NADEX

October 30, 2015

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

RE: Nadex Comment regarding Amendments to Swap Data Recordkeeping and Reporting Requirements for Cleared Swaps

Dear Mr. Kirkpatrick,

The North American Derivatives Exchange, Inc. ("Nadex" or the "Exchange") appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC" or the "Commission") Proposed Amendments to the Swap Data Recordkeeping and Reporting Requirements as set forth in the Federal Register Vol. 80, No. 168 published on August 31, 2015. Nadex applauds the Commission's continuing efforts to review and improve the regulatory requirements imposed by the Dodd-Frank Act with respect to swap transactions, and address the questions and concerns of industry participants. The Commissions' most recent proposals clearly identify on which party the obligation to report creation, confirmation, and continuation data lies, which party should select the swap data repository ("SDR"), and specifically require continuation data be reported to the same swap data repository to which the original creation and confirmation data was reported.

While the proposed amendments are likely to provide clarity to a number of industry participants as to their regulatory obligations, the proposals do not address certain issues that continue to present significant obstacles to small entities focused on providing swap trading opportunities in a regulated environment to retail market participants.

As you are aware, Nadex is a designated contract market ("DCM") and derivatives clearing organization ("DCO"), registered with and subject to regulation by the Commission. In accordance with its regulatory requirements as a DCM and DCO, Nadex has complied with its reporting obligations under parts 16 and 39 since its inception. Nadex is also one of only three registered entities legally offering binary options in the United States[1]. Nadex contracts are fully collateralized, of small notional value, and directed towards retail investors accessing the marketplace without intermediation, and thus, Nadex's products and clearing model differ significantly from traditional DCMs and DCOs. The Exchange has faced unique challenges in light of the Part 45 reporting requirements, particularly with respect to standardized reporting and economic burden, due to the retail nature of Nadex's membership base as well as the small notional value of the contracts listed and cleared.

Challenges Presented Due to Nature of Membership Base

Nadex caters to smaller, retail-type traders, who primarily trade binary options[2] offered on the Exchange. Although the Nadex Rulebook permits entities[3] to apply to become direct Trading Members of Nadex, almost all of Nadex's Members are individual[4] natural persons. All contracts traded at Nadex must be fully collateralized at the time the trade is entered, and accordingly, the Member never receives a margin call. Thus, Nadex provides a regulated venue for the smaller or less experienced trader to enter swaps of a significantly lower notional value[5], fully aware of their total risk upfront.

Nadex Members are not institutional type swap traders or market participants, and except for the market-makers, Nadex is unaware of any Member that might qualify as an Eligible Contract Participant ("ECP")[6]. Therefore, under the CEA, Nadex Members are not permitted to trade swaps over the counter. However, notwithstanding that the CFTC has deemed Nadex products to be swaps, Nadex Members are eligible to trade Nadex swap products solely because they are traded on a DCM consistent with CEA §2(e).

The drafters of CEA §2(e) recognized that retail traders (i.e., non-ECPs) should be allowed to trade swaps on a DCM by preserving the separation that exists between such retail traders and the traditional OTC/SEF swaps markets. Such a distinction is entirely reasonable since Nadex's fully collateralized products and the retail customer base are not relevant with respect to the underlying purpose of the Dodd-Frank Act ("DFA"): limiting systemic risk to the system. Unfortunately, while granting non-ECPs very limited access to the swap market, the Part 45 reporting regulations have not been crafted to reflect the increased data required to be reported. To be clear, while non-ECPs are permitted to trade "swaps" provided that they are traded on a DCM, their activity is to be reported

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[1]http://www.cftc.gov/ConsumerProtection/FraudAwarenessPrevention/CFTCFraudAdvisories/fraudadv_binaryoptions

[2] In addition to binary option contracts, Nadex also offers Variable Payout contracts. Variable Payout contracts are also fully collateralized. Assets with the largest notional value are the Gold, Crude, and Natural Gas Variable Payout contracts with a value of $1,000.

[3] Nadex offers an entity Membership option for legally created and properly registered Corporations, LLCs, Partnerships, and Trusts. The majority of these entity Members have been created either by individuals or their spouses/partners for the purpose of personal trading, and typically have only one or two Authorized Traders. Entity Members have the same privileges as individual Members and the entities, and its Authorized Traders are required to comply with the same Rules.

[4] Nadex internal documents show that in September 2015, 0.03% of active traders were entity accounts.

[5] Whereas a typical plain vanilla swap has a notional value of at least $100,000, the notional value of a Nadex binary option is $100.

[6] CEA §1a(18).

pursuant to Part 45, as though they were institutional style swaps. As the swaps are traded on Nadex as a DCM and cleared by Nadex as a DCO, Nadex has the undertaking to report creation, confirmation, and continuation data for all of its Members.

Another challenge facing entities such as Nadex relates to the Regulation §45.6 Legal Entity Identifier (LEI) requirement. As noted above, more than ninety-nine percent of Nadex members are individuals; natural persons rather than legal entities. Therefore they are ineligible to register as an entity through the CFTC mandated LEI utility. More importantly, it is clear that this requirement was created to allow regulators to trace the large risk exposures of major market participants across many domestic and international markets for purposes of market transparency and regulatory oversight and not for Nadex's products and customer base. This becomes a problem when Nadex, on behalf of its customers, reports a transaction to the SDR, and the SDR cannot recognize the Nadex member because the member does not have a LEI, nor can it obtain one.

As a result, if a regulator needs to identify the parties involved in the binary option trade it will, by necessity, come to Nadex for that information, defeating the goal of standardizing swap data. Therefore, the reporting of unidentified trades to the SDR is a hugely inefficient deployment of assets, resources and time for Nadex, the SDR and the regulators, particularly because the CFTC has this information already under the part 16 reporting regime for DCM's, and part 39 under the DCO's regulations. Essentially, Nadex is required to send a third record of the Exchange trade data to a SDR, albeit in a different format. Thus, the reporting to a SDR not only produces duplicate data, but does not change the Commission's position with respect to the information they are already receiving through Nadex's DCM and DCO reporting obligations.

Challenges Due to Notional Contract Value/Economic Burden

The cost of reporting to a SDR pursuant to the Part 45 requirements is also not inconsequential for a small entity such as Nadex. Nadex binary contracts are modest, with a notional value of $100, and are cleared by the Nadex clearinghouse. Nadex currently charges its direct Members trading and settlement fees (for contracts that settle in-the-money) $0.90 per lot, which is capped at $9.00 per transaction. Unlike typical swap contracts that may be held for months or years, the majority of Nadex contracts are traded intraday[7]. Accordingly, for the great majority of trades occurring on the Exchange, Original Swap and Clearing Swap trade information is required for positions which no longer exist at the end of the trade day.

Presently the fee schedule for the CME Swap Data Repository is $5.00 per transaction for all classes except for foreign exchange[8], above the monthly $200 minimum, and for the DTCC Derivatives Repository US LLC ("DDR") the charge, except for foreign exchange, for the most expensive tier (the most infrequent user) is $3.50[9] for each side. Clearly, given Nadex's current business model the

[7] Nadex offers Intraday 5-minute, 20-minute, 2-hour, 5.5-hour, Daily, Weekly, and Event contracts. Only positions in the Weekly, Event, and certain Daily contracts may be held from one trade day to the next.
[8] https://www.cmegroup.com/market-data/files/cme-repository-service-fee-schedule.pdf
[9] DTCC Derivatives Repository US LLC Fee Schedule - Effective July 1, 2014, *available at* http://www.dtcc.com/~/media/Files/Downloads/Data-and-Repository-Services/GTR/US-DDR/DDR_Fees.pdf

requirements imposed by Part 45 present substantial financial obstacles. The burden presents the question of whether trading and settlement fees charged by Nadex should be raised to support the reporting costs. However, an increase in fees could present negative consequences such as a decrease in activity and liquidity, and potentially deter exactly the clients Nadex's business is designed for, the smaller retail investor.

Nadex's Business Model Mitigates Risk

In addition to improving transparency, the purpose of the Part 45 reporting requirements was to reduce systemic risk involved with swap trading. In this respect Nadex supports the reporting requirements. However, one of the overarching challenges facing Nadex both as a DCM and DCO is that while the Commission has deemed Nadex products to be swaps these products have most of the characteristics of an exchange traded future or option thereon (fungibility, offset, exchange traded with standardized terms) while having few of the characteristics of a traditional swap (bi-lateral, traded over-the-counter, customized). The Nadex business model has risk mitigation factored into its contracts, as all trades must be fully collateralized before they are cleared and therefore pose no systemic risk to the financial system.

As stated previously, Nadex caters to retail-type traders, who primarily trade binary options[10] offered on the Exchange. Nadex Members are eligible to trade Nadex swap products solely because they are traded on a DCM consistent with CEA §2(e). These traders employ strategies more akin to day trading in futures and options, rather than the typical trade and hold methods swap traders favor. This inevitably leads to a higher activity level intraday, with fewer positions held over to the next trade day.

Nadex binary contracts are small, with a notional value of $100, and are cleared by the Nadex clearinghouse. Unlike the majority of swap contracts, all Nadex contracts are fully collateralized. As such, there is no margin or credit extended to the Member and therefore no margin calls are required. The Member is fully aware of its maximum exposure at the time the order is placed. Accordingly, the nature of Nadex's fully collateralized contracts and retail customer base are not relevant with respect to the underlying purpose of the DFA, that is, limiting systemic risk to the system.

To further emphasize the immateriality of Nadex's swaps in the context of the purpose for the DFA, Congress directed the Commission to exempt from registration as a swap dealer any "entity that engages in a *de minimis* quantity of swap dealing."[11] The current level of swap trading in order to qualify for the *de minimis* exception is $8 billion annually. This level is expected to be lowered to $3 billion at the end of the phase-in period. Both figures far exceed the total value of the contracts traded at Nadex on an annual basis, demonstrating that if Nadex were a swap dealer it would not even be required to register as such because the value of its trades would qualify it for the *de minimis* exception.

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[10] In addition to binary option contracts, Nadex also offers Variable Payout contracts. Variable Payout contracts are also fully collateralized. Assets with the largest notional value are the Gold, Crude, and Natural Gas Variable Payout contracts with a value of $1,000.

[11] CEA sec. 1(49)(D).

Nadex therefore contends that the broadly defined 'swap' encompasses contracts which are not the sort that threaten the stability of the market, and that by holding such contracts to the same standards as large institutional swap participants places unnecessary restrictions on small entities.

Trade Option Exemption

On May 7, 2015, the Commission published proposed amendments to the Part 45 reporting requirements with respect to Non-SD/MSPs and trade options, which would exempt them from Part 45 SDR reporting obligations[12]. The reason for the proposed amendments was in large part due to Commenters' argument that "these costs have discouraged commercial end users from entering into trade options to meet their commercial and risk management needs, thereby reducing liquidity and raising prices."[13]

In its explanation for the proposed changes, the Commission stated "[t]his amendment is intended to reduce burdens for Non-SD/MSP trade option counterparties, many of whom, as commenters explained, face technical and logistical impediments that prevent timely compliance with part 45 reporting requirements"[14] and that "Non-SD/MSPs may not have the infrastructure in place to support part 45 reporting to an SDR and [] instituting such infrastructure would impose a costly burden, particularly for small end users."[15]

Small institutions such as Nadex face similar challenges, due to the significant SDR costs, as well as the inability to provide LEIs for the majority of its users. The potential systemic risk posed by trade options was minimal as the purpose of the transactions is to hedge against commercial and physical risks, rather than speculation. Additionally, participants in trade options are smaller Non-SD/MSPs, lacking both the technical capabilities and financial means to meet the reporting requirements of Part 45. The Commission also noted that those participants who would be granted the trade option exemption would still be subject to the recordkeeping requirements of 45.2, which require market participants to maintain full and complete trade records and to make those records available for inspection to the Commission upon request. While Nadex Members trade binary options not only for hedging purposes but for speculation, as explained previously the notional value of the most widely traded contracts offered at Nadex, binary options, is $100 and all trades are fully collateralized, thereby eliminating systemic risk to the financial system. Also like those participants eligible for the trade option exemption, Nadex Members are small non-ECPs. Furthermore, like those participants eligible for the trade option exemption, Nadex is also subject to recordkeeping requirements as a DCM and DCO for activity occurring on the Exchange which it must make available to the Commission, and in addition, provides its trade data to the Commission on a daily basis in accordance with its DCM and DCO requirements under Parts 16 and 39.

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[12] Commodity Futures Trading Commission Notice of Proposed Rulemaking in 80 Fed. Reg. 26200 (May 7, 2015).
[13] *Id.* at 26202.
[14] *Id.* at 26203.
[15] *Id.* at 26203.

Regulatory Flexibility Act

The Regulatory Flexibility Act (the "RFA") requires that Federal agencies consider whether the rules they propose will have a significant economic impact on a substantial number of "small entities"[16] and, if so, the agencies must provide a regulatory flexibility analysis reflecting the impact.

There are only two Exchanges registered with the CFTC currently offering retail traders the opportunity to legally trade binary options in the United States: Nadex and the Cantor Exchange, LP ("Cantor").The Cantor Exchange also offers contacts of small notional value. Accordingly, the entire legal retail binary options industry legally operating in the US is seriously impacted by the Part 45 regulations. Imposing such burdensome requirements on essentially the only two entities available to retail traders looking to trade binary options surely qualifies as a "significant economic impact on a substantial number of small entities".

Conclusion

The Commodity Futures Trading Commission's Office of Consumer Outreach and the Securities & Exchange Commission's Office of Investor Education and Advocacy have issued an Investor Alert to warn investors of various fraudulent schemes involving OTC binary options[17]. In its Alert, the Commission identifies Nadex as among the three DCMs legally offering binary options in the United States. It specifically notes that "[a]ll other entities offering binary options that are commodity options transactions are doing so illegally." Most recently, the CFTC has launched its "RED List", which identifies unregistered foreign entities that illegally solicit U.S. residents to invest in, among others things, binary options[18]. This demonstrates the Commission's ongoing efforts to protect U.S. market participants from fraud, manipulation, and abusive practices, and to promote market integrity. The current SDR reporting requirements place a substantial burden on Nadex, essentially the primary registered entity where retail individuals are realistically able to trade binary options contracts legally in the United States. Thus, the regulations which sought to reduce risk may ultimately thwart the Commission's efforts to ensure U.S. residents have a regulated environment in which to trade such contracts.

Nadex recognizes the importance of monitoring highly leveraged institutions engaging in risky transactions, as well as the collection of data compiled into uniform and readable information, but believes the considerable burden of Part 45 reporting outweighs what little benefit, if any, the Commission might gain from such reporting by small institutions with market participants that do not

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[16] A "small entity" as defined by the RFA Act has the same meaning as "small business" in Subsection 3 of Section 601 of the RFA. Subsection 3 states that "small business" has the same meaning as the term "small business concern" under section 3 of the Small Business Act ("SBA"). The SBA states that the Small Business Administrator may specify standards by which a business may be determined to be a small business concern. The Small Business Administrator has established a table which sets forth the size standards for a small business; a commodities exchange is considered small if its average annual receipts does not exceed $38.5 million. https://www.sba.gov/sites/default/files/files/Size_Standards_Table.pdf

[17] http://www.cftc.gov/ConsumerProtection/FraudAwarenessPrevention/CFTCFraudAdvisories/fraudadv_binaryoptions

[18] http://www.cftc.gov/PressRoom/PressReleases/pr7224-15; http://www.smartcheck.gov/REDList/

pose a systemic risk to the market, and otherwise comply with their reporting obligations under separate regulations.

The Commission did indeed stand by these words when it recognized the challenges commercial non-SD/MSPs faced in order to comply with Part 45, and issued proposed amendments to the trade option exemption to address these hardships, which Nadex applauds.

Nadex commends the efforts of the Commission, and the substantial time and effort expended in the drafting and revising of Part 45, and the amendments now pending which attempt to clarify terms and the responsible reporting parties. We note, however, that significant challenges continue to plague certain sectors of the "swaps" arena. Accordingly, we encourage the Commission to continue its mission to identify, analyze, and address these challenges, including granting relief to parties in appropriate instances.

Respectfully,

Timothy G. McDermott
Chief Executive Officer