



September 13, 2019

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 Derivatives Clearing Organization General Provisions and Core Principles as Set Forth in Proposed Rule 84 FR 22226

Dear Mr. Kirkpatrick,

The North American Derivatives Exchange, Inc. ("Nadex" or the "Exchange")¹ appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC" or the "Commission") proposed amendments to the Derivatives Clearing Organization ("DCO") General Provisions and Core Principles as published in 84 FR 22226 on May 16, 2019. Nadex supports the Commission's ongoing efforts to improve and simplify the industry's regulatory requirements through the Keep it Simple Stupid ("KISS") initiative, reducing the burden of compliance on registrants and addressing the questions and concerns of industry participants. The Commission's most recent proposals under the initiative to amend various DCO requirements under Parts 1, 39, and 140 primarily pertain to risk management, reporting, and governance, and also codifies certain relief granted to DCOs through issued exemption letters.

Nadex is grateful that the proposed amendments clarify a number of Regulations that are not applicable to fully collateralized contracts. As the Commission is aware, Nadex is a designated contract market ("DCM") and DCO, registered with and subject to regulation by the Commission. Nadex contracts

¹ On February 18, 2004, the Commission issued an order ("Order") pursuant to Section 5b of the Commodity Exchange Act (the "Act"), 7 U.S.C. § 7a-1, granting Nadex, then known as HedgeStreet, Inc. ("HedgeStreet"), registration as a DCO for the clearing of fully paid-up, cash-settled, binary options listed for trading on its affiliated DCM. Thereafter, the Order was amended twice: on December 1, 2004, to allow then HedgeStreet to clear fully collateralized futures contracts in addition to fully paid-up, cash-settled binary options on various indices, rates, risks, measures, instruments, differentials, indicators, values, contingencies, occurrences, or extents of occurrences listed for trading on its DCM; and on March 30, 2010, to permit Nadex to clear contracts resulting from customer orders intermediated by futures commission merchants. The Order was most recently amended on January 16, 2014 ("Amended DCO Order") to accommodate interpretive and exemptive relief from certain of the Part 39 regulations.

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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 a traditional DCO. Due to the unique nature of Nadex's business, its operations occasionally do not fit within the parameters of the requirements. In this comment Nadex has responded to the Commission's specific requests for discussion and has identified certain areas where it considers that additional clarification of the proposed amendments is needed.

Risk Management

Regulation 39.2 Definitions

The Commission has proposed to include a definition for "fully collateralized" in Regulation 39.2. Under the proposed definition, a fully-collateralized contract is "a contract cleared by a derivatives clearing organization that requires the DCO to hold, at all times, funds in the form of the required payment sufficient to cover the maximum possible loss that a counterparty could incur upon liquidation or expiration of the contract"². Nadex's Amended Order of Registration as a Derivatives Clearing Organization dated January 16, 2014 ("Amended DCO Order") limits it to only offering fully-collateralized contracts. The Amended DCO Order states that "[a] contract cleared by Nadex will be considered 'fully-collateralized' if Nadex holds, at all times, sufficient funds to cover the maximum possible loss that may be sustained upon liquidation of the contract."³ The proposed definition of fully-collateralized is substantially similar to the definition Nadex has relied upon in its Amended DCO Order, and Nadex has no objection to the addition of this definition in Regulation 39.2. Nadex requests clarification as to whom "counterparty" refers. Our understanding is that "counterparty" refers to the opposite party to a transaction. The use of "counterparty" in the proposed definition appears to require that the DCO hold sufficient funds to cover the maximum possible loss that the counterparty to a transaction may sustain. To be fully-collateralized, however, the DCO must hold sufficient funds to cover the maximum possible loss that each party may sustain. Accordingly, Nadex proposes that "counterparty" be replaced with "party".

The Commission has also proposed an amendment to the definition of "Key Personnel" under Regulation 39.2. The new definition would identify the "Chief Information Security Officer" ("CISO") as key personnel. While Nadex does not object to the concept of designating "those persons who are or perform the functions of" the CISO as key personnel, we request clarification that it is sufficient that a staff member is assigned the responsibilities of a CISO, in addition to other responsibilities of their role. Additionally, Nadex requests guidance confirming that the CISO may be employed by the DCO or by an affiliate entity within the corporate organization, such as a parent company. Nadex considers that not allowing this would be disproportionate from achieving its policy aims. Similarly, with respect to a DCO that is also a DCM, Nadex requests guidance confirming that an individual may fulfill the role of CISO for both the DCM and DCO. Nadex notes that the focus of a CISO is information security, not the commercial

² Derivatives Clearing Organization General Provisions and Core Principles, 84 Fed. Reg. 22265.

³ Amended Order of Registration, *In the matter of the Application of the North American Derivatives Exchange for Registration as a Derivatives Clearing Organization*, January 16, 2014.

aspects of the business. Accordingly, we consider that a single individual serving as the CISO for more than one company within the corporate structure would not pose a conflict of interest concern requiring a separate individual fill the role at each company within the organization.

Regulation 39.10 Compliance with Core Principles

The Commission has proposed amendments to Regulation 39.10(d)(4), which would require the DCO to identify an Enterprise Risk Officer (“ERO”). The Commission has specifically requested public comment as to whether the ERO should report to the DCO’s board of directors, and if the DCO’s Chief Risk Officer (“CRO”) may also fill the role of ERO. It is Nadex’s position that the ERO should not report to the DCO’s board of directors. The purpose of a board of directors is to provide oversight and strategic guidance of the organization, not management of specific individuals within the organization. In order to keep the board informed of the enterprise-wide risk, it is suggested that the ERO provide reports to the board but could report to the DCO’s CEO or Chief Risk Officer or other appropriate officer of the company or, for that matter, a parent company. Nadex believes the same individual could certainly perform the functions of both CRO and ERO, as the positions do not have conflicting purposes. Additional clarification is requested, however, as to whether an individual must be assigned the title of Enterprise Risk Officer, or if the requirement will be satisfied by a CRO assuming the responsibility of enterprise risk management.

Regulation 39.16 Default Rules and Procedures

Regulation 39.16 requires a DCO to have procedures to deal with events during which a clearing member becomes insolvent or otherwise defaults on its obligations to the DCO, to make its default procedures publicly available, and to take timely action to contain losses and liquidity pressures while continuing to meet its obligations. The Commission is proposing amendments to section (b) to include clearing members in the DCO’s annual default management testing. Additionally, the Commission is proposing to amend section (c) to require a DCO to have a default committee that would be convened in the event of a default, and that such committee should include clearing members. Amendments to this section would also require the DCO to make immediate public notice on its website of a declaration of default, and clarify that the DCO shall not require a clearing member to bid for a portion of, or accept an allocation of, the defaulting clearing member’s positions that is not proportional to the size of the bidding or accepting clearing member’s positions in the same product class at the DCO. On May 3, 2012 Nadex submitted a “Request for Interpretive or Exemption from Certain Commission Regulations”, in which it requested an exemption from the requirements of Regulation 39.16. Nadex asserted that because it is not a margined DCO it does not maintain a default management plan because it is not exposed to the risk of default by Members with respect to either a default in making a margin payment or a default in meeting an assessment or other call for financial resources. Instead, Nadex requires 100% of the funds necessary to fully collateralize a Member’s positions to be on deposit with the DCO before the trade is executed. If funds are not available, a trade will not be executed. On January 16, 2014 the Division of Clearing and Risk issued interpretive letter no. 14-05 in which it agreed with Nadex’s rationale and stated that “because Nadex requires 100% of the funds necessary to fully collateralize a Member’s positions to be on deposit with Nadex before the trade is executed, Nadex has eliminated the potential for a clearing member default. It is the Division’s view that Nadex’s fully -collateralization requirements satisfy the requirements of Regulation 39.16.” In light of this interpretation, and the Commission’s intent to codify existing relief

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and guidance, Nadex requests the Commission further amend Regulation 39.16 to indicate that the requirements of 39.16 are inapplicable to DCO's that clear only fully-collateralized contracts.

Reporting

Regulation 39.19 Reporting

Under the proposed amendments, Regulation 39.19(b)(2) would require an employee of the DCO making a submission pursuant to section 39.19 to certify that he or she is duly authorized to make such a submission on behalf of the DCO. Nadex requests clarification as to whether the DCO would be required to maintain separate documentation identifying which employees it deems authorized to make submissions, and who may appoint such authorized individuals. Additionally, Nadex requests clarification as to whether the certification statement should be included in the text of the submission or if the statement will appear in the Commission portal in the form of a confirmation statement.

Amended Regulation 39.19(c)(4)(xxvi), regarding Event Specific Reporting, would require a DCO to provide to the Commission 30 days advance notice before accepting a new product for clearing. The Commission has requested comment as to the definition of "product". It is Nadex's view that "product" should be based on contract type or asset class, but not on duration of the contract. When determining product eligibility, the DCO must consider factors such as trading volume, liquidity, and the availability of reliable prices, all of which may differ by asset class. The contract type determines the basic structure and terms of the product.⁴ These factors contribute to varying levels of risk, which the Commission may have an interest in reviewing before a DCO accepts the contracts for clearing. Conversely, the Commission would gain little value in receiving 30 days advance notice of the clearing of a new product whose terms do not substantially differ from similar contracts already accepted for clearing.

With respect to the specific requirements of the notice, subsection (B) requires the DCO to indicate the date on which the new product will be accepted for clearing. Nadex points out that a definitive listing date, and likewise the date the product is accepted for clearing, may remain unknown until shortly before the launch due to ongoing testing of the contract. Accordingly, the date the DCO intends to begin accepting the contract for clearing should be considered an approximation. Nadex suggests that a DCO's statement that it "will not accept the new contract for clearing prior to XX/XX/XXXX" be sufficient to meet the requirements of this subsection.

Subsection (C) under proposed Regulation 39.19(c)(4)(xxvi) would require the DCO to state whether it will submit the new product to the Commission pursuant to Regulation 40.5 or 40.6. It should be noted that where an organization is both a DCM and DCO, the listing of a new product and its contract

⁴ For example, Nadex offers three contract types, Call Spread Variable Payout Contracts, Touch Bracket Variable Payout Contracts, and Binary Contracts. A Call Spread Variable Payout Contract is a type of variable payout contract, consisting of a floor and ceiling, and a fixed expiration date. A Touch Bracket Contract is also a type of variable payout contract, consisting of a floor and ceiling, with a conditional expiration date. A Binary Contract consists of a fixed payout and fixed expiration date. Each contract type is offered in various durations and may expire on an Intraday, Daily, or Weekly basis, however, the basic structure of each contract type does not differ.

specifications, may be filed pursuant to Regulation 40.2 or 40.3, and a separate duplicate submission on behalf of the DCO is not required. Accordingly, it is suggested that the notice require a statement as to whether the new product will require rule changes pursuant to the applicable section of Regulation 40.

Finally, Nadex asks for confirmation that notice under Regulation 39.19(c)(4)(xxvi) will not be considered a self-certification submission and that the DCO will not be required to make the submission public on its website, nor will the notice be made publicly available on the Commission website.

Regulation 39.21 Public Information

Regulation 39.21(d) requires a DCO to post all information required in Regulation 39.21(c), as well as the DCO's rulebook and a list of its clearing members on the DCO's website, unless otherwise permitted by the Commission. The Commission is proposing to remove Regulation 39.21(d) and incorporate those requirements into Regulation 39.21(c). On May 3, 2012 Nadex requested exemption from 39.21(d) with respect to making the names of its retail members, who are primarily individuals, public on its website. The Division of Clearing and Risk granted this relief in exemption letter no. 14-04 on January 16, 2014.⁵ Nadex does not object to the Commission removing section (d) and incorporating the requirements into section (c), however, it would like confirmation that the exemptive relief granted in letter no. 14-04 will continue with respect to the publication of its retail member names after the obligations are incorporated into 39.12(c).

Governance

Regulation 39.19 Reporting

Proposed Regulation 39.19(c)(4)(xxii) would require the DCO to notify the Commission of any major board decision. Nadex requests clarification as to what constitutes a "major decision", and the level of discretion the DCO has in making that determination. Additionally, clarification is requested as to whether the DCO would be required to provide an updated notice if a "major decision" is amended or withdrawn by the board subsequent to the event reporting under this section. Nadex also requests confirmation that notification of a major board decision will be treated as confidential and the DCO will not be required to post this notice on its website, nor will it be published on the Commission website.

Regulations 39.24 Governance Fitness Standards and 39.26 Composition of Governing Board

Finally, proposed Regulation 39.24 would incorporate CEA Core Principle O (Governance Arrangements) and require governance arrangements that permit consideration of the views of market participants. Similarly, proposed Regulation 39.26 would incorporate Core Principle Q (Composition of Governing Boards) and require the composition of the governing board include market participants. The Commission would define a "market participant" as "any clearing member of the DCO or customer of such clearing member, or an employee, officer or director of such an entity." As previously mentioned, Nadex members are primarily retail individuals, not industry professionals. Moreover, Nadex's market participants are not familiar with Nadex's internal operations in the same way that FCMs and other

⁵ The exemptive relief does not extend to Nadex's obligation to make public a list of all FCM Members.

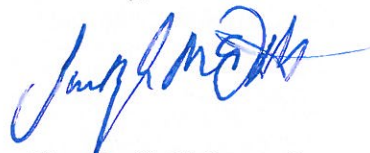
sophisticated members of traditional DCOs are familiar with the business and operations of the DCO. Unlike a traditional DCO, Nadex members do not have an ownership interest or financial stake in the clearinghouse or a default waterfall and therefore are not as substantially invested in the governance of the DCO. Solicitation of the views of Nadex's market participants, who number in the thousands, as to the governance of the DCO would not likely provide significant value as compared with the burden and cost of review of such responses. Likewise, inclusion of Nadex's market participants on its governing board lacks material benefit and could potentially hinder the efficient operation of the board. Accordingly, Nadex would request that fully collateralized, non-intermediated DCOs be exempt from compliance with Regulations 39.24 and 39.26.⁶

Chief Compliance Officer ("CCO") Duties and Annual Report Requirements

While the proposed DCO Regulations appear to address some portions of Regulation 39.10, Nadex requests that the Commission consider consistency between Regulation 3.3 and Regulation 39.10 as it relates to the language of the CCO's duties and annual report requirements. In August 2018, the CFTC amended its Regulations regarding certain duties of CCOs of swap dealers ("SDs"), major swap participants ("MSPs"), and futures commission merchants ("FCMs") and some of these language changes do not appear to have been incorporated in the amendments to the DCO Regulations.

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

Sincerely,



Timothy G. McDermott
Chief Executive Officer

⁶ Nadex notes that as a DCM, Nadex is subject to the board composition requirements in Core Principle 16 under section 5(d) of the Act, which requires at least 35% of a DCM's board of directors be comprised of public directors who meet certain fitness criteria, in order to provide an impartial contribution.

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