



## U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Clearing and Risk

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Director

CFTC Letter No. 14-04  
Exemption  
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 Exemption from Certain Commission Regulations

Dear Mr. McDermott:

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

### I. Overview of Nadex

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<sup>1</sup> Under Regulation 140.99(a)(1), the Division of Clearing and Risk (“Division”), acting under delegated authority from the Commission, may issue a written grant of relief from the applicability of the Commodity Exchange Act (“CEA”) or of a rule, regulation or order issued thereunder by the Commission. Only the party requesting an exemptive letter may rely on the letter. Commission regulations referred to herein are found at 17 C.F.R. Ch. I (2013).

<sup>2</sup> 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.

<sup>3</sup> See 17 C.F.R. pt. 39 (2013).

<sup>4</sup> Nadex also sought interpretive guidance for 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”<sup>5</sup> of Nadex, who deposit funds directly with Nadex and trade with direct access to Nadex. Intermediated trades must be executed through an “FCM Member”<sup>6</sup> of Nadex.

Pursuant to Nadex’s order of registration as a DCO (“Amended DCO Order”), Nadex is limited to clearing only “fully collateralized” contracts.<sup>7</sup> 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.<sup>8</sup>

## II. Definition of “Clearing Member”

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

<sup>6</sup> 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 is 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 must 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 also checks to confirm that the funds necessary for full collateralization are actually held in the FCM Member’s settlement account at Nadex.) FCM Members do 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 Members’ positions.

Currently, Nadex does not have any FCM Members.

<sup>7</sup> 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.

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

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 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 actually “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(c)(1)*. Regulation 39.11(c)(1) requires a DCO to perform monthly stress testing in order to make a reasonable calculation of the financial resources it would need in the event of a default by the clearing member creating the largest exposure. Nadex represents that it makes a financial resource determination prior to each trade when it checks the Member’s account to ensure that there are enough funds on deposit to cover the Member’s maximum loss. Nadex seeks an exemption from the requirement to stress test its financial resources on a monthly basis pursuant to Regulation 39.11(c)(1).

*Commission Regulation 39.11(e)(1)(ii)*. This provision requires a DCO to have financial resources sufficiently liquid to enable the DCO to fulfill its obligations as a central counterparty during a one-day settlement cycle. Regulation 39.11(e)(1)(ii) further requires that a portion of those financial resources be in the form of cash, U.S. Treasury obligations, or high quality, liquid, general obligations of a sovereign nation and sets forth the method for calculating that portion. Nadex seeks exemptive relief from the clause relating to the calculation provision, which requires that the financial resources be in an “amount greater than or equal to” the calculated amount, and the calculation provision itself. Nadex represents that, as required by the

Amended DCO Order, Nadex's contracts are considered "fully collateralized" because Nadex holds "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." Nadex represents that such funds are deposited with Nadex in advance of trading and held in cash; therefore, Nadex seeks to be exempted from the calculation requirement of Regulation 39.11(e)(1)(ii).

### Relief

The Division's understanding is as follows: Nadex clears only fully collateralized contracts; Member funds are collected in advance of trading; and such funds are in cash and are held to fully collateralize any trading. Based upon these representations, the Division herein exempts Nadex from complying with Regulation 39.11(c)(1) because Nadex maintains sufficient liquidity by having enough funds on hand to meet daily obligations and holding those funds entirely in cash. As far as complying with the calculation provision of Regulation 39.11(e)(1)(ii), Nadex does not need to, and it could not, perform the required calculation based on Nadex's fully-collateralized clearing model. In this regard, Nadex is exempt from complying with the calculation provision of Regulation 39.11(e)(1)(ii).

### B. Participant and Product Eligibility

*Commission Regulation 39.12(a)(5)(i).* Regulation 39.12(a)(5)(i) requires a DCO to require all of its clearing members, including those that are not FCMs, to provide the DCO with periodic financial reports that contain any financial information that the DCO determines is necessary to assess whether participation requirements are being met on an ongoing basis. Nadex seeks exemptive relief from this requirement to the extent that it may apply to Trading Members. Nadex has represented that Trading Members are, for the most part, retail customers who would not typically prepare periodic financial reports and, because they are limited to fully collateralized trading, present no credit or default risk to the DCO. Nadex, however, affirms that because FCM Members would handle customer funds, Nadex rules do require that FCM Members provide Nadex with "statements of financial condition at such times and in such manner as may be required from time to time."

*Commission Regulation 39.12(a)(5)(i)(B).* Nadex seeks exemptive relief with respect to the requirement that all non-FCM clearing members make available to the Commission the periodic financial reports required under Regulation 39.12(a)(5)(i) to the extent that it may apply to Trading Members based on the retail nature of Trading Members, for the same reasons set forth above.

*Commission Regulation 39.12(b)(3).*<sup>9</sup> Regulation 39.12(b)(3) requires a DCO to provide for non-discriminatory clearing of a swap executed bilaterally or on or subject to the rules of an unaffiliated swap execution facility ("SEF") or DCM. Nadex seeks relief from this requirement

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<sup>9</sup> In the Request, Nadex petitioned for interpretive relief with regard to Commission Regulation 39.12(b)(3) and (4). However, the Division believes it is more appropriate to grant an exemption.

because the Amended DCO Order limits it to clearing only fully collateralized, cash-settled contracts listed for trading on the Nadex DCM. Accordingly, Nadex asserts that it cannot accept contracts executed bilaterally or on a SEF or other DCM as required by Regulation 39.12(b)(3).

*Commission Regulation 39.12(b)(4).* Regulation 39.12(b)(4) provides that a DCO shall not require that one of the original executing parties be a clearing member in order for a product to be eligible for clearing. Nadex states that because the Amended DCO Order requires all of its cleared products to be executed on the Nadex DCM and fully collateralized, all the executing parties must be members of the Nadex DCM/DCO or intermediated customers of FCM Members of the Nadex DCM/DCO.

#### Relief

The purpose of Regulation 39.12(a)(5)(i) is to ensure that a DCO has means by which to assess its clearing members' compliance with the DCO's own participation requirements. The Division's understanding is that Nadex requires Trading Members to fully collateralize any trade before the trade is entered. Because of this, Trading Members present no credit or default risk to Nadex, and Nadex imposes no further financial requirements on Trading Members. Therefore Nadex would not need to receive periodic financial reports from Trading Members in order to assess their compliance with Nadex requirements. Accordingly, the Division exempts Nadex from the requirements of paragraphs (a)(5)(i) and (a)(5)(B) of Regulation 39.12, in so far as such regulations apply to Trading Members.

With regard to the "open access" provisions of Regulations 39.12(b)(3) and (b)(4), the Amended DCO Order limits it to clearing only fully-collateralized, cash-settled contracts listed for trading on the Nadex DCM. Because such limitation was imposed by the Commission, the Division exempts Nadex from paragraphs (b)(3) and (b)(4) of Regulation 39.12.

#### C. Risk Management

*Commission Regulation 39.13(h)(3).* Regulation 39.13(h)(3) requires a DCO to conduct stress testing on a daily basis with respect to each large trader who poses significant risk to a clearing member or the DCO, and on at least a weekly basis with respect to each clearing member account, by house origin and by each customer origin. Nadex represents that because it is not a margined DCO and requires full collateralization prior to any trading, it does not conduct stress tests with respect to large traders. Nadex further represents that it evaluates large trader reports primarily for market surveillance and trade practice purposes, not for risk management purposes. Therefore, Nadex seeks exemptive relief from the requirements of Regulation 39.13(h)(3) so long as Nadex requires Members to fully collateralize all positions.

#### Relief

It is the Division's understanding, based on Nadex's representations, that Nadex does not conduct stress tests because it ensures that 100% of any exposure on a trade is fully collateralized before the trade is allowed to match. Based upon these representations, the Division exempts Nadex from complying with Regulation 39.13(h)(3).

*D. Treatment of Funds*

*Commission Regulation 39.15(d)*. Nadex rules currently permit Nadex to transfer positions only under very limited circumstances. Nadex believes it would be inappropriate to permit a transfer of an established position at the request of a customer given the obligation of FCM Members to ensure that they hold sufficient customer funds to fully secure any customer trade before submitting such trade to Nadex. Additionally, Nadex notes that Trading Members are primarily retail traders and none are FCMs; accordingly, it would not be appropriate to transfer their positions to a different Trading Member. Nadex is therefore seeking relief from the requirements of Regulation 39.15(d).

*Relief*

It is the Division's understanding that Trading Members are not FCMs and therefore do not clear on behalf of customers. Accordingly, the requirements contained in Regulation 39.15(d) do not apply to Nadex under the present circumstances because the purpose of the transfer provision is to permit a customer to move positions and funds from one FCM to another without having to book out those positions. Nonetheless, the Division disagrees with Nadex's assertion that, if Nadex signs up FCM Members, it would be inappropriate to permit the transfer of an established position and funds at the request of a customer given the obligation of FCM Members to ensure that they hold sufficient customer funds to secure any trade before submitting a customer order to Nadex. The Division notes that Regulation 39.15(d) requires the transfer of "positions and related funds," so the funds would transfer as well. In the event that Nadex adds FCM Members, the Division would expect Nadex to comply with Regulation 39.15(d) as it pertains to those Members. In the event that Nadex adds only one FCM Member, then that Member would have to close out the positions of its customers.

*E. Public Information*

*Commission Regulation 39.21(c)(3)*. Regulation 39.21(c)(3) requires a DCO to publicly disclose its margin-setting methodology, the size and composition of its financial resource package available in the event of a clearing member default, and its default rules and procedures. Nadex requires 100% of the funds necessary to fully collateralize a Member's positions to be deposited with Nadex before a trade is executed. Thus, Nadex does not use a margin methodology or face the risk of a clearing member default, and it seeks an exemption from this requirement.

*Commission Regulation 39.21(d)*. Regulation 39.21(d) requires a DCO to make its rulebook, a list of all current clearing members, and the information listed in subsection (c) (which is discussed in the above paragraph), readily available to the general public, in a timely manner, by posting such information on the DCO's website. Nadex seeks an exemption from Regulation 39.21(d) because Trading Members are predominantly retail traders and, consequently, Nadex believes it should not be required to publicly disclose their names.

However, Nadex is not requesting relief from the Commission's requirement that Nadex publicly disclose the names of FCM Members if and when Nadex obtains FCM Members.

*Relief*

The Division understands that Nadex does not use a margin-setting methodology, maintain a financial resources package available in the event of a clearing member default, or have default rules and procedures because Nadex requires 100% of the funds necessary to fully collateralize a Member's position to be on deposit with Nadex prior to the execution of a trade. In addition, the Division understands that Trading Members are predominantly retail customers. Therefore, based upon the representations made in the Request, the Division exempts Nadex from complying with paragraphs (c)(3) and (d) of Regulation 39.21. With regard to Regulation 39.21(d), however, the relief does not extend to Nadex's obligation to make public a list of all FCM Members.

**IV. Conclusion**

This letter is based upon the representations of Nadex, as well as the Nadex Amended DCO Order and applicable laws and regulations as currently in effect. The Division believes that granting the Request would not be contrary to the public interest or to the purposes of those provisions of the Commission regulations from which Nadex has sought relief. However, any new, different or changed material facts or circumstances could change the Division's position and 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](mailto:amusalem@cftc.gov).

Sincerely,

Ananda Radhakrishnan  
Director