Lime
Brokerage LLC
Member NYSE, Nasdaq, FINRA, NFA, SIPC

June 30, 2009

Mr. James Brigagliano, Co-Acting director of Division of Trading and Markets
Mr. Marc McKayle, Special Counsel, Division of Trading and Markets
Mr. John Roeser, Assistant Director, Division of Trading and Markets
Mr. David Shillman, Associate Director, Division of Trading and Markets
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Release No. 34-59275; File No. SR-NASDAQ-2008-104

Dear Messrs. Brigagliano, Shillman, Roser and McKayle:

As per our conversation with the SEC on January 8, 2009 please find a detailed discussion on why sponsored access fails prima facie to comply with the requirements of SEC Rule 200(g)(1).

To begin this discussion, it is essential to understand what Sponsored Access is, and why an entity would desire to engage in it. While Sponsored Access can be viewed as a variety of different practices, for this discussion, we are defining Sponsored Access as the practice of an SEC-registered broker-dealer ("BD"), the sponsoring member ("Member" or "Sponsor"), permitting a sponsored participant ("Participant") to interact and enter orders directly into an SEC-registered ATS or Exchange ("Trading Center") without the interaction flowing first through the Member's trading systems ("System" or "Systems"). While the Participant could be a broker-dealer, for the purposes of this analysis we are confining this discussion solely to Participants that are not SEC-registered broker-dealers as the obligations of the Member under SEC Rule 200(g)(1) are different for entering sale orders depending upon the end-customer's status - the "aggregation unit" methodology, discussed later on in this document, is only available to BDs, and is not available to Participants that are not BDs. Hereafter, we will refer to this subset of Sponsored Access as "Naked Access".

As to why an entity would desire to be a Participant and enter into a Naked Access relationship, there are multiple reasons, but we will highlight two. First, broker-dealers are subject to a substantial amount of regulatory obligations, and these obligations may downstream to the end-customer. The most obvious and easy to highlight examples are the long and short sale obligations of Regulation SHO. As per SEC Rule 203(b), a BD, prior to affecting a short sale in any equity security, must "locate" shares available for borrowing. Looking at the Final Rule Interpretation of Regulation SHO[1], it is interesting to note that the Commission went out of its way to highlight that the locate obligation rests with the BD and not the end-customer on whose behalf the BD is effecting the short sale:

> *"As proposed, Rule 203(b) would have allowed the "person for whose account the short sale is executed" to perform a locate. We agree with commenter that the locate requirement should apply to a regulated entity - the broker-dealer effecting the sale - and have modified*

[1] www.sec.gov/rules/final/34-50103.htm

> *the adopted rule accordingly. Therefore, the rule as adopted makes clear that the broker-dealer effecting the short sale has the responsibility to perform the locate."*

For long sales, SEC Rule 200(c) states that "A person shall be deemed to own securities only to the extent that he has a net long position in such securities." The term "net" is a key provision in this statement, requiring the BD to look at the aggregate position, irrespective of other considerations, unless the entity for which the trade is being placed is a BD and meets certain explicit criteria, as elaborated upon in Rule 200(f). The most important criteria in this provision is that in order to not look at the net position in a security, the entity must be a BD and comply with the "aggregation unit" requirements.

These requirements, on the surface, do not necessarily seem onerous. However, understanding the general trading strategies used by a substantial segment of the Participant universe sheds substantial light on why these requirements could impede certain trading strategies, and why the Regulation SHO obligations are impossible to meet under many, if not most, Naked Access structures.

More and more frequently, computerized trading strategies such as algorithmic trading are proliferating. A sub-set of algorithmic trading is computerized day-trading ("CDT"). Under a typical CDT strategy, the end beneficiary usually has a zero net position per trading strategy, at the end of the day (hence "day-trading"). The obligations of Regulation SHO are clear - they are independent of strategy, no matter what the beneficiary's strategy, for all short-sales a valid locate must be obtained prior to order placement. In practice, should a beneficiary end the day flat, even if a locate was never obtained for the original short sale order (i.e. where no check was made on order placement for located shares), no clearing problems will occur, and most BD compliance systems will never detect that a valid locate was not obtained as no settlement issues are incurred. Pre-trade, order-placement validation is the only way to detect if valid locates have been obtained for a short-sale order; exception management at the clearing firm level will most likely not catch locate-procedural failures. As the current financial crisis persists, most locate lists provided by BDs have shrunk substantially as the SEC has put short-selling under close review. Therefore, the ability to sell short an expanded universe of equity securities without a valid locate exists, especially in light of the low probability of this violative behavior being detected. Beneficiaries that choose to illegally sell short securities without valid locates or pre-borrows have a competitive advantage when trading because they may continue to sell short securities unchecked while others that abide by the locate rules of Rule 203(b) verbatim may not.

Another motivation for Naked Access is speed. It is a substantial competitive advantage in any trading strategy to be able to be first to access the national best bid or offer ("NBBO"). In a CDT strategy, Participants almost always co-locate ("colo") their computer-server that is generating the trading decisions at the Trading Center that has the sponsored-relationship with the BD and the Participant. Indeed, Exchange or ATS colo and Naked Access are so closely intertwined that colo can be considered essential for Naked Access for a CDT strategy.

The insurmountable compliance problem with Naked Access when the participant is not a BD is that this trading strategy, by its very nature, is single Trading Center oriented. If the Participant is running Naked Access colo strategies at more than one Trading Center, then it is impossible, by the strategies' very nature, for the Participant to view its net position across multiple trading venues simultaneously. Indeed, it would obviate the very nature of colo, the primary benefit of Naked Access for a CDT strategy. Only by having all order, trade and position information evaluated in one central location, can the true net position of the participant be evaluated to accurately comply with the mandatory provisions of SEC Rule 200(c). The ability to not treat positions on a consolidated, net basis is only available to BDs, and only if the aggregation unit provisions of Rule 200(f) are met.

Substantially the same problems exist with Intermarket Sweep Orders ("ISO") as defined in Regulation NMS, Rule 600(b)(30). ISOs are by definition part of a multiple Trading Center trading strategy. Again, due to the nature of Naked Access colo trading, sending valid ISO orders is simply not possible. Sending an ISO order requires the sender to hit all superior priced liquidity concurrently with hitting a bid or offer that is inferiorly priced. The Participant would need to centralize trading decisions in one location to be complying with the ISO order placement requirements of Regulation NMS, Rule 600(b)(30).

Due to the very nature of Sponsored Access and the potential incentive to benefit by not complying with the explicit provisions of Regulation SHO and Regulation NMS, it should be incumbent upon any Trading Center to demonstrate how offering Naked Access does not encourage violative behavior. As well, *the regulation of Naked Access cannot rest solely with Trading Centers, but instead needs to be explicitly controlled by both FINRA and the SEC as the Sponsored Access policies of one Trading Center are directly affected by another Trading Center.*

Irrespective of all assertions to the contrary, it is simply impossible for a Sponsor to accurately monitor and control the Regulation NMS and Regulation SHO compliance obligations of a Participant if it is simultaneously sponsoring colo Sponsored Access activity by the same Participant at multiple Trading Centers. While the new NASDAQ Rule Proposal on Sponsored Access goes a long way to define the regulatory obligations of the Sponsor, it is woefully inadequate, and the minimum standard, as defined below, is simply inadequate to comply with the obligations discussed above. Specifically:

> *"At minimum, the member firm's compliance unit should receive immediate post-trade execution reports of trading activity of its Sponsored Participant"*[2]

Post-trade execution reports are 100% inadequate to assess compliance with the pre-trade order-placement compliance obligations of the rules discussed above in Regulation SHO and Regulation NMS. "Receiving" duplicate execution reports does nothing to assess compliance. Rather, the standard needs to be**.** "*receiving and monitoring, real time, duplicate order and trade reports, and assessing on a real-time basis, compliance with all pre-trade and post-trade compliance obligations with all FINRA, SEC and other SRO rules as applicable*." Anything less than this standard is encouraging violative behavior by Participants, and is in direct contravention of the intent of Regulation SHO, as highlighted by the paragraph quoted in the adopting release of Regulation SHO, quoted on the first page of this letter, where the SEC explicitly states that the intent is to place accountability with the broker-dealer. The combination of federal regulations which mandate accountability at the BD level and SRO rules which define compliance tools that inadequately address those same federal regulations is a regulatory oxymoron.

Should the Commission decide that sponsored access, as discussed in this document, is a permissible activity, then we strongly encourage the commission to clarify exactly what would constitute appropriate supervisory controls with respect to this practice. We feel that the standard needs to be that the sponsoring member needs to receive and monitor, real time, duplicate order and trade reports, and assess on a real-time basis, compliance with all pre-trade and post-trade compliance obligations with all FINRA, SEC and other SRO rules as applicable.

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[2] NASDAQ-2008-104: www.cchwallstreet.com/NASDAQ/pdf/nasdaq-filings/2008/SR-NASDAQ-2008-104.pdf

If the sponsoring member detects any order activity that was submitted by the Participant that the Sponsor's concurrent order validation system would have rejected, then the Sponsor must programmatically, on a real-time basis, take steps to immediately cancel this suspect order*. The Sponsor needs to be able to control the Participant's trading activity and have the ability to programmatically cancel all open orders and disallow the Participant's trading on the Trading Center as necessary*. To date, we do not believe any US Stock Exchanges or ATS offers this feature - to programmatically control the order flow of the Participant externally. While we understand Nasdaq, and some other Trading Centers, have websites where the order flow can be monitored and controlled, in the world of Naked Access colo trading, this is not a viable procedure due to the inherent time delays, as discussed next.

Lime's familiarity with high speed trading allows us to benchmark some of the fastest computer traders on the planet, and we have seen CDT order placement rates easily exceed 1,000 orders per second. Should a CDT algorithm go awry, where a large amount of orders are placed erroneously or where the orders should not have passed order validation, the Sponsor will incur a substantial time-lag in addressing the issue. From the moment the Sponsor's representative detects the problem until the time the problematic orders can be addressed by the Sponsor, at least two mintues will have passed. The Sponsor's only tools to control Sponsored Access flow are to log into the Trading Center's website (if available), place a phone call to the Trading Center, or call the Sponsee to disable trading and cancel these erroneous orders – all sub-optimal processes which require human intervention. With a two minute delay to cancel these erroneous orders, 120,000 orders could have gone into the market and been executed, even though an order validation problem was detected previously. At 1,000 shares per order and an average price of $20 per share, $2.4 billion of improper trades could be executed in this short timeframe. The sheer volume of activity in a concentrated period of time is extremely disruptive to the process of maintaining a "fair and orderly" market. This shortcoming needs to be addressed if the practice of Naked Access is going to be permitted to continue; otherwise, the next "Long Term Capital" meltdown will happen in a five-minute time period.

At a minimum, the Member should at least concurrently validate on a real-time basis all order flow submitted under a sponsored access arrangement, and have the ability to control this order flow should its real-time monitoring detect any issues. Without this concurrent monitoring and control, sponsored access is just another form of regulatory arbitrage, permitting order flow to be submitted under a Member's name, without the member really being responsible for any supervisory controls.

Profit incentives for Trading Centers, Sponsors, and Participants are very strong to have no pre-trade compliance on computerized order submission. We believe that the public interest is best served by high-speed Trading Center access that includes pre-trade order validation to protect against systemic risks that could result from dangerous uncontrolled computerized trading activity. From the September 1, 2004 Morgan Stanley error that resulted in a $10.8 billion order instead of the intended $10.8 million order, to the December 8, 2005 Tokyo Stock Exchange/Mizuho $347 million loss, to the February 24, 2009 unintended $31 billion order by UBS (100,000 times more than it intended), the risk, the risk of unfettered computer access to markets is significant. Given the growth and nature of new high-frequency trading participants, the potential for trading-induced multiple domino bankruptcies exists. In addition to potential compliance violations outlined in this letter, unrestrained computer-generated trading has the potential to create catastrophic economic damage to the US national market system.

Lime Brokerage offers its services to the Commission and the SROs to assist in crafting appropriate regulation that addresses the pre-trade order validation required to protect the market system from the concerns discussed in this letter. Thank you for your consideration of our views on this important matter.

Regards,

John Jacobs
Chief Operations Officer and Director of Operations
Lime Brokerage LLC

cc: Mary Schapiro, SEC
Elizabeth Murphy, SEC
James Clarkson, SEC NY
Richard Ketchum, FINRA
Mary Revell, Nasdaq
Also submitted electronically via comments on SR-NASDAQ-2008-104