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Filed Electronically

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

Peter Krenkel
President & 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

Re: “Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,” 76 *Fed. Reg.* 23732 (April 28, 2011); RIN 3038-AC97.

Dear Mr. Stawick:

Natural Gas Exchange Inc. (“NGX”) appreciates the opportunity to comment on the Commodity Futures Trading Commission’s (“Commission”) proposed rulemaking entitled, “Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,” 76 *Fed. Reg.* 23732 (April 28, 2011) (“Proposed Margin Rule”).¹ The Commission is proposing to issue margin rules for uncleared swap transactions, pursuant to Section 4s of the Commodity Exchange Act, 7 U.S.C. §1 *et seq.* (“Act”).² Among these provisions, the Commission is proposing in Proposed Rules 23.157(a)(3) and 23.157(b)(3) to permit the acceptance of noncash collateral as both initial and variation margin for uncleared over-the-counter swaps.

NGX supports this proposed rule reflecting Congress’ and the Commission’s recognition that the use of noncash collateral is common practice in the over-the-counter (“OTC”) markets.³ At the same time, however, the Commission has proposed to prohibit the use of letters of credit (a form of non-cash collateral) as margin for cleared transactions. In taking these two related but inconsistent actions – permitting the use of noncash collateral for uncleared swaps but prohibiting letters of credit as margin for cleared swaps – the Commission is introducing a profound disincentive for entities to clear swap transactions. These actions, taken together, are contrary to the goals and purposes of the Dodd-Frank Act, which is to reduce systemic risk by encouraging clearing of swaps. NGX encourages the Commission to remove this regulatory inconsistency. NGX also encourages the Commission to modify its proposed prohibition on the use of letters of credit as assets for guaranty funds, which would unnecessarily limit DCOs’ flexibility in supporting their guaranty funds.

¹ NGX filed prior comments regarding this proposed rule on March 21, 2011 (Comment No. 32021), April 21, 2011 (Comment No. 42260) and June 3, 2011 (Comment No. 44750). The March 21 letter was focused specifically on the proposed rule regarding letters of credit.

² Section 4s of the Act was added by Section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111–203, 124 Stat. 1376 (2010) (“Dodd-Frank Act”).

³ Congress recognized the importance of noncash collateral in the over-the-counter markets by including section 4s(e)(3)(C) of the Act, which specifically permits the acceptance of noncash collateral as margin for uncleared transactions.

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

NGX offers a unique, non-intermediated clearing model. All participants on the NGX trading platform self-clear on NGX DCO. None of the participants in NGX DCO clear for customers. In addition, NGX is non-mutualized.

The participants in the NGX market are predominantly composed of 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.

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, but rather, reflecting NGX’s attributes as a predominantly commercial market, its margining system more closely aligns with practices in the OTC markets.⁵ As in the OTC markets, market practice among such commercial end users is to post various forms of noncash collateral in support of their positions, including specifically, letters of credit.

Proposed Rules Permit Letters of Credit as Margin for Uncleared Swaps But Prohibit It for Cleared Swaps

Proposed Rules 23.157(a)(3) and 23.157(b)(3) permit letters of credit as margin for uncleared swaps, providing that covered swap entities (“CSE”)⁶ shall “accept as [initial and variation] margin from non-financial entities only assets for which the value is reasonably ascertainable on a periodic basis in a manner agreed to by the parties in the credit support arrangements.”⁷ The Commission notes that this Proposed Margin Rule is intended to “provide[] flexibility for margin posted by non-financial entities with CSEs as to what assets are

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 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.

⁶ “Covered Swap Entities” are defined in Proposed Rule 23.150 as a swap dealer or a major swap participant for which there is no prudential regulator.

⁷ 76 *Fed. Reg.* at 23739.

permissible.”⁸ The Commission has determined that the standard for acceptable collateral as agreed between the parties is “simply that the value of the asset is reasonably ascertainable on a periodic basis.”⁹ The Commission further concludes that collateral meeting this standard satisfies the statutory requirement of section 4s(e)(3)(C) of the Act which states that the noncash collateral that the Commission permits be “consistent with preserving the financial integrity of the markets and preserving the stability of the United States.” NGX concurs with the Commission’s determinations that permitting any collateral, as long as its value is reasonably ascertainable, is consistent with preserving the financial integrity of the markets and financial stability.

In contrast to its expansive treatment of noncash collateral in the uncleared environment, Proposed Rule 39.15(c)(1) prohibits DCOs from accepting letters of credit as initial margin for cleared contracts.¹⁰ In proposing this prohibition, the Commission expressed the concern that letters of credit are “unfunded financial resources with respect to which funds might be unavailable when most needed.”¹¹ As we noted in our prior comment letter,¹² however, because of NGX’s unique margining system, this concern is not warranted. NGX’s margining system has no daily variation pays and collects for most contracts. Accordingly, there is not the same need for immediacy in accessing initial margin on these contracts. Moreover, NGX DCO requires that letters of credit be irrevocable and available to be drawn upon generally within 24 hours.¹³ NGX DCO has an extended operating history and has never experienced a problem in drawing upon such a letter of credit within the immediacy needed for its market.

This Inconsistency Wrongly Favors Uncleared Over Cleared Transactions

As mentioned above, the vast majority of those transacting and clearing through NGX are nonfinancial end users. NGX has structured its contracts and its clearing arrangements to mirror the markets for physical and other OTC contracts for natural gas, petroleum and electricity. In mirroring the cash markets for these instruments, NGX has adopted a number of the credit practices that are common in the OTC markets, including the form of margining without a daily pay and collect and permitting noncash collateral (in the form of letters of credit) to its participants. This permits commercial participants to make use of OTC-style noncash collateral in a cleared environment.

The majority of NGX’s participants, as nonfinancial end users that transact in the markets for hedging or risk mitigation purposes, will be able to choose whether or not to clear swaps that are subject to the Act’s mandatory clearing requirement under section 2(h)(7) of the Act, the end-user exemption. The Commission has failed to explain why any form of noncash collateral the value of which is ascertainable is consistent in the context of uncleared transactions with the financial integrity of the markets, but that irrevocable letters of credit that can be drawn upon

⁸ Id.

⁹ Id.

¹⁰ “Risk Management Requirements for Derivatives Clearing Organizations,” 76 *Fed. Reg.* 3698 (January 20, 2011).

¹¹ Id. at 3710.

¹² NGX previously filed a comment letter with regard to Proposed Rule 39.15(c)(1). See, Comment No. 32021, dated March 21, 2011.

¹³ The letter of credit can be drawn upon within 24 hours if the demand is made before noon of the previous day. If the demand is made after that time, the letter of credit would be available to be drawn upon no later than 48 hours from the demand.

within 24 hours are not equally acceptable in a cleared environment.¹⁴ Permitting participants in the OTC markets to continue to use noncash collateral (including letters of credit) in connection with their uncleared transactions but prohibiting them from margining their positions using the same letters of credit for their cleared contracts is contrary to the legislative goal of the Dodd-Frank Act of encouraging clearing of OTC swaps.¹⁵

Letters of Credit Should be Accepted as Assets of Guaranty Funds

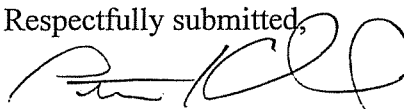
The Commission has also proposed in Rule 39.11(e)(3)(iii) to prohibit the use of letters of credit as a permissible asset of a guaranty fund. As discussed in NGX's prior comment,¹⁶ NGX's guaranty fund currently relies on a letter of credit as an asset. This letter of credit provides for ready access by the Trustee to the funds and is also 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. Any risk generally associated with letters of credit is considerably reduced by these measures. Accordingly, NGX respectfully requests that the Commission consider the acceptability of letters of credit as an asset of a DCO's guaranty fee on a case-by-case basis.

* * * * *

NGX recognizes the importance of maintaining strong clearinghouses. The over-all effect, however, of the two divergent rules relating to margin that the Commission has proposed will be to discourage end users from choosing to clear their OTC transactions. Such a result would be a significant loss for NGX DCO, a major set-back to achieving the goals of the Dodd-Frank Act and contrary to the public interest.

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 LLC, at (202) 663-6240 with any questions.

Respectfully submitted,



Peter Krenkel
President and CEO, NGX

Cc: Chairman Gensler
Commissioner Dunn
Commissioner Chilton
Commissioner Sommers
Sarah Josephson
Ananda Radhakrishnan
Robert Wasserman
Phyllis Dietz

¹⁴ See *supra* note 13.

¹⁵ As Senator Corker stated prior to passage of the Dodd-Frank Act, "[A]ll of us want to see derivatives cleared." 156 Cong. Rec. S2988-02 (April 30, 2010) (Senator Corker).

¹⁶ Submitted on December 13, 2010 (Comment No. 26699) regarding "Financial Resources Requirements for Derivatives Clearing Organizations," 75 *Fed. Reg.* 63,113 (October 14, 2010); RIN 3038-AC98, 3038-AD02.