



U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Clearing and
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Ananda Radhakrishnan
Director

CFTC Letter No. 11-05
Interpretation
August 5, 2011
Division of Clearing and Intermediary Oversight

Timothy G. McDermott
General Counsel and Chief Regulatory Officer
Nadex, Inc.
311 South Wacker Drive Suite 2675
Chicago Illinois 60606

Re: Guidance Regarding Amended Order of Registration as a Derivatives Clearing Organization (March 30, 2010) With Respect to “Fully Collateralized” Contracts Cleared by FCM Members of Nadex

Dear Mr. McDermott:

This letter provides guidance regarding North American Derivatives Exchange (Nadex) and its Amended Order of Registration as a Derivatives Clearing Organization (DCO) (the Nadex DCO Order) and Nadex’s Amended Order as a Designated Contracts Market (DCM) (the Nadex DCM Order, and, together with the Nadex DCO Order, the Nadex Orders), both dated March 30, 2010, in response to your letter dated April 1, 2011.

Among other things, the Nadex Orders allow intermediation of contracts traded on Nadex’s DCM provided that such contracts are fully collateralized. Because a futures commission merchant (FCM) customer with a fully collateralized position on Nadex may suffer losses on another exchange such that the customer would owe a balance to its FCM, Nadex sought an interpretation from the Division confirming that the position on Nadex would be considered “fully collateralized” notwithstanding such a scenario. The Division concludes that an intermediated contract traded on Nadex, on behalf of the intermediary’s customer, remains “fully collateralized,” as contemplated by the Nadex Orders, notwithstanding subsequent balances owed by that customer to the intermediary due to losses suffered on other exchanges, as long as Nadex holds, at all times, sufficient funds of such customer to cover the maximum possible loss that may be sustained by such customer upon liquidation of any or all Nadex contracts.

Overview of Nadex and the Nadex Orders

Nadex offers the trading and clearing of binary options and “spread” contracts. These contracts, by definition, have limited upside and downside risk. Historically, Nadex contracts have been traded and cleared on a “fully collateralized” basis, meaning that Nadex ensures that the parties to a trade have collectively provided the full amount of the contract’s notional value before that trade is executed and cleared.

When Nadex (then named HedgeStreet) commenced operation in 2004, it was a non-intermediated DCM and DCO with only direct retail customers. In March, 2010, the Commission issued the Nadex Orders to permit Nadex members who are futures commission merchants (FCM Members) to intermediate fully collateralized orders.^{1 2}

In April 2010, Nadex commenced intermediated trading with [redacted] as its first and only FCM member. [redacted] does not offer its clients the opportunity to trade on any futures exchanges aside from Nadex. It follows, therefore, that all client transactions intermediated through [redacted] are on Nadex and thus fully collateralized.

In early 2011, a second FCM agreed to offer Nadex products to its customers. Unlike [redacted], however, the second FCM would allow its customers the opportunity to trade a wide variety of traditional margined futures contracts at a number of other exchanges.

Issue

Nadex has alerted the Commission of a possible issue regarding the “full collateralization” requirement for Nadex in circumstances in which an FCM Member permits its

¹ See the Nadex DCM Order. “3. Registered FCMs who are qualified and accepted as Nadex FCM Members may carry customer accounts and intermediate orders to buy and sell Nadex contracts in accordance with Nadex’s rules, provided that such contracts are collateralized for 100 percent (100%) of the maximum possible loss each participant may incur with collateral held by Nadex’s Derivatives Clearing Organization prior to Nadex accepting such contracts for clearing.”

² See the Nadex DCO Order. “(2) Nadex shall, in accordance with its representations, promulgate and maintain rules that require its members that are registered futures commission merchants (“FCMs” and that qualify pursuant to Nadex rules to intermediate trades (“FCM Members”) to limit their intermediation of contracts traded on the DCM Nadex (including the acceptance of orders for the purchase or sale of such contracts, and carrying such contracts on behalf of a customer) to those that are fully collateralized; [and]....

(4) In accordance with Nadex’s representations, a contract cleared by an FCM Member will be considered to be “fully collateralized” if: the FCM Member holds, at all times, sufficient funds of each customer to cover the maximum possible loss that may be sustained by such customer upon liquidation of any or all Nadex contracts, and pending orders for such contracts, placed or cleared through such FCM Member...”

customers to trade on margin at other futures exchanges. Specifically, if an intermediated customer puts on a Nadex trade that is fully collateralized when the order is placed and the trade is executed and cleared, but an adverse mark-to-market change in the value of that customer's futures position at another exchange subsequently results in a margin call by the FCM, the customer will have a margin deficit to the FCM Member until that margin call is met. In such a circumstance, the FCM Member could be said not to be "fully collateralized."

Request for Interpretation

Nadex seeks interpretative relief for the benefit of itself and its FCM Members to clarify that under the circumstances described above, the Nadex position remains "fully collateralized" as required by the Nadex Orders.

Commission Interpretation

The Nadex DCO Order requires that for contracts cleared by Nadex, that Nadex hold "at all times, sufficient funds of each FCM Member to cover the maximum possible loss that may be sustained by such FCM Member upon liquidation of any or all Nadex contracts into which any customer of such FCM Member has entered through such FCM intermediary" and that for contracts cleared by an FCM Member, that the FCM Member hold "at all times, sufficient funds of each customer to cover the maximum possible loss that may be sustained by such customer upon liquidation of any or all Nadex contracts and pending orders for such contracts, placed or cleared through such FCM Member." With respect to Nadex, an intent of the Nadex DCO Order was to allow Nadex to use an intermediary as long as the use of an intermediary would not present a greater risk to Nadex than the risk presented by Nadex's direct customers. With respect to the FCM Member, an intent of the Nadex DCO Order was to ensure that the costs and risks to the FCM Member of clearing a Nadex contract were the same as those which would have been experienced by the Nadex DCO were it to have cleared that contract.

It is the Division's understanding that when an FCM Member intermediates a Nadex contract on behalf of a customer, the FCM Member would, at all times, have the cash that collateralizes each customer's Nadex position reserved, on a gross basis, at the Nadex DCO. The Nadex DCO would continue to hold the full amount of collateral, on a gross basis, pending the closing or expiration of that position. The loss by an FCM Member's customer on another DCM that results in that customer's under-margining with respect to that FCM Member is an external issue, unrelated to Nadex. As long as the full amount of the potential loss is held by Nadex for the FCM Member, the use of the intermediary is of no greater risk to Nadex than using a direct customer and the costs and risks to the FCM Member are equivalent to those which would have been experienced by the Nadex DCO.

It is therefore the Division's view that when an FCM Member intermediates a Nadex contract on behalf of a customer, that both Nadex and the FCM Member are in compliance with the Nadex DCO Order, with respect to that customer, if the Nadex DCO at all times holds

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sufficient customer segregated funds to cover the maximum possible loss that may be sustained by such customer. It is the Division's interpretation that both Nadex and the FCM Member are in compliance with the Nadex DCO Order notwithstanding the possibility that such customer may have suffered a loss on an unrelated exchange, potentially causing such customer to be undermargined with respect to the FCM Member.

This letter is based upon the representations of Nadex, the Nadex Orders and applicable laws and regulations in their current form and any new, different or changed material facts or circumstances might render this letter void. Moreover, this letter represents the position of the Division only and does not necessarily represent the views of the Commission or those of any other division or office of the Commission. If you have any questions concerning this correspondence, please contact Jon DeBord, Attorney-Advisor, at 202-418-5478 or jdebord@cftc.gov.

Sincerely,

Ananda Radhakrishnan
Director