nadex.com
north american derivatives exchange

Nadex, Inc.
311 South Wacker Drive
Suite 2675
Chicago, IL 60606

Timothy G. McDermott
+1 (312) 884-0171
tim.mcdermott@nadex.com

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Via E-Mail: dcodcmsefGovernance@cftc.gov

Mr. David Stawick
Secretary of the Commission
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington D.C. 20581

RE: Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest
(RIN 3038–AD01)

Dear Mr. Stawick:

North American Derivatives Exchange, Inc. ("Nadex") submits this letter in response to the proposed rules concerning "Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest" ("Proposed Rules") published by the Commodity Futures Trading Commission (the "CFTC" or the "Commission"). 75 FR 63732 (Oct. 18, 2010). Nadex appreciates the opportunity to comment on the Proposed Rules and asks the Commission to narrow the scope of the proposed rules to comport with the structure of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[1] and allow for greater flexibility in the application of any final rules to promote competition.

Nadex is a Designated Contract Market ("DCM") and Derivatives Clearing Organization ("DCO"). Nadex is unique among DCMs and DCOs in that it caters to retail clients and offers unique contracts (binary options and spread contracts on a wide range of underlyings) that are fully collateralized. As such, Nadex provides retail traders with a DCM/DCO alternative to over-the-counter retail markets.

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

Nadex originally was designated as a contract market and registered as a derivatives clearing organization in 2004 (then operating under the name "HedgeStreet, Inc."). As recently as March 30, 2010, the Commission issued orders at Nadex's request amending its designation as a Contract Market and registration as a DCO, permitting the offering and clearing of intermediated trading. Since April 2010, Nadex's markets have, in fact, been available to both non-intermediated customers of Nadex as well as intermediated customers trading on Nadex through a Futures Commission Merchant ("FCM") Member.

Since December 2007, Nadex has been owned by a single parent company, London-based IG Group Holdings plc, which is a FTSE 250 financial services company with operating units in 14 different countries around the world. Two of these operating units are members of Nadex: a market maker and an FCM Member that intermediates customer orders. Obviously, Nadex is conscious of the potential for conflicts of interest in these circumstances and, accordingly, Nadex has put in place a range of governance standards and policies and procedures to address these conflicts. These include customary approaches under the Core Principles**,** including independent board membership requirements and maintenance of a Regulatory Oversight Committee comprised of independent directors, as well as approaches that are unique to Nadex. These unique approaches include the commitment to promptly report to CFTC staff any investigations that involve affiliated entities and the maintenance of clear "Chinese Walls" between Nadex and its affiliates. Nadex's governance standards and policies and procedures were described in detail for the Commission in connection with its issuance of Nadex's amended DCM and DCO Orders earlier this year. Nadex continues to believe that it is appropriately mitigating conflicts of interest and will, of course, continue to monitor circumstances and improve its governance standards and policies and procedures appropriately. That the Commission saw fit to grant NADEX amended DCM and DCO Orders less than eight months ago suggests to us that the Commission was satisfied with our current policies and procedures for managing the conflicts that arise due to IG Group's business structure.

The Proposed Rules, however, would apparently require IG Group to surrender 80% of its voting rights in Nadex or, alternatively, to require the affiliated FCM and market maker to terminate their Nadex memberships. In this respect, it should be noted that start-up exchanges and clearinghouses typically experience low initial volume levels, making it difficult to attract dedicated market-makers and intermediaries that are willing to invest the time, effort and capital that are necessary to develop and increase volume and attract other intermediaries to the exchange and clearinghouse. By effectively eliminating the ability to have related parties act as founding members of the DCM and DCO, the Proposed Rules create significant barriers to entry for emerging exchanges and clearinghouses. Nadex believes that the Proposed Rules, if enacted, would significantly harm Nadex's ability to continue to offer its regulated markets to retail traders. IG Group believes that this result is particularly unfair given the amount of investment that it has put into Nadex over the past three years and given that the regulatory purpose of the Proposed Rules can be achieved through other means.

As the Commission is aware, launching new DCOs or DCMs to serve new markets or to compete with existing markets has been a daunting challenge for many different

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organizations that have tried and failed over the years. The limitation on the voting rights of related parties in the Proposed Rules would increase the obstacles to success significantly and effectively eliminate the possibility for the development of new, innovative DCMs or DCOs. As a result, any party seeking to offer a new product will have to go to the existing large, established exchanges in the hope that they can be convinced to list the product, including those products that might compete with the established exchange's existing product base. In short, Nadex believes that the Proposed Rules unfairly and unnecessarily change the existing conflicts-of-interest standards for existing DCMs and DCOs and restrict the potential for new registrants to enter and compete in the futures trading and clearing space.

The Dodd-Frank Act's Suggestion of Possible Limits On Voting Rights Is Directed Only At Swaps-Related Activities

As stated in the background discussion of the Proposed Rules, "Title VII of the Dodd-Frank Act amended the Commodity Exchange Act ("CEA") to establish a comprehensive new regulatory framework for swaps and certain security-based swaps." 75 FR at 63732. In so doing, the Dodd-Frank Act establishes different regulatory regimes for Swap Execution Facilities ("SEFs") and DCMs/DCOs that offer and clear swaps on the one hand and DCMs/DCOs that are limited to only the futures business. For example, the Dodd-Frank Act added to the CEA sets of Core Principles applicable to SEFs and Swap Data Repositories ("SDRs"). These SEF and SDR Core Principles have some similarity to, but are not the same as, the Core Principles applicable to DCMs and DCOs. In addition, the Dodd-Frank Act included a number of statutory requirements with respect to SEFs and those DCMs and DCOs that choose to engage in swaps execution or clearing. At the same time, however, the Dodd-Frank Act left intact in many respects the pre-existing Core Principles applicable to DCMs and DCOs. This different treatment is not surprising because of the different markets and functions these entities serve and the differing contexts of the long-established regulated futures industry and the new, centrally-cleared regulated swaps industry.

The Proposed Rules are based primarily on Section 726 of the Dodd-Frank Act. Section 726 directs the Commission to address conflicts of interest in connection with the swaps business that is being mandated to move from over-the-counter markets to the centrally cleared and more transparently traded markets. Thus, Section 726 addresses rules solely for the limited group of DCMs and DCOs that seek to offer or clear swaps, but not for other DCOs and DCMs:

> "[T]he Commodity Futures Trading Commission shall adopt rules which may include numerical limits on the control of, or the voting rights with respect to, any derivatives clearing organization **that clears swaps, or swap execution facility** or board of trade designated as a contract market **that posts swaps or makes swaps available for trading** ... ."

Dodd-Frank Act §726(a) (emphasis added). This focus on entities engaged in the swaps business is quite reasonable in the context of the federally-mandated transfer of that $300 trillion (notional) business into new venues. While this direction to adopt some rules regarding conflicts of interest for swaps-related entities is mandatory, it is important to note

that even in the context of those swap related-entities, Section 726 does not mandate adoption of a rule that restricts voting rights. Instead, such limits are identified only as a potential consideration. Id. ("…which may include numerical limits on . . . voting rights") (emphasis added). Section 726 certainly does not mandate or even suggest that such limitations should be applied to DCOs that do not clear swaps or to DCMs that do not post swaps or make swaps available for trading.

Congress easily could have said that the Commission "shall" adopt rules which may include numerical limits on voting rights with respect to "any derivatives clearing organization, swap execution facility or board of trade designated as a contract market." By limiting the directive of Section 726 to swaps-related entities, however, it is clear that Congress intended those DCOs and DCMs that are not engaged in swaps-related business to be treated differently.

Moreover, even with respect to the instruction to consider possible restrictions on voting rights with respect to swap-related entities, Section 726 only addresses a limited class of potential owners whose voting rights might be restricted—that is, those voting rights owned by:

> "... a bank holding company (as defined in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841)) with total consolidated assets of $50,000,000,000 or more, a nonbank financial company (as defined in section 102) supervised by the Board, an affiliate of such a bank holding company or nonbank financial company, a swap dealer, major swap participant, or associated person of a swap dealer or major swap participant."

Dodd-Frank Act §726(a). Again, there is no suggestion that the voting rights of every affiliate of every member should be limited. To the contrary, Dodd-Frank is directed at a particular problem (undue control over the clearing and trading of swaps by a particular group of entities) in a particular context (the move to mandatory clearing of swaps).

Section 726 directs the Commission to consider restricting the voting rights of entities with respect to the specified (i.e., swaps-related) DCMs and DCOs only under a very defined set of circumstances. Section 726(b) sets forth specific circumstances that must be found to exist in order for such rules to be adopted. Specifically, Section 726(b) states that the Commission shall adopt rules if it determines that "[A] such rules are necessary or appropriate [1] to improve the governance of, or [2] to mitigate systemic risk, promote competition, or mitigate conflicts of interest in connection with a swap dealer or major swap participant's conduct of business with, [B] a derivatives clearing organization, contract market, or swap execution facility that [1] clears or posts swaps or makes swaps available for trading and [2] in which such swap dealer or major swap participant has a material debt or equity investment." Dodd-Frank Act §726(b). Again, the expressly stated purpose of Section 726 is directed at DCMs and DCOs doing swaps business. It is difficult to imagine how restrictions on ownership of DCMs and DCOs that do not clear swaps or make swaps available for trading could be "necessary or appropriate" to improve the governance of, or mitigate risk in connection with, a swap dealer's conduct of business with registered entities

that do engage in the swaps business. In short, Section 726 does not contemplate (much less mandate) any restriction of voting rights with respect to DCMs and DCOs that are not involved in any swaps-related business.

The Proposed Rules also cite Sections 725(d) as a basis for this rulemaking. (See 75 FR 63733 n.7). That section, like Section 726, is directed specifically at conflicts that arise out of swaps-related activity:

> "The [CFTC] shall adopt rules mitigating conflicts of interest in connection with the conduct of business by a swap dealer or a major swap participant with a derivatives clearing organization, board of trade, or a swap execution facility that clears or trades swaps in which the swap dealer or major swap participant has a material debt or material equity investment."

Dodd-Frank Act §725(d) (emphasis added). Like Section 726, Section 725(d) does not provide any basis for extending the voting restrictions to DCMs and DCOs that do not engage in any swaps-related business.

Finally, the Proposed Rules cite Sections 735(b) and 725(c) as the basis for future rulemakings on governance and mitigation of conflicts of interest. (See 75 FR 63733 n.8 and 63734 n.17) These sections, however, contain nothing like the explicit direction of Section 726 regarding numerical limits on voting rights. Instead, the Core Principles for DCMs in Section 735(b) and DCOs in Section 725(c) provide an appropriate basis for the consideration by the Commission of rulemaking that addresses governance issues but do not provide for restrictions on voting rights in DCMs and DCOs that do not engage in any swaps-related business. (See 75 FR 63734 n.17, containing a list of governance areas to be considered for additional rulemaking).[2]

In 2009, the Commission published acceptable practices with respect to how DCMs address conflicts of interest in order to provide safe harbors for compliance with Core Principle 15. Nadex supports the policies that underlie those acceptable practices and believes that strong governance rules consistent with those acceptable practices are sufficient to ensure that DCMs and DCOs appropriately mitigate any conflicts of interest present in their businesses.

[2] The Dodd-Frank Act added to the CEA sets of Core Principles applicable to Swap Execution Facilities ("SEFs") and Swap Data Repositories ("SDRs"). These SEF and SDR Core Principles have some similarity to, but are not the same as the Core Principles applicable to DCMs and DCOs. In addition, the Dodd-Frank Act included a number of statutory requirements with respect to SEFs and those DCMs and DCOs that would engage in swaps execution or clearing. At the same time, however, the Dodd-Frank Act left intact the pre-existing Core Principles applicable to DCMs and DCOs. This different treatment is not surprising because of the different markets and functions these entities perform and the differing contexts of the long-established regulated futures industry and the new, centrally-cleared regulated swaps industry.

Any Limits On Voting Rights Of DCMs and DCOs Should Include A Broad Waiver Provision

As noted above, the Proposed Rules should not limit the voting rights of any owners of DCMs or DCOs that do not do swaps-related business. However, if the Commission does impose limits in this regard, the limits should be accompanied by broadly available waiver provisions. The Proposed Rules include a waiver provision with respect to the voting and ownership limitations for DCOs only. Nadex believes the opportunity to obtain a waiver from these limitations should be extended to DCMs as well.

In addition to extending to DCMs the availability of a waiver of voting and ownership limitations, the circumstances in which a waiver is available should be modified to promote flexibility, innovation and competition in the markets. Specifically, the Proposed Rules indicate that a waiver could be obtained for "a reasonable period of time", in circumstances where the limitations are not "necessary or appropriate" to (a) improve governance, (b) mitigate systemic risk, (c) promote competition, (d) mitigate conflicts of interest in connection with a swap dealer's or major swap participant's conduct of business with the DCO with respect to fair and open access and participation and product eligibility, and (e) otherwise accomplish the purposes of the Act. Nadex believes that the waiver should be available as long as the limitations are not "necessary" to improve governance, mitigate systemic risk, promote competition, etc. That is, the fact that the limitations may be an "appropriate" approach to addressing these concerns should not eliminate the ability of a DCM or DCO to address these concerns in some other effective and appropriate manner. Moreover, when the limitations are not necessary, the waiver should not be limited to "a reasonable period of time", but should be available for as long as the limitations remain unnecessary.

Any Limits On Voting Rights Should Not Unfairly Prejudice Publicly-Traded Parent Entities Listed On Non-Domestic Exchanges

Again, as noted above, the Proposed Rules should not limit the voting rights of any owners of DCMs or DCOs that do not do swaps-related business. However, if the Commission does impose some types of limits in this regard, the limits should not unfairly favor parents of SEFs, DCMs and DCOs that are publicly-listed on domestic exchanges. In this regard, the Proposed Rules contain provisions that could be deemed to constitute protectionist barriers to competition:

> If the derivatives clearing organization is a subsidiary, paragraph (b)(2) of this section shall apply to its parent, whether direct or indirect, in the same manner as it applies to the derivatives clearing organization. If any parent is publicly listed on a <u>domestic</u> exchange, then such parent must follow the voting requirements promulgated by the Securities and Exchange Commission or the entity on which such parent is listed.

75 FR at 63751 (emphasis added) (proposed regulation §39.25(b)(4)). <u>See</u> <u>also</u> 75 FR at 63748 (regarding SEFs), 63749 (regarding DCMs). These provisions prescribe treatment for

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domestically listed parent companies that differs from the treatment of all other (i.e., non-domestically listed) parent companies.

Such overt favoritism of United States-based entities will send a protectionist message to potential foreign investors looking to do business in the United States and to foreign regulators who may consider similar protectionist measures that preclude companies that are publicly-listed in the United States from their markets. Certainly, an exemption from the proposed voting limitations for parent companies that are subject to the SEC's jurisdiction and the NYSE's listing standards would be appropriate. In the same vein, companies subject to the jurisdiction of the Financial Services Authority and the listing standards of the London Stock Exchange should be exempt.

Nadex Supports The European Commission's Rejection Of Limitations On Ownership

Nadex supports the European Commission's rejection of limitations on ownership, as recognized in the Proposed Rules:

> The European Commission Proposal explicitly rejects ownership limitations. See Section 4.3.4 of the European Commission Proposal (stating that structural governance requirements ''are considered more effective in addressing any potential conflicts of interest that may limit the capacity of CCPs to clear, than any other form of regulation which may have undesirable consequence on market structures (e.g., limitation of ownership, which would need to extend also to so-called vertical structures in which exchanges own a CCP).

75 FR 63742-43 n.78. While Nadex believes the correct answer is to reject prescribed limitations on ownership or voting rights, Nadex notes that international comity provides an additional reason why the Commission should reject such limitations.

Conclusion

The Commission and the industry have had great success—with respect to both safety and transparency in its markets and innovation and competition—with a flexible approach to governance issues, allowing registrants to pursue governance practices and procedures that appropriately mitigate risks given the context of the markets they serve. The Commission should continue with a flexible approach and avoid strict limits that risk damaging the competitiveness of our markets in the United States and the ability of market participants – including DCMs, DCOs, intermediaries and customers – to access markets abroad.

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Should you have any questions regarding the above, please do not hesitate to contact me by telephone at (312) 884-0171 or by email at tim.mcdermott@nadex.com.

Sincerely,

Timothy G. McDermott
General Counsel and Chief Regulatory Officer

cc: Chairman Gary Gensler
Commissioner Michael Dunn
Commissioner Jill E. Sommers
Commissioner Bart Chilton
Commissioner Scott D O'Malia

Nancy Liao Schnabel, Special Counsel, DCIO
Lois Gregory, Assistant Deputy Director for Market Review, DMO