October 11, 2022

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 Governance requirements for Derivatives Clearing Organizations (RIN 3038-AF15)

Dear Mr. Kirkpatrick,

The North American Derivatives Exchange, Inc. ("NADEX"), appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC" or the "Commission") notice of proposed rulemaking (the "NPR") as set forth in RIN 3038-AF15. NADEX supports the Commission's efforts to improve regulation of the futures industry through derivatives clearing organization ("DCO") governance requirements that are transparent and efficient. However, the NPR does not acknowledge the unique nature of a DCO, such as NADEX, that offers fully collateralized contracts to retail market participants. Below, we discuss how each of the proposed requirements of the NPR do not coincide with the business of NADEX. In short, the NPR's one-size-fits-all approach is not necessary where the principles-based approach of the current DCO requirements provides the appropriate governance requirements.

A. Establishment and Consultation of RMC – §39.24(b)(11)

Current regulations require a DCO to consider the views of clearing members and customers of clearing members as part of the DCO's governing process, and to have arrangements that support the relevant public interest considerations of clearing members, customers of clearing members, and other relevant stakeholders. To promote compliance with these obligations, the Commission is proposing that all registered DCOs should establish a risk management committee ("RMC") composed of clearing members that the DCO would be required to consult with to gain the clearing members' expert opinion

on key risk management issues. Footnote 9 of the Commission's NRP confirms that current regulations do not explicitly require a DCO to establish an RMC or prescribe the nature of its role.

As an initial matter, while NADEX is not opposed to the establishment of a RMC and agrees that for many DCOs a RMC composed of clearing members would benefit greatly, it does not support *requiring* the establishment of a RMC. Despite the fact that the purpose of all DCOs is to serve as a central clearing party to reduce risk, not all DCOs operate the same and carry the same risk. As will be explained in this comment, the contracts traded on the NADEX DCM and accepted by the NADEX DCO for clearing are 100% collateralized prior to any transaction taking place. This sets NADEX apart from a traditional DCO as it carries virtually no risk. Therefore, requiring it to establish a RMC and specific procedures such as the recording of minutes and frequency of meetings would serve no meaningful purpose. Footnote 9 recognizes that the majority of DCOs already use RMCs. It would therefore follow that the current practice of leaving the decision to use or not use RMCs in the hands of the DCO who knows their business best is sufficient to protect the DCO and its clearing members.

i. New Products Categorically Impact Risk Profile

In response to the Commission's inquiry as to whether a new product should be categorically treated as a matter that could materially affect the DCO's risk profile for purposes of the proposed RMC consultation requirement, it is NADEX's position that merely accepting a new product for clearing does not necessarily materially affect the DCO's risk profile, or indeed, affect it at all. To illustrate, under NADEX's current business model and pursuant to its Amended DCO Orders[1], all contracts accepted for clearing are considered "fully collateralized" because NADEX holds "sufficient funds of each Nadex [NADEX] Member to cover the maximum possible loss that may be sustained by such Member upon liquidating of any or all Nadex [NADEX] contracts to which such Member or customer of such member is a party." Member funds used to fully collateralize transactions that NADEX clears are deposited by the Member with NADEX in advance of trading and held in cash. As all transactions are fully collateralized in advance, Members pose no credit or default risk to the DCO. On January 16, 2014 the Division of Clearing and Risk ("DCR") issued CFTC Letter No. 14-04 granting NADEX exemptions from compliance with a number of DCO Regulations; perhaps most notable among the exemptive relief for purposes of this comment is from §39.13(h)(3) pertaining to Risk Management. This regulation requires a DCO to conduct stress testing on a daily basis with respect to each large trader who poses a significant risk to a clearing member or the DCO. In the exemption letter, DCR staff stated that "[i]t is the Division's understanding, based on Nadex's [NADEX] representations, that Nadex [NADEX] does not conduct stress tests because it ensures that 100% of any exposure on a trade is fully collateralized before the trade is allowed to match. Based upon these representations, the Division exemptions Nadex [NADEX] from complying with Regulation §39.13(h)(3)." Thus, DCR staff likewise recognize that under NADEX's current business model, little to no risk is posed to the DCO or its clearing members, so much that it agreed to exempt NADEX from a DCO's normal stress testing requirement. This blanket exemption is applicable so long as contracts are fully collateralized, regardless of the underlying market upon which the contract is based or the structure of the contract itself. Accordingly, DCR staff has recognized that the addition of a new fully collateralized

[1] Amended Order of Derivatives Clearing Organization Registration, North American Derivatives Exchange, Inc., terms and conditions no. 3 (January 16, 2014).

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product for clearing has no impact on the DCO's risk profile. NADEX, therefore, requests that a DCO's proposal to clear a new product should not be categorically treated as a matter that could materially affect the DCO's risk profile.

ii. Requirement to Consult with RMC

For all the same reasons enumerated above, NADEX does not believe it should be *required* to consult a RMC in its decision to accept a new product for clearing that is fully-collateralized. It has already been established that the addition of a fully collateralized contract would not affect the DCO's risk profile (otherwise NADEX would not have received exemptive relief from stress testing). Consultation with a RMC regarding the risk of a fully collateralized contract will not result in a robust discussion or generate a novel outcome; the question of risk with regard to a fully collateralized contract has already been determined, not only by NADEX but by DCR.

iii. Definition of New Product

NADEX does not believe that consultation with a RMC would prove a meaningful use of resources in all instances where a DCO is considering accepting new products for clearing. The Commission's suggestion that DCO boards consult with a RMC appears to stem from a concern that a new product carries the heightened potential for novel and complex risks. This may not be the case, however, where a "new" product is substantially similar to a product already accepted by the DCO. Presumably, if the DCO is already clearing a certain product, it has been thoroughly internally reviewed and discussed, and the potential risks considered and decided upon. A substantially similar product is not likely to pose materially different risks. Additionally, in the event a substantially similar new product is presented to a RMC and the resulting advice or opinions deviate from those provided by the RMC in response to consultation on an already-accepted product, the DCO risks adopting inconsistent and potentially discriminatory clearing practices. The Commission asks commentators whether it should define what constitutes a new product. A definition would provide the DCOs clarity around the Commission's expectations. NADEX would ask the Commission to consider that consultation with a RMC regarding a substantially similar product would not generate substantial value if similar consultation has already occurred. Alternatively, NADEX would request the Commission leave the matter of consultation with a RMC regarding a substantially similar product to the DCO's discretion.

B. Policies and Procedures Governing RMC Consultation – §39.24(b)(11)(i)

The Commission is proposing new regulation §39.24(b)(11)(i) which would require a DCO to maintain written policies and procedures to make certain that the RMC consultation process is described in detail. While in general, we are not of the view that a DCO should be required to create a RMC if the size or nature of the business does not warrant such a committee, if a DCO does have a RMC written documentation as to its policies and procedures, as well as minutes of the meetings would evidence the DCO's diligence in managing operational risk. The Commission proposes that the written policies and procedures are described in "detail". We would request guidance as to the level of detail these documents should contain. Depending on the business model of the DCO, for example a fully collateralized retail based DCO, clearinghouse risk may be minimal. In instances where the risk is minimal, there is no need for a granular level of detail in the DCO's documentation.

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C. Representation of Clearing Members and Customers on RMC - §39.24(b)(11)(ii)

Core Principle O and Regulation §39.24 require DCOs to consider the views and legitimate interests of clearing members and customers of clearing members in their decision-making process. In furtherance of this requirement, the Commission is proposing new regulation §39.24(b)(11)(ii) which would require the RMC include clearing members and customers of clearing members. NADEX is not in support of this proposed new regulation as the prescriptive requirement presumes that a one-size-fits-all approach to risk management is appropriate for all DCOs regardless of their business model, which is not the case.

The Commission states in the NPR that "[w]hile not required by Commission regulations, many DCOs have addressed the above requirements by establishing advisory RMCs comprised of clearing members that provide *expert opinion* on key risk management issues." (emphasis added). The Commission further states that "while serving on an RMC, clearing members and end-users would be able to use their *risk management expertise* to promote the safety and efficiency of the DCO and foster the stability of the broader financial markets." (emphasis added). In making these statements and asserting that the inclusion of clearing members and customers of clearing members on a DCO's RMC is beneficial, the Commission assumes that all clearing members and customers of clearing members not only have expertise in the financial industry, but specifically have expertise in risk management. While this may be the case at a traditional DCO such as CME or ICE, this does not necessarily apply to a retail-focused DCO. The overwhelming majority of NADEX's clearing members are individuals who are not industry professionals. The relatively few clearing members that are entities are "mom and pop" type businesses. These clearing members are often new to the trading industry and require time and education to become acquainted with and comfortable with self-directed investing of short term derivatives. NADEX's clearing members are not familiar with its internal operations in the same way that futures commission merchants ("FCM") and other sophisticated members of traditional DCOs are familiar with the business and operations of the DCO. The typical retail member's "operational risk management expertise", or more aptly stated lack thereof, holds true regardless of whether the DCO clears fully-collateralized or margined contracts. Moreover, unlike a traditional DCO, NADEX members trading and clearing fully-collateralized contracts do not have an ownership interest or financial stake in the clearinghouse or a default waterfall and therefore are not substantially invested in the governance of the DCO.

The Commission is also proposing that the RMC consist of more than one clearing member and more than one customer of a clearing member. Again, this approach will not fit all DCOs. For example, a newly registered DCO may only have one clearing member. That DCO would be unable to include multiple clearing members on a RMC and *ipso facto* violate the regulation.

The Commission aims to ensure a minimum level of market participant participation with proposed §39.24(b)(11)(ii), however, there is more than one way to achieve this goal. For example, NADEX welcomes comments, criticisms, and suggestions from participants. The submission of ideas is discussed in the Terms of Use and the Membership Agreement, both of which are available on the website. The "Contact Us" page on the website provides users with an email address, physical address, and the option to start a live chat. A live agent is available for chat when NADEX is open for business,

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from 9:00am through 5:00am ET the following day. This means of receiving market participant input is appropriate for NADEX's retail business, is convenient for the participant and requires a minimal time commitment, and is a means of providing feedback to a business that the majority, if not all, of internet users are familiar with.

In the Commission's NPR published on May 16, 2019 in RIN 3038-AE66, the Commission made a similar proposal as it does now to include "market participants" on a DCO's Board of Directors. The Commission proposed to define "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."[2] NADEX, at the time known as Nadex, commented with the same remarks it now makes regarding the proposal as it did in response to the Commission's 2019 proposal to include such individuals on a DCO's Board. The Commission remarked in its December 2019 discussion of the final regulations and in response to Nadex's concerns that "[t]he Commission is, however, sympathetic to Nadex's concerns that the burden and cost of including market participants that are primarily retail and not exposed to the risk of lost margin or the default of the DCO's and other customers may not be warranted for fully collateralized, non-intermediated DCOs. In light of this and other comments in this regard, the Commission wishes to give further consideration as to how to define "market participant" and declines to define it at this time."[3] In its most recent proposal, rather than providing a modified definition of market participant that provides the DCO with room for interpretation and discretion to design its committee(s) as it sees fit for its specific business, the Commission now *explicitly* proposes the appointment of "clearing members" and "customers of clearing members" to the RMC.[4] Accordingly, as the Commission recognized in 2019 that with respect to a retail DCO the inclusion of clearing members in the governance of the DCO would not provide a benefit or improve the efficiency of the business, NADEX requests that the Commission give the same consideration to these arguments in contemplating the final language of new Regulation §39.24(b)(11)(ii) should it decide to adopt the rule. NADEX requests the Commission consider an amended definition of "market participant" in substitution for "clearing member" and "customer of a clearing member" that would allow the DCO to operate within its own discretion in a manner best suited to its business model. Alternatively, we propose that any retail focused DCO be exempt from this requirement in the event the new regulation is adopted as-is.

D. Rotation of RMC Membership - §39.24(b)(11)(iii)

The Commission requests comment as to whether it should set a minimum frequency for RMC membership rotation. It should be within the DCO's discretion to set a specific frequency for RMC member rotation or require no rotation. As explained in the previous section, not all DCO's market participants will be sophisticated industry professionals. Finding a willing participant the DCO deems fit to participate in a RMC may not be an easy task, and requiring to repeat the process on a recurring basis has the potential to create more disruption and inefficiency than benefit. As a practical matter, depending on the size of the DCO and the qualifications of its participants, there simply may not be enough

[2] *Derivatives Clearing Organization General Provisions and Core Principles*, 84 Fed. Reg. 22,244 (May 16, 2019).
[3] *Derivatives Clearing Organization General Provisions and Core Principles*, 85 Fed. Reg. 4825 (Jan. 27, 2020).
[4] *Governance Requirements for Derivatives Clearing Organizations*, 87 Fed. Reg. 49,561 (Aug. 11, 2022).

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individuals suitable and interested in serving on the committee to rotate regularly. A DCO is not required to rotate its board directors, including public directors, and stricter rules should not be required of a board committee. We believe the decision to should be left to the DCO which is in the best place to determine the needs of its' business and is able to assess the performance of RMC members.

E. Establishment of RWG to Obtain Input - §39.24(b)(12)

The Commission is proposing new regulation §39.24(b)(12) to require a DCO to establish one or more risk working groups ("RWGs") and to maintain policies and procedures regarding the formation and role of each RWG. The NPR recognizes the significant time commitment than an RMC would require of its members, and that this will limit the number of individuals able to serve on the RMC. The goal of the proposed RWG is to provide more opportunities for those with a state in DCO risk management to provide input with a smaller time commitment. To echo our position from earlier sections, one size does not fit all. Depending on the size of the DCO it may be difficult to find members to comprise one committee. For the same reasons it will be no less difficult to find members to comprise a working group. Moreover, a working group may not be necessary if depending on the DCO's business model it carries minimal risk or if the RMC is able to manage the workload. The Commission noted in the NPR that of the 15 registered DCOs, 12 have RMCs. Of the 12 with RMCs, six of those have RWG. These numbers indicate that the DCOs already recognize if a RMC is needed to provide guidance to the board, and similarly, if the RMC is so burdened that a RWG should be assembled. Requiring the DCO to create a RMC and RWG has the potential to needlessly waste time and resources. As previously explained, the DCO is in the best position to determine its needs based on its specific business and size and the proposed regulation should not be implemented.

F. Fitness Standards for RMC Members - §39.24(c)(1)

The Commission is proposing to supplement current regulation §39.24(c), which requires the DCO to establish and enforce appropriate fitness standards for its directors, members of any disciplinary committee, members of the DCO, any other individual or entity with direct access to the settlement or clearing activities of the DCO, and any other party affiliated with any of the foregoing individuals or entities by adding members of the RMC to the list. Again, in general we are not of the view that a DCO should be required to create a RMC if the size or nature of the business does not warrant such a committee. However, in keeping with the consistency of the current regulation, it is reasonable that the DCO should set minimum fitness standards for an individual to serve on its RMC.

G. Role RMC Members as Independent Experts - §39.24(c)(3)

The Commission is proposing new regulation §39.24(c)(3) which would require a DCO to maintain policies designed to enable its RMC members to provide independent, expert opinions in the form of risk-based input on all matters presented to the RMC for consideration, and perform their duties in a manner that supports the safety and efficiency of the DCO and the stability of the broader financial system. While we agree independent input is important when making significant risk matters, however, we point out that the NPR recognizes that a DCO's board of directors has the ultimate responsibility to make major decisions with respect to the DCO. To the extent that the DCO's board contains one or more director who would satisfy the independence standard, we feel the requirement for a DCO to design policies requiring

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independence of its RMC members is unnecessary. Members of the RMC would function in an advisory capacity only. When matters discussed by the RMC are presented to the DCO's board, an independent director should be able to provide the independent input, or question the opinions or advice of the RMC, the Commission desires to support the safety and efficiency of the DCO and broader financial system.

Moreover, many DCOs are dual registered as DCMs. DCMs are required pursuant to Core Principle 16 (Conflicts of Interest) to establish a board of directors comprised of at least 35% public directors, as defined in (B)(b)(2), with the same requirement applicable to executive committees. Therefore, dual registered entities are already considering independent views in its decision making. Accordingly, to the extent a DCO already includes one or more independent directors that meet the standards set forth in Core Principle 16, proposed regulation §39.24(c)(3) should be inapplicable.

The Commission also requests comment on whether requiring RMC members to act as independent experts, neither beholden to their employers' commercial interest nor acting as fiduciaries of the DCO raises any potential legal issues for those members. It appears the Commission is asking if a fiduciary's duties to his/her/their beneficiary may be waived in the interest of his/her/their service to the RMC. The ability to waive fiduciary duties is dependent upon the company's legal entity type and its state of incorporation/organization. In Delaware, for example, where most corporations are organized, the Court of Chancery recently decided in *Manti Holdings, LLC v. The Carlyle Group, Inc.* (Del. Ch. Feb. 14, 2022) that a stockholder of a Delaware corporation can not waive claims against corporate directors for breach of fiduciary duties. Because the fiduciary laws of the state in which each DCO is organized may differ, the proposed regulation would not be able to be applied uniformly, and therefore should not be implemented.

H. Market Participant Consultation Prior to a Rule Change

The Commission is requesting comment as to whether a DCO should be required to consult with a broad spectrum of market participants prior to submitting any rule change pursuant to §§ 40.5, 40.6, or 40.10.[5] As described throughout this comment, a one size fits all approach does not work for all DCOs. The NPR notes that "[m]any DCOs have *dozens* of clearing members." (emphasis added). For these DCOs, collecting and reviewing commentary on rule changes may be possible. On the other hand, NADEX has literally *thousands* of clearing members. As previously explained, due to the retail nature of NADEX's business, its members are not industry professionals. Any benefit that might be derived by a request for input from members prior to a rule submission would be dwarfed by the overwhelming burden of collecting, reviewing, and responding to (as the Commission also proposes) a voluminous response from its client base.

In July 2011 the Commission adopted final rules amending sections of Part 40 (Provisions Common to Registered Entities) in order to incorporate new requirements under the Dodd-Frank Act. Section 40.6 was amended to require a registered entity to, among other things, 1) submit the filing 10 business days before the effective date of the submission, 2) include a concise explanation and analysis of the operation,

[5] This comment discusses Regulation 40.6, the Regulation under which NADEX most frequently submits its rule certifications, however, the same arguments can be made for 40.5 and 40.10, with the exceptions that the Commission has a 45 day review period under 40.5 and 60 day period for 40.10.

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purpose, and effect of rules certified, and 3) to post the submission on the registered entity's website concurrent with the filing. The purpose of the Dodd-Frank Act and the amended regulations was, of course, to increase accountability and transparency to market participants. Because of these requirements, registered entities are in effect already opening rule submissions to the public for comment before a rule change takes effect. Proposed rule changes are made publicly available for 10 business days along with an explanation and analysis of the proposed changes. Market participants, or indeed the general public, can view the rule changes prior to their implementation on the registered entities' website and submit commentary if they so choose. The registered entity has the ability to consider comments within the 10 business day window and withdraw the submission in the event a determination is made that either the rule should not be implemented, or should undergo revisions before it is resubmitted to the Commission. Requiring an additional period for participant commentary is redundant and would hinder the efficient operation of the registered entity while providing little benefit.

I. RMC Member Information Sharing With Firm to Obtain Expert Opinions

The Commission is requesting comment as to whether a DCO should be required to maintain policies and procedures designed to enable an RMC member to share certain types of information it learns in its capacity as an RMC member with fellow employees in order to obtain additional expert opinion. Granting such broad latitude for committee members to discuss sensitive topics pertaining to a DCO's risk management with unrelated employees is a dangerous road to travel. While the RMC may have the ability to protect sensitive material discussed at a meeting by means of a confidentiality agreement with all members, it is unlikely the committee member would request the same of a non-member colleague in a private discussion. Confidential information could easily be spread with no protections or recourse available. Moreover, while discussions at the RMC meeting are witness by all members who attend, there is no way for the RMC to know if information and opinions that result from a privacy conversation outside the presence of the committee – either positive or negative – are being relayed by the committee member. The committee member may only report the content of such conversations with which he agrees. It is the responsibility of the DCO to appoint members to its committees who are knowledgeable about the business and competent to perform the duties expected of a committee member. Permitting separate discussions with non-member colleagues indicates that the appointed committee members are not adequate to address matters brought before the committee. We would therefore request that the proposed requirement not be implemented.

J. Cost-benefit Consideration

In its cost-benefit analysis, the Commission identifies several cost areas for DCOs who do not already have a RMC and RWG. NADEX suggests the Commission factor in the following additional, significant costs:

1) potential compensation for RMC and RWG members who are unwilling to serve otherwise;
2) additional staffing needs in order to collect and review comments from thousands of clearing members regarding each new proposed rule certification;
3) additional staffing or software to assist in monitoring for leaks of confidential information discussed at the RMC should members be permitted to engage in discussions with others outside of the committee meeting.

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Conclusion

The Commission is a principles-based regulator focused on outcome rather than specific conduct, and qualitative over quantitative results.[6] In 2020, former CFTC Chairman Tarbert published an article in the Harvard Business Law Review that explains the benefits of a principles-based regulatory regime and is directly on point with the overall sentiment of this comment. Chairman Tarbert states that "[t]he fact is that the more detailed, complex rules we adopt, the more difficult it is to comply with them. Regulations should be as simple and concise as possible to achieve their objectives."[7] He explains that under a principles-based approach "firms are responsible for finding the most efficient way of achieving regulatory objectives"[8] and that unlike a principles-based approach, a rules-based regime is "almost inevitably over- or under-inclusive."[9] The proposed regulations addressed in this comment deviate from the Commission's historical approach to regulation and seek to blanket DCOs of all sizes and shapes with rules that do not necessarily fit. As illustrated throughout this comment, the majority of proposed regulations are impractical, overly burdensome, or unnecessary when applied to NADEX's current business. It is the DCO itself that is in the best position to determine its needs.

Former Chairman Tarbert's article compared the circumstances under which a principles or rules-based approach should be employed; he noted that sophistication of the market participants is a key factor, and that a rules-based approach is more suitable for retail market participants. To be clear, we do agree that a rules-based approach is appropriate as applicable to the retail participant who does not possess the industry knowledge or experience to devise a framework for compliance, but rather needs to be instructed on how to comply. But the new Part 39 regulations would apply to the DCO, which *is* a sophisticated industry professional. Former Chairman Tarbert also explained that whether a participant is subject to supervision by a self-regulatory organization ("SRO") is a consideration. He stated

> SROs are generally closer to market participants than are regulators. As a result, they generally have a better understanding of the businesses and operations of market participants than governmental regulators do. In such cases, it may make sense for a regulator to adopt general principles in an area while directing or encouraging the SRO to impose more specific rules. SRO-based systems are often good examples of hybrid systems, as a regulatory authority promotes broad-based principles that SROs subsequently translate into detailed rules."[10]

This is exactly the structure under which NADEX has operated, and would like to continue operating. NADEX complies with its regulatory obligations under a principles-based regime, while taking a rules-based approach with its retail participants. The proposed regulations, if approved, would set the precedent to regulate the DCOs as if they were retail market participants.

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[6] Rules for Principles and Principles for Rules: Tools for Crafting Sound Financial Regulation, Harvard Business Law Review, 2020, Vol. 10, p.6.

[7] *Id.* at 7.

[8] *Id.* at 5.

[9] *Id.* at 8.

[10] *Id.* at 16.

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Under the NPR's Cost-Benefit Analysis section, the Commission notes "[o]f the fifteen DCOs currently registered with the Commission, twelve already have some form of an RMC, which may have been intended, in part, to fulfill the DCO's compliance obligations under DCO Core Principle O and §39.24. Of the fifteen DCOs currently registered with the Commission, six already have some form of an RWG, which may have been intended, in part, to fulfill the DCO's compliance obligations under DCO Core Principle O and §39.24." Based on these findings, it is difficult to understand the reasoning for codifying the practice into regulation. It appears DCOs are demonstrating compliance under a principles-based regime without being prescriptively instructed to do so. Twelve DCOs determined a RMC was appropriate for their business, and six added the support of a RWG. Of the three DCOs that do not have a RMC, the nature of their business does not warrant one (e.g. for a DCO with fully-collateralized contracts). There appears to be no harm to the industry necessitating a prescriptive requirement for an RMC for all DCOs. In short, DCOs have voluntarily taken the exact steps the Commission now seeks to require of all DCOs without an analysis of the appropriateness for a DCO's specific business, such as NADEX.

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

Best regards,

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