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Sent: Monday, November 8, 2010 4:28 PM
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Subject: FW: Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform Act
Attach: Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform et al_1.PDF

Dear Mr. Stawick:

We are submitting the attached comment letter on behalf of our client, the Natural Gas Exchange ("NGX"). In this letter NGX comments on the term "swap" as it is defined under the Dodd-Frank Act and how the Commission should further clarify the exclusion provided thereunder with respect to exchange-traded and cleared forward contracts.

Please contact the undersigned if you have any questions.

Respectfully submitted,

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TMX group NGX

November 4, 2010

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

Re: "Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act" 75 *Fed. Reg.* 51429 (August 20, 2010).

Dear Mr. Stawick:

Natural Gas Exchange Inc. ("NGX") appreciates the opportunity to submit its views in advance of the Commodity Futures Trading Commission ("Commission") proposing rules relating to the definition of terms in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[1]"

The term "swap" is broadly defined under the Dodd-Frank Act, but contains an exclusion for "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."[2] This is similar, but not identical, to the forward contract exclusion under section 1a(27) of the Act, as amended, which provides that "the term 'future delivery' does not include any sale of any cash commodity for deferred shipment or delivery." The Commission previously provided legal certainty to the market through interpretation of the meaning and extent of the forward contract exclusion.[3] NGX believes that based on the facts and reasoning discussed below, it is in the public interest for the Commission to address the issue anew, providing legal certainty with respect to the two exclusions, particularly as applied in the context of trading such contracts on a multi-lateral trading facility.

Natural Gas Exchange

NGX is a trading and clearing system for energy products in the North American market and provides electronic trading, central counterparty clearing and data services to

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

[2] See Commodity Exchange Act (CEA) §1a(47)(B)(ii), 7 U.S.C. §1 *et seq.* (1999) (as amended by the Dodd-Frank Act) ("CEA").

[3] *See* CFTC Statutory Interpretation Concerning Forward Transactions, 55 *Fed. Reg.* 39188 (1990) (CCH ¶ 24,925) ("1990 Statutory Interpretation").

the North American natural gas, electricity and oil markets. NGX operates an electronic marketplace through which NGX contracting parties ("Participants") may enter into, among other contracts, spot and forward physically settled natural gas and oil contracts for delivery at various Canadian and U.S. locations. NGX also provides clearing services through which it acts as central counterparty for transactions entered into on the NGX electronic marketplace, certain transactions executed in the OTC market and transactions entered into on a third party exempt commercial market. As discussed in greater detail below, deliveries of the physically delivered forward contracts take place through Canadian and U.S. pipeline hubs and oil storage and transmission facilities.

Since March 1, 2004, NGX has been a wholly owned subsidiary of TMX Group Inc.[4] NGX's primary operations are located in Calgary, Alberta. NGX is regulated by the Alberta Securities Commission ("ASC").[5]

NGX notified the Commission on November 5, 2002, of its operation as an ECM. On December 12, 2008, NGX was registered by the Commission as a Derivatives Clearing Organization ("DCO"). On May 19, 2010, NGX requested that the Commission's Division of Market Oversight confirm that it will not recommend that the Commission take enforcement action against NGX, a Foreign Board of Trade ("FBOT"), in connection with direct access to the NGX market by its U.S. Participants.[6] That request remains pending.

On September 14, 2010, NGX filed with the Commission pursuant to section 723(c)(2)(A) of the Dodd-Frank Act and the Order, a petition for grandfather relief. As NGX noted in a comment submitted in response to the Commission's request for comment on its Order relating to the procedures for filing petitions such claims for relief,

> An [exempt commercial market's] analysis with respect to which regulatory category is most properly applied to its market may very well depend upon the Commission's adoption of rules relating to key definitions. These include the definition of "swap," and the exemption therefrom for contracts for deferred shipment or delivery.[7]

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[4] TMX Group operates cash and derivative markets for multiple asset classes including equities, fixed income and energy products. TMX Group is a corporation incorporated under the Business Corporations Act (Ontario) and has its head office in Toronto, Ontario. Its shares have been listed for trading on the Toronto Stock Exchange since November 2002. TMX Group is a reporting issuer in every province and territory of Canada.

[5] On October 9, 2008, NGX's status in Alberta changed from being an exempt exchange to a recognized exchange. In addition, NGX became a recognized clearing agency under Alberta laws.

[6] The request for no-action relief was made pursuant to the Commission Policy Statement entitled, "Boards of Trade Located Outside of the United States and No-Action Relief from the Requirement to Become a Designated Contract market or Derivatives Transaction Execution Facility," 71 *Fed. Reg.* 64443 (November 2, 2006.) ("Policy Statement").

[7] *See* Comment Letter Of NGX, dated October 18, 2010,, submitted in response to CFTC Request for comments regarding "ECM/EBOT Grandfather Relief" 75 *Fed. Reg.* 56513 (September 16, 2010)."

Because NGX lists for trading physically-settled forward contracts, it is vitally concerned that the meaning of the forward contract exclusion for futures under section 1a(27) of the Act and for swaps under 1a(47(b) of the Act (together the "forward contract exclusions") be clear, particularly in the context of a traded market. The guidance that the Commission provides to the market on the issue will fundamentally effect the regulatory framework for these markets.

The Forward Contract Exclusion

In 1921, the Futures Trading Act[8] was enacted to curb widespread instances of disruptive trading practices and speculation on and off exchanges.[9] Congress sought to limit price fluctuations related to grain by imposing a 'prohibitive tax' on "contracts for future delivery not traded on contract markets."[10] The Futures Trading Act, however, specifically excluded from the tax (i) contracts for future delivery made by "owners and growers of grain, owners and renters of land on which grain was grown and associations of such persons" and (ii) future delivery contracts made by or through designated members of boards of trade.[11] During the Congressional testimony leading up to enactment of the Futures Trading Act, witnesses noted that the first exemption was too narrowly construed and would have taxed a "variety of legitimate commercial transactions in which delivery of the grain was delayed.[12] To make clear that forward contracts were to be excluded from taxation, Congress excluded from the term "futures delivery" "any sale of cash grain for deferred shipment or delivery." [13] The forward contract exclusion has remained unchanged from that time. Nevertheless, it has been subject to interpretation to keep pace with the evolution of markets and contracting practices.

Statutory Interpretation Concerning Forwards

In a seminal interpretation, the Commission found that the forward contract exclusion of the Act applied to the purchase or sale of 15-day Brent crude oil contracts.[14] In the 1990 Interpretation, the Commission recognized that "the evolution of commercial transactions of this variety suggests that more guidance by the Commission is appropriate

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[8] See The Futures Trading Act, Pub. L. No. 67-66 § 2, 42 Stat. 187 (1921). In 1936, Congress enacted the Commodity Exchange Act which essentially replaced the Futures Trading Act.
[9] See Characteristics Distinguishing Cash and Forward Contracts and "Trade Options," 50 *Fed. Reg.* 39656 (1985).
[10] See Characteristics Distinguishing Cash and Forward Contracts and "Trade Options," 50 *Fed. Reg.* 39656 (1985).
[11] See *id.*
[12] See *id.*
[13] The House in agreeing to the Senate's additional exclusionary language added the words "or delivery" following "shipment."
[14] See CFTC Statutory Interpretation Concerning Forward Transactions, 55 *Fed. Reg.* 39188 (1990) (CCH ¶ 24,925) ("1990 Interpretation").

than can be accomplished through case-by-case analysis.[15] In the 1990 Interpretation, the Commission concluded that determining whether a commercial transaction fell within the scope of the exclusion depended on whether the transaction created "specific delivery obligations."[16] The Commission noted in its analysis of the Brent market that its "emphasis on delivery as the feature distinguishing transactions within the scope of the Section 2(a)(1) exclusions was first enacted in 1921 as part of the Future Trading Act." The Commission continued, noting that,

> certain other distinguishing characteristics of such contracts have been identified. In this regard, forward contracts have been described as transactions entered into for commercial purposes related to the business of a producer, processor, fabricator, refiner or merchandiser who may wish to purchase or sell a commodity for deferred shipment or delivery in connection with the conduct of its business.[17]

The Commission concluded that contracts entered into between commercial participants in connection with their business, which create specific delivery obligations that impose substantial economic risks of a commercial nature to these participants, but which may involve in certain circumstances string or chain delivery . . . are within the scope of the [forward contract] exclusion.[18] Although the Commission acknowledged that there was not a "definitive list of elements" to consider when determining which transactions are excluded from the CEA, it noted that

> [t]he underlying postulate of the exclusion is the Act's regulatory scheme for futures trading should not apply to private commercial merchandising transactions to delivery but in which delivery is deferred for reasons of commercial convenience or necessity.[19]

Exclusion of forwards from definition of swaps

The Dodd-Frank Act for the first time generally brings swaps within a comprehensive regulatory framework, much as grain futures were brought within a regulatory framework in the 1922 Act. The Dodd-Frank Act includes within the statutory framework mandatory clearing and trade execution requirements for certain swaps or categories of swaps. As noted above, "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically

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[15] *Id.* at p 37,365.

[16] (noting that "[m]orevover, the delivery obligations of these transactions create substantial economic risk of a commercial nature to the parties required to make or take delivery thereunder"). The 1990 Interpretation emphasized that "[a]ll parties entering into these contracts must have the capacity to bear such risks and cannot discharge these obligations through exchange-style offset." *See also* CFTC v. Co-Petro Marketing Group, Inc., 680 F.2d 573, 578 (1982) (stating that "a cash forward contract is one in which the parties contemplate physical transfer of the actual commodity).

[17] Id. at p.a 37, 368.

[18] Id. at p. 37369.

[19] See 1990 Interpretation at 37,367.

settled" is excluded from the definition of "swap" and as a consequence, the regulatory framework that applies to swaps. The exclusion of forward contracts from swaps regulation is expressed in different words than the forward exclusion from futures regulation, applying to forward contracts "so long as the transaction is intended to be physically settled."

Although the language of the forward contract exclusion from futures regulation is expressed in different words from the forward contract exclusion from swaps regulation, Senators Blanche Lincoln and Christopher Dodd, two of the framers of Title VII of the Dodd-Frank Act, wrote to their colleagues in the House of Representatives, that

> [i]n implementing the derivatives title Congress encourages the CFTC to clarify through rulemaking that the exclusion from the definition of swap for "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled" is intended to be consistent with the forward contract exclusion that is currently in the Commodity Exchange Act and the CFTC's established policy and orders on this subject, including situations where commercial parties agree to "book-out" their physical delivery obligations under a forward contract.[20]

Thus, it is anticipated that the Commission, in promulgating rules defining certain key terms, will clarify that the forward contract exclusion from swap regulation is to be interpreted in a manner consistent with the current understanding of the forward contract exclusion from futures regulation.

However, as in 1990, significant changes in the markets, in this case spurred by technological changes, strongly suggests that in issuing an interpretation removing any ambiguity with respect to the extent and application of the forward contract exclusion from swap regulation, the Commission provide additional legal certainty with respect to the relatively recent development of trading of physically-settled forward contracts on multi-lateral trading facilities, such as NGX.

Evolution of exchange-traded forward contracts

NGX first listed for trading "Physical Gas Transactions" in February 1994. In order to provide greater legal certainty for trading of these products by U.S. entities with direct market access from the U.S., NGX notified the Commission on November 5, 2002, of its operation as an ECM.

NGX defines a "Physical Gas Transaction" as "a transaction for the purchase or sale of a Physical Gas Product, excluding Bilateral Transactions, the terms of which

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[20] *See* Letter from Senators Christopher Dodd and Blanche Lincoln to Congressmen Barney Frank and Colin Peterson, dated June 30, 2010 at 3. ("Dodd-Lincoln Letter").

include this Agreement and for greater certainty also includes the particulars applicable to such Physical Gas Product as set forth in the NGX Product List and Schedules "F" or "G". The general terms of the contracts are set forth in the Articles of the Contracting Party Agreement ("CPA") and the specific terms and conditions are in the Product List and Schedules.

A Participant enters into a Physical Gas Transaction by entering a bid or offer into the NGX Trading System. Upon execution of the transaction, the Participant will either be a purchaser or seller of that amount of Physical Gas Product at a price or formula specified at contract initiation with a specified Physical Settlement Date.[21] NGX does not specify a standard contract size; rather each Participant will enter bids or offers for the quantity of gas that it chooses at or above the minimum transaction size of 100 MMBtu or 100GJ. Upon settlement of a contract, NGX will pay to (or receive from) each Contracting Party the full notional value of the transacted volume. Invoiced amounts are paid on a net basis payable in the same currency.

All obligations of NGX as CCP and a Participant to make or take delivery of the commodity under the Physical Gas Transactions will be netted and the Contracting Party's delivery obligation arising from each Transaction will be satisfied by the delivery or taking of delivery of the Contract Quantity on a net basis. Thus, each Participant's long and short contract obligations are netted to a single amount to deliver or take delivery.

NGX's lists for trading physical gas contracts that use three different methods for calculation of the settlement price. The contract price can be based on the electronically negotiated price (called "Fixed Price Products"), on a reference price to a cash-price series, such as those published by NGX itself or by an independent, third-party index provider (called "Index Products"), or by reference to a futures contract price with an appropriate locational differential (called "Basis Products"). Contracts using these three types of settlement price methodologies are listed for a significant number of different delivery locations in Canada.

NGX also lists for trading Physical Oil Transactions, on a separate trading platform. The buyer and seller agree to pay the agreed upon contract price and take or make delivery of the specified grade and variety of oil at the specified delivery location. Each Participant's obligations to make or take delivery of oil with the same delivery specification at the same delivery location will be netted, so that the Participant will have only a single net obligation to make or take delivery of the specified oil at the same delivery location. Payment obligations in the same currency will also be netted. The Participants must comply with the rules and the procedures of the transportation system rules, including title transfer procedures, at the delivery location.

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[21] As defined by the CPA, the "Physical Settlement Date is the Business Day determined by the Exchange from time to time as posted on the Exchange Website no less than one month prior to the occurrence of such date . . . ."

The CPA includes a detailed Force Majeure provision which details when force majeure applies, including disruption to the transportation system at a delivery location. A change in market conditions is specifically excluded from force majeure, as is a pending reduction in transportation services that has not yet occurred. It also details the impact of a single source supply stream that is disrupted on contract obligations.

Contracts may specify one of 17 possible Canadian transportation systems and 5 different delivery locations. In addition, there are 23 different grades or oil products listed, including, for example, condensate, light sour blend, mixed sour blend, mixed sweet blend and sweet crude. U.S. contracts may specify one of 5 different delivery locations, five transportation systems, and 8 crude types. Two pricing conventions are provided: Fixed Price or Differentials.

A hallmark of the markets for exchange-traded forward contracts are the fact that market participants are generally commercials and the high proportion of contracts that result in delivery despite the netting of contractual and delivery obligations. Unlike the typical futures contract, an exchange-traded forward market may see greater than half the volume of contracts result in actual delivery. And, it is the intent of market participants that their contracts result in delivery of the commodity. However, as their supply needs change, for example, these commercial traders may adjust their contractual obligations by selling back into the market an amount of the commodity that they previously bought. This is not done for hedging or speculative purposes, but rather to adjust their bona fide physical delivery needs, which are dynamic and may change over time, even on a daily basis.

In contrast to these exchange-traded forward contracts, NGX also lists for trading financially-settled contracts for future delivery which it terms to be Financial Contracts, abbreviated as "Fin." The obligations under these contracts are fully performed by payment to NGX of amounts due under the contract. This is in vivid contrast to the nature of the physical forward contracts and to the participants in the two markets. The financial contracts are traded in the market both by commercials intending to take delivery as well as commercials and others who do not intend to take delivery of the contract but instead to use the contract to transfer or assume price risk.

Finally, exchange traded forward contracts tend to delivered in less liquid delivery locations. As trading at a delivery becomes more liquid, additional, non-commercial traders may enter the market, altering the nature of the market from an exchange traded market in forward contracts to a market for exchange-traded derivatives. In some respects, this follows the evolution of futures markets generally, which grew out of the trading of forward contracts in the Chicago markets.

Exchange-traded forward contracts are a relatively new development.[22] Market participants intend by their trading in these markets to effectuate contracts resulting in actual delivery. In light of this fundamental fact of their commercial and delivery nature, NGX believes that it is part of the Congressional mandate to the Commission to clarify the meaning and extent of the forward contract exclusions as applied to such markets. NGX believes that one means by which the Commission could best clarify the forward contract exclusions as they apply to an exchange-traded market in forward contracts is through the issuance of a non-exclusive safe-harbor. This would provide the important legal clarification referred to by Senators Lincoln and Dodd in their letter to a significant segment of the forward contract market.

Terms of a non-exclusive safe harbor

The terms of a non-exclusive safe harbor for exchange-traded forward contracts would be grounded in the characteristics noted above: all market participants would be required to be commercials and a high percentage of contract volume would be required to result in actual delivery. We would suggest that the percentage of contracts resulting in physical delivery be greater than 50% of all contracts traded on the market computed on a rolling three-month average. This would provide the needed flexibility for commercials to trade out of contracts for delivery as their bona fide need for the commodity changes due to changing commercial developments. If the market becomes so liquid that it attracts non-commercials, and they are admitted as participants, that would change the character of the market and it would no longer qualify as a forward market. Similarly, if the proportion of delivered-upon contracts fell below the 50% trigger, that would signal the evolution of the market as one listing forward contracts to a market that is listing futures or swap contracts. At that point, after a short grace period, the market would be required to begin listing the contracts under the procedures applicable to futures or swaps, as applicable.

The suggested terms of the non-exclusive safe-harbor would provide a bright-line test for distinguishing forward from futures markets and are grounded in past Commission analysis of the forward contract exclusion. The terms are consistent with a finding that the parties have the intent to make or take delivery, have the ability to do so, and evidence that delivery in fact routinely takes place.[23]

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In exercising its rulemaking authority to clarify the meaning of the forward contract exclusion, as intended by the framers of the Dodd-Frank Act, NGX respectively petitions the Commission to include within those rules a non-exclusive safe-harbor based

[22] Of course, as noted above, the first contracts traded on the Board of Trade of the City of Chicago were forward contracts as well.

[23] See Characteristics Distinguishing Cash and Forward Contracts and "Trade Options," 50 *Fed. Reg.* 39656 (1985) (noting that "[f]oward contracts frequently are not standardized" rather contract terms are often negotiated, in particular the terms relating to "grade, delivery point and settlement date").

on the objective factors discussed above. This will provide the needed legal certainty to an important market segment and fulfill the Commission's mandate under the Dodd-Frank Act and be in the public interest.

NGX commends the Commission's efforts to continue to safeguard trading and clearing activities and looks forward to working with the Commission throughout the course of the Dodd-Frank rulemaking process.

We would be happy to discuss our comments above at greater length with the staff. Please feel free to contact Cheryl Graden at 416-947-4359, or Paul M. Architzel of Alston & Bird, LLP, outside counsel to NGX at 202-239-3492, if you have any questions regarding NGX's comments. On behalf of NGX I thank the Commission for providing us with the opportunity to provide our thoughts with respect to the Commission's rulemaking.

Respectfully submitted,

Peter Krenkel
President and CEO

c: Chairman Gensler
Commissioner Dunn
Commissioner Chilton
Commissioner Sommers
Daniel Berkovitz, General Counsel