



March 16, 2016

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 Proposed Regulation Automated Trading

Dear Mr. Kirkpatrick,

The North American Derivatives Exchange, Inc. (“Nadex” or the “Exchange”) is a retail focused derivatives clearing organization (“DCO”) and designated contract market (“DCM”) registered with the Commodity Futures Trading Commission (the “Commission”), offering binary options and spread contracts. Nadex is grateful for the opportunity to comment on the Commission’s proposed regulations pertaining to automated trading, as set forth in the Federal Register 80, No. 242, at 78824, published December 17, 2015.

Nadex commends the Commission’s continuing efforts to protect market participants from abusive practices and systemic risk. Proposed Regulation AT (“Reg. AT”) seeks to add controls and transparency to the use of automated trading by requiring the registration of certain traders not otherwise obligated to register, as well as the implementation of technical and compliance systems by the traders, FCMs, and DCMs. It is fair to say that pre-trade risk controls and risk management requirements, many of which the industry has proactively implemented, may prevent certain malfunctions and mitigate failures that do occur. Nadex generally supports the premise upon which Reg. AT was drafted, but feels certain aspects are too broad, unclear as to applicability, and that the undertaking of implementation by those potentially affected has been underestimated.

The proposed amended definition of “floor trader” would include “any person who purchases or sells futures or swaps solely for such person’s own account in a place provided by a contract market for the meeting of persons similarly engaged, where such place is accessed by such person in whole or in part through DEA (as defined in proposed §1.3(yyyy)) for

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Algorithmic Trading . . .”.¹ The Commission explains in the proposed regulations that “the term “Direct Electronic Access” (“DEA”) means “an arrangement where a person electronically transmits an order to a DCM, without the order first being routed through a separate person who is a member of a DCO to which the DCM submits transactions for clearing. By “routed,” the Commission means the process by which an order physically goes from a customer to a designated contract market.”² The Commission estimated that under the proposed definitions, approximately 100 entities would be required to register and comply with Reg. AT.³

On January 16, 2014, in its interpretive letter responding to Nadex’s request for exemptive relief from certain provisions of Part 39, the Commission found all Nadex members to be “clearing members”. Accordingly, by the Commission’s proposed definition of DEA, Nadex members, who are considered both the trader and the clearing member, that submit orders by means of an algorithm would be subject to the terms of Reg. AT, as those orders would not be routed through a “separate” clearing member. However, it is clear that the Commission did not intend for Nadex members to fall within the class of traders subject to registration under proposed Reg. AT, as the estimated number of affected participants would be significantly higher than 100, potentially in the thousands. Nadex therefore contends that the definition of DEA as written does not accurately reflect the Commission’s intent, and broadly encompasses participants that pose no systemic risk to the industry.

The Commission specifically noted that with respect to algorithmic trading it “expects that such trading will be performed by entities, not natural persons,” and requests comment as to whether any AT Person subject to proposed Reg. AT would “be a natural person or a sole proprietorship with no employees other than the sole proprietor”.⁴ It should be noted that the majority of Nadex members are individual natural persons, and a portion of its entity members are sole proprietorships with no other employee than the sole proprietor. Each of these members has the potential ability to engage in automated trading on the Exchange. Based on the Commission’s statement regarding natural persons, Nadex does not believe the Commission intended for its members to fall within the definition of floor trader, and therefore an AT Person. Under the proposed definition of DEA, the answer to the Commission’s question is yes, a natural person or a sole proprietorship could potentially qualify as an AT Person and be subject to proposed Reg. AT.

Nadex believes the exclusion of its members from the category of traders required to register as a floor trader and comply with the requirements of Reg. AT is appropriate, not only

¹ Fed. Reg. Vol. 80 at 78846 (December 17, 2015).

² *Id.* at 78844.

³ *Id.* at 78885.

⁴ *Id.* at 78843.

because over 99% of its client base is comprised of natural persons⁵, but also due to the nature of Nadex's business model which is already structured in a way that combats the risks Reg. AT seeks to avert. The Commission identifies those risks as:

- 1) Operational, such as malfunctions, incorrectly deployed algorithms, algorithms reacting to inaccurate or unexpected data;
- 2) Market liquidity;
- 3) Market integrity, as automated trading facilitate misconduct;
- 4) Transmission such as shocks based on erroneous orders impacting multiple markets;
- 5) Clearing and settlement;
- 6) Effective risk management.

Nadex recognizes that the above risks may be present when algorithms are used to enter numerous contracts of significant notional value on margin. Such activity potentially poses systemic risk to the industry, for instance if a 'bug' in the code is undetected, and could lead to serious adverse effects. However, applying blanket regulations to DCMs, FCMs, and traders does not consider the measures certain institutions have already implemented to address and prevent the risks described. Additionally, DCMs are already required to address many of these risks according to their compliance obligations under Regulation 38.250, DCM Core Principle 4. With respect to the Nadex market in particular, it is not likely any of the risks the Commission identified poses a realistic threat, regardless of whether Nadex members are trading using algorithms or not. For example, all orders submitted to the Exchange must be fully collateralized before a trade can occur, thereby eliminating the risk that a trader would be unable to meet a margin call, even in the event a malfunction in the algorithm caused excessive unintended order submissions. Moreover, Nadex has created Rules that limit the number of orders that may be submitted to the Exchange via FIX connection in order to prevent excessive messaging. An automatic "limiter" blocks orders coming into the Exchange that exceed these parameters. The limiter, along with the Exchange's dedicated market makers, also help to prevent a significant reduction in liquidity due to a malfunction of an algorithm over FIX. Conflation thresholds address excessive quotes submitted by a market maker to prevent a backlog of quotes and which may slow the Exchange. Therefore, the implementation of Reg. AT would not in effect offer additional protection to market participants over that already being provided.

Despite the Commission's projection that Reg. AT would affect approximately 100 entities, one could speculate that if Nadex's retail members do fall under the proposed definition of floor trader, and each of these members used some sort of automatic trading, thereby subject to Reg. AT, the potential number of market participants affected by the regulation could reach the thousands. In this scenario, the Commission has greatly underestimated the burden Reg. AT would place on Nadex members, who are either retail

⁵ Statistic based on a database search on March 8, 2016.

individuals (natural persons) trading for their own accounts, or small retail entities trading the entity's funds. The significant expense to the member in order to comply would undoubtedly be cost prohibitive for the great majority of Nadex members. The Commission has estimated that the cost to a newly registered floor trader could total close to \$1 million. Given the retail market Nadex caters to, coupled with the \$100 notional value of the majority of contracts traded at Nadex, no retail member could justify the upfront cost of \$1 million to register and comply with Reg. AT. Moreover, Nadex notes that it is unlikely its members would be in a position to hire an attorney experienced in the commodity futures industry to explain the requirements, draft policies and procedures, draft annual reports, ensure compliance with the Commodity Exchange Act, and assist with ongoing review.

The exorbitant costs to implement procedures to comply with Reg. AT would most likely deter Nadex members from using any sort of automated trading. It is highly doubtful, however, that outright deterrence was the Commission's goal when proposing these regulations. Furthermore, as one of the few Exchanges sanctioned by the Commission to offer binary options in the United States, imposing such burdensome requirements on retail traders utilizing automated trading may drive these traders to unregulated markets overseas. Reg. AT would essentially prohibit retail traders from use of automated systems altogether, or push those traders to seek alternative unsanctioned offshore markets. Commission Giancarlo noted these challenges in his November 24, 2015 statement explaining that "Regulation AT would add numerous costs to small market participants and raise barriers to entry. Small market participants may be less likely to employ risk controls consistent with Regulation AT so they would incur costs to develop or purchase such risk controls. They would also incur costs to hire additional employees to develop and implement policies and procedures for the development, testing, monitoring and compliance of their Algorithmic Trading systems. Small market participants would have to hire additional employees to continuously monitor their Algorithmic Trading systems on a real-time basis."⁶ Nadex agrees with Commissioner Giancarlo's statement and requests the Commission consider that the potential effects of Reg. AT on small traders are inconsistent with the intended goal.

The proposed regulations would also require a DCM to provide a description of not only known attributes of its electronic trading platform, but also asserts "this may not relieve an exchange of the *obligation to disclose information if the exchange should have known* of an attribute,"⁷ (*emphasis added*). This requirement places an unreasonable and impossible responsibility on the DCM to publicly disclose that which it does not know. This requirement could be clarified with the addition of the words "once the attribute becomes known to the exchange", which is presumed to be the Commission's intent when drafting the requirement.

⁶ <http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement112415>

⁷ Fed. Reg. Vol. 80 at 78869 (December 17, 2015).

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Proposed Regulation 1.80(d) would require that “prior to an AT Person’s initial use of Algorithmic Trading to submit a message or order to a DCM, such AT Person must notify its clearing member FCM, as well as the DCM on which the AT Person is trading, that it will engage in Algorithmic Trading. The Commission intends that this requirement ensures that clearing member FCMs and exchanges have sufficient advance notice to implement and calibrate pre-trade and other risk controls to manage risks arising from the AT Person’s trading.”⁸ While Nadex agrees that the AT Person should provide notification prior to engaging in Algorithmic Trading, in certain circumstances this reliance on the AT Person may be problematic. Incoming orders do not indicate what prompted the order submission, and accordingly, unless the AT Person has provided notice of the planned use of an algorithm or has connected to the entity by FIX gateway, clearing FCMs and DCMs may have no other way of knowing which traders are using algorithms. Thus, FCMs and DCMs may be completely dependent on AT Persons to provide notice of their algorithmic trading, lest they unknowingly violate their own requirements under the regulations. Failure on the part of the AT Person to provide notification would have an unfair domino effect on the clearing FCM and DCM’s ability to comply with the Reg. AT. Accordingly, the regulation should clearly specify that in the absence of notice on the part of the AT Person, the FCM and DCM are absolved of any liability for noncompliance with Reg. AT.

Proposed Regulation 1.83(a) and (b) would require AT Persons and FCMs to provide DCMs annually with a certified report, detailing its pre-trade risk controls. Proposed Regulation 40.22 would require the DCM to establish a program for review and evaluation of the reports, and further would require “measures by the DCM reasonably designed to identify and remediate any insufficient mechanisms, policies and procedures described in such reports, including identification and remediation of any inadequate quantitative settings or calibrations of pre-trade risk controls required of AT Persons pursuant to §1.80(a).”⁹ The Commission also proposes Regulation 170.18, which would require AT Persons, not already required to become a member of a registered futures association (“RFA”) under Regulations 170.15, 170.16, or 170.17 to become a member of an RFA.¹⁰ While Nadex agrees AT Persons and their clearing FCMs should maintain books and records regarding their pre-trade risk controls and regular testing results, and that this information should be made available to the DCM upon request, regular review should be conducted by the RFA rather than the DCM. As the RFA serves the “vital self-regulatory role by functioning as frontline regulators of their members”¹¹, it is fitting that it ensure its registered AT Persons comply with the Commission Regulations and maintain appropriate policies and procedures as required. Moreover, requiring the DCM to identify and

⁸ *Id.* at 78854.

⁹ Fed. Reg. Vol. 80 at 78876 (December 17, 2015).

¹⁰ *Id.* at 78849.

¹¹ *Id.*

remediate deficiencies in the AT Person's reports, settings, risk-controls, etc. as Regulation 40.22 would call for, is improper. The proposed regulations would essentially place the DCM in the role of an advisor or consultant to the AT Person. The AT Person could hold the DCM responsible for any errors or malfunctions that occur as the result of the DCM's "remediation", or shift blame to the DCM in the event those changes are found inappropriate or insufficient by the CFTC or RFA. Current Commission regulations require DCMs to establish and enforce exchange Rules, however, DCMs are not required to collect annual reports from its members or market participants explaining how they comply with the exchange Rules. Accordingly, a DCM Rule requiring AT Persons to maintain books and records, and have pre-trade risk controls in place should be implemented in the same fashion.

Nadex also points out that it is not the sheer number of contracts traded that poses systemic risk to the industry, rather it is the total value of those contracts. For example, in the instance of a US 500 binary option contract valued at \$100, even if a Nadex member traded the position limit of 2,500 contracts, the total value of the contracts entered would be \$250,000. Compare that with the underlying e-mini S&P 500 futures contract, which has an approximate value of \$100,000 for just one contract. Basing registration on the number of contracts traded could mean that a Nadex member trading 2,500 contracts would need to register, yet an e-mini S&P 500 futures trader entering 3 contracts may not need to register, even though the value of that position is more than the position at Nadex. Therefore, a more reasonable approach would be to base registration requirements on the notional value of the contracts traded using the automated trading system.

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 obligations¹². The amendments were approved by the Commission on March 16, 2016, and will become effective upon publication in the Federal Register. The reason for the 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

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.

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infrastructure would impose a costly burden, particularly for small end users.”¹⁵ Likewise, Nadex retail members would face similar challenges to understand their obligations under Reg. AT, as well as implementation of the regulations and ongoing compliance, including the initial and maintenance costs. The Commission recognized that the potential systemic risk posed by trade options was minimal, and that participants in the trade options market are typically smaller Non-SD/MSPs, lacking both the technical capabilities and financial means to meet the requirements of Part 45. For the same reasons the Commission recognized a trade option exemption would be appropriate, so too should it limit the scope of Reg. AT’s applicability, or alternatively, recognize that an exemption from the proposed Reg. AT is appropriate for certain algorithmic traders that pose a low risk to the industry.

The subject of a source code repository will no doubt be opposed and addressed in depth by many commenters, and accordingly Nadex merely notes its objection to the proposal which jeopardizes confidential and proprietary information.

It was noted in the Commission’s Roundtable discussion on February 23, 2016 that “when the SEC studied volatility spikes in the equities markets or so-called mini crash flashes, they noted that the majority of such events were caused by human mistakes, such as fat finger errors, rather than algorithmic trading bugs.” The question therefore remains whether the implementation of Reg. AT will in fact prevent or greatly mitigate systemic risk resulting from an algorithm malfunction, and whether the benefits of Reg. AT will outweigh the costs to those affected. Considering the nature of retail traders, the business model and safeguards already in place, it seems that at least in some markets the benefits do not outweigh the costs. A blanket application of Reg. AT has the potential to discourage retail traders from participating in the market, or motivate traders to develop alternative means to circumvent the regulations. Nadex would therefore request the Commission consider the unintended market participants who could face substantial burden if subject to Reg. AT.

Thank you for consideration of these comments, and please do not hesitate to contact us should you have any questions in this regard.

Sincerely,



Timothy G. McDermott
Chief Executive Officer

¹⁵ *Id.* at 26203.

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