<u>Comment on Proposed SR-NASD-2006-026; SR-NASD-2006-027 - NASDAQ Plans to Implement New Pricing for CTCI Connectivity</u>

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<u>Summary</u>

The U.S. financial securities industry is best served by ensuring that clearing firms have access to intraday risk management tools that can effectively monitor acceptable levels of credit and risk exposure for correspondent firms. NASD member clearing firms are subject to a Securities and Exchange Commission ("SEC") Order [Release No. 34-47208; File No. SR-NASD 2002-157] that requires them to use NASDAQ's ACT Risk Management system unless they have a comparable intraday risk management system; however, comparable systems require access to the very data that is the subject matter of SR-NASD-2006-026 and SR-NASD-2006-027. The proposed price increase under SR-NASD-2006-026 and SR-NASD-2006-027 would impose an undue burden on competition and be contrary to the purposes of the Securities Exchange Act of 1934 unless measures are taken to ensure that clearing firms have continued access to execution data on cost effective terms so as to allow alternative providers of intraday risk management systems to compete on a level playing field with NASDAQ's ACT Risk Management. **<u>FTEN, Inc. (FTEN) respectfully requests that proposed SR-NASD-2006-026 and SR-NASD-2006-027 be modified such that the term "Station" is clearly defined specifically within the context of clearing firms to refer only to the cost of bandwidth necessary to transmit real time execution messages for all correspondents of a clearing firm.</u>**

<u>NASDAQ's ACT Risk Management and Current Market Conditions</u>

In October 1990, the SEC approved the risk management functions of NASDAQ's Automated Confirmation Transaction (ACT) service. The SEC mandated that all NASD members participate in the service "[i]n order to establish ACT as the industry standard for reporting and comparing equity transactions in The NASDAQ stock market." These rules required that all NASD member clearing firms use NASDAQ's risk management system known as ACT Risk Management. In January 2003, the SEC issued an Order approving an opt-out provision from ACT Risk Management [Release No. 34-47208; File No. SR-NASD 2002-157]. In this order, the SEC said "The ability of [clearing firms] to adequately assess the risk of their correspondent firms is critical to the protection of investors and the public interest, as required by the Act. Therefore, the Commission finds that the [request by NASDAQ to modify the rule otherwise requiring all clearing firms use NASDAQ's ACT Risk Management System] is consistent with the Act because the proposal seeks to ensure that all NASD clearing members retain the ability to monitor the trading activities and risk exposures of their correspondent firms, either by using the ACT risk management program, or another risk management tool comparable to ACT's risk management program. The proposed rule change also fosters cooperation and coordination with persons engaged in the regulating, clearing, settling, and processing of information with respect to and facilitating transactions in securities because it ensures that NASD clearing members utilize a risk management tool that monitors the acceptable levels of credit and risk exposure for correspondent firms, which helps to ensure the rapid and reliable comparison and settlement of transactions." With the benefit of hindsight, it seems that this enlightened view taken by NASDAQ would allow clearing firms to produce their own systems to evaluate risk. However, as with many software and services markets, the ability to provide tools to address enterprise needs often comes from third parties who can develop more sophisticated technology offerings by addressing the needs of numerous clients and meeting the market needs of many, as opposed to just addressing the in-house needs of a single firm.

In the 1990s when these rules were promulgated, NASDAQ's ACT Risk Management system provided adequate coverage of intraday trading and volatility risks in the Over-the-Counter (OTC) market because NASDAQ was, for all practical purposes, the OTC market. But, with the dramatic increase in popularity of ECNS since the 1990s (which for the most part are not covered by ACT Risk Management), ACT Risk Management now covers less than fifty percent of the OTC market. And, since the 1990s the lines between securities listed on the New York Stock Exchange ("Listed" securities) and OTC securities have blurred and trading now frequently involves market sectors that are unrelated to whether stocks are Listed or OTC. ACT Risk Management does not provide coverage for Listed trades and provides coverage for less than half the OTC market. When taken together, ACT Risk Management, while an excellent tool in its day now covers at most one-third of the market.

Intraday RiskXposure

FTEN is an enterprise software provider with a corporate mandate to maintain its independence and facilitate financial commerce by identifying and addressing inefficiencies in existing financial services processes and procedures – FTEN is not an exchange, a clearing firm, a financial services company or a broker dealer. FTEN was asked by clearing firms if it could help address the growing challenges in managing and monitoring acceptable levels of intraday credit and risk exposure for correspondents resulting from: (1) Market fragmentation - in addition to the longstanding OTC/Listed dichotomy eluded to above, the existence of multiple liquidity destinations for OTC trading creates risk scenarios that are not capable of being detected at any one of the individual liquidity destinations; (2) Limitations of pre-trade risk management systems – pre-trade risk management systems fail to provide effective risk management for trades handled outside the systems, information about which is not available until the next trading day when significant harm from risk infractions may have occurred and the availability of effective remedial actions may be severely limited. In addition, these systems are further hampered in their attempt to provide adequate protection due to the increasing popularity of (a) multiple party transactions, (b) disparate, non-integrated trading platforms and (c) black-box trading strategies that do not support latency introduced by pre-trade processes; and (3) Delayed implementation of shorter settlement cycles – the practical difficulties of implementing Straight-Through-Processing and shortened settlement cycles have delayed the anticipated risk management benefits that these initiatives were supposed to make available. Solutions that provide broader market transparency, facilitate improved regulatory oversight, enhance accountability and improve intraday risk management without requiring changes to established procedures or systems are therefore necessary to address the market trends identified above.

In response to these client requests, FTEN developed Intraday RiskXposure ("RiskXposure" or "RX"). RiskXposure is an innovative, patent-pending system (USPTO Pub. No.: 20050203825 - Financial Data Processing System) that enables clearing firms to comply with the SEC Order to "utilize a risk management tool that monitors the acceptable levels of credit and risk exposure for correspondent firms." RiskXposure provides better management and monitoring of acceptable levels of intraday credit and risk exposure for correspondents by uniquely aggregating, analyzing and processing execution messages from each of the liquidity destinations (e.g., NASDAQ, NYSE, INET, BRUT, ARCA, etc.) throughout the trading day. In addition to providing nearly 100% market coverage, RiskXposure also: (1) imports clients' positions - the only way to calculate real Profit & Loss and to assess real risk within the context of correspondents' holdings; (2) generates intraday reports on securities analysts say to watch - RiskXposure is the only system that provides information on current holdings - opening positions plus intraday trades, so reports have real, actionable value to risk managers - should a client already have a position in, or the millisecond a client takes a position in, a flagged security then risk managers are alerted; (3) supports "what-if" modeling - RiskXposure is the only system that enables risk managers to search for correspondents holding a particular security intraday and model price movement by an estimated percentage to highlight those that could be in trouble if such price movement were to occur; and (4) can store historical data and provide research and reporting tools to support trend analysis, verification of third party transaction fees and response to regulatory inquiries and audits.

In March 2005, NASDAQ announced new port fees for NASDAQ and BRUT which made the cost of acquiring execution data necessary to support alternative intraday risk systems in FIX format economically prohibitive. This pricing generated adverse public reaction (e.g., Securities Industry News ran a story entitled Nasdaq: Mixed Message on Connectivity stating that NASDAQ might have "...a nasty April Fools' Day surprise for some correspondent clearers ..." - see http://securitiesindustry.com/midweek.cfm?articleid=15188). NASDAQ subsequently informed FTEN that it had not contemplated the impact of port pricing changes on FTEN's Intraday RiskXposure offering since no one else uses execution messages in the novel and unique way that FTEN does to provide real-time, cross-market intraday risk management. In fact, despite overwhelming evidence that risk management is a key issue facing financial services companies generally and clearing firms specifically due to their correspondent oversight and financial responsibilities, other than FTEN's Intraday RiskXposure offering there is still no third party alternative to ACT Risk Management and ACT Risk Management fails to provide coverage for Listed securities and covers only one-third of the OTC market. Over the ensuing year, NASDAQ and FTEN have held discussions regarding a variety of different ways to ensure continued access to execution data necessary to support alternative risk management solutions (e.g., ensuring continued access to execution messages in CTCI format), although it is important to note that NASDAQ data is only a minority of the data relevant to comprehensive real-time management of cross-market intraday credit and exposure risk.

Proposed New Pricing for CTCI Connectivity

The proposed new pricing for CTCI connectivity set forth in SR-NASD-2006-026 and SR-NASD-2006-027 may make sense in the context of broker-dealers and clients who want access to execution messages for their own purposes. However, in the context of clearing firms who have an affirmative obligation to manage the risk and trading activities of their correspondents, the proposed pricing creates an inherent conflict of interest since clearing firms must "monitor the trading activities and risk exposures of their correspondent firms, either by using the ACT risk management program, or another risk management tool comparable to ACT's risk management program" and comparable alternative systems require access to the very data which is the subject matter of SR-NASD-2006-026 and SR-NASD-2006-027. Other liquidity destinations either charge clearing firms nothing for this data or only charge minimal fees to cover the actual cost of providing the data. Execution messages for NASDAQ affiliates are no longer available on economically viable terms in FIX format and the proposed pricing set forth in SR-NASD-2006-026 and SR-NASD-2006-027, if not carefully defined, could make the only remaining format in which such data is provided, CTCI, uneconomical as well. We believe clearing firms should be entitled to this data on fair and equitable terms so they can exercise their option to use an alternative intraday risk management system and comply with the SEC Order. It should also be noted that in the context of clearing firms, the data in question reflects trades done by their correspondents for which the clearing firms are ultimately financially responsible, the details of which they are legally entitled to and copies of which they already receive the next day from the National Securities Clearing Corporation without additional charge. Therefore, the provision of this very same data to clearing firms in real-time as necessary to support alternative intraday risk systems should be provided to them for only the incremental cost of providing it in real time, a requirement easily and cost effectively met with the commodity information technologies readily available today.

Having previously increased the fees for execution messages provided in FIX format (see http://securitiesindustry.com/midweek.cfm?articleid=15188 referenced above), the proposed price changes set forth in SR-NASD-2006-026 and SR-NASD-2006-027 would correlate fees charged for execution messages provided in the only other available format, CTCI, to the number of "Stations" involved without including a precise definition of "Station." This proposed terminology makes sense only to the extent the term "Station" is defined to refer to a permissible user of data versus the number of parties for whom data is provided. Such an interpretation would be consistent with the idea that the data actually belongs to the clients who originate and pay for trades and clearing firms who are ultimately financially responsible for the trades. In the current technology environment there is relatively minimal cost associated with providing this data on a real time basis. Though clearing firms will obviously require larger data communication "pipes" to provide relevant data for multiple clients on a real time basis, the incremental cost should be de minimus and should only relate to the actual cost of transmitting more packets of information. If the current proposal is to be primarily based on the definition of the word “Station,” the term should be defined to refer to a permissible user of data versus the number of parties for whom data is provided. For example, with regard to a broker-dealer each "Station" should encompass data associated with a Market Participant ID (“MPID”) that the broker-dealer owns, but with regard to a clearing firm a "Station" should encompass data associated with all MPIDs for which the clearing firm provides clearing services. If the word “Station” were to be defined otherwise (e.g., if the term were defined in the context of clearing firms such that each correspondent of the clearing firm would equal a “Station”), then there would be no economic means to provide third party risk analysis systems as data fees would have to be paid for hundreds if not thousands of clearing firm correspondents. Surely this cannot be the result intended by allowing NASDAQ affiliates to charge for data on trades originated by clients who have already paid for the trades and the reporting and administrative costs associated with such trades and with respect to which clearing firms are ultimately financially responsible.

Conclusion

FTEN, Inc. respectfully requests that proposed SR-NASD-2006-026 and SR-NASD-2006-027 be modified such that the term "Station" is clearly defined specifically within the context of clearing firms to refer only to the cost of bandwidth necessary to transmit real time execution messages for all correspondents of a clearing firm, bearing in mind that this data belongs to the originators of these trades and is being used to provide alternative and more inclusive intraday risk management so that alternative comparable intraday solutions remain available “to ensure that all NASD clearing members retain the ability to monitor the trading activities and risk exposures of their correspondent firms.”