

Annual Assessment Report
Natural Gas Exchange Inc.

**2011
Report**

Alberta
Securities
Commission

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Introduction

This report summarizes the Alberta Securities Commission's (ASC) assessment of compliance by the Natural Gas Exchange Inc. (NGX) with its obligations under the *Securities Act* (Alberta) (the Act) and the Recognition Orders (defined below) for the 2011 calendar year and for the subsequent quarter ending March 31, 2012 (the Reporting Period).

Background

(a) Regulatory Status

NGX, a wholly-owned subsidiary of TMX Group, Inc. (TMX Group), carries on business as an exchange in Alberta under an ASC recognition order (Exchange Recognition Order) dated October 9, 2008 made under section 62 of the Act. As a recognized exchange under section 63(2) of the Act, NGX is required to regulate the operations, standards of practice and business conduct of its participants in accordance with its rules and practices.

NGX is subject to regulatory oversight based on compliance with the operating principles (Operating Principles) and reporting requirements specified by the ASC under the Exchange Recognition Order. Under the Memorandum of Understanding (MOU) respecting the Oversight of Exchanges and Quotation and Trade Reporting Systems, the ASC is the lead regulator of NGX and is primarily responsible for its oversight.¹

NGX also provides clearing and settlement services to contracting parties under a separate ASC recognition order (Clearing Agency Recognition Order) dated October 9, 2008 made under section 67 of the Act. NGX is subject to regulatory oversight based on compliance with the clearing principles and reporting requirements specified by the ASC under the Clearing Agency Recognition Order. For the remainder of this report, the Exchange Recognition Order, together with the Clearing Agency Recognition Order, are herein referred to as the "Recognition Orders".

NGX has been granted exemptions from the requirements to be recognized as an exchange, subject to certain terms and conditions, by the Ontario Securities Commission, the Autorité des marchés financiers, British Columbia Securities Commission and the Manitoba Securities Commission. These exemptions are based in part on the ASC's recognition of NGX as an exchange, consistent with the MOU.

NGX is registered to operate in the United States (U.S.) with the Commodity Futures Trading Commission (CFTC) as a derivatives clearing organization (DCO). NGX also operates a marketplace in the U.S. under an exemption granted by the CFTC as an exempt commercial market. An MOU concerning cooperation and the exchange of information related to the supervision of cross-border clearing organizations was established between the ASC and the CFTC in June 2010 to allow for

¹ Under the lead regulator model in Canada, the jurisdiction in which the head office is located recognizes the exchange and is the lead regulator having primary responsibility for the oversight of the exchange, while other jurisdictions in which the exchange carries on business exempt the exchange, subject to appropriate terms and conditions, and rely on the oversight carried out by the lead regulator. In the case of certain exchanges in Canada, including NGX, the lead regulator model has been partially effected under the terms of an MOU respecting the Oversight of Exchanges and Quotation and Trade Reporting Systems effective January 1, 2010 among the ASC, the British Columbia Securities Commission (BCSC), the Autorité des marchés financiers (AMF), the Ontario Securities Commission (OSC) and the Manitoba Securities Commission (MSC).

effective regulation of NGX by Canada and the U.S. In February 2012, NGX submitted an application to the CFTC to become registered as a foreign board of trade (FBOT).

(b) Current Business Operations and History

In 2004, the TMX Group acquired 100 per cent of NGX shares. NGX currently operates an electronic trading and clearing system based in Calgary for the trading, clearing and settlement of natural gas, power, and crude oil physical and financial contracts.

Prior to October 2008, when the ASC recognized NGX as an exchange and as a clearing agency under the Recognition Orders, NGX had been operating an electronic trading, clearing and settlement system in Alberta for the trading of natural gas, electricity and related contracts under a series of exemptive relief orders granted by the ASC in 1993.

In 2007, NGX entered into an agreement with InterContinentalExchange, Inc. (ICE), to form a technology and clearing alliance for the North American natural gas and Canadian power markets. Under the arrangement, the cleared and bilateral markets for North American physical natural gas and Canadian electricity operated by NGX were listed on ICE's electronic trading platform in February 2008.

Under the Recognition Orders, NGX was permitted to trade and clear natural gas, electricity and related contracts. Under an order dated April 14, 2009, the ASC varied the Recognition Orders to permit NGX to trade and clear crude oil contracts. In 2009, the TMX Group acquired NetThruPut Inc. (NTP), an electronic crude oil trading and clearing platform, and integrated the operations of NTP into NGX as part of a consolidation of TMX Group's energy trading and clearing operations.

In May 2011, the Maple Group Acquisition Corporation applied to the ASC for various orders in connection with its intention to directly acquire 100 per cent of the outstanding shares of TMX Group, and indirectly, TSX Venture Exchange and NGX. The ASC varied NGX's Recognition Orders in June 2012 by requiring an undertaking from NGX to establish, maintain and comply with policies and procedures to identify and manage conflicts of interest and confidentiality issues that may arise as a result of the new ownership.

Market Regulation's Oversight Program

In order for NGX to maintain its recognition as an exchange and as a clearing agency under the Act, NGX must continue to comply with the requirements of Alberta securities laws and the Recognition Orders. The ASC's oversight program primarily includes:

- determining the adequacy of NGX's policies and procedures for ensuring ongoing compliance with its obligations under Alberta securities laws and the Recognition Orders; and
- identifying issues in NGX's operating and compliance procedures that may need to be addressed to ensure ongoing compliance with its obligations under Alberta securities laws and the Recognition Orders.

The ASC received filings required under the Recognition Orders for the Reporting Period. ASC staff conducted analyses of all filed materials, including any required follow up with NGX staff. The ASC does not have any outstanding concerns regarding any NGX materials filed during this time frame.

In addition to the reporting requirements specified in the Recognition Orders, NGX is required to fulfill the undertakings specified in the Recognition Orders. More specifically, in paragraph 5(h) of the Exchange Recognition Order, NGX undertakes to notify the ASC in advance of any significant change in the operation of the Trading System (as defined in the Exchange Recognition Order). In paragraph 6(g) of the Clearing Agency Recognition Order, NGX undertakes to notify the ASC 10 business days in advance of any significant change in the operation of the Clearing System (as defined in the Clearing Agency Recognition Order). NGX reported the following significant changes during the Reporting Period:

- i. *NGX's New Clearing System*
NGX reported the conversion to a new clearing system.
- ii. *Changes to Trading and Clearing Model for Crude Products*
NGX reported changes to the crude oil netting methodology and cancellation policy for crude oil bilateral transactions.

NGX complied with the requirements to report significant operational changes by providing the ASC with presentation materials and written proposals, and followed up on outstanding requests as required. ASC staff reviewed all proposals and found no significant outstanding issues with respect to the creation or implementation of those initiatives.

In conjunction with receiving the reports required by the Recognition Orders, ASC staff engaged in regular communication with NGX executive team members and operational staff members. ASC staff coordinated quarterly meetings with the NGX president to review NGX's operational results and future business plans. ASC staff also conducted periodic on-site reviews with NGX operational staff to monitor the migration to NGX's new clearing system and to review NGX's business practices against stated policies and procedures. During the Reporting Period and the second quarter of 2012, ASC staff specifically organized on-site examinations with NGX to review features of the new clearing system and changes to its crude oil business.

NGX Business and Regulatory Activities

(a) Summary of NGX's Business Activities

NGX achieved 15.47 million terajoules in total energy volume² in 2011 compared to 16.72 million terajoules in 2010. The lower volumes were largely a result of lower natural gas prices and less price volatility in the market during 2011. NGX crude oil revenues were also lower, reflecting limited traction following the launch of crude oil products in March 2011 under the NGX/ICE alliance and increased competition from voice brokers, including from Shorcan Energy Brokers³. The decrease was partially offset by increased volumes and transaction fees for U.S. cleared products, as NGX expanded physical gas clearing with additional new U.S. hubs.

² NGX total energy volume includes trading and clearing in natural gas, crude oil and electricity.

³ TMX Group Press Release February 8, 2012. www.tmx.com/en/pdf/TMXGroup2011Q4Release.pdf

Throughout 2010 and into early 2011, NGX was in the process of replacing its existing clearing system to allow for increased functionality and reporting capacity. In August 2011, NGX requested an extension to the ASC's requirement to conduct a third party review of NGX's clearing operation risks and controls in 2011, as required by the Recognition Orders. The ASC granted the extension until December 31, 2012 with a requirement for NGX to provide an additional self-certification document confirming that it has completed adequate system testing and has appropriate documentation to ensure ongoing compliance with its Recognition Orders. In February 2012, NGX advised the ASC of its upcoming office move, which necessitated the relocation of its backup server from NGX to Q9 Networks Inc.

In February 2011, NGX transitioned its crude oil products onto the ICE trading platform as part of an extension of its alliance with ICE. In March 2011, NGX implemented a crude oil margin netting initiative for qualified contracting parties, which requires that contracts for the same-month delivery positions be managed on a net basis, regardless of the type or location of crude, to provide margin offsets. In January 2012, NGX changed the policy with respect to cancellation of bilateral crude oil transactions. The new policy allows a contracting party to contact NGX to cancel a trade unilaterally within a given period in situations where the contracting party, having learned the identity of the other party to the transaction, determines that it is unwilling or unable to transact with that party.

(b) Summary of NGX's Regulatory Initiatives

NGX seeks to comply with regulatory developments across various jurisdictions where NGX operates. As the ASC is the lead regulator for NGX, the ASC has requested that NGX provide periodic updates regarding its ongoing regulatory status with other jurisdictions.

The ASC, in conjunction with the Canadian Securities Administrators (CSA), has been drafting regulatory changes that may impact NGX's business.

In February 2011, the OSC granted NGX a variation to its exemptive relief order (originally granted on March 31, 2009) to take into account amendments to the *Securities Act* (Ontario), which require clearing agency recognition within Ontario. The amended OSC order continues to provide an exemption from recognition (now as both a clearing agency and as an exchange), and was granted on the basis that NGX's clearing agency functions are regulated by the ASC and meet the exemption criteria as set out in OSC Staff Notice 24-702 *Regulatory Approach to Recognition and Exemption from Recognition of Clearing Agencies*.

In August 2011, the ASC released proposed recognition criteria for the regulation of derivatives exchanges that carry on business in Alberta. The proposed criteria would require a derivative exchange based in Alberta, and any foreign-based derivatives exchange with participants in Alberta, to seek recognition under section 62 of the Act, and to comply with the criteria set out for both obtaining and maintaining recognition. NGX submitted its comment letter to the ASC on September 6, 2011.

The CSA published Consultation Paper 91-402 *Derivatives: Trade Repositories* in June 2011, Consultation Paper 91-403 *Derivatives: Surveillance and Enforcement* in November 2011, Consultation Paper 91-404 *Derivatives: Segregation and Portability in OTC Derivatives Clearing* in February 2012, Consultation Paper 91-405 *Derivatives: End-User Exemption* in April 2012, and Consultation Paper 91-406 *Derivatives: OTC Central Counterparty Clearing* in June 2012. NGX

participated in the TMX Group comment letters submitted in response to the request for comments for the first three of these papers. The deadline for comments on the other two papers is September 2012.

In the U.S., NGX submitted an application to the CFTC for FBOT status in May 2010, which was updated and resubmitted on February 17, 2012. NGX has submitted 19 comment letters to date on proposed rules relating to, amongst other matters, DCO governance, conflicts of interest, position limits, and risk management. The ASC has been notified of the regulatory submissions NGX has made to other regulatory jurisdictions during the Reporting Period and has reviewed materials accordingly.

Conclusion

In the ASC's view, NGX has demonstrated compliance with its obligations under Alberta securities laws and the Recognition Orders during the Reporting Period. Going forward, ASC staff will continue to conduct oversight activities of NGX in the context of NGX's business and developments in the broader marketplace.