

June 3, 2011

Via Online Submission

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: Risk Management Requirements for Derivatives Clearing Organizations
(RIN 3038-AC98)**

Dear Mr. Stawick:

North American Derivatives Exchange, Inc. (“Nadex”) submits this letter in response to the proposed rules concerning “Risk Management Requirements for Derivatives Clearing Organizations” (“Proposed Rules”) published by the Commodity Futures Trading Commission (the “CFTC” or the “Commission”). 76 Fed. Reg. 3698 (Jan. 20, 2011). Nadex appreciates the opportunity offered by the extended comment period to comment on the Proposed Rules and asks the Commission to allow for greater flexibility in the application of any final rules concerning margins.

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 underlying markets) that are fully collateralized. As such, Nadex provides retail traders with a DCM/DCO alternative to over-the-counter retail markets.

Proposed Minimum “Liquidation Time” for Initial Margin

Proposed Regulation 39.13(g)(2)(ii) would require a DCO to “use models that generate initial margin requirements sufficient to cover the derivatives clearing organization’s potential future exposures to clearing members based on price movements in the interval between the last collection of variation margin and the time within which the derivatives clearing organization estimates that it would be able to liquidate a defaulting

clearing member's positions (liquidation time)." 76 Fed. Reg. At 3720 This risk-based requirement would continue appropriate margin practices that DCOs historically have implemented to address risk while still preserving their flexibility to structure appropriate initial margin levels for particular products. Nadex agrees with this portion of the Proposed Rule. However, the Proposed Rule goes beyond this risk-based approach and seeks to establish absolute restrictions on DCOs' ability to set appropriate margins without regard to actual "liquidation time" by establishing a minimum liquidation time of one day for all traditional futures contracts. Specifically, the CFTC states

a DCO [shall] use a liquidation time that is a minimum of one business day for all other products that it clears, and shall use longer liquidation times, if appropriate, based on the unique characteristics of particular products or portfolios.

76 Fed. Reg. at 3704 (discussing Proposed Rule 39.13(g)(2)(ii)). The explanation for this one-day minimum liquidation time is that "[a] minimum of one business day is the current standard that DCOs generally apply to futures and options on futures contracts." *Id.*

It is true that a one-day minimum has been a time-period "generally appl[ied]" by DCOs in calculating initial margins. We nonetheless respectfully submit that it would be a mistake for the Commission to mandate a practice that reflects the margining and banking procedures of the last century simply because that is the way that DCOs have operated in the past. In essence, to justify a restrictive regulation simply by noting that it reflects a current or historical standard applied by traditional DCOs ignores – indeed prohibits – the potential for innovation in the industry.

Nadex accordingly suggests that the Commission should omit any mandated "minimum liquidation time" from its Proposed Regulation and simply rely on actual liquidation times for traditional futures and options on futures¹. That is, the Commission should delete from Proposed Rule 39.13(g)(2)(ii) the phrase "and a liquidation time that is a minimum of one business day for all other products that it clears". Without the omitted language, the regulations still would require:

- initial margin sufficient to cover potential exposures in normal market conditions;
- initial margin requirements that are commensurate with the risks of each product and portfolio, including any unique characteristics of, or risks associated with, particular products or portfolios;
- the use of models that generate initial margin requirements sufficient to cover the DCO's potential future exposures to clearing members based on price movements in

¹ The Proposed Rules also include a five-day minimum liquidation time for cleared swaps that are not executed on a DCM. Proposed Rule 39.13(g)(2)(ii). Nadex does not express any opinion with respect to the appropriateness of this proposal regarding cleared swaps other than to note that the same arguments in favor of giving DCOs discretion to analyze appropriate risk factors to determine appropriate minimum liquidation periods for futures would appear to apply equally to such cleared swaps.

- the interval between the last collection of variation margin and the time within which the DCO estimates that it would be able to liquidate a defaulting clearing member's positions (liquidation time); and
- the use of longer liquidation times, if appropriate, based on the unique characteristics of particular products or portfolios.

Given the fact that such risks would be product-specific and portfolio-specific, the Commission's proposal does not specifically identify particular risks that a DCO must consider. The Commission nonetheless requested comments regarding whether there are other specific risks that should be identified and addressed in the Regulation. We agree with the Commission's proposed approach and do not believe it would be beneficial to attempt to identify additional specific risks that a DCO must address in determining initial margins.

Proposed 99% Confidence Level for Initial Margin

Proposed Regulation 39.13(g)(2)(iii) would require that the models used by a DCO to calculate initial margin "meet an established confidence level of at least 99%." In proposing this 99% requirement, the Commission acknowledges that

[W]hile some DCOs generally apply a 99% confidence level to some or all products that they clear, other DCOs apply a confidence level between 95% and 99% with respect to certain products. In addition, certain DCOs may achieve an average confidence level of 99% across all products that they clear, although not every product may meet the 99% confidence level.

76 Fed. Reg. at 3704. Given the significant change proposed by the Commission, the Commission seeks comment "regarding whether a confidence level of 99% is appropriate with respect to all applicable products, spreads, accounts and swap portfolios." *Id.*

Nadex believes that the Commission should not prescribe a uniform, specific confidence level for all products cleared by all DCOs, but instead should continue to empower each DCO with discretion to determine the appropriate confidence levels based on particular characteristics of the products it clears, its customer base, and its other risk management tools, subject in all cases to Commission oversight and review. Certainly, issues of the depth of underlying markets, the existence of multiple venues trading similar products on which a defaulting clearing member's portfolio can be liquidated or hedged, the size of the DCO and its systemic importance, the duration of the products and many other factors could play into a determination that a the confidence level for a specific product offered by a particular DCO should be more or less than 99%. DCOs should have the ability to take such factors into account and the discretion to apply appropriate confidence levels based on their analysis.

In support of the proposed 99% level, the Commission notes that on September 15, 2010, the European Commission proposed the European Market Infrastructure Regulation ("EMIR"), which would require that margins "shall be sufficient to cover losses that result

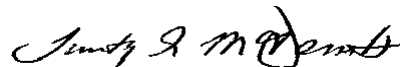
from at least 99 per cent of the exposures movements over an appropriate time horizon. ...” 76 Fed. Reg. at 3704 n.39. However, EMIR is also only a proposal. Further, and importantly, the timetable for the consideration and implementation of EMIR is far behind the Commission’s current schedule. We accordingly submit that it would be unwise for the Commission to seek to align its regulations to the eventual implementation of EMIR. Moreover, a number of justifications could exist for different rules under the different regimes. For example, EMIR does not distinguish between systemically important DCOs and other DCOs, and the Commission might well consider stricter confidence level guidelines for systemically important DCOs (although Nadex firmly believes that a hard-and-fast 99% requirement is not the right approach, even for systemically important DCOs). Given the success that DCOs have had with managing risk, Nadex believes that there is no justification for imposing a mandatory 99% requirement on all DCOs for all products.

Conclusion

The DCOs have demonstrated an extraordinary and exemplary ability to manage risk—no DCO has ever defaulted—during a time of extraordinary growth and stress in the financial markets. The DCOs have specialized expertise that, as appropriate, reflects the special attributes of the products that they clear. Absent evidence that a given DCO is not appropriately managing risk, the DCOs should be allowed to exercise their own best judgment and deploy their considerable risk management skills to determine the time horizons and confidence levels for their respective margining systems.

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

John C. Lawton, Deputy Director, DCIO
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