mosaic of proposed rules implementing Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) in its entirety.² Natural Gas Exchange Inc. (“NGX”) appreciates the Commission inviting comment on the rules as a complete package.

NGX is taking this opportunity to supplement its previously filed comment letters on the proposed rules relating to Derivatives Clearing Organizations (“DCO”) with this comment on the proposed rules entitled, “Risk Management Requirements for Derivatives Clearing Organizations,” 76 *Fed. Reg.* 3698 (January 20, 2011) (“Notice”).

NGX is concerned that the settlement procedures in proposed rule 39.14(c) could be read to require all DCOs, regardless of their size and the nature of their operations, to use more than one settlement bank. As discussed in greater below, in light of the significant variation in the size and scope of operations among DCOs, proposed rule 39.14(c) should be clarified to provide greater flexibility.

¹ Reopening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 *Fed. Reg.* 25274 (May 4, 2011).

² See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111-203, 124 Stat. 1376 (2010).

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, which is located in Calgary, Alberta, was registered by the Commission as a DCO.³

As explained in our prior comment letters, 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 number 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 clearinghouses 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.

As a consequence, NGX has a unique system for collateralizing the contracts entered into by participants and, unlike typical DCOs, keeps separate the settlement function from the deposits that collateralize participant obligations.

Settlement Banks Requirements

Core Principle E, as amended by the Dodd-Frank Act,⁴ requires a DCO to employ money settlement arrangements to eliminate or strictly limit its exposure to settlement bank risks (including credit and liquidity risks from the use of banks to effect money settlements). In furtherance of this mandate, proposed § 39.14(c) sets forth three specific requirements. First, proposed rule 39.14(c)(1) would require a DCO to have documented criteria for those banks that it would use, and that it would permit its clearing members to use, as settlement banks. The criteria must address the capitalization, creditworthiness, access to liquidity, operational reliability, and regulation or supervision of such banks. Second, proposed rule 39.14(c)(2) would require a DCO to monitor each approved settlement bank on an ongoing basis to ensure that it continued to meet the documented criteria of proposed rule 39.14(c)(1). Finally, proposed rule 39.14(c)(3) requires a DCO to monitor the full range and concentration of its exposure to its own and its clearing members’ settlement banks and assess its own and its clearing members’ potential losses and liquidity pressures in the event that the settlement bank with the largest share

³ 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.

⁴ Section 5b(c)(2)(E) of the Commodity Exchange Act (“CEA”); 7 U.S.C. 7a-1(c)(2)(E).

of settlement activity were to fail. If reasonably necessary to eliminate or strictly limit exposures to settlement banks, a DCO would be required to: (i) maintain settlement accounts at additional banks; (ii) approve additional settlement banks for use by its clearing members; (iii) impose concentration limits with respect to its own or its clearing members' settlement banks; and/or (iv) take any other appropriate actions.

As currently written, proposed rule 39.14(c), taken as a whole, could be read as requiring all DCOs, regardless of their size or nature, to have multiple settlement banks.⁵ However, in certain circumstances, this requirement could have a number of unintended consequences, including possibly increasing operational risk, without any concomitant regulatory benefit.

The Definition of “Settlement” Should be Clarified

Core Principle E as amended by Dodd-Frank Act refers to the processes of the DCO to “complete money settlements on a timely basis”; “ensure that money settlements are final when effected”; “maintain an accurate flow of funds”; and “employ money settlement arrangements to eliminate or strictly limit the exposure of the derivatives clearing organization to settlement bank risks (including credit and liquidity risks from the use of banks to effect money settlements)”. It further provides that DCOs clearly establish rules relating to the risks of physical settlements and managing the risks arising therefrom. On its face, therefore, Core Principle E addresses risks arising in the flow of funds in connection with the settlement of accounts or positions.

The proposed definition of “settlement” in rule 39.14 could be read somewhat more broadly, however, and should be clarified. The proposed definition of “settlement” includes “deposit and withdrawal of initial margin for futures, options, and swap positions”. As noted above, NGX does not mingle collateral (which is on deposit as a good faith deposit) and funds in settlement accounts. This is because NGX has a unique clearing model that does not require daily variation margin payments and collections. Because collateral (initial margin) may be kept on account at a depository bank, it would be clearer when applied to the NGX model, to use the term “payment and receipt” rather than the term “deposit” when referring to initial margin. This would assist in distinguishing the rule’s application to the NGX settlement banks that engage in the flow of funds from the NGX depository (which qualifies as an approved depository under Commission Rule 1.49. 17 C.F.R. §1.49.).

Risk Varies Depending on the Size and Nature of the DCO

Although NGX shares the Commission’s goal of reducing financial risk, the benefit of requiring all DCOs, regardless of size, to use multiple settlement banks is questionable. In this regard, the Commission should provide greater flexibility, permitting a DCO to demonstrate that the use of a single settlement bank is appropriate from both a policy as well as a financial perspective.

As the Commission is aware, with the exception of a relatively small power contract, NGX currently does not engage in daily variation margin payments to and collections from its

⁵ Proposed rule 39.14(c) generally refers to settlement banks, in the plural, assuming that all DCOs will maintain accounts with at least two settlement banks.

clearing participants. Rather, participant collateral is held at a depository bank while the position is open and additional participant collateral may be called for as required. Moreover, with the exception noted above, settlement on NGX contracts occurs only on a monthly basis. That settlement is on a net basis, participant obligations first having been netted to reduce the size and amount of funds needed to make full settlement. This is aligned with practices in the cash market and is consistent with the end-user nature of the vast majority of NGX participants. Accordingly, the type of daily settlement risk that proposed rule 39.14 addresses is not present in the NGX model and the degree of risk in the monthly settlement process is reduced. Therefore, requiring NGX to employ multiple settlement banks for this very limited activity will not provide a regulatory benefit and at the same time introduces unnecessary economic challenges and operational complexity in an already complicated physical delivery system.

The Proposed Rule Should Take into the Amount of Settlement Activity

A relatively small sized DCO that offers specialized clearing and settlement services may be more commercially attractive to the provider of settlement services if it is able to use a single settlement bank. Depending upon the nature of the specialized services required, a settlement bank may require a minimum level of activity prior to establishing the systems necessary to service the business. Requiring a DCO with a relatively small need for settlement services to divide the flow of funds may cause the DCO to be less attractive, bear higher costs and be less competitive with larger DCOs. NGX does not dispute that where the clearing house has daily settlements or even monthly settlements in a greater amount, requiring more than one settlement bank may materially reduce systemic risk without any adverse effects. However, imposing such a requirement on a DCO with relatively small settlement flows would have a negligible impact on systemic risk while creating a significant competitive burden.

The Proposed Rule May Result In Increased Operational Risk

Requiring every DCO to have multiple settlement banks might have the unintended consequence for certain DCOs of increasing operational risk. A very high percentage of contracts cleared by NGX are settled through physical delivery. Thus, contract settlement and delivery is more complex at NGX than at many larger DCOs. This higher level of complexity, compared for example with a DCO that settles the vast majority of its contracts financially, requires the settlement bank to be expert and to maintain specialized processes and operational capabilities. For example, NGX's settlement bank plays an integral role in ensuring that the movement of settlement funds is in alignment with available collateral positions. Concentrating all settlement and delivery operations through one settlement bank therefore provides greater operational certainty to NGX and its clearing participants. On the other hand, requiring multiple settlement banks would undermine NGX's ability to provide this additional layer of control and verification. Thus, the introduction of multiple settlement banks would increase operational risk and the risk to the clearing house, even though, because of the relatively small size of the net settlements, the financial risk of a single settlement bank is not great.

Non-mutualized Clearing Model

There is an additional reason why the rule should permit greater flexibility. NGX is a non-mutualized clearing house. All of the clearing risk is borne by NGX, none of it is

mutualized among its clearing participants. Accordingly, NGX is properly incentivized to make an appropriate choice with respect to the number of settlement banks, balancing the possible financial risk against the clearing economics and the operational certainty that is gained by using a single rather than multiple settlement banks.

Proposed and Existing Regulations Adequately Limit Financial Risk

Proposed and existing regulations addressing settlement procedures will protect against systemic risk without requiring the use of multiple settlement banks. Proposed rule 39.14(c) (1) addresses the quality of settlement banks by limiting settlement banks that DCOs could use to financially stable, low-risk entities. Proposed Rule 39.14(c)(2) would require DCOs actively to monitor their exposure to settlement bank risk, ensuring that they consider on a routine basis their exposure to their settlement bank or banks. Additionally, Commission Rule 1.49 requires that non-U.S. depositories have an excess of \$1 billion of regulatory capital. These proposed and existing regulations will strictly limit exposure to settlement bank risk.


Accordingly, NGX respectfully requests that the Commission clarify proposed rule 39.14(c), if adopted, by providing greater flexibility with respect to compliance by DCOs with unique clearing models, permitting them to demonstrate that a single settlement bank complies with Core Principle E.

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NGX appreciates the Commission’s focus on proposing clear and precise standards related to settlement procedures. However, the proposed rules discussed in this comment letter may have unintended consequences, which in the case of NGX, due to its unique aspects, might even increase risk to the clearing house. We believe that this result is the opposite of the Commission’s intent in proposing the rule and can be readily addressed in the final rule.

Please feel free to contact Cheryl Graden at (416) 947-4359, or our outside counsel, Paul M. Architzel of Wilmer Cutler Pickering Hale and Dorr LLP, at (202) 663-6240, with any questions about these comments.

Respectfully submitted,


for: Peter Krenkel
President and CEO, NGX