

UNITED STATES COMMODITY FUTURES TRADING COMMISSION

**FORM DCO (Corrected Copy)**

**DERIVATIVES CLEARING ORGANIZATION  
APPLICATION FOR REGISTRATION**

COVER SHEET

Natural Gas Exchange Inc.

- If this is an **APPLICATION** for registration, complete in full and check here.
- If this is an **AMENDMENT** to an application, list below all items that are being amended and check here.
- If this is an **APPLICATION FOR AN AMENDMENT** to an existing registration, list below all items to be amended and check here.

- (1) Amend Natural Gas Exchange's ("NGX") Order of Registration ("Registration Order"), dated December 12, 2008, by superseding and amending paragraphs 1 and 2 to read as follows:

IT IS FURTHER ORDERED THAT:

- (1) NGX is permitted to engage in activities as a DCO related to physically delivered or financially settled contracts (futures or swaps) based on energy products that could qualify as exempt commodities as defined in Section 1a(20) of the CEA, 7 U.S.C. 1a(20), traded on or subject to the rules of a Foreign Board of Trade.
- (2) NGX is also permitted to engage in activities as a DCO related to physically delivered or financially settled swap contracts as defined in Section 1a(47) of the CEA, 7 U.S.C. 1a(47) based on energy products that could qualify as exempt commodities as defined in Section 1a(20) of the CEA, 7 U.S.C. 1a(20), and which are traded bilaterally or subject to the rules of a Designated Contract Market or a registered Swap Execution Facility.
- (3) NGX may also engage in activities to clear spot or forward contracts not subject to the CEA.
- (2) As previously petitioned under Commission Rule 39.14(b), permit NGX to provide for settlement of variation adjustments to collateral using an accrual, rather than a daily payment and collection, methodology for contracts, as applicable.

As explained in the petition to modify NGX's Registration Order ("Petition") to which this Form DCO is attached, the modification of the Registration Order being requested is limited in scope to update the Registration Order to reflect recent changes brought about by the amendments to the Commodity Exchange Act, 7 U.S.C. §1 et seq. ("Act") by the Dodd-Frank Wall Street

Reform and Consumer Protection Act.<sup>1</sup> This requested amendment does not reflect any changes in the operations of the clearinghouse.

The Dodd-Frank Act has replaced the Section 2(h) ECM category for trading facilities, providing that ECMs may continue operating as such for a transitional period. NGX has, during this period, filed with the Commission an Application for Registration as a Foreign Board of Trade (“FBOT”) under 17 C.F.R. Part 48. That Application remains pending.

As a FBOT, NGX is required to characterize its contracts as either futures or swaps. (This was not required under the ECM status.) NGX is making clear under its FBOT Application that certain contracts traded on NGX which are futures contracts under Canadian law would also be classified as futures contracts under the FBOT Application. As a consequence, the contracts that NGX clears as a DCO (“NGX DCO”) for the NGX exchange should be regarded as “futures” within the meaning of the Act and Commission regulations. NGX DCO will also be clearing contracts that are executed over-the-counter (“OTC”) under the NGX rule relating to Exchange of Futures for Related Products (“EFRP”). These OTC transactions may be either for products that are physicals (spot or forwards) or for swaps. Both are covered under the EFRP rule, such that the OTC transactions clear as futures contracts.

NGX currently is permitted, by its Registration Order, to clear contracts that are within the meaning of “swap” as long as the contract is an energy contract.<sup>2</sup> As an FBOT, NGX would be recognized as an approved venue for the execution of cleared swaps and accordingly, would be able to clear swaps traded on the FBOT, once its Application is granted, just as it is currently permitted under the Registration Order. In addition, NGX DCO, consistent with the scope of its current Registration Order, remains authorized to clear swaps on a Designated Contract Market or a Swap Execution Facility. Accordingly, the intent and the purpose of the requested amendment is to make clear that NGX may continue to operate as it does under the Registration Order as currently in effect, adjusted only to reflect the changed legal status within which NGX will now operate.

In addition, NGX previously petitioned the Commission for an order under Commission Rule 39.14(b) to permit NGX DCO to provide for settlement of variation adjustments to collateral using an accrual, rather than a daily payment and collection, methodology.<sup>3</sup> NGX hereby includes that request for consideration under this Form DCO requested amendment.

NGX is submitting the following documents, which demonstrate NGX DCO’s compliance with the DCO Core Principles and rules thereunder, which relate to consideration of the requested amendments:

- (1) Exhibit A-2, a copy of NGX’s amended rulebook;
- (2) Exhibit A-3, a narrative summary of NGX’s clearing activities;

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<sup>1</sup> Public Law 111–203, 124 Stat. 1376 (2010).

<sup>2</sup> This is pursuant to the reference in paragraph 2 of the Order referring to 12 U.S.C. §4421(2).

<sup>3</sup> See petition under Commission Rule 39.14(b) from Paul M. Architzel of WilmerHale on behalf of NGX (March 23, 2012).

- (3) Exhibit A-4, NGX's current business plan;
- (4) Exhibit C-2, a discussion of the products that NGX DCO currently, and will continue to, clear once NGX exchange becomes an FBOT, following amendment of the Registration Order;
- (5) Exhibit E, a narrative discussing the NGX DCO settlement procedure; and
- (6) Exhibit F, a description of NGX's unchanged policy relating to the segregation of clearing members' funds (and explanation that NGX holds no customer funds).

**GENERAL INFORMATION**

- Name under which business is conducted, if different than name specified above (include acronyms, if any):

**Not Applicable.**

- If name of derivatives clearing organization is being amended, state previous derivatives clearing organization name:

Not Applicable.

- **Registered Office**

The Exchange Tower  
 130 King Street West, 3rd Floor  
 Toronto, ON M5X 1J2

- **Mailing address, if different than address specified above:**

Natural Gas Exchange Inc.  
 10th floor  
 300-5th Avenue SW  
 Calgary, Alberta  
 Canada T2P 3C4  
 Phone: 403.974.1700  
 Fax: 403.974.1719

- **Additional contact information:**

Website URL

[www.ngx.com](http://www.ngx.com)

Main Phone Number

**403 974 1700**

- **List of principal office(s) and address(es) where derivatives clearing organization activities are/will be conducted:**

Office

Address

**Principal Office**

Natural Gas Exchange Inc.  
10th floor  
300-5th Avenue SW  
Calgary, Alberta  
Canada T2P 3C4  
Phone: 403.974.1700  
Fax: 403.974.1719

**U.S. Office**

Natural Gas Exchange Inc. -  
Suite 270  
19500 State Highway 249  
Houston, Texas  
U.S.A. 77070  
Phone: 281.720.0525  
Fax: 281.720.0530

**BUSINESS ORGANIZATION**

- Applicant is a:

Corporation

Partnership (specify whether general or  limited)

Limited Liability Company

Other form of organization (specify)

- Date of formation: March 1, 1993
- Jurisdiction of organization: Canada
- List all other jurisdictions in which Applicant is qualified to do business (including non-US jurisdictions):  
Canada and the United States

- List all other regulatory licenses or registrations of Applicant (or exemptions from any licensing requirement) including with non-US regulators:

US Exempt Commercial Market

US Derivatives Clearing Organization

ASC (Alberta)- Exchange and Clearing Agency Recognition

BCSC (British Columbia) – Exemption order dated Sept 19, 2001, relating to exchange and swap, exempt from registration

MSC (Manitoba) –Exemption order dated April 22, 2009

OSC (Ontario) – order dated July 27, 2012

SSC (Saskatchewan)– Exemption order dated Dec 1, 2004

AMF (Quebec) –Exemption order dated May 2, 2012.

- **FEIN or other Tax ID#:**

EIN 98-0471215

- **Fiscal Year End:**

Dec. 31

**CONTACT INFORMATION**

- Provide contact information specifying name, title, phone numbers, mailing address and e-mail address for the following individuals:

- a. The primary contact for questions and correspondence regarding the application

Cheryl Graden,  
Chief Legal Officer  
10th floor  
300-5th Avenue SW  
Calgary, Alberta  
Canada T2P 3C4  
Phone: 416 947 4359  
E-mail Address  
cheryl.graden@tmx.com

- b. The individual responsible for handling questions regarding the Applicant's financial statements

Melanie Laidlaw,  
Director, Financial Planning & Analysis  
Natural Gas Exchange Inc.  
Tel: (403) 974-1713  
Cell: (403) 613-0739  
Email: melanie.laidlaw@ngx.com

- c. The individual responsible for serving as the Chief Risk Officer of the Applicant pursuant to § 39.13 of the Commission's regulations

Steve Lappin,  
Chief Risk Officer  
10th floor  
300-5th Avenue SW  
Calgary, Alberta  
Canada T2P 3C4  
Phone: 403.974. 4308  
Steven.Lappin@ngx.com

- d. The individual responsible for serving as the Chief Compliance Officer of the Applicant pursuant to § 39.10 of the Commission's regulations

Cheryl Graden,  
Chief Compliance Officer  
Please see above

- e. The individual responsible for serving as the chief legal officer of the Applicant

Cheryl Graden,  
Chief Legal Officer  
Please see above

- Outside Service Providers: Provide contact information specifying name, title, phone number, mailing address and e-mail address for any outside service provider retained by the Applicant as follows:
  - a. Certified Public Accountant  
KPMG  
2700-205 5 AVE SW,  
Calgary, AB T2P 4B9 KPMG
  
  - b. Legal Counsel  
Paul M. Architzel  
Wilmer Cutler Pickering Hale and Dorr LLP  
1875 Pennsylvania Avenue, NW,  
Washington, DC 20006r  
202-633-6240  
Paul.Architzel@wilmerhale.com
  
  - c. Records Storage or Management  
N/A
  
  - d. Business Continuity/Disaster Recovery  
N/A
  
- Applicant agrees and consents that the notice of any proceeding before the Commission in connection with this application may be given by sending such notice by certified mail to the person named below at the address given.

**Print Name and Title**

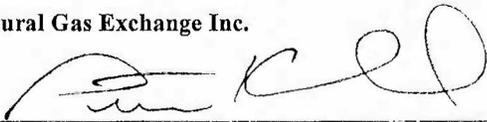
Cheryl Graden,  
Chief Legal Officer  
Please see above

**SIGNATURE/REPRESENTATION**

- The Applicant has duly caused this request for an amendment to the current registration to be signed on its behalf by its duly authorized representative as of November 15, 2012. The Applicant and the undersigned represent hereby that all information contained herein is true, current and complete. It is understood that all required items and Exhibits are considered integral parts of this Form DCO and that the submission of any amendment represents that all items and Exhibits that are not amended, remain true, current, and complete as previously filed.

Name of Registrant Requesting Amendment

**Natural Gas Exchange Inc.**



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By: Peter Krenkel

Title: President and Chief Executive Officer

Dated: November 15, 2012

## **Form DCO— Exhibit A-2— General Information Compliance**

### **Request:**

Attach as Exhibit A-2, a current copy of Applicant's rulebook. The rulebook must consist of all the rules necessary to carry out Applicant's role as a derivatives clearing organization. Applicant must certify that its rules constitute a binding agreement between Applicant and its clearing members and, in addition to the separate clearing member agreements, establish rights and obligations between Applicant and its clearing members.

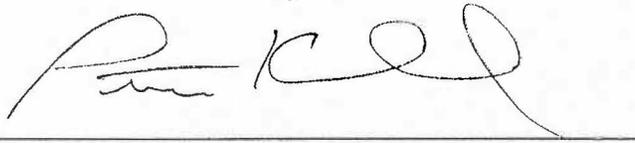
### **Response:**

A copy of the Contracting Party Agreement ("CPA"), which constitutes both the rules of the NGX clearinghouse as well as the clearing member agreement, as amended, is being submitted under separate cover.

## CERTIFICATION; Form DCO— Exhibit A-2

Natural Gas Exchange Inc. (“NGX”) hereby certifies that the Contracting Party Agreement (“CPA”) constitutes a binding agreement between NGX and its clearing participants and establishes rights and obligations between NGX and its clearing participants.

For Natural Gas Exchange Inc.



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By: Peter Krenkel

Title: President and Chief Executive Officer

Dated: November 15, 2012

## Form DCO— Exhibit A-3— General Information Compliance

### Request:

Attach as Exhibit A-3, a narrative summary of Applicant's proposed clearing activities including (i) the anticipated start date of clearing products (or, if Applicant is already clearing products, the anticipated start date of activities for which Applicant is seeking an amendment to its registration) and (ii) a description of the scope of Applicant's proposed clearing activities (e.g., clearing for a designated contract market; clearing for a swap execution facility; clearing bilaterally executed products).

### Response:

NGX DCO already clears physically or financially settled energy contracts that are executed on the NGX market or are OTC. NGX anticipates no material change in its clearing operations as a result of this amendment. NGX is a Canadian exchange and under Section 4(a) of the Act is a foreign board of trade. NGX has operated since 2002 providing access to U.S. persons as an Exempt Commercial Market ("ECM") pursuant to Section 2(h) of the Act, 7 U.S.C. §4(h) (2009). NGX in 2008 was recognized as a clearing agency by the Alberta Securities Commission. NGX has been registered with the Commission as a DCO since 2008 to clear energy contracts executed on NGX exchange and similar contracts entered into off of the NGX market. In light of the amendment to the Act by the Dodd-Frank Wall Street Reform and Consumer Protection Act, which removed ECM status, NGX has applied to become a registered FBOT under Part 48 of the Commission's Rules. This Application was submitted on February 17, 2012 and remains pending. NGX anticipates that its FBOT application will be granted during or before December 2012. There will be no change in NGX DCO's role as clearinghouse for NGX. The FBOT rules contemplate that a DCO may clear for Registered FBOTs.<sup>4</sup>

As part of its Application for Registration as an FBOT, NGX is required to identify the instruments traded thereon as either futures, options or swaps.<sup>5</sup> This was not required of ECMs. The majority of contracts traded on, and cleared by, NGX are regulated in Canada as futures contracts, or a subset of futures called "exchange contracts."<sup>6</sup>

In conjunction with its pending Application for Registration as an FBOT, NGX is amending its Contracting Party Agreement ("CPA")<sup>7</sup> to more clearly identify these products as being futures contracts.<sup>8</sup> NGX has also clarified that all OTC transactions cleared by NGX DCO will be cleared by NGX DCO under the CPA's Exchange of Futures for Related Product ("EFRP") rules.<sup>9</sup> As explained in the NGX October Compliance Notice,<sup>10</sup> currently all clearing

<sup>4</sup> See 17 C.F.R. §48.8(a)(3)(ii)(A).

<sup>5</sup> See 17 C.F.R. §48.7(c)(1)(i).

<sup>6</sup> See §1(s) of the Alberta Securities Act.

<sup>7</sup> The CPA includes and constitutes the rules of NGX and NGX DCO.

<sup>8</sup> Accordingly, these contracts are "foreign futures" within the meaning of 17 C.F.R. §30.1(a).

<sup>9</sup> The products available for clearing under the EFRP procedures include forward contracts in physical crude oil and natural gas products, which may be facilitated by voice brokers, NGX or the IntercontinentalCommodityExchange or swaps which may be facilitated by voice brokers.

by NGX DCO is of futures contracts. These will either be futures contracts listed for trading on NGX as a registered FBOT or products submitted for clearing under the EFRP rule.

In addition, NGX DCO is currently authorized as a Registered DCO to clear contracts which may be considered to be “swaps” as defined by Section 1a(47) of the Act. NGX DCO, pursuant to its current authorization, which is not being requested to be amended, may also clear swaps in energy products.

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<sup>10</sup> See NGX Compliance Notice, at: <http://www.ngx.com/pdf/ComplianceNoticeOct52012.pdf> (“Compliance Notice”).

## Form DCO— Exhibit A-4— General Information Compliance

### Request:

Attach as Exhibit A-4, a detailed business plan setting forth, at a minimum, the nature of and rationale for Applicant's activities as a derivatives clearing organization, the context in which it is beginning or expanding its activities, and the nature, terms, and conditions of the products it will clear.

### Response:

NGX has operated within the U.S. as an ECM since 2002<sup>11</sup> and as a DCO since 2008. NGX will continue to provide electronic trading, central counterparty clearing and data services to the North American natural gas and electricity markets. NGX will also continue to offer without change its non-intermediated clearing model in which all participants on the NGX trading platform self-clear on NGX DCO (i.e., none of the participants clear for customers.)<sup>12</sup>

In addition, NGX will continue to be non-mutualized such that clearing participants are not required to contribute to the guaranty fund, which is fully financed by NGX DCO's proprietary funds. As a central counterparty, NGX DCO will also maintain its practice of guaranteeing completion of the settlement process by arranging for deliveries and settlement payments to be made. Through this process, NGX DCO ultimately stands behind the settlement process, and in case of default, will complete the delivery process to the non-defaulting party.

NGX plans to continue operations as currently constituted after its Application for Registration as an FBOT is granted and its Petition to amend its DCO Registration Order is granted.

As discussed above, there is no change in the business plan or operation of the DCO contemplated at this time. The only change is one of regulatory status for NGX occasioned by the amendment to the Act made by the Dodd-Frank Act.

### Rationale for Current and Future Clearing Services

NGX DCO offers clearing to the NGX exchange. NGX has since 2002 offered the North American natural gas, oil (since 2009) and power markets a centralized market place for the trading of physically – and financially settled – energy products. This service has been crucial to the energy sector insofar as it provides greater transparency to the trading of energy products, enhancing price discovery in these markets. Through this requested amendment NGX is neither beginning nor expanding its clearing operations.

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.

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<sup>11</sup> NGX first notified the Commission of its operation as an ECM on November 5, 2002.

<sup>12</sup> *But see* discussion in Exhibit F. NGX stands ready to admit customer clearing if there is a commercial demand for such a model.

Moreover, among the contracts cleared by NGX DCO under its EFRP provisions are forward contracts in the physical commodity.<sup>13</sup> 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. Accordingly, NGX DCO has provided credit enhancement services both with respect to open contracts and the settlement process for those transacting in these markets, reducing possible systemic risk. This is an important public policy goal of the Dodd-Frank Act.

### **Nature of contracts cleared**

NGX trades and clears a number of different products, including physical and financially settled contracts in natural gas, oil and power traded on the NGX market. A complete listing of contracts listed for trading on NGX FBOT market and their terms and conditions are described in Exhibit E of NGX’s FBOT application, which is being submitted under separate cover.

NGX DCO will also accept for clearing through the EFRP process forward and swap contracts for Physical and Financial Natgas, Financial Power and Physical and Financial Crude Oil which are executed bilaterally. These contracts may be documented by the OTC counterparties in any number of ways, including ISDAs, NAESBs or other similar types of agreements. Voice brokers may facilitate such bilateral transactions, and assist in transmission of trade details to NGX. The counterparties to transactions which may be swaps subject to Commission jurisdictions are responsible for complying with any requirements which may apply to their trading of swap contracts.

NGX will also accept for clearing via EFRP forward contracts for the physical delivery of crude oil and natural gas the matching of which are assisted by NGX. These bids and offers are available in a separate pricing stack from futures. The counterparties to such matched forward contracts may, by separate agreement, present them to NGX for clearing via EFRP. Forward contracts cleared by EFRP will include physical Natgas forward contracts offered by the IntercontinentalExchange (“ICE”) for delivery at several hubs in the U.S.

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<sup>13</sup> Forward contracts may be traded in the bi-lateral markets and presented for clearing to NGX. To the extent that forward contracts trade on NGX, they will not be traded on NGX pursuant to its registration as an FBOT.

## Form DCO— Exhibit C-2— Product Eligibility

### Request:

b. Product Eligibility – Provide as **Exhibit C-2**, an explanation of the criteria for instruments acceptable for clearing including:

- (1) The regulatory status of each market on which a contract to be cleared by Applicant is traded (e.g., DCM, SEF, not a registered market), and whether the market for which Applicant clears intends to join the Joint Audit Committee. For bilaterally executed agreements, contracts, or transactions not traded on a registered market, Applicant must describe the nature of the related market and its interest in having the particular bilaterally executed agreement, contract, or transaction cleared;
- (2) The criteria, and the factors considered in establishing the criteria, for determining the types of products that will be cleared;
- (3) An explanation of how the criteria for deciding what products to clear take into account the different risks inherent in clearing different agreements, contracts, or transactions and how those criteria affect maintenance of assets to support the guarantee function in varying risk environments;
- (4) A precise list of all the agreements, contracts, or transactions to be covered by Applicant's registration order, including the terms and conditions of all agreements, contracts, or transactions;
- (5) A forecast of expected volume and open interest at the outset of clearing operations, after six months, and after one year of operation; and
- (6) The mechanics of clearing the contract, such as reliance on exchange for physical, exchange for swap, or other substitution activity; whether the contracts are matched prior to submission for clearing or after submission; and other aspects of clearing mechanics that are relevant to understanding the products that would be eligible for clearing.

### Response:

#### Status

NGX will operate in the U.S. as a registered FBOT. It is not a member of the Joint Audit Committee. NGX will also clear forward contracts listed on an ICE trading platform. NGX may also register as a SEF and clear the swaps traded thereon.

#### Criteria for clearing

The products which will be cleared are those which are listed for trading on NGX FBOT. They are described in Exhibit E of NGX's FBOT application, which will be submitted under separate cover, and are incorporated herein by reference. As noted above, in addition, forward

contracts executed bi-laterally or on the NGX or ICE markets will be subject to clearing by NGX via EFRP. ICE and NGX have entered into a broad cooperation agreement.

NGX considered a number of factors in determining which contracts to list and to clear. These include the number of commercial entities in the particular energy market and volume of contracts traded, availability of robust pricing or if there are no prices, NGX's ability to act as a price discovery market, need for enhanced credit arrangements which can be provided by a CCP; whether the contract is one that is an exempt commodity within the meaning of Section 1a(20) of the Act, and whether there is a large and liquid deliverable supply so that the contracts listed for trading and clearing are not readily susceptible to manipulation.

### **Forecast for clearing**

During calendar year 2011, NGX DCO cleared 15,234,196.4 terra joules. We forecast no reduction in clearing activity from the prior year.

### **Mechanics**

As discussed above, contracts listed for trading on NGX are matched electronically by the NGX trading algorithm and automatically presented for clearing.

Contracts are also able to be presented to NGX DCO for clearing via EFRP. The details of these contracts are entered into the clearing system via ICE Block directly by the counterparties or the counterparties' agent, or alternatively, via telephone by an NGX employee to whom the counterparties report the details of the trade. EFRP trades are matched prior to submission to the clearing house, either through the interaction of an automated trade matching engine or through the bilateral agreement of the parties. NGX conducts a credit check to verify that each counterparty has sufficient collateral to support clearing of the transaction.

The risk management processes are discussed in Exhibit E.

## Form DCO— Exhibit E— Settlement Procedures

### Request:

Attach as **Exhibit E**, documents that demonstrate compliance with the settlement procedures requirements set forth in § 39.14 of the Commission's regulations, including but not limited to:

- a. Settlement – Provide as **Exhibit E-1**, a full description of the daily process of settling financial obligations on all open positions being cleared. This must include:
  - (1) Procedures for completing settlements on a timely basis during normal market conditions (and no less frequently than once each business day);
  - (2) Procedures for completing settlements on a timely basis in varying market circumstances including in the event of a default by the clearing member creating the largest financial exposure for Applicant in extreme but plausible market conditions;
  - (3) A description of how contracts will be marked to market on a least a daily basis;
  - (4) Identification of the settlement banks used by Applicant (including identification of the lead settlement bank, if applicable) and a copy of Applicant's settlement bank agreement(s). Such settlement bank agreements must (i) outline daily cash settlement procedures, (ii) state clearly when settlement fund transfers will occur, (iii) provide procedures for settlements on bank holidays when the markets are open, and (iv) ensure that settlements are final when effected;
  - (5) Identification of settlement banks that Applicant will allow its clearing members to use for margin calls and variation settlements;
  - (6) A description of the criteria and review process used by Applicant when selecting settlement banks; procedures for monitoring the continued appropriateness of all settlement banks including a description of how Applicant monitors its concentration risk or exposure to each settlement bank;
  - (7) The specific means by which settlement instructions are communicated from Applicant to the settlement bank(s);
  - (8) A timetable showing the flow of funds associated with the settlement of products for a 24-hour period or such other settlement timeframe specified by a particular product; this may be presented in the form of a chart, as in the following example:  
  
[this is where the chart was]
  - (9) A description of what happens in the event that there are insufficient funds in a clearing member's settlement account;
  - (10) An explanation of how and when Applicant will collect variation margin, whether and under what circumstances it will collect variation margin on a intraday basis, what will happen if

variation margin is not received in a timely manner, and a proposed variation margin collection schedule based on changes in market prices;

(11) All the information above, to the extent relevant, for any products cleared that may be denominated in a foreign currency; and

(12) With respect to physical settlements, identify Applicant's rules that clearly state each obligation of Applicant with respect physical deliveries, and explain how Applicant intends to identify and manage risks arising from physical settlement.

**Response:**

**Margining system**

NGX DCO has a distinctive and highly conservative margining methodology. NGX DCO requires clearing participants to deposit collateral in an amount that is up to 125 percent of the participant's exposure to NGX DCO. This is in contrast to a traditional futures clearing model because NGX DCO does not permit a participant's collateral to decline below 100% of its exposure to NGX DCO. Thus, NGX DCO collects from its clearing participants collateral that is equal to or greater than the amount of NGX's exposure to its clearing participant.

NGX DCO requires participants to post additional collateral *before* breaching the maintenance margin level. Clearing participants are required to deposit collateral in advance rather than relying upon an extension of (overnight) credit by the clearing house on behalf of the clearing member. Requiring that margin obligations be pre-funded ensures that NGX DCO always has sufficient collateral on hand to cover price movement risk over the entire liquidation period for all open positions; that is, the amount of NGX DCO's exposure to the clearing participant is, at a minimum, fully collateralized.

**Settlement process**

NGX currently offers a non-intermediated trading and clearing model; each clearing participant only clears for itself. None of NGX's participants currently clears (or trades) for customers.

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. Reflecting its focus on commercial end-user participants, NGX DCO extends its guarantee as central counterparty ("CCP") through completion of the settlement process.<sup>14</sup> Accordingly, NGX DCO 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.

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<sup>14</sup> This is in contrast to many DCOs which step out of the settlement process.

With the exception of its electricity contracts,<sup>15</sup> NGX, since beginning clearing operations, has used an accrual-style adjustment to reflect daily variation in the value of a clearing participant's positions in relation to its posted collateral. This method of accounting for the variation in the value of a clearing participant's positions relative to posted collateral is reflective of practices in the physical forward markets for energy.

NGX's accrual-methodology operates as follows. Each clearing participant posts with NGX initial margin for the transactions which it clears. As the position is marked to market, the daily accrual of gains and losses occurs in the clearing participant's account. Funds are not moved, however, between the accounts of clearing participants. Specifically, NGX calculates on a daily basis the change in the overall risk of the clearing participant's position relative to its posted collateral. Positive daily variation amounts are treated as gains that are recognized in the NGX risk management system and in the overall calculation of margin requirements for a clearing participant's portfolio. Typically, these gains on variation payments are not realized by the clearing participant until settlement, which for physical natural gas contracts is the 25th day following the month of delivery. Although it is possible for a clearing participant to withdraw funds that are in excess of its collateral obligations, clearing participants in natural gas contracts typically permit gains to accumulate in the clearing participant's account while the contract remains open, and the gains are realized by the clearing participant in the final settlement, which is at full contract value.

Where there is a negative daily variation valuation, the losses are recognized in the risk management system. If the clearing participant has insufficient collateral posted as a result of these declines when compared to the overall risk of its positions, the clearing participant must post with NGX an amount necessary to restore the collateral account to an acceptable level. Specifically, clearing participants with a declining portfolio value are required to top-up the collateral on deposit when the value of the deposited collateral has eroded to 125% of the amount required to be maintained.

NGX's mark-to-market process is conducted continuously and in real time. The amount of collateral needed by a clearing participant is recalculated throughout the day to reflect new exchange transactions. NGX makes margin calls throughout the day based on mark-to-market values that reflect current pricing, ensuring that deposited collateral and exposures remain in sync.

### **NGX Margining System Provides Same Protection As Daily Pay and Collect**

Since its inception, NGX has used its accrual methodology to reflect daily gains and losses in each clearing participant account without moving funds between such accounts. The NGX accrual margining system provides an effective means of conducting risk management, tailored to the markets that it clears, particularly in light of the high number of contracts that are physically delivered and therefore settled through NGX at full contract value.

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<sup>15</sup> A small number of NGX contracts require settlement of daily variation movements though pays and collects. Specifically, the NGX power contracts provide for daily payment and collection with respect to variation adjustment to positions. However, the vast majority of NGX contracts which reflect cash market practice in the natural gas and oil markets do not use daily payment and collection with respect to variation adjustment to positions.

NGX is not adversely exposed from the accrual of daily variation amounts in the accounts of its clearing participants and is no less protected in the event of a clearing participant default as compared to the daily payment and collection margining framework mandated by Commission Rule 39.14(b). Because every participant on NGX self-clears, there is no less protection to NGX from its accrual method of settlement compared to a daily payment and collection settlement system. Daily pays and collects among clearing members do not increase the amount of collateral available to a DCO over that which is available to NGX under its accrual methodology. In either settlement system, a clearing participant will be required to top-up the amount of collateral in its account to reflect relative declines in the value of its positions. And in either case, such amounts will be available to the DCO in case of the default of the clearing participant.

Moreover, it should be noted that accruing variation adjustments is operationally less complex than making daily payments and collections for both NGX and its clearing participants. This reduced complexity reduces operational risk associated with daily settlement systems.

In addition, although a clearing participant is not prohibited from withdrawing excess collateral which has been accrued, funds are not routinely paid by NGX on a daily basis, thereby encouraging clearing participants to maintain greater levels of collateral in their accounts until final settlement takes place. This reduces the potential default risk to NGX during the delivery period, when contracts must be fully collateralized. Accordingly, failure by the Commission to grant an Order permitting NGX to continue using its accrual method of settlement will increase the overall operational and default risks to NGX.

On March 23, 2012, NGX petitioned the Commodity Futures Trading Commission (“Commission”), through its outside counsel, for an order under Commission Rule 39.14(b) permitting NGX to provide for settlement of variation adjustments to collateral using an accrual, rather than a daily payment and collection, methodology. For the reasons stated above, and in the March 23, 2012 Petition, which is incorporated herein by reference, NGX renews that requested relief.

## Form DCO— Exhibit F— Treatment of Funds

### Request:

Attach as **Exhibit F**, documents that demonstrate compliance with the treatment of funds requirements set forth in § 39.15 of the Commission's regulations, including but not limited to

a. Safe custody – Provide as **Exhibit F-1**, documents that demonstrate:

- (1) How Applicant will ensure the safekeeping of funds and collateral in depositories and how Applicant will minimize the risk of loss or delay in accessing such funds and collateral;
- (2) The depositories that will hold the funds and collateral and any written agreements between or among such depositories, Applicant or its clearing members regarding the legal status of the funds and collateral and the specific conditions or prerequisites for movement of the funds and collateral; and
- (3) How Applicant will limit the concentration of risk in depositories where funds and collateral are deposited.

b. Segregation of customer and proprietary funds – Provide as **Exhibit F-2**, documents that demonstrate:

- (1) The appropriate segregation of customer funds and associated acknowledgement documentation; and
- (2) Requirements or restrictions regarding commingling customer funds with proprietary funds, obligating customer funds for any purpose other than to purchase, clear, and settle the products Applicant is clearing, procedures regarding customer funds which are subject to cross-margin or similar agreements, and any other aspects of customer fund segregation.

c. Investment standards – Provide as **Exhibit F-3**, documents that demonstrate:

- (1) How customer funds would be invested in instruments with minimal credit, market, and liquidity risks, and in compliance with the requirements of § 1.25; and
- (2) How Applicant will obtain and keep associated records and data regarding the details for such investments.

### Response:

All of NGX DCO's Participants are self-clearing, therefore they have no customers for whom funds must be segregated. NGX DCO itself segregates the collateral of Participants from its own proprietary funds and there is no mutualization of risk among clearing Participants.

NGX DCO is aware that Commission Rule 39.12(b)(4), provides that a DCO may not require that one of the original executing parties be a clearing member in order for a product to be eligible for clearing. The dis-intermediated nature of NGX is a reflection of its nature as a facility whose membership is composed mainly of non-financial end-users. Accordingly, there is no reason to believe that the nature of NGX DCO will alter. However, in the event that a customer wished to clear on an intermediated basis, NGX DCO will permit a customer to do so. In that event, NGX DCO anticipates that customer positions will be margined both on a gross basis (as will be required by Commission rules) and fully segregated.

Finally, with respect to the treatment of clearing participant funds, there is no commingling of the cash collateral of the respective participants; such amounts are deposited and maintained in separate, interest bearing accounts and the interest earned on such cash collateral is remitted to the Participant quarterly. The Bank Collateral Agreement between NGX and its clearing and settlement bank provides that the property of the relevant Participant may only be applied in accordance with the terms of the Contracting Party's Agreement ("CPA") and confirms that the clearing and settlement bank may *only* have access to, and use, the collateral: (1) for the purpose of carrying out NGX instructions with respect to the acceptance or release of collateral under the CPA; (2) for the processing and payment of amounts owing under the CPA; and (3) as a permitted assignee of NGX's rights under the CPA (as security for NGX's obligations under the Credit Facility), subject to the terms of the CPA.