

## **EXPLANATION AND PURPOSE FOR NEW NYMEX CLEARING SERVICE**

The New York Mercantile Exchange, Inc. ("NYMEX" or the "Exchange") intends to launch a major new Exchange initiative concerning clearing of contracts transacted in the over-the-counter ("OTC") market. The Exchange recently announced that it would introduce this new service for a specified slate of standardized products, which are discussed below, commencing on May 31, 2002. Other entities already have commenced or soon will commence providing comparable services, and consequently, the Exchange is moving to launch this new service on an expedited basis.

This document is intended to provide the Commodity Futures Trading Commission ("CFTC" or "Commission") with a general description of this project in order to assist the Commission and Commission staff in reviewing this initiative. NYMEX is registered with the Commission as a contract market and as a derivatives clearing organization ("DCO").

### **A. Benefits of Expanded Clearing Services**

#### **1. Public Interest Considerations**

Congress has recognized a strong public policy interest in favor of OTC clearing. First, one of the stated policy purposes of the CFMA itself is to reduce systemic risk via OTC clearing. Second, consistent with this legislative objective, the CFMA also revised Section 3 of the Act (Findings and Purpose) to include the following among the statutory purposes of the Act: "to ensure the financial integrity of all transactions subject to this Act and the avoidance of systemic risk". Third, it is also worth noting that Section 3 now further states that another purpose of the Act is "to promote responsible innovation and fair competition among boards of trade, other markets and market participants." Finally, the CFMA now expressly permits the clearing of OTC swaps and other derivatives.

Beyond offering an opportunity for reducing systemic risk, the Exchange's new clearing service will offer other public interest benefits. The Exchange believes strongly that there is real value to the energy marketplace as well as to government regulators in increasing the transparency of such markets. As an overview and as detailed further below, the exchange of futures for swaps mechanism will be used for the swap transactions and the exchange of futures for physicals mechanism will be used for the forward transactions to provide market participants with a means to exchange their OTC transactions for futures contracts. Thus, the Exchange intends for each of the contracts identified in this submission to be processed and cleared by the Exchange as a futures contract.

EFP and EFS transactions have served a valuable function in linking the broader physical markets, which often involve hedging and pricing nonstandardized physical commodities, to the standardized futures markets. For example, EFPs permit physical deliveries to be made against a hedged position without the obvious physical and locational constraints imposed by the futures contracts. EFPs thus foster a broader participation in futures markets by commercial participants.

Indeed, the Exchange believes strongly that it is beneficial to financial markets generally for some portion of derivatives positions to be brought to the Exchange, where they will be subject to being marked-to-market on a daily basis and to the other historically prudent safeguards that have contributed to the essential financial soundness of domestic futures exchanges. In this regard, these contracts would not be traded at the Exchange. NYMEX nonetheless would impose position limit or accountability levels and reportable level requirements (for purposes of Exchange large trader reporting rules) on positions maintained in these contracts as prudential measures and as a support to the Exchange's financial surveillance of such positions.

Consistent with the approach for other EFP and EFS transactions that are individually negotiated by the parties, the Exchange would not be offering price reporting for these contracts as of the start date for this new service. However, the broader marketplace and the public would have access to the type of end-of-day data that has historically been made available by futures exchanges, such as open interest and closing settlement prices. In addition, the Commission would have access to the data generated by large trader reporting on these new contracts. In short, permitting OTC transactions to be converted into futures transactions and cleared on the regulated futures exchange offers multiple levels of transparency to

markets users and to the Commission, which can only enhance the Commission's oversight functions and responsibilities.

As Exchange staff read the Act and the Commission's regulations, there are no specific requirements regarding the manner of transmission of eligible products to the DCO for clearing. Hence, the Exchange believes that it is consistent with the Act and regulations for a DCO to accept transactions for clearing via an EFS mechanism. As a note, this approach is not expressly prohibited by the Act or the regulations. Moreover, under the new regulatory framework of the Commodity Futures Modernization Act of 2000 ("CFMA"), where a DCO may be totally separate from and have no affiliation or linkage with a trade execution facility, the Exchange believes that this is an appropriate means for transactions to be submitted to a DCO for clearing. Converting a swaps transaction into a futures contract may not be the only permissible means of trade submission, but it is probably best viewed as included within a number of acceptable approaches.

There may be certain historical notions in the marketplace about what constitutes a futures contract, but the Exchange intends to be forthcoming about the services to be offered. Specifically, the Exchange has no intention to deceive or mislead any potential users of this service. At all times, potential users will be clearly advised and will understand that their initial transactions will occur in the largely unregulated OTC market (consistent with one or more exemptions or exclusions from more general CFTC regulation).<sup>1</sup> In addition, users will understand that the regulated aspects of their transactions will pertain only to the actual clearing of the transactions.

## **2. Market Benefits**

### **a. Benefits to Market Participants**

This new service offers a number of important benefits to market participants. As background, for many years energy market participants essentially had two choices with respect to managing their market and price risk. They could seek the safety of the cleared markets on the Exchange, or they could turn to customized instruments that traded on a principal-to-principal basis. These instruments, however, left them fully exposed to the risk of counterparty default. Over time, the energy products traded in OTC markets became increasingly standardized. But the risk of counterparty credit risk remained.

With the signing into law of the CFMA and the roll-out of the Exchange's new clearing service, the choices are now much easier for market participants. Previously, the Exchange had considered launching a number of new products that would be listed for trading and for clearing at the Exchange as part of the enymexK project. For technology reasons, the Exchange determined not to go forward with that project. However, under the enymexK approach, the Exchange would have been under a burden to develop liquidity in order to encourage participants to avail themselves of clearing. Under the current project, market participants may trade the specified contracts in existing liquid OTC markets and then use the Exchange's services to mitigate counterparty credit risk.

Market participants can now take advantage of the financial depth and integrity of the Exchange clearinghouse while conducting business with parties of their own choosing at prices of their own negotiation. Parties have considerable flexibility in terms of the time and manner of conducting their OTC transactions. From there, two paths lead to the Exchange clearinghouse - either through a broker or by the seller in the transaction who directly posts the deal on the Exchange over-the-counter (OTC) clearing website. In either case, the principals to the trade must have previously established an account with an Exchange clearing member firm. Clearing firms have an online system to pre-set account limits for each customer and commodity cleared. The Exchange has established standards for the trades it will accept and has set risk management rules regarding initial margin, daily marking-to-market, and settlement. In

---

<sup>1</sup> Pursuant to new NYMEX Rule 9.04A, each of the parties to the OTC transaction shall be responsible for ensuring that the OTC transaction complies with CFTC regulatory requirements as applicable for such transaction, including as appropriate compliance with the terms of a statutory exemption or exclusion under the Commodity Exchange Act from other CFTC regulation relied upon by the parties to the OTC transaction.

addition, large trader reporting and position limit and accountability rules will apply to OTC-cleared trades.

Submitting a trade to the Exchange clearing system would offer several advantages over uncleared business:

- Financial performance is guaranteed.
- Trades are processed by a neutral third party.
- More complete risk management is provided.
- Trades can be booked for longer terms without fear of counterparty default or bankruptcy.
- Customer funds are always segregated from those of brokerage houses, clearing member firms, and the Exchange.

Moreover, recent events in energy markets have reemphasized the value of mitigating counterparty credit risk. There is a strong need for credit mitigation in natural gas and in electricity markets, but there is also a need to some extent for the markets in refined products (e.g., heating oil and gasoline).

As a note, the Exchange will be marketing this new clearing service largely to companies that are already actively trading in OTC energy markets. These products will not be marketed or otherwise made available to the retail public. Instead, the types of traders and firms currently trading in OTC energy markets are sophisticated market participants who generally would qualify as an “eligible contract participant” for purposes of trading an exempt commodity in an OTC context.

With respect to EFP transactions, it is also worth noting that, for a number of years the Exchange has had established rules and practice for energy futures contracts traded on the Exchange that applied a rebuttable presumption to an EFP in an energy contract transacted between non-commercial entities. Basically, the Exchange would presume that such a transaction was not bona fide; however, the parties to the transaction could rebut this presumption by providing documentation to demonstrate that the transaction was bona fide. New rule amendments to NYMEX Rule 6.21 that will apply to EFPs in the physical delivery contracts to be listed only for clearing at the Exchange will extend this approach to these new contracts as well. For purposes of that rule, a commercial market participant is defined as “a person or entity which transacts business in the normal channels of commerce in the cash commodity or related commodity underlying the EFP posted on the Exchange.”

#### **b. Benefits to Futures Commission Merchants**

Futures commission merchants carry accounts for a good number of energy companies that trade on NYMEX and also trade in OTC markets. The trading on NYMEX may be undertaken to hedge the risk of an energy swap entered into by an energy company trading in the OTC market, where the floating price referenced in the swap shall mean, for example, the settlement price for each of the final three days of trading in an expiring contract month in the Exchange’s Natural Gas futures contract. Typically, the FCM would not be carrying the OTC position of that company in an account maintained at the FCM. Thus, the FCM generally would not be in a position to assess whether a position established on the Exchange was an unhedged transaction or rather was undertaken in connection with an OTC transaction.

The introduction of this new clearing service would present an opportunity for the FCM to see much more of the overall “book” of transactions executed by the energy company because more of the company’s transactions would be carried by the FCM. Accordingly, the FCM would be in a more informed position in analyzing trading by the energy company, further facilitating the FCM’s risk management activities.

#### **B. Products**

As an overview, the product slate will include outright West Texas Intermediate and natural gas calendar swaps, a series of natural gas basis swaps, on-peak physical electricity transactions, and refined product crack spread and location basis calendar swaps. A limited description of these contracts is

provided in an attached NYMEX Notice to Members, which also lists the contract months to be listed for each new contract.

### 1. Product List

The products that will be eligible for clearing on NYMEX on May 31, 2002 are listed below <sup>2</sup>:

#### Physical Delivery: Electricity

1. Palo Verde Electricity
2. PJM Electricity
3. Mid-Columbia Electricity

#### Physical Delivery: Crude Oil

4. Light Louisiana Sweet Crude Oil
5. West Texas Intermediate Midland Crude Oil
6. Mars Blend Crude Oil
7. West Texas Sour Crude Oil

#### Cash-Settled Contracts

8. Henry Hub Swap
9. Henry Hub Basis Swap (Platts IFERC)
10. West Texas Intermediate Crude Oil Calendar Swap
11. Dubai Crude Oil Calendar Swap
12. US Gulf Coast Unleaded 87 Octane Gasoline Crack Spread Calendar Swap (Platts)
13. US Gulf Coast No. 2 Heating Oil Crack Spread Calendar Swap (Platts)
14. Unleaded 87 Octane Gasoline Up-Down Spread Calendar Swap (Platts)
15. No. 2 Heating Oil Up-Down Spread Calendar Swap (Platts)
16. NYMEX AECO/NIT Basis Swap (Alberta Natural Gas)
17. Chicago Basis Swap (NGI)
18. Houston Ship Channel Basis Swap (Platts IFERC)
19. San Juan Basis Swap (Platts IFERC)
20. SoCal Basis Swap (NGI)
21. Transco Zone 6 Basis Swap (Platts IFERC)
22. New York Harbor Unleaded Gasoline Crack Calendar Swap

---

<sup>2</sup> Certain of these contracts, such as contracts that trade at a basis to other contracts, have the potential to be cleared at negative prices. It is the understanding of Exchange staff that the Commission's information systems at present can accept such prices.

- 23. New York Harbor No. 2 Heating Oil Crack Calendar Swap
- 24. Northwest Pipeline Rockies Basis Swap (Platts IFERC)
- 25. Panhandle Basis Swap (Platts IFERC)

## 2. Product Eligibility Standards

The 25 contracts on this list include the majority of the most actively traded energy contracts in OTC markets today. The Exchange has used the services of a number of Exchange advisory committees to assist in the selection of the contracts to be accepted for clearing at the Exchange.

In general, the Exchange has determined to limit the contracts accepted for clearing to mature contracts with generally accepted standardized terms that enjoy broad market use and acceptance in OTC energy trading. In other words, the Exchange has purposely restricted eligible contracts for this clearing service to those that have demonstrated commercial viability and significant liquidity in OTC energy markets. The assessment as to adequate liquidity in the OTC energy markets has been conducted on a case-by-case basis for each contract. On the other hand, for example, the Exchange has refrained from listing other contracts because of ongoing concerns about the impact on such contracts of changes in governmental specifications or other regulatory risk.

NYMEX has specified the standardized terms that would be necessary for OTC products to be cleared at the Exchange, which would be made available on the Exchange's website, and the Exchange would only accept OTC transactions with the terms specified by NYMEX. These contracts will not be listed for trading at the Exchange on the launch date of this new Exchange clearing service.

## 3. Prior Commission Review of Certain Contracts and Terms

Four of the futures contracts listed above involve physical delivery of crude oil. These four contracts are: Light Louisiana Sweet Crude Oil, WTS Crude Oil, WTI Midland Crude Oil and Mars Blend Crude Oil. As a point of comparison, for these new contracts (to be listed only for clearing), the Exchange intends to use in substance the same terms and conditions that the Commission previously approved, by letter dated June 13, 2001, for four futures contracts that the Exchange had proposed to list for trading on the Exchange (as part of the enymexK project). As a note, as a result of the termination of that project, those contracts have never been listed for trading at the Exchange.

Also, three of the contracts on this list are electricity futures contracts that involve physical delivery. These new futures contracts will have essentially the same terms as contracts for which the Exchange previously received Commission approval but that were subsequently delisted from trading at the Exchange by letter dated February 14, 2002. (All of the Exchange's electricity futures contracts were declared dormant in this same submission – NYMEX Submission 02.15.)

The three new electricity futures contracts to be listed for clearing are Palo Verde Electricity, PJM Electricity and Mid Columbia Electricity. As a point of comparison, the terms for the new contracts to be listed on a clearing-only basis are substantially the same as the terms for the contracts that were previously approved by the Commission for the contracts that had been listed for trading on the Exchange.

Previously, the electricity futures contracts listed for trading on the Exchange had permitted trading in an expiring contract month until four business days prior to the first calendar day of the delivery month. The Exchange's rules for the new electricity contracts that will be only cleared at the Exchange will permit posting of transactions until three business days prior to the first calendar day of the delivery month. In addition, the Exchange has ensured that the electricity products to be listed for clearing at the Exchange are consistent with respect to delivery notification times. Finally, the Exchange has also modified the contract unit size to reflect more closely the trading of power in OTC markets.

In addition to these contracts, the Exchange listed a new Henry Hub Swap futures contract for

trading on the Exchange, commencing on December 3, 2001 following self-certification of the new contract to the Commission. This contract was essentially a cash-settled version of the Exchange's Natural Gas futures contract and has been settled based upon the Natural Gas futures contract. In preparation for the May 31, 2002 launch of the Exchange's OTC Clearing initiative, which will include a Henry Hub Swap contract as part of its product slate, the Exchange recently determined, effective for trade date May 15, 2002, to delist the contract that had been listed for trading on NYMEX ACCESS7.

The terms for the Henry Hub Swap to be listed at the Exchange for clearing only commencing on May 31, 2002 generally will be the same as the contract that had been listed for trading on the Exchange. However, NYMEX has made two modifications to the terms and conditions for this contract. First, the contract quantity will be reduced from 10,000 to 2,500 MMBtu (million British thermal units). Second, transaction sizes for trading in any delivery month shall be restricted to whole number multiples of the number of calendar days in that contract month.

### **C. Trade Submission Process**

The process of substitution of a NYMEX futures contract for an OTC transaction shall not be deemed to have been completed unless and until the parties to the OTC transaction have successfully concluded the submission of the OTC transaction to the Exchange as an EFP or EFS transaction, as applicable, pursuant to the respective provisions of NYMEX Rule 6.21 or Rule 6.21A and pursuant to the provisions of Rule 9.04A. For forward transactions involving deferred delivery of the physical commodity to be submitted to the Exchange, the parties to the OTC transaction shall utilize the EFP procedure, and for swap transactions to be submitted to the Exchange, the parties to the OTC transaction shall utilize the EFS procedure.

#### **1. Availability for New Transactions**

NYMEX would prefer to make its clearing services as flexible as possible in order to broaden the availability of this service. Hence, NYMEX will make this service available for transactions that OTC participants would enter into with the specific intention of using NYMEX's standardized terms from the outset.

#### **2. Availability for Existing Transactions**

In addition, NYMEX would make this service available for existing OTC transactions or agreements that have been in effect for some period of time. Thus, OTC participants could enter into a forward contract with each other involving delivery in one year and agree after six months to modify their forward contract to adopt the NYMEX terms and conditions and submit the trade to NYMEX for clearing. This approach is consistent with the legislative objectives for the CFMA, which included reducing systemic risk and providing greater stability to markets during times of market disorder.

In other words, the Exchange believes strongly that, in the event, for example, of another Enron type of crisis, OTC market participants should be allowed the flexibility to convert existing OTC agreements into futures contracts that could be cleared by NYMEX, even if those OTC agreements have been in effect for some period of time.

#### **3. Confirmation Clearing**

Each user of the Exchange's new clearing service must establish a relationship with one or more Exchange Clearing Members carrying an account(s) for that user. Clearing Members must register with the Exchange the account numbers for the accounts that may be used by the user for this new service. This registration by a Clearing Member of its customers is intended to authenticate the relationship of a customer with a Clearing member and also provides a measure of Clearing Member control over access to this service for their customers.

Thereafter, as of Day 1, there will be two entry points for trade data to be submitted to the Exchange for clearing purposes. One entry point will be Confirmation Clearing, a new Exchange service

specializing in OTC trade confirmation services. In particular, the Exchange will be providing third-party record-keeping and confirmation services to parties transacting purely non-cleared bilateral trades. Although this Confirmation Clearing service will focus upon trade confirmation, Exchange staff have developed the means for OTC trades that have been confirmed by this service to be submitted by the parties to the Exchange thereafter for clearing.

When the principals to an OTC trade determine to submit the trade to the Exchange for clearing, the submit screen would display the following message:

**I understand and acknowledge that in submitting and/or confirming the terms of this trade to NYMEX for clearing, I agree to exchange my swaps or physical transaction, as applicable, for a standardized NYMEX futures contract via either the Exchange's exchange of futures for swaps or exchange of futures for physicals procedure, as applicable. I understand that the standardized NYMEX futures contract may be listed at the Exchange only for purposes of clearing. Finally, in connection with the trade being submitted and/or confirmed, I agree to accept and to be bound by all applicable Exchange rules, which will be available on the Exchange's website and which may be updated from time to time.**

This text will also be displayed to buyers and sellers using the web interface means of submitting trades that is detailed in the next subsection below.

Upon submission of a transaction to the Exchange, the transaction would be routed to printers on the Exchange's operations floor for processing pursuant to the procedures described in the subsection below on risk management filters.

#### **4. Web Interface**

##### **a. Web Interface Trade Submission Procedures**

The second entry point that will be available on Day 1 is via a web interface. Each user of this new service must establish a relationship with one or more Exchange Clearing Members carrying an account(s) for that user. Clearing Members must register with the Exchange the account numbers for the accounts that may be used by the user for this new service.

Basically, an OTC market participant would start at the NYMEX website and click on an icon for OTC clearing. This icon would link the user to a log-in screen where the user would log in with his ID number and password. Consistent with floor practice at the Exchange, NYMEX would permit the seller of a trade to submit the terms of the OTC trade to the Exchange after logging in but not the buyer. In addition, while swap or other OTC transactions would have been transacted between principals, OTC "brokers" also have an established role in facilitating such trades, and the Exchange would permit such a broker to submit the terms of a completed transaction to the Exchange.

Accordingly, when a seller enters a trade, he would be required to provide the terms of trade, his own Clearing Member and account information, contact information and a name and contact information for the counterparty to the trade. Because the Exchange is only providing this new service for certain specified contracts with standardized terms, the relevant trade terms for these transactions are simplified and reduced to the same terms required for transactions executed by open outcry:

- 1) contract;
- 2) contract month;
- 3) price; and
- 4) quantity.

As noted, only the sell side could initiate a clearing order submission into the OTC Web Interface. As soon as the seller submits the trade, the buyer would automatically get a system-generated email asking him to login to the OTC web site, provide his Clearing Member and account information and "accept" the trade. Neither party would be aware of and/or required to supply under any circumstances account information of the other side. By submitting the trade terms to the Exchange, the seller would

expressly acknowledge that the seller had agreed to enter into an EFS or EFP, as applicable, and to be bound by the rules of the Exchange for that transaction. A copy of the Exchange's EFP and EFS rule amendments are included in this submission. The buyer's acceptance of the terms would constitute a similar acknowledgment.

In the instance when an OTC broker enters a trade, he would be required to enter the terms of trade, as well as the contact information for both the buy and sell sides of the trade. The broker would not be aware of and/or required to supply under any circumstances the Clearing Member and account information of either party to the trade. Both parties to the trade would automatically get a system-generated email asking them to log-in to the NYMEX web site and provide their Clearing Member and account information before "accepting" the trade. The criteria to match buy-sell trades would include product, quantity, and price; however only matched OTC trades would be submitted to the Exchange.

Once the trade terms had been entered into the web interface, the trade would be kept live for a certain set period, e.g., 1:30 p.m. on the business day that the trade was initially submitted to the Exchange. If one or both parties, as applicable, did not log in and accept the trade by the end of that set period, the trade would be "timed-out," the trade details would be purged from the system, and the parties would need to consider re-submitting the transaction on another occasion.

#### **b. Web Interface Trade Deletion Procedures**

The Exchange will implement procedures to address several scenarios as detailed below:

Scenario 1. A seller erroneously puts in the wrong trade details and wants to void the trade. He would first call the Exchange's Customer Service center to have the trade deleted. In this scenario, the trade has not yet been accepted by the buyer. Consequently, Customer Service staff, who have the authority to cancel the trade from the OTC web server, would be able to do so using the VOID button on the trade details page.

Customer Service then would call Floor Operations staff immediately to hold the trade from being entered into NYMEX ACCESS7. If the trade has not been entered into NYMEX ACCESS7 yet, then the trade ticket would be physically sent back to Customer Service for their records. However, if the trade had already been entered into NYMEX ACCESS7 by Floor Operations, then it would need to be voided in NYMEX ACCESS7, as per the current NYMEX ACCESS7 procedures.

Scenario 2. A seller erroneously puts in the wrong trade details and wants to void the trade. He would first call the NYMEX Customer Service center immediately. Under this scenario, the trade had not yet been accepted by the buyer, but when Customer Service proceeds to delete the trade, the buyer accepts the trade before they can complete the process. Customer Service then would inform the seller that the trade had already been accepted by the buyer.

Under this scenario, if both the buyer and seller agree to cancel the trade, both parties would need to call Customer Service and the trade could thereafter be deleted from the system. If both parties do not agree on canceling the trade, then the dispute likely would be resolved under the Exchange's arbitration proceedings.

Once both buyer and seller agree to have the trade deleted, Customer Service calls the floor operations immediately to hold the trade from being entered into Access. If the trade has not been entered into NYMEX ACCESS7 as yet, then the trade ticket is physically sent back to Customer Service for their records. However, if the trade has already been entered into access by the floor operations, then it would need to be voided in NYMEX ACCESS7, as per current NYMEX ACCESS7 procedures.

#### **D. Risk Management Filter**

The parties to the OTC transaction shall be solely responsible for accurately confirming the details of the OTC transaction to the Exchange, and a Clearing Member carrying the account of either party will have no responsibility in the confirmation of trade terms for the EFP or EFS transaction. Once the trade

terms had been confirmed by the parties, either through use of the Confirmation Clearing services or through use of the web interface procedures described above, NYMEX staff would manually enter the trade terms into NYMEX ACCESS7.

The long-term goal of the Exchange is to build an enterprise-wide technology infrastructure that will be utilized for OTC clearing as well as other projects and applications. However, in the near term, the Exchange intends to leverage existing technology infrastructure and clearing processes already in place to expedite market-entry for this new clearing service. Accordingly, on the launch of this new Exchange service, Exchange Floor Operations staff would manually enter the terms of a transaction into NYMEX ACCESS7 in order to take advantage of the Credit Checking functionality that is provided by the Exchange to NYMEX Clearing Members as part of NYMEX ACCESS7.

Thus, Each Clearing Member must register with the Exchange in the manner provided any customer authorized by the Clearing Member to submit transactions to the Exchange pursuant to this rule, and must also register with the Exchange the applicable account numbers for each such customer.

In general, in connection with the NYMEX ACCESS7 system, for each account carried by a Clearing Member, that Clearing Member enters into the system the authorized commodities and a dollar amount serving as the total risk value for that customer account. This risk value is set by the Clearing Member using its business judgment and the Exchange does not play a role in the establishment of particular risk value levels for specific customers of the Clearing Member. Accordingly, and as provided by new NYMEX Rule 9.04A, for each account number that has been registered with the Exchange pursuant to that rule, a Clearing Member also must input into NYMEX ACCESS7 authorization indicating the specific commodities for which a transaction may be submitted to the Exchange pursuant to that rule.

In addition, if the account had not previously been set up as an account that could be traded on the NYMEX ACCESS® system pursuant to NYMEX Rule 11.23, the Clearing Member also must input into NYMEX ACCESS® a dollar amount that shall serve as the Total Risk Value for that account. If the account has been set up as an account that could be traded on the NYMEX ACCESS® system in compliance with NYMEX Rule 11.23, the Total Risk Value for that account will cover the total amount of risk both for the commodities that may be traded on NYMEX ACCESS® and the commodities for which a transaction may be submitted to the Exchange pursuant to this rule.

A trade submitted via the OTC Web Interface for clearing will be considered a clearing order at the time when it had actually been entered into the NYMEX ACCESS7 trading system by the Exchange's trade entry staff. The time when the trade is entered into NYMEX ACCESS7 would be considered the official time-stamp of the time of receipt by the Exchange as a clearing order for risk filter screening. This risk screening process is generally completed within a matter of seconds.

With respect to the contracts to be listed for clearing on the OTC product slate, the Exchange would program the system to ensure that these contracts could not be traded on NYMEX ACCESS7. Thus, the trade terms would be entered into the system for the sole purpose of assessing whether the OTC trade would fall within the total risk value established by the Clearing Member for that account. All trade data entered into the system for this purpose would be maintained in an Exchange database and would be backed up on a regular basis. In the case where the total risk value for one side to a transaction would be exceeded by that transaction, the trade would be rejected. Exchange customer service staff would send an e-mail to that side of the transaction informing him that the trade had been rejected, and a system message automatically would be transmitted to the Clearing Member by the NYMEX ACCESS7 system.

In the event that a trade was rejected at this stage, it would be a matter for the principals to the trade to determine their subsequent courses of action. In other words, the parties independently would make a business decision as to how to proceed, and the Exchange would not participate in this process. At all times until both clearing orders have successfully cleared the Credit Check, a transaction submitted to the Exchange pursuant to Rule 9.04A would remain as an uncleared, bilateral OTC transaction wherein the parties to the OTC transaction would continue as principals in that transaction.

Once a trade had successfully passed through this Credit Checking functionality, the Exchange

would be deemed to have accepted the transaction for clearing. In addition, the EFS or EFP procedure also would be deemed to have been completed, and futures contracts thereafter will effectively be substituted for the OTC transaction that is thus extinguished between the Parties to the OTC Transaction. Thereafter, the trade would be routed electronically from NYMEX ACCESS7 to TMS, the Exchange's trade processing system, and then to Clearing 217.

Although the system would be programmed to ensure that these contracts could not be traded on NYMEX ACCESS7, the entry by Exchange staff of the clearing orders reflecting the two sides of the transaction would be displayed on the system momentarily as bids and offers as applicable for the relevant contract. The Exchange has prepared a Notice regarding the display of such prices on the system, which is included in this filing and which will be maintained on the Exchange's website. In addition, the Exchange intends to issue periodic bulletins over the NYMEX ACCESS7 system to remind system users that such market data are displayed in connection with transactions previously executed in the OTC market and do not reflect live transactions on the system. The Exchange is including this Notice in the rules that will be certified as part of this filing.

#### **E. Trade Data Deadlines**

The business hours for this new clearing service will be 7:30 a.m. to 1:30 p.m. Eastern Standard Time. However, if a trade was submitted after 1:30 p.m. or if both parties had not accepted the terms of the trade by that time, the trade would not be included in the trades to be processed and cleared for that business day. As noted, trades that are not confirmed and that do not pass the risk management levels established by either clearing firm by 1:30 p.m. on the day of the original trade submission will be "timed-out" and declared void and thus will be rejected by the system.

#### **F. New Futures Positions**

In converting an OTC swap into a futures contract for clearing purposes, the Exchange in effect would divide the swap into its constituent parts, *i.e.*, the individual contract months comprising the term of the swap. Thus, for example, if two parties executed a two-year natural gas swap, the Exchange would break the swap down into an open position in each of 24 contract months.

The customer margin funds provided to Clearing Members by their customers for such products would be held in segregation consistent with the treatment of margin funds for other futures contracts. As a note, during the initial planning for the Exchange's new clearing initiative, the Exchange considered the introduction of a new third category of account for purposes of Clearing Members' maintenance of margin funds (as an alternative to the long-established categories of house and customer accounts). However, the introduction of this new third category would have necessitated major systems changes both with respect to Exchange and to Clearing Member information technology systems and procedures. In addition, this change would have also impacted on outside entities, such as custodian banks. Consequently, in addition to the prohibitive cost associated with this approach, the Exchange concluded that the programming and testing of such changes also would have severely delayed the launch of this vitally important new service to the marketplace.

#### **G. Daily Mark-to-Market and Settlement**

##### **1. Use of Exchange Staff as Settlement Committee**

Because these contracts will not be listed for trading at the Exchange, NYMEX's new settlement rule would provide that these contracts be settled on a daily basis by Exchange staff selected by the Exchange President. The terms for final settlement on the last day that the contracts are listed for clearing at the Exchange are provided for under the terms and conditions rules for the individual contracts.

The Exchange staff participating on this settlement committee would include staff from the Exchange's Research and Clearing Departments. The Exchange believes that the staff who would be involved in this settlement process would offer neutrality and independence but also extensive expertise in their respective areas. This group would be headed by the Exchange's Senior Vice President for Planning

and Development, who has been with the Exchange since 1987, and also would include several staff members who have developed substantial expertise in their respective product areas and who generally have been with the Exchange for more than a decade.

## **2. Relevant Data**

Staff would use various sources of price data depending on the particular nature of the contract. For certain contracts specified in the rule that are essentially traded in the OTC market on the basis of NYMEX prices, such as the WTI Calendar Swap and the Henry Hub Swap contract, staff would settle the contract based upon the applicable NYMEX prices. For other contracts, staff would consider other market information, such as the following:

- (1) price data obtained from a cross-section of OTC brokers collectively representing both buyers and sellers in OTC markets;
- (2) price data obtained from OTC market participants, considering both buyers and sellers in such markets;
- (3) price data from other sources deemed to be reliable and accurate; and
- (4) other relevant data and information.

Accordingly, at the end of each NYMEX trade day, staff would generate a settlement price to be used by the Exchange's Clearing Department to mark positions in individual contract months to the market. At this time, the Exchange intends to conduct a daily survey of the top ten or so OTC brokers currently participating in OTC energy transactions; this survey would be conducted at or around 3:30 p.m. each business day, and such brokers would provide prices in the products for which they are familiar. The survey respondents would be requested to provide price information on these contracts as of the close of the Regular Trading Hours session on NYMEX, which currently ends at 2:30 p.m. on each week day.

The Exchange believes that such brokers would be a good source for such information in that these brokers are actively involved in the market and represent both buyers and sellers. The Exchange intends to establish a means for such brokers to transmit the requested information electronically to the Exchange in a way that protects the identity of the submitting broker. In addition, from time to time, Exchange staff intend to conduct periodic verifications of a portion of the prices submitted to the Exchange by such OTC brokers.

Exchange staff would reject the outlying prices submitted from the OTC broker survey and would calculate an average of the remaining prices. As a reasonability check on the data submitted by these brokers, Exchange staff also would conduct a limited survey of actual market participants in OTC energy markets; this poll would be balanced so as to provide equal weighting to buyers and sellers. Finally, on occasion, Exchange staff also might back up these data by considering other sources of information on OTC energy prices. Based on all of the above, Exchange staff would derive a settlement price that would be used for marking the OTC clearing products to the market.

The settlement prices for these new contracts would not be disseminated over the Exchange's price reporting system. However, these settlement prices would be made publicly available later that day on the Exchange's website and also included in the end-of-day data that the Exchange provides to the Commission and also makes available to the public.

## **3. Evaluation of the Value of Data to be Utilized**

The value of the settlement prices that are generated bears some relation to the quality of the data that is utilized by Exchange staff in this process. In this regard, as indicated previously, four of the 25 contracts to be listed have pricing that is based upon or otherwise converges with NYMEX prices. These contracts include the following:

Henry Hub Swap;  
 New York Harbor No. 2 Heating Oil Crack Calendar Swap;  
 New York Harbor Unleaded Gasoline Crack Calendar Swap; and  
 WTI Crude Oil Calendar Swap.

The Henry Hub Swap contract is based upon pricing for the Exchange's Natural Gas futures contract, and the WTI Calendar Swap contract is based upon pricing for the Exchange's Light Sweet Crude Oil futures contract. Both Exchange contracts are mature and liquid futures contracts. For the trade date of May 14, 2002, trading volume in the Exchange's Natural Gas contract totaled 117, 998 contracts. For the trade date of May 14, 2002, trading volume in the Exchange's Light Sweet Crude Oil contract totaled 253, 716 contracts. In addition, it should be noted that the Henry Hub Swap and the WTI Crude Oil Calendar Swap are the two most widely traded energy contracts in OTC markets today.

With respect to the other contracts to be listed upon commencement of this new service, as noted previously, these contracts were selected in part because of the liquidity available in OTC markets for these contracts, and this liquidity is useful in providing an accurate determination of the value of the contracts. With that said, two additional points warrant some consideration. First, because these contracts are not being listed for trading at the Exchange, the settlement prices assigned to these contracts by Exchange staff would not be generated for purposes of price discovery and dissemination but rather solely for risk management purposes.

Second, following up on that point, it is also worth noting the distinctive nature of the basis swap contracts that will be listed for clearing at the Exchange. In general, these basis contracts are priced relative to the relationship between two pricing sources. For example, final settlement for each contract month in the NYMEX Chicago Basis Swap contract for each contract month would be equal to the bidweek price (average) for the Chicago Citygate under the Midwest heading found in NGI's Bidweek Survey minus the NYMEX (Henry Hub) Natural Gas Futures contract final settlement price for the corresponding contract month. As a result of the pricing for these contracts being based on the price relationship between the two price sources noted, the historical experience in OTC energy markets has been that such basis contracts have not been notably volatile contracts.

## **H. Margins**

### **1. Standard Volatility Analysis**

The OTC products would be margined using Clearing 217's established SPAN standard portfolio analysis system. Essentially, Exchange staff would utilize its established processes and procedures for this new category of futures contracts. In particular, with respect to futures contracts for which no option contract is listed, Exchange staff on a daily basis consider the actual volatility of the contract using the prior 30 days to measure the historical volatility of the contract as an estimate of the price volatility of the commodity. This same analysis will be used for these contracts as well.

Exchange staff then assesses the level of commodity price risk for a particular commodity that is associated with that level of volatility. Thereafter, Exchange Research Department staff would calculate the commodity price risk for the specific commodity. In general, Exchange staff uses a quantity of standard deviations that is statistically associated with a 99% probability of occurrence. As a note, the chief Research Dept. staff member assigned to calculate margin levels has a Ph.D. in economics, continues to teach college level finance courses on an ongoing basis, and has been associated with the Exchange in this capacity for more than a decade.

Overall, margin levels are adjusted to reflect current volatility levels. In determining actual margin levels, however, staff also would take note of a wide variety of other factors affecting market fundamentals, including seasonal demand patterns, weather expectations, inventory and production levels, and governmental or other political factors. The final decision on raising, lowering or maintaining margin levels would be made by the Exchange President or the President's designee.

The Exchange also would undertake an analysis to assess any market volatility correlation between the OTC product and existing NYMEX products. Based on the results of that analysis, the Exchange might permit certain offsets in margins between the various products. For example, consistent with current practice, the Exchange might offer an inter-commodity spread credit in connection with margin on a contract traded at NYMEX and an OTC product that is exchanged via EFS for a futures position at

the Exchange.

## **2. Initial Exchange Undertakings on Margin Treatment**

Finally, as a prudential matter, the Exchange represents that it would undertake the following actions with regard to margin treatment for these contracts during the 90 calendar days following the launch of the Exchange's OTC clearing initiative ("Review Period"):

A. With respect to the Mid-Columbia Electricity, PJM Electricity and Palo Verde Electricity contracts to be listed initially and with respect to any other electricity contracts that may be listed during the Review Period, the Exchange agrees that customer margin rates shall be consistent with a 99% level of confidence that such margin rates should reflect the risk of price movement over a four-day period.

B. With respect to the WTI Calendar Swap, the Henry Hub Swap and the Henry Hub Basis Swap contracts, which are either totally or primarily priced in OTC markets on the basis of NYMEX pricing (and similar contracts that may be listed during the Review Period), the Exchange would apply its standard risk analysis and margin procedures, which would provide a 99% level of confidence that the customer margin rate should reflect the risk of price movement over two days.

C. With respect to all other contracts to be listed only for clearing at the Exchange and which as a group generally would involve contracts with terms consistent with those of liquid and actively traded OTC contracts (and with respect to similar contracts that may be listed during the Review Period), the Exchange agrees that the margin rates applicable to customers shall be increased by 20% above the margin rate generated as a result of the Exchange's standard risk analysis and margin procedures.

D. In addition, the Exchange agrees that it will consider use of intercommodity spread credits as appropriate to the affected markets.

E. Finally, following the end of the Review Period, the Exchange agrees that it will submit a report to the Commission reviewing its experiences with the special margin provisions provided in paragraphs A and C above, and discussing any proposed changes to such special margin provisions. The Exchange further agrees that such special margin provisions shall remain in effect during the Commission's review of this report.

It should be noted that the margin approach noted above for the electricity contracts, in setting margin rates that should reflect the risk of price movement over a four-day period, would double from two days to four days the period of price movement typically reflected in customer margin rates. In practice, the additional period of price movement covered by such customer margin rates thus should generally result in margin rates that are approximately 60%-70% higher than the customer margin rates that should reflect the risk of price movement over two days.

### **I. Final Settlement**

Once an OTC trade had been exchanged for a futures position and processed through Clearing 217, the parties to that transaction in effect now would have an open position. Under the usual description in treatises on futures trading, in offering clearing services, the Exchange in effect would be agreeing to serve as the buyer to every seller and the seller to every buyer. Thus, an OTC market participant now could act independently of the other OTC party with respect to its open position on the Exchange. As is the case with other futures contracts, such a party could simply determine to maintain its open position until the final contract month had terminated. This termination might involve either a final cash settlement or physical delivery of a specified energy product.

As a note, a general characteristic of a good number of the cash-settled OTC instruments is that their value subsides over time so that final settlement often can involve fairly nominal amounts.

The final settlement price on the last trade date in an expiring contract month would be determined in relation to the nature of that particular contract. If the OTC product exchanged for a futures contract for clearing was a "look-alike" of a NYMEX contract, the settlement price for the NYMEX futures contract trading on the Exchange would be used for the final settlement price for the OTC look-alike contract being cleared at the Exchange. However, if the terms of the OTC product were not based on an existing NYMEX product, the Exchange would settle the contract based upon transaction prices that are disseminated widely by various price reporting services as provided by the applicable rules for that contract.

#### **J. Offset**

On the other hand, consistent with other futures contracts, it would also be possible for a participant to extinguish an open position in one of these products that was maintained in a customer account for that participant by the FCM. This is perhaps most easily explained through the use of an example. Suppose that Energy Corp A. entered into a two-year Henry Hub swap that was submitted to and accepted by the Exchange for clearing. However, after six months, Energy Corp. A wants to liquidate this open position in its account maintained at FCM X.

Basically, what Energy Corp A. would do would be to enter into another OTC transaction in which it essentially took the mirror opposite of its position in the original transaction, except that this second OTC trade would have a duration of 18 months rather than 24 months. Upon the acceptance of this trade into Clearing 21, the second trade would be split into the 18 contract months and would offset and extinguish the existing open positions in each of those months.

#### **K. Position Limits, Accountability and Reporting.**

Historically, futures exchanges have utilized position limits and position accountability levels on contracts listed at such exchanges for purposes of market surveillance and as a support in ensuring the financial integrity of transactions cleared at the applicable exchange. Although these contracts will not be listed for trading at the Exchange, the Exchange intended to utilize such tools as an ongoing support and enhancement of its overall financial surveillance and monitoring.

Accordingly, the amendments to NYMEX Rules 9.26, 9.27 and 9.34 are consistent with the rule changes that the Exchange submitted via self-certification one year ago for the contracts associated with the enymexK project, except that with respect to position accountability levels, the Exchange has now provided specific levels for each of the applicable contracts.

Basically, the approach undertaken in these rules is that for the any one month/all months combined limit, position accountability will be used for all contracts. For the expiration and current delivery month limits, the Exchange will maintain hard position limits as specified in the rule for each of the OTC clearing contracts involving physical delivery. Finally, the amendments to Rule 9.34 establish a reporting level of 25 contracts for each contract listed for clearing only at the Exchange, the same reporting level currently used for many other Exchange contracts.

#### **L. Financial Surveillance and Oversight**

A document has been included as an attachment that provides a general overview of the Exchange's financial safeguard system. This document briefly summarizes Clearing Member financial requirements and staff review of financial statements; the Exchange's Guaranty Fund and Exchange default priorities; Clearing Member margin limits; banking institution requirements; general parameters of margin policy; segregation of customer funds; daily surveillance procedures; and the role of the Joint Audit Committee in financial oversight policy and review.

In addition to the daily financial surveillance procedures noted in the attachment, Exchange staff also has an established Risk Management group, which meets as often as necessary but at least once a week. The group is comprised of staff from the Compliance, Research, Operations and Clearing

departments. This Risk Management group considers current margin levels and also reviews any companies that may be on the group's ongoing "watch" list. This list could include companies that are Member Firms at the Exchange as well as companies that do business on the Exchange.

For each such company, the Risk Management Group notes recent changes in bond yields and stock prices for the company and other market information, including information obtained from the Exchange's large trading reporting files. As a result of this review, the Risk Management Group may recommend to senior management that Clearing Members carrying accounts for a particular company be contacted to discuss whether the company's positions should be reduced.

#### **M. Internal Compliance at FCMs**

It is worth noting that, with respect to financial monitoring and risk management, FCMs have their own internal staffs dedicated to such activities, and that many of these FCMs are also audited regularly by the largest accounting firms in the accounting profession.

#### **N. Liquidation of Open Positions in the Event of a FCM Default**

The Exchange's Board of Directors has also approved a new Resolution for the Executive Committee to address the manner of liquidation for contracts not listed for trading at the Exchange when a Member Firm FCM defaults and is subsequently suspended. Briefly, the approved Resolution would provide that the Executive Committee, acting pursuant to its powers under Article 8 of the Exchange's Bylaws, could take any action that it deems to be necessary and appropriate to accomplish such liquidation.

Such action could include, but would not be limited to, the appointment of one or more Exchange designees to be assigned responsibility for entering into any type of transaction deemed necessary, including those not executed on the Exchange to offset the open positions. For each such designee, the Executive Committee would determine the degree of discretion granted to such designee, including with respect to price and the time frame for orderly liquidation of the open positions.

#### **O. Impact of Default on Market Participants**

One estimate is that at most 5% and most likely no more than 1% of the Exchange's open interest and trading volume in the energy contracts is attributable to the traditional retail customer. Fifty percent of the volume in NYMEX energy contracts is generated by NYMEX locals, with the remaining volume originating with commercials and in some instances by sophisticated speculators, such as commodity funds. Thus, the predominant impact of a financial problem associated with one of these new contracts would be felt by other institutional or sophisticated market participants that are similarly situated.

This impact is further limited by the particular FCMs emphasizing retail business at the Exchange. With respect to energy trading at NYMEX by the retail investor, it has been the Exchange's experience that such customers are largely concentrated in four FCMs that actively seek out such business. From the Exchange's perspective, the key regulatory consideration is the extent of capital that is available at the applicable FCM to provide a back-stop for the transactions cleared by that FCM. In this regard, based upon the most recent month-end modified capital summary available of these and other NYMEX Clearing Members, it can be noted that, as of February 28, 2002, three of the four FCMs are large and well-capitalized firms. Indeed, each of these three firms had available regulatory capital of more than \$100 million. The fourth FCM had over \$19 million available in regulatory capital. However, following recent consolidations, this clearing member's business is largely comprised of clearing trading by retail customers and by locals.

The final comment to be made on this issue is that the risk of any customer on the Exchange, including retail customers, is directly affected by the quality of the risk management and financial surveillance capabilities at the Exchange. The Exchange believes that NYMEX has an excellent track record in these areas, and the Exchange is continually searching for ways to enhance and expand upon that tradition of excellence.

**P. Summary Disciplinary Procedures**

The disciplinary sanction applicable to a non-Member user of these services would be denial of further direct access to the system. Exchange Members who use this system would continue to be subject to Exchange rules.