

**RULE ENFORCEMENT REVIEW  
OF  
NORTH AMERICAN  
DERIVATIVES EXCHANGE**



**Division of Market Oversight  
November 15, 2013**

**RULE ENFORCEMENT REVIEW OF  
NORTH AMERICAN DERIVATIVES EXCHANGE (NADEX)  
TRADE PRACTICE SURVEILLANCE**

**Commodity Futures Trading Commission – Division of Market Oversight**

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## **I. Introduction**

The Division of Market Oversight (“Division”) of the Commodity Futures Trading Commission (“Commission”) has completed a rule enforcement review of the trade practice surveillance program of North American Derivatives Exchange Inc. (“Nadex” or “Exchange”).<sup>1</sup> The review covered the period from June 15, 2011 through June 15, 2012 (“target period”). The Division’s review focused on compliance with two core principles under Section 5(d) of the Commodity Exchange Act (“Act” or “CEA”),<sup>2</sup> as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).<sup>3</sup> In particular, the Division’s review focused on Core Principles 2 (*Compliance With Rules*) and 12 (*Protection of Market Participants*) which relate to an exchange’s trade practice surveillance program.

## **II. Methodology**

Division staff interviewed members of Nadex’s Compliance Department (“Compliance” or “Compliance Department”) and reviewed documents used by Compliance in fulfilling the Exchange’s self-regulatory responsibilities. In addition, Nadex provided Division staff with a

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<sup>1</sup> Rule enforcement reviews prepared by the Division are intended to present an analysis of an exchange’s overall compliance capabilities during the period under review. Such reviews deal only with programs directly addressed in the review and do not assess all programs or core principles. The Division’s analyses, conclusions, and recommendations are based, in large part, upon the Division’s evaluation of a sample of investigation and disciplinary case files, and other exchange documents. This evaluation process, in some instances, identifies specific deficiencies in particular exchange investigations or methods but is not designed to uncover all instances in which an exchange does not address effectively all exchange rule violations or other deficiencies. Neither is such a review intended to go beyond the quality of the exchange’s self-regulatory systems to include direct surveillance of the market, although some direct testing is performed as a measure of quality control. The findings and recommendations herein, represent the view of the Division only, and do not necessarily represent the position or view of the Commission or of any other office or division of the Commission.

<sup>2</sup> 7 U.S.C. 1 *et seq.*

<sup>3</sup> *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010). The Division’s review focused on Sections 5(d)(2) (“new Core Principle 2”) and 5(d)(12) (“new Core Principle 12”) of the Act as amended by the Dodd-Frank Act because the new Core Principles were in effect for approximately eleven months of the target period.

live demonstration of its trade practice surveillance system. Documents reviewed by Division staff included the following:

- reports used routinely for trade practice surveillance;
- investigation files for Trade Practice Inquiries, General Inquiries, and Complaints; and associated work product;<sup>4</sup>
- minutes of meetings of the Board of Directors and the Regulatory Oversight Committee (“ROC”) held during the target period;
- annual reports of the ROC;<sup>5</sup> and
- an investigation log tracking the disposition of trade practice matters.

The Division provided Nadex with an opportunity to review and comment on a draft of this report on October 21, 2013. On October 31, 2013, Division staff conducted an exit conference with Exchange officials to discuss the report’s findings and recommendations.

### **III. Summary of Findings and Recommendations**

#### **A. Findings**

- The Exchange maintains an adequate trade practice surveillance system. Nadex has the ability to detect potential rule violations, including trade practice violations, through SMARTS, an alert and analysis program. In addition, Compliance detects and analyzes potential rule violations by analyzing Nadex’s trading database and reviewing FCM error accounts.
- Nadex tracks three types of investigations: Trade Practice Inquiries, General Inquiries, and Complaints. All trade practice issues, regardless of their source, are classified as Trade Practice Inquiries. Compliance drafts an Investigative Memorandum and an Investigation Origination Form for each Trade Practice Inquiry.
- The Division found that Nadex generally maintains adequate documentation of its investigations. However, some, but not all, Investigation Memoranda contain a CRO

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<sup>4</sup> Because the Exchange conducted only one Trade Practice Inquiry, the Division’s review included all investigations conducted during the target period. See Section VII(B)(1) for a discussion of investigation categories at Nadex.

<sup>5</sup> The Division reviewed the ROC annual reports for 2010, 2011, and 2012.

signature and CRO approval date. In addition, in one investigation, the Division found that the Exchange's written analysis was lacking with regard to the issue of jurisdiction.

- The Division found that Nadex's investigation log lacks necessary information. Specifically, the log does not identify when an investigation was completed by staff, nor does it identify the date of the CRO's approval.
- The Exchange conducted eleven investigations during the target period, one of which was a Trade Practice Inquiry. At the conclusion of the target period, all but one investigation, a General Inquiry, had been closed. The remaining investigation was closed approximately four months after the target period ended.
- The Division found that all investigations were conducted in a timely manner. Each of the eleven investigations was completed in 115 days or less, and the average length of investigation was approximately 46 days.
- The Division found the quality and documentation of investigative work to be thorough and complete. In general, the Exchange reviewed relevant documents and used those documents effectively when conducting investigations, drafting summaries and analyses of investigations, and determining whether or not violations occurred.
- Division staff found that for all investigations conducted during the target period, the Exchange's actions, and the sanctions imposed, if any, were appropriate. However, in one investigation, the sanctions imposed would be inappropriate under current Commission regulations.

#### B. Recommendations

- The Exchange should ensure that each Investigation Memoranda includes a CRO signature and a CRO approval date.
- In cases where the Exchange determines that it lacks jurisdiction over persons subject to a disciplinary investigation, the corresponding investigation memoranda should include a written analysis of the reasons jurisdiction is lacking.
- The Exchange should ensure that Nadex's investigation log contains all necessary information for each investigation, including the date on which each investigation was completed by staff and the date of CRO approval.
- The Exchange should implement tie-breaking procedures to resolve tie votes of the ROC, or alternatively, the Exchange should ensure that the committee is composed of an odd number of members greater than one.
- As is now required by Commission Regulation 38.158(e), the Exchange may not issue more than one warning letter to the same person or entity found to have committed the same rule violation within a rolling twelve month period.

## **IV. Nadex Operations**

### **A. Historical Overview**

Nadex, under the name HedgeStreet, initially applied for designation as a contract market and registration as a derivatives clearing organization (“DCO”) on March 12, 2001. On February 18, 2004, the Commission approved HedgeStreet’s contract market designation and DCO registration applications.

Specifically, the Commission approved HedgeStreet to offer option contracts on a non-intermediated basis.<sup>6</sup> Clearing services were provided by HedgeStreet acting as a registered DCO. Each transaction was fully paid, meaning that there would be no margining of positions on the Exchange.<sup>7</sup> Pursuant to a regulatory services agreement that HedgeStreet submitted to the Commission with its designation application, the Exchange contracted with the National Futures Association (“NFA”) to assist it in carrying out various self-regulatory responsibilities, including, but not limited to, trade practice surveillance, market surveillance, and investigative and disciplinary functions. HedgeStreet completed its first day of trading on October 4, 2004.

On December 5, 2005, the Commission amended HedgeStreet’s Order of Designation and authorized HedgeStreet to allow its member accounts to be carried by FCMs.<sup>8</sup> Since 2008, a total of two FCM members, one of which is an affiliate of Nadex, have facilitated trading on the Exchange. During the target period, a single FCM operated on the Exchange. After July 2012, Nadex has operated purely on a non-intermediated basis.

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<sup>6</sup> See Section IV(B) for more information about contracts currently offered by Nadex.

<sup>7</sup> Prior to trading, HedgeStreet members were required to fund their HedgeStreet account from a bank account in the United States.

<sup>8</sup> The Commission specified that contracts could be cleared by a DCO without collecting prepaid collateral prior to acceptance of clearing, provided that collateral sufficient to cover one hundred percent of the maximum possible loss incurred by each participant would be collected no later than the day after contracts were accepted for clearing.

Effective December 10, 2007, IG US Holdings (“IG US”), a wholly owned subsidiary of IG Group Holdings plc (“IG Group”), became the sole owner of the entire equity interest in HedgeStreet. Following the acquisition, three significant changes occurred. First, on February 8, 2008, the Exchange notified the Commission that Market Risk Management, a subsidiary of IG US, would be acting as the sole market maker on the Exchange.<sup>9</sup> Second, on May 8, 2009, the Exchange terminated its regulatory services agreement with NFA and the Exchange took over full performance of its self-regulatory functions. Third, on June 21, 2009, HedgeStreet changed its name to Nadex.

**B. Current Products**

Nadex currently offers two types of products: binary options and bull spreads. Binary options, which account for the vast majority (89.5 percent) of the trades on the Exchange, allow members to take risks based on the occurrence or non-occurrence of an event or condition.<sup>10</sup> At expiration, each binary option settles at zero (if the event does not occur) or 100 (if the event occurs). Prior to expiration, the price of the option will fluctuate based on the market’s perspective on the likelihood of the occurrence. Members who seek to profit from the event’s occurrence can buy the binary option at the prevailing offer price (which will range from zero to 100). Conversely, members who seek to profit from the event’s non-occurrence can sell the option at the prevailing bid price. Sellers’ and buyers’ potential losses are known at the time of purchase or sale. A buyer’s profit is limited to the difference between the purchase price and 100, while a buyer’s loss is limited to the difference between the purchase price and 0. A seller’s

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<sup>9</sup> During the target period, Market Risk Management was the sole market maker active on the Exchange. In response to concerns raised by the Division regarding an affiliate acting as a market maker, the Exchange agreed to make changes to its operations. In addition to ensuring appropriate separation between Market Risk Management’s and the Exchange’s computer systems, the Exchange agreed that Market Risk Management would not have access to any material non-public information from the Exchange.

<sup>10</sup> See Section V for detailed product volume information.

profit is limited to the difference between the purchase price and 0; a seller's loss is limited to the difference between the purchase price and 100.

Nadex offers binary options based on prices and events. Price-based binary options set forth a yes/no proposition on stock index futures prices, forex rates, and commodity futures prices. The values of these options are based on whether the price of products, typically offered by other exchanges, is above or below a certain price at a certain time. For example, Nadex's Gold binary option contract is based on the price of COMEX Gold futures. A corresponding binary option on Nadex may offer, for example, a chance to bid on whether the price of gold futures will be above \$1,382 per troy ounce at 1:30 PM on a certain date. Event binary options allow members to take risks on the value of the fed funds rate set by the Federal Open Market Committee, jobless figures released by the Department of Labor, and nonfarm payrolls statistics released by the Bureau of Labor Statistics.

Like binary options, Nadex's bull spread options allow members to take risks based on the price of an underlying instrument ("spot rate"). Stock index futures prices, forex rates, and commodity futures can serve as the spot rate. In contrast to binary options, spreads are expressed in ranges. However, as with binary options, buyers' and sellers' maximum potential gains and losses are known at the time of sale because Nadex's spreads settle at rates referenced to the level of the spot rate. For example, the spread contract, euro / U.S. dollar ("EUR/USD") 1.3000-1.3250 (3pm) would settle at: the spot rate, if the spot rate is within the range at 3 pm; 1.3000, if the spot rate is below 1.3000; or 1.3250, if the spot rate is above 1.3250. Prior to expiration, according to Nadex, the price of the spread will fluctuate based on the underlying EUR/USD rate and the optional insurance value of the floor and ceiling of the spread. If the underlying rate is

close to the spread's floor (1.3000), the spread would typically trade at a price slightly higher than the underlying rate.

Nadex's binary options and bull spreads are swaps subject to the regulatory framework established by Title VII of the Dodd-Frank Act.<sup>11</sup> Section 721 of the Dodd-Frank Act added new section 1a(47) to the CEA, defining "swap" to include not only "any agreement, contract, or transaction commonly known as," among other things, "a commodity swap," but also "[an] option of any kind that is for the purchase or sale, or based on the value, of 1 or more . . . commodities . . . ."<sup>12</sup> The Commission's regulations define a commodity option transaction or commodity option as "any transaction or agreement in interstate commerce which is or is held out to be of the character of, or is commonly known to the trade as, an 'option,' 'privilege,' 'indemnity,' 'bid,' 'offer,' 'call,' 'put,' 'advance guaranty' or 'decline guaranty'."<sup>13</sup> All binary options and bull spreads currently offered by Nadex fall under this definition. As swaps, the regulatory requirements to which Nadex's products are subject include the real-time reporting of swap transaction data, swap data recordkeeping and regulatory reporting requirements, and recordkeeping and regulatory reporting requirements for pre-enactment and transition swaps, as

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<sup>11</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

<sup>12</sup> See 7 U.S.C. 1a(47)(A)(i). The swap definition excludes options on futures (which must be traded on a DCM pursuant to part 33 of the Commission's Regulations) (see CEA section 1a(47)(B)(i), 7 U.S.C. 1a(47)(B)(i)), but it includes options on physical commodities (whether or not traded on a DCM) (see CEA section 1a(47)(A)(i), 7 U.S.C. 1a(47)(A)(i)). Other options excluded from the statutory definition of swap are options on any security, certificate of deposit, or group or index of securities, including any interest therein or based on the value thereof, that is subject to the Securities Act of 1933 and the Securities Exchange Act of 1934 (see CEA section 1a(47)(B)(iii), 7 U.S.C. 1a(47)(B)(iii)) and foreign currency options entered into on a national securities exchange registered pursuant to section 6(a) of the Securities Exchange Act of 1934 (see CEA section 1a(47)(B)(iv), 7 U.S.C. 1a(47)(B)(iv)).

<sup>13</sup> 17 CFR 1.3(hh).

applicable.<sup>14</sup> As they were not applicable during the target period, the Division’s review did not address these requirements.

C. Market Maker

As noted above, during the target period, Nadex had a Market Maker Agreement with one entity, Market Risk Management, an Exchange affiliate. As the only market maker on the Exchange, Market Risk Management offers a bid-ask spread for each of Nadex's products. It adjusts its prices based on the level of the underlying instrument, and according to Compliance staff, Market Risk Management almost always serves as the best bid or offer for all products. Consequently, it is a party to the vast majority (over 99 percent) of trades on the Exchange.

Nadex adheres to policies designed to maintain separation between the Exchange and Market Risk Management. During the on-site interview, Compliance staff explained that the entity is treated like any other member with respect to information access and investigations. Nadex does not provide Market Risk Management with any information that is not shared with members. Although the Exchange has never sanctioned or investigated Market Risk Management, Compliance staff explained that Nadex carefully monitors the market maker's activity by reviewing trade practice alerts which involve the market maker.<sup>15</sup> Compliance staff monitors the offers made by Market Risk Management to verify that the market maker is adhering to the terms of the Market Maker Agreement. In addition, on a monthly basis, the Exchange sends Division staff a list of all ALMAS alerts triggered by Market Risk Management

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<sup>14</sup> Real-Time Public Reporting of Swap Transaction Data, 77 Fed. Reg. 1182 Jan. 9, 2012) (“Part 43”); Swap Data Recordkeeping and Reporting Requirements, 77 Fed. Reg. 2136 (Jan. 13, 2012) (“Part 45”); Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps, 77 Fed. Reg. 35200 (Jun. 12, 2012) (“Part 46”).

<sup>15</sup> See Section VII(A) for a discussion of the automated trade practice surveillance system used by Nadex to generate trade practice alerts (“ALMAS”).

during the month. Nadex has not implemented any ALMAS alerts or other types of alerts specifically designed for surveillance of the market maker.

D. Nadex Governance

**1. Ownership and Board of Directors**

Nadex is wholly-owned by IG Group. A UK-based company, IG Group offers a variety of “speculative products” to retail and professional customers.<sup>16</sup> In addition to Nadex, IG Group's operating companies include: IG Index, a financial spread betting business regulated by the UK Financial Services Authority (“FSA”) and the UK Gambling Commission;<sup>17</sup> and IG Markets, offering derivative contracts including Contracts for Difference (“CFDs”), which is regulated by the FSA and is a member of the London Stock Exchange.

The Exchange’s Board of Directors (“Board”) is composed of five directors. Three directors are affiliated with IG Group: the CEO of Nadex and two representatives of IG Group. Two members of the board, who serve on the Regulatory Oversight Committee (“ROC”), are self-certified as public directors. As Nadex’s sole shareholder, IG US Holdings has the direct authority to select and remove Board members, including public directors.

**2. Regulatory Oversight Committee**

A ROC oversees the Exchange’s regulatory program. ROC committee members are appointed by the Board, according to the ROC charter, but the Chief Regulatory Officer (“CRO”) is also involved in the selection process. Among the responsibilities of the ROC, as listed in its charter, are to: (i) “oversee all facets of Nadex’s regulatory program, including trade

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<sup>16</sup> <http://www.iggroup.com/corporate/brands.html>.

<sup>17</sup> The UK Gambling Commission regulates IG Index's offering of “Binary Bets,” which IG Index describes as “fast-moving 'yes/no' bets that provide dealing opportunities in volatile markets.” <http://www.igindex.co.uk/spread-betting/binary-bets.html>.

practice and market surveillance; audits, examinations, and other regulatory responsibilities; and the conduct of investigations;” (ii) “review the size and allocation of the regulatory budget and resources; and the number hiring and termination, and compensation of regulatory personnel;” (iii) oversee Nadex’s chief regulatory officer, who will report directly to the ROC;” and (iv) “prepare an annual report assessing Nadex’s self-regulatory program for the Board and the Commission.” The ROC Charter also provides that the ROC shall (i) “meet quarterly and keep minutes of its meetings;” (ii) “recommend changes that would ensure fair, vigorous, and effective regulation;” and (iv) “[r]eview significant regulatory proposals and advise the Board as to whether and how such changes impact regulation.” In addition, the ROC is also authorized to address issues that potentially cannot be resolved through standard reporting channels. For example, if a Nadex employee perceives that the Compliance Department is not properly monitoring or regulating the Nadex marketplace, or that the department has failed to address or investigate a matter within a reasonable period of time, the employee can escalate issues to the CRO or the ROC.

ROC meetings are held quarterly. During meetings, the CRO and other Compliance employees present information relating to notable cases, Exchange operation, and regulatory developments, including Dodd-Frank compliance, internal audits, and Commission audits. The CRO serves as the meeting secretary. Outside of formal meetings, the CRO interacts with the ROC mainly by phone and e-mail. Through these informal interactions, the CRO keeps the ROC informed of important issues, such as new rules that apply to the Exchange.

The Exchange’s ROC charter requires a minimum membership of two individuals, both of whom must be public directors. Currently, the committee is composed of two Board members who have self-certified themselves as public directors. No tie-breaking procedures are in place

to resolve differences between the two members if a conflict were to arise. The Division is concerned that with two members and no tie-breaking procedures, the ROC may be confronted with irreconcilable conflicts in the event of a difference of opinion between ROC members.

Accordingly, the Division recommends that:

- **The Exchange should implement tie-breaking procedures to resolve tie votes of the ROC, or alternatively, the Exchange should ensure that the committee is composed of an odd number of members greater than one.**

## V. Trading Volume during the Target Period

Total trading volume at Nadex during the target period was 987,153 contracts. The Exchange offered 50 different products (27 binary options and 23 bull spreads) for trading.<sup>18</sup> Binary option products accounted for approximately 89.5 percent of total volume, with five binary options accounting for approximately 51.45 percent of total exchange volume: US 500 accounted for 20.4 percent; Wall St. 30 accounted for 10.7 percent; EUR-USD accounted for 9.1 percent; Gold accounted for 6.4 percent; US SmallCap accounted for 4.8 percent.<sup>19</sup> Bull spreads accounted for approximately 10.5 percent of total volume, with five bull spreads accounting for approximately 7.05 percent of total exchange volume: EUR-USD accounted for 3.18 percent; AUD-USD accounted for 1.42 percent; US 500 accounted for 1.01 percent; GBP-USD accounted for 0.76 percent; Crude Oil accounted for 0.68 percent. All trades are placed electronically by one of two methods: (1) Nadex's proprietary web portal or (2) Financial Information eXchange ("FIX") electronic communication protocol. Only Nadex's market maker, Market Risk

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<sup>18</sup> See Section IV(B) for a description of Nadex's products, binary options and bull spreads.

<sup>19</sup> Nadex calculates the expiration values of its contracts based on contracts at other exchanges and data providers. The US 500 binary option is based on CME E-mini S&P 500 Index Futures. The Wall St. 30 binary option is based on CBOT E-mini Dow Futures. The EUR-USD binary option is based on data from Reuters. If Reuters is unavailable, Nadex would obtain the data from Bloomberg or another data provider deemed appropriate by the Exchange under the circumstances. The Gold binary option is based on COMEX/NYMEX Gold Futures. The US SmallCap binary option is based on ICE Mini Russell 2000 Index Futures.

Management, enters trades through FIX; all other Nadex members trade through the web portal. The Exchange does not offer open outcry trading or off-exchange trading (EFPs, EFSs, EOOs, or block trades). Additional trading volume, open interest, and product information is provided in Tables 1, 2, and 3, below.

Table 1 below lists the total Exchange volume and total number of products listed during the target period and during the 12 months prior to the target period (June 15, 2010 to June 15, 2011). Exchange volume is subdivided by trading in binary options and trading in bull spreads. As indicated below, during this two-year period, the number of products decreased from 56 to 50 (10 percent), but the Exchange experienced significant growth, with volume increasing by more than 100 percent (from a total volume of 472,266 to 987,153 contracts). Compliance stated that the primary driver for the increase in volume was an increase in the number of Exchange members.

Table 1. Volume by product type.

	<b>Time period</b>	<b>Volume (in contracts)</b>	<b>Percentage of total volume</b>	<b>No. of Products Traded</b>
Binary Options	6/15/10 to 6/15/11	395,739	83.80%	31
	6/15/11 to 6/15/12	883,477	89.50%	27
Bull Spreads	6/15/10 to 6/15/11	76,527	16.20%	25
	6/15/11 to 6/15/12	103,676	10.50%	23
Total	6/15/10 to 6/15/11	472,266	N/A	56
	6/15/11 to 6/15/12	987,153	N/A	50

Table 2 below lists the total Exchange trading volume by year from 2009 to 2012. Total Exchange volume grew every year during this period. Volume increased by 116% from 2009 to 2010, by 357% from 2010 to 2011, and by 79% from 2011 to 2012.

Table 2. Volume by year.

<b>Year</b>	<b>Total volume</b>
2009	94,844
2010	204,414
2011	934,643
2012	1,677,035

Table 3 below lists the names, total trading volumes, and average monthly open interest for the Exchange's five primary binary option products (ranked by trading volume) during the target period. Trading in the US 500, the Exchange's most heavily traded product, represented 20.42% percent of total Exchange volume during the target period.

Table 3. Volume for primary binary option products.

<b>Binary Option Product</b>	<b>Volume (in contracts)</b>	<b>Percentage of Total Exchange Volume</b>	<b>Avg. Month-End Open Interest</b>
US 500	201,580	20.42%	250.7
Wall St. 30	105,202	10.66%	21.7
EUR-USD	89,840	9.10%	39.1
Gold	63,385	6.42%	233.1
US SmallCap	47,835	4.85%	4.7

Table 4 below lists the names, total trading volume, and average monthly open interest for the Exchange's five primary bull spread products (ranked by trading volume) during the

target period. Trading in the EUR-USD spread, the Exchange's most heavily traded bull spread, represented 3.18 percent of total Exchange volume during the target period.

Table 4. Volume for primary spread option products.

<b>Spread Option Product</b>	<b>Volume (in contracts)</b>	<b>Percentage of Total Exchange Volume</b>	<b>Avg. Month-End Open Interest</b>
EUR-USD	31,401	3.18%	0
AUD-USD	14,027	1.42%	0
US 500	9,984	1.01%	0
GBP-USD	7,520	0.76%	0
Crude Oil	6,683	0.68%	0

## **VI. Staffing, Organization and Training**

During the Division's last rule enforcement review of the Exchange (which was prior to the purchase by IG US), NFA was contractually responsible for performing many of the Exchange's self-regulatory functions, including trade practice surveillance. That report, which was published in March 2008, covered the target period April 1, 2005, through December 31, 2006. During that target period, the Exchange's Compliance Department was comprised of two people. In May 2009, Nadex terminated its regulatory services agreement with NFA, hired additional compliance staff, and assumed the functions previously delegated to NFA.

Nadex's Compliance Department now consists of four staff members. The Compliance Department is led by a highly experienced CRO who also serves as the General Counsel and Corporate Secretary for the Exchange, and who, during the target period, served as the Chief

Compliance Officer for Nadex operating as a DCO.<sup>20</sup> The CRO's regulatory responsibilities include managing the Compliance Department budget, approving the opening of investigations, approving rules to be filed with the Commission, and discussing investigations with Compliance staff. Non-regulatory responsibilities account for approximately half of the CRO's time. During the target period, the CRO was assisted by the following individuals:

- Regulatory Officer, whose responsibilities include analyzing and reviewing trade practice alerts generated by the Securities Markets Automated Research Trading and Surveillance System ("SMARTS"), and participating in investigative interviews.<sup>21</sup>
- Compliance Officer, whose responsibilities include facilitating the opening of new member accounts, verifying customer identities, reviewing the Exchange's promotional materials, and assisting with on-boarding and reviewing FCM members.<sup>22</sup>
- Legal Counsel / Compliance Associate, whose regulatory responsibilities include drafting rule filings and investigative reports, tracking customer complaints and reminders issued to members.<sup>23</sup> This individual also assists the Regulatory Officer in conducting trade practice surveillance and assists the Chief Compliance Officer in account opening and

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<sup>20</sup> The CRO joined the Exchange's staff in January 2009. His 17 years of experience in financial compliance and litigation include four years with CME and seven years in private practice. On November 1, 2012, a new individual was appointed to the position of Chief Compliance Officer. *See* note 22.

<sup>21</sup> The Regulatory Officer has 25 years of futures compliance experience, including 22 years at CME.

<sup>22</sup> At the time of the Division's on-site visit, the Compliance Officer position had been vacant since August 31, 2012; during the vacancy, other Compliance Department personnel temporarily took over responsibility for the duties of this position. On October 8, 2012, a new Compliance Officer was hired. On November 1, 2012, the new Compliance Officer was appointed to the position of Chief Compliance Officer. The Chief Compliance Officer is a statutorily required position with DCOs; conversely, the Compliance Officer is a front-line employee of the DCM's Compliance Department.

<sup>23</sup> The Legal Counsel / Compliance Associate has three years of futures compliance experience.

promotional review.<sup>24</sup> The employee also assists the CRO with General Counsel and Corporate Secretary responsibilities, including maintaining records of meetings of the Board of Directors and the ROC and reviewing contracts.

During the target period, the Regulatory Officer, Compliance Officer, and Compliance Associate interacted regularly to discuss compliance issues and concerns, and occasionally, the whole Compliance Department met with the CRO on an ad-hoc basis. The CRO explained that such department-wide meetings often occur before or after the weekly meeting of the Exchange's Management Team. The CRO also met separately with the Compliance Associate as needed to discuss the status of investigations, the steps needed to be taken in investigations, and the potential resolution of investigations.

The Exchange does not have mandatory training for Compliance staff. However, when new employees are hired, they receive on-the-job training regarding the Exchange's automated trade practice surveillance tools, the Compliance Manual, and Nadex rules. All members of the Compliance Department participate in anti-money laundering training. In addition, various members of the Compliance Department attend conferences sponsored by the American Bar Association and the Futures Industry Association.

IG Group provides information technology support services to Nadex.<sup>25</sup> In particular, IG Group provides support for the Exchange's desktop computers and IT network.<sup>26</sup> The group also

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<sup>24</sup> The Compliance Department's promotional review includes a review of informational brochures and other sales or educational documents, including reports, letters, circulars, memoranda, or publications disseminated to or directed to the public.

<sup>25</sup> IG Group also provides human resources and marketing services to the Exchange. IG Group provides the following human resource services: recruiting, background checks, terminations, accounts payable processing, data entry and coding for the Exchange's Treasury Department. The following services related to marketing are provided: marketing implementation, media buys and reporting for online marketing, paid search and search engine optimization, support for email marketing campaigns, support and development for the Exchange's customer relationship management system.

provides support for Nadex's bespoke applications, such as the Exchange's back-end systems and the Exchange's administrative user interface, and for third party tools, such as website content management systems and online marketing analytic systems.<sup>27</sup> Although IG Group does not conduct trade practice surveillance or have any compliance responsibilities, it is responsible for ensuring that the Exchange's data properly interfaces with SMARTS, the Exchange's trade practice surveillance system. Other than the aforementioned support, there are no other IG divisions or departments that collect, maintain, or disseminate information critical to compliance or trade practice activities at the Exchange.

The Division believes that the Compliance Department personnel are qualified and experienced, and that the number of personnel was sufficient for trade practice purposes during the target period. However, Nadex's volume has increased dramatically since 2010. The Division reminds Nadex that if this growth continues, the Exchange should reassess its staffing needs to ensure that the number of Compliance Department personnel is sufficient to effectively conduct trade practice surveillance.<sup>28</sup>

## **VII. Trade Practice Surveillance Program**

### **New Core Principle 2 – Compliance with Rules**

- A. IN GENERAL – The board of trade shall establish, monitor, and enforce compliance with the rules of the contract market, including-
  - i. access requirements

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<sup>26</sup> For desktop issues, Nadex is responsible for attempting to resolve problems before reaching out to IG Group. With respect to network support, Nadex submits requests to IG Group to make changes to network settings. In addition, IG Group may recommend that Nadex's network settings be changed. In such a circumstance, IG Group provides Nadex with a change request form in advance of the change.

<sup>27</sup> Nadex is responsible for the day to day operation of bespoke applications in use at the Exchange.

<sup>28</sup> The Division notes that DCMs have been required to comply with Commission Regulation 38.155 since October 17, 2012. Regulation 38.155 requires that a DCM monitor the size and workload of its compliance staff annually and ensure that its compliance resources are at appropriate levels. A review of the appropriate level of compliance resources and staff should consider trading volume increases.

- ii. the terms and conditions of any contracts to be traded on the contract market; and
  - iii. rules prohibiting abusive trade practices on the contract market.
- B. CAPACITY OF CONTRACT MARKET – The board of trade shall have the capacity to detect, investigate, and apply appropriate sanctions to any person that violates any rule of the contract market.
- C. REQUIREMENT OF RULES – The rules of the contract market shall provide the board of trade with the ability and authority to obtain any necessary information to perform any function described in this subsection, including the capacity to carry out such international information-sharing agreements as the Commission may require.

**New Core Principle 12 – Protection of Market Participants:**

The board of trade shall establish and enforce rules

- A. to protect markets and market participants from abusive practices committed by any party, including abusive practices committed by a party acting as an agent for a participant; and
- B. to promote fair and equitable trading on the contract market.

During the entirety of the target period, Appendix B to Part 38 of the Commission’s regulations provided that a contract market’s trade practice surveillance program should have the arrangements, resources, and authority necessary to perform effective rule enforcement.<sup>29</sup> The arrangements and resources attendant to the program should facilitate the direct supervision of the contract market, including analysis of relevant data. Trade practice surveillance programs can be carried out by the contract market itself or through delegation to a third party.

An acceptable program should have systems that maintain all data reflecting the details of each transaction executed on the contract market. In this regard, the program should include routine electronic analysis of transaction data to detect potential trading violations. The program should also provide for appropriate and thorough investigation of potential trading violations

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<sup>29</sup> On May 10, 2012, the Commission issued its Final Rules, *Core Principles and Other Requirements for Designated Contract Markets*, 77 Fed. Reg. 36612 (June 19, 2012), which became effective on October 17, 2012, after the target period. Among other things, this rulemaking revised guidance and acceptable practices for some core principles and, for several core principles such as Core Principles 2 and 12, adopted rules, some of which codified previous guidance and acceptable practices. Because these rules were not effective during the target period, the Division evaluated the Exchanges’ trade practice surveillance program pursuant to the substantive standards contained in the pre-existing guidance and acceptable practices.

brought to the contract market's attention, including member and Commission referrals and customer complaints.

A. Automated Surveillance System

Nadex's primary trade practice surveillance tool is SMARTS, an alert and analysis program. A subcomponent of the SMARTS system, the ALMAS tool, generates real-time trade practice alerts. Parameters for the alerts are set by Compliance. The system is programmed to produce alerts based on the following trade practice issues: (a) money-pass, (b) pre-arranged trading, (c) position limits, (d) daily settlement price manipulation, (d) trading ahead, (e) taking the other side of a customer order, (f) futures price divergence, and (g) wash trading.<sup>30</sup> These alerts can be triggered by the behavior of any market participant, including the market maker. During the target period, 1,149 ALMAS alerts were generated, including 370 alerts (32 percent) triggered by Nadex's market maker. All alerts triggered by Nadex's market maker were either daily settlement price manipulation alerts or futures price divergence alerts. For all market participants other than Nadex's market maker, the most common alert was money pass, which generated 305 alerts (39 percent of all alerts). Four additional categories of alerts were triggered by market participants other than the market maker: 212 daily settlement price manipulation alerts (27 percent of non-market maker alerts), 175 pre-arranged trading alerts (22 percent of non-market maker alerts), 86 futures price divergence alerts (11 percent of non-market maker alerts), and 1 trading ahead alert (less than 1 percent of non-market maker alerts).

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<sup>30</sup> The futures price divergence alert is triggered when the price of a trade differs significantly from the value of the underlying instrument.

The wash trading alert is triggered when the same account trades opposite itself. Nadex's matching system currently prevents the same account from trading opposite itself. As a result, the wash trading alert system does not generate any alerts.

ALMAS alerts are monitored on a real-time basis by Compliance throughout the business day. Alerts generated during overnight trading are reviewed the following day.<sup>31</sup> In reviewing the alerts, Compliance may conduct additional review regarding the trade(s) or trader(s) in question to determine if a rule violation has occurred. In particular, the following information may be reviewed: the activity level of the traders in question, the size of the trade, the timing of the orders, whether the orders liquidated into an open position, the relationship between the trade price and the market price, the overall activity of the contract. In addition, Compliance may use the SMARTS Replay tool, which displays the complete market depth and all active bids and offers. Each alert is either dismissed or elevated to an investigation.<sup>32</sup> In either case, Compliance adds a short paragraph into the system explaining the basis for the decision. Based on a review of approximately half of the notes for the ALMAS alerts generated during the target period, including all of the alerts triggered by the market maker, the Division believes that the notes provide an adequate justification for dismissed alerts.

Several other SMARTS components enable Compliance to detect potential rule violations. ARC, a research and profiling tool, generates ad-hoc reports based on queries run by Compliance staff. On a monthly basis, Compliance staff runs the following ARC reports: Client Product Report, Client Counterparties Report, Prearranged Trading Report, and Collusion Report. These reports are used to detect a number of rule violations, including spoofing and pre-arranged trading.<sup>33</sup>

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<sup>31</sup> Nadex's hours of trading are 6 pm ET Sunday to 4:15 pm ET Friday, excluding the hour between 5 pm and 6 pm Monday through Thursday.

<sup>32</sup> See Section VII(B) for a description of how Nadex tracks investigations.

<sup>33</sup> The Prearranged Trading Report lists the occasions where two members trade opposite one another with less than a specified time limit between the bid and offer. Because Nadex's market maker is a party to the vast majority of trades, it is noteworthy when two Nadex members engage in a trade opposite one another instead of opposite the market maker. Compliance explained that such trades raise the possibility of pre-arranged trading.

In addition, ARC enables Compliance to identify a market participant's overall trading profile by running target searches of the participant's activity. For example, using this tool, Compliance can query which counterparties have traded opposite a specific participant, or the typical hours of a participant's trading activity. Spread User, a graphical research tool, provides a visual representation of market activity at the time of a trade. The tool enables Compliance to, among other things, determine the depth of the market connected to a particular trade, identify which side of the market placed an aggressive order that ultimately led to a trade, and visualize the trading price of an option during a particular time period.

Compliance also conducts market profiling and generates ad-hoc reports through Dashboard, a front-end system that provides access directly into Nadex's trading database. Compliance uses Dashboard to help resolve ALMAS alerts and to verify that the market maker is adhering to the terms of the Market Maker Agreement. In addition, Compliance staff uses a real-time market maker monitor to display the market maker's average spread, maximum spread, minimum spread, average bid price, average offer price, and total number of quotes made. If the average market quantity for each contract does not match the requirements set forth in the Market Maker Agreement, the CRO is notified. In one instance during the target period, in November 2011, the market maker failed to meet these requirements by failing to replenish the offer side of a single contract. After being notified of this failure by the Exchange, the market maker resumed offering a two-sided market.

Nadex also identifies trade practice issues by reviewing FCM error accounts, which Compliance is responsible for reviewing on a monthly basis. However, during the target period, there was no activity in the FCM error accounts.

#### B. Investigations

## 1. Investigation Process

Nadex tracks three types of investigations: Trade Practice Inquiries, Inquiries (“General Inquiries”), and Complaints. Trade Practice Inquiries involve trade practice issues identified through Nadex’s surveillance system described above, typically through ALMAS alerts or by customer complaints. General Inquiries involve potential problems identified by the Exchange that do not relate to trade practice issues. For example, the discovery of a prospective member’s criminal history could result in the creation of a General Inquiry.<sup>34</sup> “Complaints” are customer complaints that do not relate to trade practice issues; a complaint which raised trade practice issues would be designated as a Trade Practice Inquiry. All three categories of investigations are tracked by Compliance in an investigation log.

Compliance conducts and documents each investigation. Compliance creates an Investigation Origination Form to track the course of the investigation, resulting in a timeline of steps taken during the investigation. Ad-hoc Compliance meetings are held throughout the course of investigations to discuss case theories and dispositions. During investigations, Compliance conducts witness interviews and requests relevant documents from market participants. At the conclusion of each investigation classified as a Trade Practice Inquiry or a General Inquiry, and regardless of whether rule violations were found, a member of the Compliance Department drafts an Investigative Memorandum. The Investigative Memorandum includes the analysis used to determine whether a violation took place, facts relevant to the

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<sup>34</sup> Nadex identifies problematic criminal history and other potential problems of prospective members in several ways. First, applicants are requested to submit criminal history information on their membership application. Secondly, at the time an application is submitted, Equifax identification verification is run on the individual, which also includes an Office of Foreign Asset Control (“OFAC”) search. Finally, shortly after an application is submitted, Nadex performs a criminal background check on the individual through McDonald Information Services (“MIS”). The MIS check also includes an identity verification component. After an application has been accepted, Nadex continues to monitor, through MIS, information regarding potential criminal history. On an ongoing basis, members are required, pursuant to Nadex Rule 3.3, to notify the Exchange regarding certain criminal actions.

investigation, which if any Exchange rules were violated, and a recommended sanction. In the case of Complaints, a Complaint Report Form is drafted. This form includes, among other things, the nature of the Complaint and the recommended action to be taken. In addition, the form includes a brief timeline of the events in the case.

In the case of Trade Practice Inquiries and General Inquiries, Compliance staff prepares an Investigation Memorandum upon concluding its investigatory work. Such memoranda include staff's findings and recommendations, and are reviewed and approved by the CRO. If no rule violations were found, this conclusion is documented in the Investigation Memorandum, and the member is not contacted. In cases where rule violations were found, Compliance sends a copy of the memorandum to the subject of the investigation. The subject has 15 days to respond to or contest the sanction recommendation. If the subject contests the findings, the subject may request a formal hearing. Compliance staff determined that rule violations had been committed in the sole Trade Practice Inquiry and in each of the five General Inquiries conducted during the target period, but no formal hearings were requested.

## 2. Adequacy of Investigations

As discussed in more detail below, Nadex conducted a total of eleven investigations during the target period: one Trade Practice Inquiry, three Complaints, and seven General Inquiries.<sup>35</sup> Because the Exchange only conducted a single Trade Practice Inquiry during the target period, Division staff was unable to comprehensively assess the quality of the Exchange's trade practice investigation techniques. However, Division staff expanded its review of investigations during the target period to include all eleven investigations completed, regardless of whether such investigations involved trade practice matters.

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<sup>35</sup> This number represents investigations which were opened, active, or closed during the target period.

a. Investigative Work and Documentation

The Division found that Nadex generally maintains adequate documentation and files of its investigations. The investigation files contain relevant information, including audio recordings of telephone calls with market participants, emails between Nadex and market participants, and relevant trade records. The quality of investigative work is thorough and complete. Questions posed by Compliance to the subjects of investigations were targeted to soliciting information to determine compliance with Nadex rules. Compliance staff members were well informed during such conversations, basing their questions on trading data and other relevant data as appropriate. Division staff found that the Exchange reviewed relevant documents and used those documents effectively when conducting investigations; drafting Investigation Memoranda, Investigation Origination Forms, and Complaint Report Forms; and determining whether or not violations occurred.

Complaint Report Forms contained adequate detail regarding the nature of the complaint and the complaint's resolution. Investigation Origination Forms provide a comprehensive view of each step of an investigation, and Investigation Memoranda typically provide the facts of a case and a thorough analysis explaining whether or not a rule violation took place. The Division found, however, that some, but not all Investigation Memoranda contain a CRO signature and CRO approval date. Such a signature would provide certainty as to which version of each memorandum is final. Additionally, including the CRO approval date would enable the Exchange to more easily determine the source of any delays in the investigation process.

Accordingly, the Division recommends that:

- **The Exchange should ensure that each Investigation Memoranda includes a CRO signature and a CRO approval date.**

In one investigation (“Jurisdictional Fraudulent Account Investigation”), the Division found that the Exchange’s analysis in an Investigation Memorandum was lacking with regard to the issue of jurisdiction. In the Jurisdictional Fraudulent Account Investigation, the Exchange concluded that an account had been set up without the knowledge of the individual (“account holder”) in whose name the account was created. In September 2011, the account holder alleged that another individual (“other individual”), who had previously applied for a Nadex account in his own name, had fraudulently created her account. The other individual did not fund the account in his own name, and at the time, Nadex’s jurisdiction only extended to individuals who had successfully funded their Nadex accounts.<sup>36</sup> In the investigation memorandum, Compliance concluded that the other individual had engaged in conduct that “would violate numerous Exchange rules.” As a result, in addition to closing the account holder’s account, Nadex denied the other individual’s account application and barred him from reapplying to the Exchange in the future. In a follow-up conversation after Division staff’s onsite visit, Compliance explained that the Exchange had considered the issue of jurisdiction and concluded it did not have jurisdiction over the other individual. The reasons for this conclusion were that the other individual failed to fund the account that he had created in his own name and that there was no “concrete proof” that he had control over the account holder’s account. However, the memorandum contained no discussion regarding whether the Exchange had jurisdiction over the other individual. Accordingly, the Division recommends that:

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<sup>36</sup> On August 20, 2012, Nadex implemented Rule 2.10 (Consent to Jurisdiction), which provides: “Any Person initiating or executing a transaction on or subject to the Rules of the Exchange directly or through an intermediary, and any Person for whose benefit such a transaction has been initiated or executed, expressly consents to the jurisdiction of the Exchange and agrees to be bound by and comply with the Rules of the Exchange in relation to such transactions, including, but not limited to, rules requiring cooperation and participation in investigatory and disciplinary processes.”

- **In cases where the Exchange determines that it lacks jurisdiction over persons subject to a disciplinary investigation, the corresponding investigation memoranda should include a written analysis of the reasons jurisdiction is lacking.**

b. Review of Investigations

Division staff reviewed the steps taken by the Exchange in each investigation conducted during the target period as well as the disposition of each such investigation. The Division found that the Exchange’s actions, and the sanction imposed, were appropriate in ten of the eleven investigations conducted during the target period.

All eleven investigations conducted during the target period have been closed. The sole Trade Practice Inquiry involved a member who engaged in pre-arranged trading in violation of Nadex Rule 5.19(b), (i), and (o). Because Compliance believed that the member had controlled and fraudulently created the accounts involved in the pre-arranged trading as well as other accounts, Compliance determined that the member had violated Nadex Rules 3.1, 5.19(c) and (k).<sup>37</sup> Finally, by failing to cooperate in the investigation, the Exchange concluded that the member violated Nadex Rule 3.3.<sup>38</sup> Nadex closed the investigation by revoking the individual’s Nadex membership and prohibiting him from trading Nadex products in the future.

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<sup>37</sup> Nadex Rule 3.1 – Trading Members – Applications, Classifications, and Privileges

(f) A Trading Member that is an individual may not maintain and/or trade more than one Nadex account

Nadex Rule 5.19 – Prohibited Transactions and Activities

...

(c) No Person shall enter into or attempt to enter into any trade on the Market that does not result in a change of beneficial ownership . . . or that has some other illegitimate purpose

...

(k) No Person shall intentionally provide erroneous or fraudulent information to Nadex on a membership application or otherwise

<sup>38</sup> Nadex Rule 3.3 – Member Obligations

(a) Each Member and any Authorized Trader(s) thereof, must comply with these Rules, applicable provisions of the Commodity Exchange Act, and relevant Commission regulations. Each Member and any Authorized Trader(s) thereof must also cooperate promptly and fully with Nadex, its agents, and/or

Of the three Complaints closed during the target period, two involved allegations that the settlement price was incorrect; in both instances, Nadex determined that the settlement price was accurate and therefore took no action with respect to the Complaints. The remaining Complaint involved a member alleging that his account was negative because his account had been hacked. As evidence, the member stated that bank accounts owned by other individuals had been added to his Nadex account. Nadex discovered a software bug which could have allowed certain members to see the bank account number and routing number of other members, though it found no evidence that any accounts had lost money as a result of the bug. The Exchange closed the investigation by resolving the bug, offering identity theft protection to the members whose accounts were affected, and providing a credit to the account of the member who had raised the issue.

Of the seven General Inquiries, three involved accounts being opened fraudulently (“Fraudulent Account Investigations”). The first Fraudulent Account Investigation involved three Nadex accounts which had been created and funded through checks drawn on credit cards without the knowledge of the individuals in whose names the accounts were created. Nadex returned the funds to the credit card company and closed the member accounts. In the second such case, the Jurisdictional Fraudulent Account Investigation discussed above, Nadex closed the account in question, denied the application of the individual alleged to have fraudulently opened an account, and barred that individual from opening a Nadex account in the future.<sup>39</sup> The third Fraudulent Account Investigation involved a Nadex account that was funded and traded without

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the Commission in any investigation, call for information, inquiry, audit, examination, or proceeding . . . If any Member or Authorized Trader(s) thereof fail to satisfy these obligations, Nadex may revoke or suspend the Member's privileges in full or in part. Each Member may also be subject to civil or criminal prosecution.

<sup>39</sup> See Section VII(B)(2)(a).

the knowledge of the individual in whose name the account had been created. The Exchange closed the account and did not hold the individual in whose name the account had been created responsible for an account deficit caused by the trading.

The four remaining General Inquiries involved a variety of issues. The first such case involved a member (“sender”) who had made deposits from his bank account into the Nadex accounts of two other members (“recipients”). The Exchange determined that the sender and recipients had violated Nadex Rule 3.1 by funding Nadex accounts with a bank account in another individual’s name, and that the recipients had violated Nadex Rule 5.2 by allowing the sender to access their accounts.<sup>40</sup> The second General Inquiry involved an applicant who owned two corporate entities. The applicant provided all requested identification verification documents and disclosed a criminal background on his application. After Compliance assessed the applicant’s background and determined that the nature of the disclosed criminal incidents did not pose a threat to Nadex, Compliance allowed the individual to become a member. After the member made a deposit of \$15,000, Compliance requested additional information regarding one of the member’s corporate entities. In response, the member stated that the corporate entity

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<sup>40</sup> Nadex Rule 3.1 – Trading Members – Applications, Classifications, and Privileges

(a) To be eligible to become a Trading Member:

(i) An applicant who is an individual, must:

. . .

3) have an account or accounts in the Trading Member's name with a Financial Institution that the Trading Member will use to fund its Nadex account at the Nadex settlement bank and to receive funds from its Nadex account . . . .

Nadex Rule 5.2 – Trading Member Access to Nadex

(d) Each Trading Member will be responsible for protecting its ID and password . . . In addition, a Trading member may not knowingly or negligently permit any Person not authorized by Nadex and by the Trading Member to use the ID and password to access the secure portion of the Nadex website. Each Trading Member is required to immediately notify Nadex if it knows, or has reason to believe, that its ID or the ID and/or password of any Authorized Trader have been disclosed to any Person not authorized by Nadex and the Trading Member to use such ID and/or password . . . .

invested in domain names, that he is not a professional trader, that he does not solicit funds, and that all funds in his Nadex account were solely his. Compliance determined that neither corporate entity owned by the member appeared to be soliciting funds for investment. In resolving the General Inquiry, Compliance found no evidence that the member had violated Nadex rules. The third General Inquiry involved a member who had failed to disclose in his application that he was subject to a state-issued Desist and Refrain Order (“Order”) for acting as a broker-dealer and trading advisor without registering with the SEC or obtaining a certificate from the state, and for making untrue or misleading statements to customers. Due to the nature of the Order and the member’s failure to disclose it, the Exchange determined that the member had violated Rules 3.1 and 3.3.<sup>41</sup> The Exchange terminated the member’s account and

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<sup>41</sup> Nadex Rule 3.1 – Trading Members – Applications, Classifications, and Privileges

(a) To be eligible to become a Trading Member:

(i) An applicant who is an individual, must:

...

3) have an account or accounts in the Trading Member’s name with a Financial Institution that the Trading Member will use to fund its Nadex account at the Nadex settlement bank and to receive funds from its Nadex account. . . .”

Nadex Rule 3.3 – Member Obligations

...

(d) Each Member must immediately notify Nadex in writing upon becoming aware:

(i) that the Member, any of the Member’s officers or any of the Member’s Authorized Traders has had trading privileges suspended, access to, or membership or clearing membership in, any Regulatory Agency denied;

(ii) that the Member, any of the Member’s officers or any of the Member’s Authorized Traders has been convicted of, pled guilty or no contest to, or entered a plea agreement to, any felony in any domestic, foreign or military court;

(iii) that the Member, any of the Member’s officers or any of the Member’s Authorized Traders has been convicted of, pled guilty or no contest to, or entered a plea agreement to a misdemeanor in any domestic, foreign or military court which involves:

(1) embezzlement, theft, extortion, fraud, fraudulent conversion, forgery, counterfeiting, false pretenses, bribery, gambling, racketeering, or misappropriation of funds, securities or properties; or

membership, returned the funds therein, and barred the member from opening a new Nadex account for two years.

In the final General Inquiry, the Access Sharing Investigation, a Nadex member shared access to his account with his son. Initially, the member was specifically reminded not to do so; less than a year later, the Exchange issued a warning letter for improperly sharing access to an account. The case first came to the attention of the Compliance Department in August 2011 through a call with Nadex Customer Service. In the call, the member said that the member's son had set up the account. The member called back and said, "we just got locked out of our new account," and "well, my son was signing in." Customer Service informed the member that Nadex rules only permit one person to operate an account. In reply, the member said, "I understand but it can't work that way with me . . . he's actually working for me doing all my trading." The following day, Compliance emailed the member to inform him that "individual accounts at Nadex are not permitted to have authorized traders other than the account owner." Furthermore, Compliance stated, "pursuant to Nadex Rule 5.2(d), you may not share your Nadex username and password with anyone not authorized by Nadex." Compliance asked him to confirm that only he would access the account. The member replied in the affirmative, stating, "only I will be accessing the account." In May 2012, after Nadex learned that the member had continued to let his son trade in the account, the Exchange issued a warning letter to the member

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(2) any transaction in or advice concerning futures, options on futures, leveraged transactions or securities;

(iv) that the Member, any of the Member's officers or any of the Member's Authorized Traders has been subject to, or associated with a firm that was subject to regulatory proceedings before any Regulatory Agency;

(v) that the Member, any of the Member's officers or any of the Member's Authorized Traders is currently a party to any investigation or proceeding, the resolution of which could result in an event described in Rule 3.3(d)(i)-(iv)

for violating Nadex Rules 3.5 and 5.2, and a warning letter to the son for violating Nadex Rules 3.1, 3.5 and 5.2.<sup>42</sup>

The Division notes that current Commission Regulation 38.158(e), with which DCMs were required to comply by October 17, 2012, after the target period, would preclude the Exchange from issuing a warning letter in a similar case in the future. That rule prohibits DCMs from issuing more than one warning letter to the same person found to have committed the same rule violation within a rolling twelve month period. Further, the Division has previously recommended in past rule enforcement review reports that exchanges not issue more than one warning letter to the same market participant for the same violation in a rolling twelve month

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<sup>42</sup> Nadex Rule 3.5 – Authorized Traders

- (a) . . . Only those individuals authorized by the Trading Member and approved by Nadex may enter and execute transactions on the Market for the Trading Member's account.

Nadex Rule 5.2 – Trading Member Access to Nadex

(d) Each Trading Member will be responsible for protecting its ID and password, and with respect to an entity Trading Member, the ID(s) and password(s) of its Authorized Trader(s), from improper disclosure. In addition, a Trading Member may not knowingly or negligently permit any Person not authorized by Nadex and by the Trading Member to use the ID and password to access the secure portion of the Nadex website. Each Trading Member is required to immediately notify Nadex if it knows, or has reason to believe, that its ID or the ID and/or password of any Authorized Trader have been disclosed to any Person not authorized by Nadex and the Trading Member to use such ID and/or password. Under any circumstances, the Trading Member will be deemed to know that such ID and/or password have been disclosed to an unauthorized person 12 hours after any order is entered by that unauthorized person in your account.

Nadex Rule 3.1 – Trading Members – Applications, Classifications and Privileges

To be eligible to become a Trading Member:

- (i) An applicant who is an individual must:
  - . . .
  - (4) certify that
    - . . .
    - (iv) the applicant will trade only for itself and will not trade as an intermediary for any other person or entity
- (f) A Trading Member that is an individual, may not maintain and/or trade more than one Nadex account . . . .

period.<sup>43</sup> The Division expects all exchanges to take note of recommendations in its public rule enforcement review reports and apply such recommendations accordingly within their own programs. Consistent with its previous recommendations, and as is now required by Commission Regulation 38.158(e):

- **The Exchange may not issue more than one warning letter to the same person or entity found to have committed the same rule violation within a rolling twelve month period.**

### 3. Timeliness of Investigations

Division staff examined all eleven investigations conducted during the target period for timeliness. As mentioned above, during the target period, the Exchange closed ten investigations. The sole investigation conducted during the target period that remained open was closed approximately four months after the conclusion of the period. Each of the eleven investigations was completed in 115 days or less, and the average length of investigation was approximately 46 days. Table 4 below provides the average length of investigation by investigation type. The Division found that all eleven investigations were conducted in a timely manner.

Table 4. Length of investigations.

	<b>Number</b>	<b>Average length</b>
Trade Practice Inquiries	1	92 days
General Inquiries	7	58 days
Complaints	3	3 days

### 4. Investigation Log

Nadex maintains a log detailing all investigations at the Exchange (“investigation log”). The investigation log identifies each investigation as belonging to one of the three categories

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<sup>43</sup> See “Rule Enforcement Review of the Minneapolis Grain Exchange,” (2009), at 9 and 58. See also “Rule Enforcement Review of the Kansas City Board of Trade,” (1998).

mentioned above:<sup>44</sup> Trade Practice Inquiries, General Inquiries, or Complaints. The log lists for each matter which rules were violated, if any, and any attendant disciplinary action. The investigation open date and the investigation close date are listed in each instance.

The open date corresponds to the date the activity in question is identified as potentially problematic after an initial review is conducted by Compliance. For Trade Practice Inquiries triggered by ALMAS alerts, the open date corresponds to the date on which Compliance reviews the alert and determines that an investigation is warranted. In most cases, the open date for these investigations corresponds to the date of the ALMAS alert because ALMAS alerts generated during the business day are reviewed during the same business day. For ALMAS alerts which are generated in overnight trading, which Compliance reviews on the first business day after the alert is generated, the start date corresponds to the first business day after the alert is generated. For investigations triggered by complaints, the open date corresponds to the date on which Compliance determines that an investigation is warranted after reviewing the complaint.<sup>45</sup> Typically, the open date corresponds to the same day as the complaint is made because Compliance reviews most complaints the day they are made. However, complaints received by Customer Service after work hours would be reviewed by Compliance the following business day. Accordingly, the open date for such complaints would correspond to the business day after the complaint was received.

The close date corresponds to the date on which the case is considered final. This date depends on the nature of the case. In disciplinary cases in which the member does not contest the findings in the investigation memorandum, the close date represents the date on which the

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<sup>44</sup> See Section VII(B)(1).

<sup>45</sup> As explained in Section VII(B)(1), complaints are designated as Trade Practice Inquiries if trade practice issues are involved. Customer complaints which do not involve Trade Practice Issues are designated as Complaints.

findings are deemed admitted, which occurs 15 days after the member is notified of the findings. In cases in which no recourse is recommended, or a member voluntarily terminates his or her account, or is sent a warning, the close date represents the date the matter is resolved with the member. Neither the close date nor any other date on the chart identifies the date when an investigation was completed by staff. In addition, the log does not separately identify the date of CRO approval.

The Division concludes that the investigation log is not sufficiently detailed. Although the dates and other information on the log appear to be accurate, and the open date tracks when Compliance begins investigations, neither the close date nor any other date on the chart identifies when investigatory work ceased. Thus, the log does not track the duration of Exchange staff's investigatory work. The absence of such information on the log could hinder the Exchange's ability to evaluate the timeliness of an investigation. In addition, the omission of the date of CRO approval could prevent the Exchange from readily identifying the probable reason why an investigation was untimely. Accordingly, the Division recommends that:

- **The Exchange should ensure that Nadex's investigation log contains all necessary information for each investigation, including the date on which each investigation was completed by staff and the date of CRO approval.**