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November 4, 2009

BY EMAIL

Mr. David Stawick
Secretary
Commodity Futures Trading Commission
1155 - 21st Street, NW
Washington, DC 20581

COMMENT

Re: Notice of Intent to determine whether certain contracts offered for trading on Natural Gas Exchange Inc. ("NGX") perform a significant price discovery function

Dear Secretary Stawick:

NGX is pleased to have the opportunity to comment on the Commodity Futures Trading Commission's (the "Commission") notice of intent (the "Notice") to determine whether the following contracts (the "Proposed Contracts") perform a significant price discovery function:

- AB-NIT Physical Basis LD1
- AB-NIT Physical Fixed Price
- Union Dawn Physical Basis LD1
- Union Dawn Physical Fixed Price
- AB-NIT Index 7a

For the reasons described herein, it is NGX's view that these contracts lack sufficient liquidity to perform a significant price discovery function.

Background

Material liquidity is a significant component in the analysis of whether contracts serve a significant price discovery function. While Appendix A to Part 36 (Guidance on Significant Price Discovery Contracts ("the "Guidance"))[1] of the rules and regulations regarding significant

[1] !& C.F.R. 36 (2009).

price discovery contracts ("SPDCs") specifies that "not all listed factors must be present to support a determination that a contract performs a significant price discovery function", it is stated that with respect to price linkage and arbitrage, "a significant amount of liquidity *presumably would be necessary* for a contract to perform a significant price discovery function in conjunction with these factors". With respect to "material price reference", in most cases the consideration of liquidity is implicitly understood to be a relevant, if not fundamental factor, where material price reference is being considered.[2]

The centrality of material liquidity to any SPDC determination is also supported by the Commission's 2007 Report on the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial markets where it is stated that "the Commission believes that the CEA's current level of regulation is appropriate for ECM contracts relying on the 2(h)(3) exemption *when trading volume remains low* and prices are not significantly relied upon by other markets".[3] It is worth noting that Congress revealed its intent that liquidity be an essential element of any SPDC determination in their grant of authority to the CFTC over two categories of ECM contracts; (i) *contracts with enough volume* to impact trading on a designated contract market; or (ii) *contracts with enough volume* to be quoted as an independent price reference by the public.[4] In each case sufficient volume was referenced as a necessary precondition to any finding that additional regulation of ECM contracts is warranted.

<u>The Proposed Contracts</u>

The Commission outlines in the Notice three bases upon which the AB-NIT basis and Union Dawn basis contracts may be SPDCs ((i) material liquidity; (ii) price linkage; and (iii) material price reference) and two bases upon which the AB-NIT fixed price, Union Dawn fixed price and AB-NIT index 7a may be SPDCs ((i) material liquidity; and (ii) material price reference). NGX submits that in the case of each of the Proposed Contracts a SPDC determination cannot be supported on price linkage and/or material price reference alone, without the contracts otherwise being "materially liquid".

None of the Proposed Contracts qualify as sufficiently material to meet the threshold intended by Congress and supported by the SPDC rules. In particular, with respect to the Union Dawn and AB-NIT basis contracts, there were approximately 8 trades per day and approximately 23 trades per day, respectively, on average over a calendar quarter. Regarding the AB-NIT index contract, there were only approximately 10 trades per day on average over a calendar quarter. Liquidity in these and the other Proposed Contracts is immaterial with average trades per hour as low and 1 and no higher than 15 trades per (trading) hour. Comparing these statistics in the context of the Henry Hub LD1 swap, NGX's highest volume (and trades per day) contracts comprise less than 1 percent of the liquidity level of the Henry Hub LD1 market.

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[2] In the Guidance it is stated that "Under a Material Price Reference analysis, the Commission expects that material liquidity in the contract likely will be the primary motivation for a publisher to publish particular prices".

[3] Commodity Futures Trading Commission, *Report on the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets* (October 2007).

[4] The Joint Explanatory Statement of the Committee of Agriculture conference, H.R. Rep. No. 1110 627, 110 Cong., 2nd Sess. at 978-86 (2008).

The Commission seems to have applied a threshold for "material liquidity" that is extremely low, and in general insufficient to support a determination that these contracts are no longer emerging markets but in fact serve a significant price discovery function. Material liquidity, a difficult concept to define based on the unique differences and subtle but important distinctions of some markets, was nonetheless intended to be a "broad concept that captures the ability to transact immediately with little or no price concession".[5] In the Guidance it is also stated that to prove material liquidity, the contract must trade with sufficient volume "to have a material effect on other agreement, contracts, or transactions listed for trading" on another designated contract market or ECM. And where "material liquidity exists, a more less continuous stream of prices can be observed and the prices should be similar", such as "where trades occur multiple times per minute". The levels of liquidity outlined above for the Proposed Contracts cannot be what Congress intended in establishing the dividing line between contracts ripe for full regulation and those still emerging and in need of further incubation.

We believe the Commission may have extrapolated from the ECM "early reporting" regime (where there is a five trade per day threshold for ECM reporting purposes) and inappropriately adopted an arbitrary threshold of five trades per day as the standard for material liquidity under the new SPDC regime. Without more extensive analysis and testing the validity of this threshold through a public comment process, NGX submits that this low standard risks undoing the important distinction to be preserved under the Commodity Futures Modernization Act between mature markets and those that are still emerging.

Conclusion

NGX recognizes that a "one size fits all" approach to determining material liquidity under the new SPDC regime is not appropriate for the task of determining which ECM contracts genuinely perform significant price discovery functions. However, by purporting to adopt a threshold as low as 5, 10 or 20 trades per day as sufficiently material to attract a SPDC designation cannot be in alignment with the intent of Congress, who recognized the fundamental importance of preserving tiered regulation and the important distinction, from a regulatory perspective, between mature or significant markets and those that are still emerging.

Yours truly,

Cheryl Graden

Cheryl Graden
Chief Legal Counsel, NGX

cc: Peter Krenkel, President, NGX

[5] Appendix A to Part 36, 17 C.F.R. 36 (2009).