



U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Clearing and Risk

Ananda Radhakrishnan
Director

CFTC Letter No. 14-05
Interpretation
January 16, 2014
Division of Clearing and Risk

Timothy G. McDermott
General Counsel and Chief Regulatory Officer/CEO-designate
North American Derivatives Exchange, Inc.
311 South Wacker Drive, Suite 2675
Chicago, Illinois 60606

Re: Request for Interpretation of Certain Commission Regulations

Dear Mr. McDermott:

This interpretative letter¹ responds to your request dated May 1, 2013 (“Request”)² for an interpretation of certain provisions of Commodity Futures Trading Commission (“Commission”) regulations applicable to registered derivatives clearing organizations (“DCOs”).³ According to the Request, North American Derivatives Exchange, Inc. (“Nadex”) is seeking interpretive guidance with respect to certain provisions of the Commission’s Part 39 regulations “[d]ue to the unique nature of Nadex’s business model.”⁴ The specific provisions with respect to which Nadex sought interpretive guidance are discussed below.

I. Overview of Nadex

¹ Under Regulation 140.99(a)(3), the Division of Clearing and Risk (“Division”), may issue an “interpretative letter,” which is written advice or guidance issued by the staff of a division of the Commission or by the Office of General Counsel (“OGC”). An interpretative letter binds only the issuing division (or OGC, as applicable), does not bind the Commission or other Commission staff, and may be relied upon by third parties. Commission regulations referred to herein are found at 17 C.F.R. ch. 1 (2013).

² Nadex originally submitted its request on May 3, 2012. Because the products it clears are now considered swaps under the definition of “swap” in Sec. 1a(47) of the CEA and Commission Regulation 1.3(xxx), Nadex amended its request and removed the request for relief from certain swaps-related requirements contained in Part 39.

³ See 17 C.F.R. pt. 39 (2013).

⁴ Nadex also sought exemption from other provisions of Part 39 and the Division is responding to that portion of the Request in a separate letter.

According to the Request, Nadex offers a clearing model that is different from the clearing model offered by a traditional DCO. Specifically, Nadex is a retail-focused operation that allows individuals and entities to become direct “Trading Members”⁵ of Nadex, who deposit funds directly with Nadex and trade with direct access to Nadex. Intermediated trades must be executed through an “FCM Member”⁶ of Nadex.

Pursuant to Nadex’s order of registration as a DCO (“Amended DCO Order”), Nadex is limited to clearing only “fully collateralized” contracts.⁷ That is, Nadex requires Members (Trading Members and FCM Members) to have on deposit a sufficient amount of funds to fully collateralize (*i.e.*, completely cover) any loss that could be incurred in connection with a position resulting from the fill of any order before such order is accepted by Nadex’s designated contract market (“DCM”) for placement in the order book for potential execution. The funds that fully collateralize any resulting position are held by the DCO until the unexecuted order is cancelled, or a resulting position is liquidated or expires and settles. This “fully collateralized” model prevents Nadex from being exposed to credit risk stemming from Members’ potential inability to meet a margin call or a call for additional capital.⁸

II. Definition of “Clearing Member”

Commission Regulation 1.3(c) defines a “clearing member” as “any person that has clearing privileges such that it can process, clear and settle trades through a [DCO] on behalf of

⁵ In order to become a Trading Member, a retail trader must complete and submit an online application, meet the requirements for membership set forth in Nadex Rule 3.1, and make an initial deposit of \$100.

⁶ The term “FCM Member” is defined in Nadex Rule 1.1(m) to mean “any Member that is registered with the Commission as a Futures Commission Merchant and is authorized by Nadex to intermediate customer orders on the [Nadex] Market.”

Nadex Rule 3.2 outlines the requirements for membership as an FCM Member. Once approved, the FCM Member would be permitted to intermediate customer orders, distribute Nadex data to its customers pursuant to any data distribution agreement with Nadex, and to access Nadex’s trading systems electronically. FCM Members would ensure that their respective customers have funds available in their customer accounts at the FCM Member to fully collateralize their trading activity before the FCM Member submits their orders to Nadex. (Upon receipt of such orders, however, Nadex would also check to confirm that the funds necessary for full collateralization are actually held in the FCM Member’s settlement account at Nadex.) FCM Members would not take on any mutualized risk with other Nadex FCM Members by virtue of their status as FCM Members, regardless of the size of their customers’ positions or any other Member’s positions.

Currently, Nadex does not have any FCM Members.

⁷ Specifically, language in the Amended DCO Order states that Nadex

shall limit its activity as a registered DCO to clearing fully collateralized, cash-settled, futures and options contracts listed for trading on the contract market Nadex. In this regard, Nadex’s contracts will be considered to be “fully collateralized” if Nadex holds, at all times, sufficient funds of each Nadex Member to cover the maximum possible loss that may be sustained by such Member upon liquidating of any or all Nadex contracts to which such Member or customer of such Member is a party.

⁸ Nadex does not make margin calls or provide for other default waterfall protections to guard against losses due to Member default.

itself or others.” In the Request, Nadex asserts that Members “do not ‘process, clear and settle trades’ on behalf of themselves or others. Rather, Nadex handles all of the processing, clearing and settling of trades for its direct Trading Members.”

Nadex further asserts that, “While Nadex FCM Members handle their customers’ orders, deposit customer funds with Nadex and process information regarding their customers’ trades, they do not, and indeed cannot, *clear and settle* their customers’ Nadex trades.” Therefore, Nadex believes that “FCM Members function more like non-clearing FCMs in the traditional margined DCO environment, with Nadex performing all the clearing functions of the traditional clearing FCM and DCO.” Nadex also notes that, unlike traditional clearing members of a DCO, Trading Members and FCM Members (if and when Nadex has FCM Members) do not contribute to any default fund, and there is no post-trade call for initial or maintenance margin by Nadex to Members or, in the case of FCM Members, by the intermediary to its customers.

The Division disagrees with Nadex’s interpretation that Members are not clearing members. The Commission’s definition of “clearing member” recognizes that such member does not “process, clear and settle trades” itself, but rather does so “through” the DCO pursuant to the terms of a direct contractual relationship with the DCO. Moreover, the definition of “clearing member” does not require that such member contribute to a default fund or post initial or maintenance margin. Although DCOs typically impose such requirements on its clearing members, the absence of such requirements does not mean a DCO’s members do not fall within the definition of “clearing member.”

III. Specific Provisions of Part 39

A. Financial Resources

Commission Regulation 39.11(a)(1). Regulation 39.11(a)(1) requires a DCO to maintain sufficient financial resources to withstand the default of the clearing member creating the largest financial exposure for the DCO. Nadex represents that it clears only fully-collateralized, cash-settled contracts; that the full collateralization of any trading activity by or through a Member occurs prior to any trade; and consequently, that no member default should ever occur with respect to trading activity. Nadex seeks an interpretation that its compliance with its obligation under the Amended DCO Order to clear only fully-collateralized contracts constitutes compliance with the requirements of Regulation 39.11(a)(1).

Commission Regulation 39.11(b)(1). Regulation 39.11(b)(1) lists the financial resources available to satisfy the requirements of Regulation 39.11(a)(1). Pursuant to the Amended DCO Order, Nadex’s contracts are considered “fully collateralized” if Nadex holds, at all times, sufficient funds of each Member to cover the maximum possible loss that may be sustained by such Member upon liquidation of any or all Nadex contracts to which such Member or customer of such Member is a party. Nadex represents that those funds are deposited with Nadex in advance of trading. Nadex seeks an interpretation that the funds collected in advance of trading by Members and held to fully collateralize any trading constitute a “financial resource deemed acceptable by the Commission” under Regulation 39.11(b)(1)(vi).

Commission Regulation 39.11(f)(1). Regulation 39.11(f)(1) details the information that DCOs must submit quarterly to the Commission. Nadex is requesting an interpretation regarding the quarterly financial reporting requirements of Regulation 39.11(f). Currently, Nadex submits monthly reports to the Commission pursuant to the Amended DCO Order. Nadex represents that the monthly reports, which address financial resource requirements that were designed for Nadex's fully-collateralized business model, provide the Commission with effectively the same type of information required by Regulation 39.11(f)(1)(i)(A) and (B). Nadex's current monthly reports include a balance sheet, income statement, and statement of cash flows as well as a description of how Nadex complies with the requirements of the Amended DCO Order. Nadex represents that the information contained in the monthly reports is consistent with the information required in Regulation 39.11(f)(1)(i)(C) and 39.11(f)(1)(ii). Nadex further represents that, with respect to Regulation 39.11(f)(1)(iii), Members do not maintain guaranty fund deposits with Nadex.

Nadex requests confirmation that it can satisfy its reporting obligations under Regulation 39.11(f)(1) by continuing to meet the reporting requirements set forth in the Amended DCO Order. Also, Nadex requests guidance as to whether such continued reporting should be monthly or quarterly.

Division Interpretation

The purpose of Regulation 39.11(a)(1) is to ensure that a DCO has sufficient financial resources available to protect itself in the event that one of its clearing members defaults. Nadex has made the following representations: Nadex clears only fully-collateralized contracts; Member funds are collected in advance of trading; and such funds are held to fully collateralize any trading. Should there be an FCM Member that clears for customers, positions of those customers would likewise be fully collateralized. Because full collateralization is one way to protect against a clearing member default, it is the Division's view that Nadex is in compliance with Regulation 39.11(a)(1). Further, the Division notes that Regulation 39.11(b)(1)(i) permits a DCO to use initial margin (*i.e.*, clearing member funds) to satisfy the requirement of Regulation 39.11(a)(1). It is therefore the Division's view that Nadex is in compliance with Regulation 39.11(b)(1) as well because the intended outcome is achieved.

It is also the Division's view that Nadex's current financial reporting generally satisfies Regulation 39.11(f)(1). However, the Division notes that Nadex is currently computing its operating costs using historical costs. Nadex must comply with Regulation 39.11(c)(2) and compute operating costs on a projected basis.

Nadex must submit its financial reports in accordance with Regulation 39.11(f) and the guidance that has been provided to all DCOs.⁹ Nadex should submit its reports quarterly, as required by the regulation, unless otherwise instructed by the Division.

⁹ See Memorandum from Ananda Radhakrishnan, Director of the Division, to All Registered Derivatives Clearing Organizations, June 7, 2012; see also subsequent Memorandum from Ananda Radhakrishnan, Director of the Division, to All Registered Derivatives Clearing Organizations, January 31, 2013.

B. Participant and Product Eligibility

Commission Regulation 39.12(a)(1)(v). Nadex seeks interpretive guidance with respect to Regulation 39.12(a)(1)(v), which provides that a DCO shall not require clearing members to maintain a swap portfolio of any particular size or to meet a swap transaction volume threshold. Nadex represents that new Trading Members must fund their Nadex accounts with a minimum deposit of \$100, but there is no requirement as to how much a Trading Member must trade. In addition, Nadex represents that it will terminate the account of any Trading Member that is inactive for a period of one year, but that any Trading Member whose account has been terminated may reapply for membership at any time. Nadex seeks an interpretation that the initial deposit requirement of \$100 and the ability to terminate the account of a Trading Member for inactivity are not inconsistent with, and do not violate the requirements of, Regulation 39.12(a)(1)(v).

Commission Regulation 39.12(a)(2)(i). Nadex seeks interpretive guidance with respect to Regulation 39.12(a)(2)(i), which require DCOs to mandate that their clearing members have access to sufficient financial resources to meet obligations arising from participation in the derivatives clearing organization in extreme but plausible market conditions and gives non-exclusive examples of permitted financial resources for this purpose. Nadex asserts that this provision does not apply to Members because it only applies to “clearing members” and Members are not “clearing members” as defined in Regulation 1.3(c). Nadex further seeks an interpretation that its rules concerning full collateralization, as mandated by the Amended DCO Order, satisfy the condition that “participation requirements shall require clearing members to have access to sufficient financial resources to meet obligations arising from participation in the [DCO] in extreme but plausible market conditions.”

Commission Regulation 39.12(a)(3). Nadex seeks interpretive guidance with respect to Regulation 39.12(a)(3), which requires clearing members to have adequate operational capacity to meet obligations arising from participation in the DCO. Regulation 39.12(a)(3) gives non-exclusive examples of requirements that a DCO must impose in this regard. Again, Nadex asserts that this provision does not apply to Members because it only applies to “clearing members” and Members are not “clearing members” as defined in Regulation 1.3(c). Specifically, Nadex represents that Members are not required to have “the ability to process ... transactions cleared by a clearing member ... and the ability to participate in default management activities.” According to Nadex, it is Nadex as the DCO that performs the clearing activities for the transactions of all Members.

Pursuant to the Amended DCO Order, FCM Members are required to have certain operational capacity to comply with the requirements of full collateralization with respect to their customers. In light of its fully-collateralized business model, Nadex seeks an interpretation that its rules concerning full collateralization, as mandated by the Amended DCO Order, satisfy the condition that participation requirements shall require clearing members to have adequate operational capacity to meet obligations arising from participation in the DCO.

Division Interpretation

The Division understands that Nadex requires Trading Members to initially deposit \$100 to open a Nadex account and that Nadex will terminate an account after a period of inactivity of one year. The Division also understands that following the initial deposit, there is no requirement as to how much a Trading Member must trade and that following an account termination due to inactivity, a Trading Member can reapply for membership at any time thereafter. The Division does not view these Nadex requirements as inconsistent with Regulation 39.12(a)(1)(v).

With respect to the requirements of Regulation 39.12(a)(2)(i), the Division understands that Nadex maintains a fully-collateralized business model whereby both Trading Members and FCM Members must provide the DCO with funds prior to trading. It is the Division's view that, while Members are clearing members as contemplated by Regulation 39.12(a)(2)(i), Nadex's rules requiring full collateralization satisfy the condition that "participation requirements shall require clearing members to have access to sufficient financial resources to meet obligations arising from participation in the [DCO] in extreme but plausible market conditions."

Regarding Regulation 39.12(a)(3), the Division's view, as discussed previously, is that all Members are clearing members, as such term is used in the Commission's regulations. The Division acknowledges a difference, however, between the Trading Members that clear for their own accounts and the FCM Members that would clear on behalf of customers. Consequently, the Division interprets Nadex's rules regarding full collateralization as satisfying Regulation 39.12(a)(3) with regard to Trading Members. However, the Division does not agree that Nadex's rules satisfy its obligations with regard to FCM Members. If and when Nadex gains FCM Members, Nadex must require them to have "adequate operational capacity to meet obligations arising from participation" in Nadex, including, but not limited to, the ability to process orders and fulfill payment and delivery obligations. The Division does agree that Nadex's rules regarding full collateralization satisfy the requirement that FCM Members have the ability to participate in default management activities under the rules of the DCO, as Nadex has represented that it otherwise does not have default rules and procedures (for which exemptive relief is being granted concurrently with this interpretive guidance).

C. Risk Management

Commission Regulation 39.13(c). Nadex seeks an interpretation that a chief executive officer or other officer (not including the Chief Compliance Officer ("CCO")), assuming such officer possesses the qualifications for the role, could serve as the Chief Risk Officer ("CRO"), a position required under Regulation 39.13(c).

*Commission Regulation 39.13(e).*¹⁰ Nadex seeks relief from Regulation 39.13(e), which requires a DCO to measure its credit exposure to each clearing member and mark-to-market each clearing member's open house and customer positions at least once each business day and monitor its credit exposure to each clearing member periodically during each business day. Nadex represents that it is not a margined DCO and therefore it does not take on credit exposure

¹⁰ In the Request, Nadex petitioned for exemptive relief with regard to Commission Regulation 39.13(e). However, the Division believes it is more appropriate to grant interpretative guidance.

to Members or mark-to-market positions. Nadex represents that it ensures 100% of any exposure on a trade is fully collateralized before the trade is allowed to match.

Commission Regulation 39.13(f). Nadex seeks interpretive guidance to the effect that its compliance with the requirements of full collateralization constitutes an acceptable form of compliance with Regulation 39.13(f), which requires a DCO to limit its exposure to potential losses from clearing member defaults. Nadex represents that it is not a margined DCO and that it limits its exposure to potential losses from defaults of Members by ensuring that 100% of any exposure on a trade is fully collateralized before the trade is allowed to match, not through post-trade collections of margin.

Commission Regulation 39.13(g).¹¹ Nadex seeks relief from Regulation 39.13(g), which requires DCOs to have a margin methodology that is risk-based and reviewed on a regular basis. Among other requirements, the provision sets forth the parameters required for the margin methodology. Nadex represents that it is not a margined DCO and does not set initial margin requirements in the “traditional” sense contemplated by the regulation. Rather, according to Nadex’s representation, it ensures that 100% of any exposure on a trade is fully collateralized before the trade is allowed to match.

Commission Regulation 39.13(h)(1). Nadex seeks interpretive guidance to the effect that its compliance with the requirements of full collateralization constitutes an acceptable form of “risk limits” on Members in accordance with Regulation 39.13(h)(1). Nadex represents that it eliminates its exposure to risk from any individual Member by ensuring that 100% of any exposure on a trade is fully collateralized before the trade is allowed to match, not through post-trade collections of margin.

Commission Regulation 39.13(h)(5)(i). Nadex seeks interpretive guidance with respect to the requirement that a DCO have rules concerning its clearing members’ risk management policies and procedures. Nadex represents that Nadex, itself, fully manages the risk of Trading Members’ trading activity by requiring the deposit of funds sufficient to collateralize 100% of such activity before any trading is allowed to occur. Nadex asserts that Trading Members, who are primarily retail customers, should not be required to maintain their own current written risk management policies and procedures or to produce information and documents regarding their risk management policies, procedures, and practices to Nadex or the Commission.

Nadex states that it would also perform the same risk management function with respect to FCM Members (currently there are none). Nadex would require FCM Members to have procedures in place that are appropriate for Nadex’s fully-collateralized business model, including a requirement to document and demonstrate their ability to do a pre-trade “cap check” to ensure that they are complying with their obligations under the full-collateralization regime.¹² Nadex further explains that it would not require FCM Members to provide Nadex with

¹¹ In the Request, Nadex petitioned for exemptive relief with regard to Commission Regulation 39.13(g). However, the Division believes it is more appropriate to grant interpretative guidance.

¹² Nadex Rule 3.4(h).

information regarding liquidity of their financial resources (other than periodic financial reporting) because the relevant resources to support FCM Members' trading activities are held by Nadex. Similarly, FCM Members would not be required to provide Nadex with information regarding liquidity or to have settlement procedures as all settlements are completed by Nadex.

Nadex emphasizes that, with respect to Regulation 39.13(h)(5)(i)(B) and (C), Nadex rules require all Members to "cooperate promptly and fully with Nadex, its agents and/or the Commission in any ... call for information;"¹³ and that each Member "consents to allow Nadex to provide all information Nadex has about the Member ... to the Commission."¹⁴ Accordingly, Nadex seeks interpretive guidance to the effect that, in light of Nadex's fully-collateralized business model and the fact that current Members are typically retail customers, not industry professionals, its rules concerning Members' risk management policies and procedures constitute an acceptable form of compliance with the requirements of Regulation 39.13(h)(5).

Commission Regulation 39.14(c)(3). Regulation 39.14(c)(3) requires a DCO to monitor its exposures to its own and its clearing members' settlement bank(s) and the related potential losses and liquidity pressures in the event that the settlement bank with the largest share of settlement activity were to fail. Regulation 39.14(c)(3) also requires a DCO to take certain actions if reasonably necessary to eliminate or strictly limit such exposures. Nadex represents that as a fully-collateralized DCO, it does not use a settlement bank in the traditional manner. Rather, it has a primary "settlement bank"—namely, JP Morgan Chase NA—at which Nadex maintains the accounts that hold Members' funds. Members do not have their own separate clearing accounts for Nadex at JP Morgan Chase NA. There are no daily pays/collects for margin or daily mark-to-market settlements or expirations. All funds necessary to fully collateralize any positions are held by Nadex at the bank prior to the execution of the trades that create the resulting positions. Nadex maintains a second banking relationship with BMO Harris NA, but does not typically hold Member funds there. Nadex does maintain written policies for what constitutes an acceptable settlement bank for Nadex and does monitor its banking relationships.

Due to the unique nature of Nadex's fully-collateralized business model, Nadex is seeking interpretive guidance from the Division confirming that the use of a single settlement bank by Nadex is acceptable under Regulation 39.14(c)(3), and that Nadex is not required to monitor Members' potential losses and liquidity pressures in the event that JP Morgan Chase NA were to fail.

Division Interpretation

The Division is of the view that Nadex satisfies the CRO requirement under Regulation 39.13(c) if the individual selected for the position possesses the qualifications for the role of

¹³ Nadex Rule 3.3(a).

¹⁴ Nadex Rule 3.3(b).

CRO. The Division notes that Regulation 39.13(c) does not prohibit a chief executive officer or other officer (other than the CCO) from also assuming the role of CRO.¹⁵

Paragraphs (e), (f), (g), and (h)(1) of Regulation 39.13 address the risks that a DCO faces by requiring margin from its clearing members. The Division is of the view that because Nadex does not collect margin and instead requires full collateralization, it eliminates these risks. Therefore, it is the Division's view that Nadex satisfies the requirements set out in paragraphs (e), (f), (g), (h)(1), and (h)(5)(i) of Regulation 39.13.

Because Nadex is a fully-collateralized DCO and has rules concerning Members' risk management policies and procedures, it is the Division's view that such rules constitute an acceptable form of compliance with Regulation 39.13(h)(5).

The Division notes that Regulation 39.14(c)(3) does not require a DCO to use more than one settlement bank; a DCO may take "any other appropriate actions" in order to eliminate or limit exposure to its settlement bank. However, the Division's view is that Nadex is required to monitor Members' potential losses and liquidity pressures in the event that JP Morgan Chase were to fail. That is, Nadex is responsible for monitoring the health of the settlement bank because if such bank were to fail, then Members' funds could potentially be impacted.

D. Default Rules and Procedures

*Commission Regulation 39.16.*¹⁶ Nadex seeks relief from Regulation 39.16, which requires a DCO to have rules and procedures for the efficient, fair, and safe management of a default and to have a default management plan. In addition, a DCO must have procedures regarding timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a clearing member default. Nadex represents that it has neither default rules and procedures nor 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. According to Nadex, if funds are not available, then a trade will not be executed.

Division Interpretation

The Division agrees 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 full-collateralization requirements satisfy the requirements of Regulation 39.16.

¹⁵ See 76 Fed. Reg. 69,334, 69,363 (Nov. 8, 2011).

¹⁶ In the Request, Nadex petitioned for exemptive relief with regard to Commission Regulation 39.16. However, the Division believes it is more appropriate to grant interpretative guidance.

E. Public Information

Commission Regulation 39.21(b).¹⁷ Nadex seeks relief from Regulation 39.21(b), which requires a DCO to make information concerning its rules, as well as the operating and default procedures governing its clearing and settlement systems, available to market participants. Nadex has represented that it does not have default procedures.

Division Interpretation

As noted above, it is the Division's view that Nadex's full-collateralization requirements constitute satisfactory default procedures. Accordingly, the Division would view Nadex's making available to market participants information concerning those requirements as satisfying Regulation 39.21(b).

IV. Conclusion

This letter is based upon the representations of Nadex, the Amended DCO Order, and applicable laws and regulations in their current form; 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 letter, please contact Andrea Musalem, Special Counsel, at 202-418-5167 or amusalem@cftc.gov.

Sincerely,

Ananda Radhakrishnan
Director

¹⁷ In the Request, Nadex petitioned for exemptive relief with regard to Commission Regulation 39.21(b). However, the Division believes it is more appropriate to grant interpretative guidance.