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February 17, 2009

Elizabeth Murphy  
Secretary  
Securities and Exchange Commission  
Station Place  
100 F Street, NE  
Washington D, C 20549-1090

Submitted electronically via SEC website

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

Dear Ms. Murphy:

Following please find a discussion of our concerns regarding Release No. 34-59275; File No. SR-NASDAQ-2008-104, in which Nasdaq seeks to modify the requirements for members that provide "Sponsored Access" to Nasdaq's execution system. Lime Brokerage has previously shared strong concerns regarding the structural issues surrounding the practice of sponsored access (comments on File Nos. SR-NYSE-2008-71 and SR-NYSE-2008-100, <http://sec.gov/comments/sr-nyse-2008-71/nyse200871.shtml>). Please note that the concerns we submitted in response to the previous rule filings are just as applicable here.

First of all, to summarize our concerns with the practice of sponsored access:

1. By allowing non-broker-dealers to obtain direct access to an exchange, Direct Sponsored Access ("sponsored access") acts as a de facto grant of membership to non-broker-dealer and is in violation of Section 6 (c)(1).
2. Sponsored access undermines proper oversight of markets and their participants. Previously the SEC concluded that it was not "practical" nor did it serve "the best interests of investors or the markets generally to allow non-broker-dealers to be members of national securities exchanges, because of the lack of regulatory oversight the Commission would have over these entities."
3. Sponsored access makes compliance with many rules difficult or impossible. Compliance obligations of the sponsoring broker-dealer are performed by the end customer, who is the agent for addressing issues related to long sales, short sales and locates, creditworthiness, erroneous trades, manipulative trading, restricted lists and Regulations NMS, among others.
4. Oversight by contractual agreement falls short of direct oversight. This is probably the biggest issue with sponsored access, as will be discussed below.

This Nasdaq rule filing says the right words, and places accountability where it belongs. However, it is disingenuous in that neither the rule, nor Nasdaq itself, provides the tools to properly manage the supervisory control obligations for which Nasdaq permits its broker-dealer members to “subcontract” out to its end customers. If the sponsored customer (“Sponsored Participant”) is validating its own orders prior to submission into the public markets, then the Sponsored Participant is acting as an agent of the broker-dealer by performing the sponsoring broker’s (“Sponsoring BD” or “Sponsor”) compliance obligations. As such, the Sponsored Participant needs to be subject to any and all compliance obligations that the sponsoring broker-dealer has – including being subject to direct audit and review by the designated regulatory agencies, and also being subject to the Exchange and SRO membership and registration rules.

The Nasdaq rule filing avoids going down the above-discussed path, and rather seeks to carve-out an exemption that if the Sponsor and Sponsored Participant structure their obligations appropriately, then the Sponsored Participant can submit its orders directly to an exchange and all parties, the sponsoring broker included, have met their appropriate compliance obligations. Should the Commission approve this Nasdaq rule filing, we see this as the likely result – a de-facto safe harbor will have been created.

We feel that if the practice of sponsored access is going to be permitted, then the “structural” issues need to be addressed first. If the Sponsored Participant is acting as an extension of the broker-dealer, then it needs to be treated like an extension of the broker-dealer, and the Sponsored Participant’s activity and its supervisory controls need to be subject to direct scrutiny by the SEC and the various SROs. Should the Commission permit exchanges to carve out various exceptions to the existing regulatory structure then the specific holes in the sponsored access framework need to be clarified. Issues we have with the Nasdaq rule filing are as follows:

1. Proposed Nasdaq Rule 4611(d)(3)(A): “All trading activity by the Sponsored Participant shall comply with all applicable federal securities laws and rules and Exchange rules..” The Nasdaq rule proposal states that the Sponsor has a regulatory obligation to ensure compliance, but there is no mechanism for compliance to be determined on a continual, ongoing basis. Rather, the structure sounds like an outsourced compliance program, with the record-keeping obligation by the sponsoring member being nebulous at best. What records from the Sponsored Participant are appropriate to be obtained by the Sponsor to determine that the Sponsored Participant’s trading activity is complying with all applicable laws and rules? How often must these records be reviewed by the Sponsor? What are the record-retention obligations by the Sponsor, and Sponsored Participant, if any?
2. Proposed Nasdaq Rule 4611(d)(3)(F): “Sponsored Participant shall agree that the Sponsoring Member or Nasdaq may immediately terminate the Sponsored Access if the Sponsored Participant or third party access provider fails to abide by its commitments.” How immediate is “immediate”? What mechanism is there for the Sponsor to “immediately” terminate the sponsored access trading of its Sponsored Participant? What exact regulatory obligations is the Sponsor implied to be tracking if it should be so empowered to turn off the Sponsored Participant’s trading?
3. Proposed Nasdaq Rule 4611(d)(4): . “Financial Controls. Each Sponsoring Member shall establish adequate procedures and controls that permit it to effectively monitor and control the Sponsored Access to systemically limit the Sponsoring Member’s financial exposure.” The general nature of sponsored access is such that it is mainly desired by high frequency algorithmic trading strategies where minimum order-placement latency is especially important. By not going through a broker-dealer’s infrastructure, additional order validation checks are avoided and the order is inserted into the trading center as fast as possible. These types of trading strategies typically generate hundreds of orders per second. Therefore, the “structure” of the tool to be used by the Sponsor to appropriately monitor and control the exposure of the Sponsored Participant is critical.

We believe it is critical that the Sponsor concurrently monitor, on a real-time basis, the Sponsored Participant’s order placement and trading activity, and have the ability, on a real-time programmatic basis, to recall any and all orders that would have not passed the Sponsor’s own financial validations on order

placement had the order been directly submitted through the Sponsor's own trading system. It is also incumbent upon the trading center that is a party to this arrangement, to provide adequate tools for the Sponsor to control this trading activity. Presently Nasdaq does not support the capability to programmatically recall an order that a sponsored participant submitted. Rather, the Sponsor must manually log on to a Nasdaq website and look for the order and cancel it. Should the Sponsor desire to terminate all trading for the Sponsored Participant, the process is similar. While using a website to cancel an order may sound like a small point, recall that we are talking about potential order placement rates of hundreds of orders a second by one Sponsored Participant. From the time the sponsoring member becomes aware of an order-placement issue until the erroneously submitted order is located on the trading center's website to be cancelled, would be two minutes minimum, and five minutes would be a more realistic figure. Assuming an order-placement rate of 100 orders per second (very reasonable for this style of trading), then in two minutes 12,000 additional orders would have been placed. This type of delay is simply unacceptable when talking about a credit issue – if there was a credit issue at the first order, the 12,000 additional orders would most likely only compound the problem. Should a trading center permit sponsored access, then it must also offer a tool that can effectively permit the Sponsor to address financial issues the moment they occur, which is when the order is first placed, and the cancellation mechanism needs to be high speed and programmatic.

4. Proposed Nasdaq Rule 4611(d)(5)(A): "Regulatory Controls: Each Sponsoring Member shall have systemic controls to ensure compliance with applicable Regulatory requirements, including but not limited to compliance with rules relating to short selling; trading halts; proper uses of order types; proper use of Intermarket Sweep Orders; trading ahead of customer limit orders; prohibitions against manipulative trading practices, including wash sales and marking the close; restricted lists of securities for purposes of SEC Rule 10b-18; and applicable margin rules." The problems with this section of Nasdaq's rule filing are the same as the issues discussed in above item 3. The Sponsor needs to be able to concurrently monitor, on a real-time basis, the Sponsored Participant's order placement and trading activity, and have the ability, on a real-time programmatic basis, to recall any and all orders that would have not passed the Sponsor's own compliance and regulatory validations on order placement had the order been directly submitted through the Sponsor's own trading system. A real-time method, with minimal delay, is required for the Sponsor to be able to have the "systematic control" that Nasdaq alludes to. However, Nasdaq does not offer such "systematic control" other than the telephone or a website, both of which do not have provide the time-critical tools to effectively manage high-frequency sponsored access order flow.

5. Proposed Nasdaq Rule 4611(d)(5)(B): "Each Sponsoring Member shall ensure that compliance personnel receive timely reports of all trading activity by its Sponsored Participants sufficient to permit the Sponsoring Member to comply with applicable Regulatory Requirements, and to monitor for illegal activity..." This provision is probably the most troublesome aspect of Nasdaq's rule filing. By its very nature receiving reports of "trading" activity is insufficient – many of the supervisory control obligations that a broker-dealer is responsible for complying with are necessarily performed when the order is placed, not when order is executed and becomes a trade. The requirement should be for the Sponsor to receive duplicate reports of all orders and trades. As well, the time standard is ill-defined. Clearly there is recognition that the sponsoring member has some-type of compliance obligation – but what is it, and when does it need to be addressed? It is our contention that the Sponsor has the obligation to concurrently assess all compliance obligations, the exact obligation the broker-dealer would otherwise have should the sponsored-access flow have gone through its systems, while receiving real-time duplicate order and execution reports.

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 appropriate supervisory controls are 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/order placement compliance obligations with all FINRA, SEC and other SRO rules as applicable. If the sponsoring member detects any order activity that was submitted by the Sponsored 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

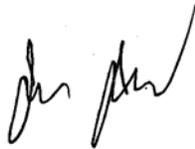
cancel this suspect order. In addition, the Sponsor needs to be able to control the Sponsored Participant's trading activity and have the ability to programmatically cancel all open orders and disallow the Sponsored Participant's trading on the Trading Center as necessary.

At a minimum, the Sponsor should at least concurrently validate on a real-time basis all 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.

Any trading center that will enable trading on a sponsored access basis needs to offer appropriate tools for the Sponsoring Member to control it, including the ability to programmatically recall erroneously submitted orders by the Sponsored Participant. The exact obligations of the Sponsor need to be clarified as well – the nature and frequency of oversight of the Sponsored Participant's activity. While the activities of the Sponsor are best regulated by the SEC and FINRA, until these responsibilities are explicitly clarified, continuing to permit the practice of direct sponsored access by non-broker-dealer participants creates an atmosphere of regulatory arbitrage. Therefore, the practice should be immediately prohibited until defined supervisory control procedures are clarified by the SEC and FINRA, in coordination with the securities exchanges that desire to permit sponsored access.

We believe that the issues surrounding sponsored access can best be summarized by the comments submitted by another commenter regarding this same rule proposal (<http://www.sec.gov/comments/sr-nasdaq-2008-104/nasdaq2008104-1.pdf>) – “The proposed rules... subject Sponsoring Member firms to the unreasonable standards of **ensuring** the integrity of their sponsored participants, as well as **preventing** the submission of erroneous orders...”. This is the crux of the issue – what is the SEC's (and FINRA's) view on adequate compliance controls – is it unreasonable to expect firms to have supervisory controls systems that can monitor and control the activity of their sponsored participants? We don't think so. We also do not think the Nasdaq rule proposal goes far enough, and that both the SEC and FINRA need to clarify that regardless of whether compliance obligations are met by the end customer, an outsourced service provider, or the member itself, it is always the broker-dealers obligation to monitor, supervise **and** control all activities that occur under its name.

Regards,



John Jacobs  
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