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

September 24, 2008

Florence Harmon
Acting Secretary
Securities and Exchange Commission
Station Place
100 F Street, NE
Washington, DC 20549-1090

Re: File No. SR-NYSE-2008-71

Dear Ms. Harmon:

Lime Brokerage LLC ("Lime")[1] appreciates the opportunity to comment on the New York Stock Exchange's ("NYSE") proposal to amend NYSE Rule 123B (Exchange Automated Order Routing System) to allow members or member organizations ("sponsoring member") to provide non-member clients ("sponsored participant") with direct access to the exchange for the entry and execution of orders on the exchange.[2] The NYSE's proposal to permit sponsored participants to bypass the sponsoring member's system (or a service bureau's system provided by the sponsoring member) and to transmit orders directly to the exchange ("direct access") violates, among other provisions, Sections 6(b)(1), 6(b)(5), and 6(c)(1) of the Securities Exchange Act of 1934 ("Exchange Act"). As a result, there is no reasonable basis to conclude that the proposed rule change is consistent with the requirements of the Exchange Act, as required by Section 19 of the Exchange Act. Accordingly, the Securities and Exchange Commission ("SEC" or "Commission") should institute proceedings to disapprove this attempt to broaden access to the exchange beyond its members.[3]

Billed as a mere technical amendment, the proposal to eliminate the sponsoring member's active role with regard to its clients orders, in fact, raises a host of fundamental issues regarding the oversight of markets and their participants. What the NYSE fails to acknowledge in its brief description of the proposal is that providing direct access ─ without intermediation by the broker-dealer ─ prevents the broker-dealer from effectively complying with a variety of important investor protection rules and, in turn, frustrates the ability of the exchange to monitor trading on its market. After all, the exchange does not have direct oversight authority with regard to its members' clients. Therefore, the rule change undermines the fundamental regulatory structure of the Exchange Act.

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[1] Lime is a technologically advanced brokerage firm located in New York City that caters to a diverse and sophisticated client base. Lime's clients include professional traders, hedge funds, asset managers, and other broker-dealers. Our customers rely on Lime's robust and advanced technology to execute equities, futures and options transactions on multiple exchanges, ECNs and other trading venues. For more information about Lime, *see* www.limebrokerage.com.

[2] Securities Exchange Act Rel. No. 58429 (Aug. 27, 2008).

[3] Section 19(b)(2) of the Exchange Act. Moreover, as a procedural matter, we note that the NYSE's rule filing does not meet the definition of a non-controversial filing made pursuant to Section 19(b)(3)(A) and Rule 19b-4(f)(6). As such, the filing should not be effective upon filing.

I. Direct Access by Non-Broker-Dealers Violates the Membership Requirements of the Exchange Act

Section 6(c)(1) under the Exchange Act prohibits exchanges from granting membership to any person not registered as a broker-dealer or associated with a broker-dealer. By allowing non-broker-dealers to obtain direct access to the exchange, NYSE Rule 123B acts as a de facto grant of membership to non-broker-dealers in violation of Section 6(c)(1). Indeed, the ability to effect transactions directly on the exchange is the hallmark of exchange membership.[4] In adopting the membership requirements in Section 6(c)(1), Congress intended to strengthen the oversight of exchange trading by requiring all persons utilizing an exchange's facilities to effect transactions to register as a broker-dealer with the Commission.[5] With this provision, Congress intended to eliminate direct institutional access to the exchanges; it certainly did not intend to provide a back-door opportunity for institutions to continue trading directly on the exchanges.[6]

II. Direct Access Undermines Proper Oversight of Markets and Their Participants

Direct access undermines the basic regulatory oversight structure of the Exchange Act. If a sponsored participant submits an order directly to the exchange, the sponsoring member is unaware of the order until after it is executed. Therefore, the sponsoring member has no way of monitoring the order and evaluating its compliance with various applicable rules and regulations before it is transmitted to the exchange for execution. As such, NYSE Rule 123B establishes a framework in which broker-dealers, as a practical matter, cannot comply with their obligations under various SEC and exchange rules on a pre-trade basis. Therefore, the NYSE has adopted a rule that, by its terms, thwarts its members' ability to comply with the securities laws and rules in violation of Section 6(b)(1).[7] With neither the exchange, nor the sponsoring broker-dealer, able to meet their respective regulatory obligations pursuant to its terms, NYSE Rule 123B ultimately threatens the investor protection role of the securities laws in violation of Section 6(b)(5).[8]

The SEC previously has recognized the significant regulatory impediments to allowing direct institutional access to exchanges. The SEC stated that "in order to ensure the central goals of exchange regulation, direct institutional members or participants in exchanges would have to be subject to the majority of rules and regulations to which broker-dealers are currently subject."[9] In light of these

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4 *See, e.g.,* Section 3(a)(3)(A) of the Exchange Act (defining a member with a reference to its ability to effect transactions on the exchange).

5 Securities Acts Amendments of 1975, Report of the Senate Comm. on Banking, Housing and Urban Affairs to Accompany S.249, S. Rep. No. 75, 94th Cong., 1st Sess. (1975).

6 Moreover, since the sponsored participants are performing functions normally reserved to registered personnel of a broker-dealer, the definition of a "branch office" in FINRA Rule 3010(g)(2) and the definition of OSJ in FINRA Rule 3010(g)(1) could be interpreted to include the customers' places of business.

7 Section 6(b)(1) of the Exchange Act requires that the exchange be "so organized and ha[ve] the capacity to be able to carry out the purposes of this title and to comply, and (subject to any rule or order of the Commission pursuant to section 17(d) or 19(g)(2)) to enforce compliance by its members and persons associated with its members, with the provisions of this title, the rules and regulations thereunder, and the rules of the exchange."

8 Section 6(b)(5) of the Exchange Act (requiring exchange rules to be designed "to protect investors and the public interest").

9 Securities Exchange Act Rel. No. 40760 (Dec. 8, 1998).

concerns, 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."[10] As the list of rules below attests, these conclusions remain true.

A. Direct Access Makes Compliance with Many Rules Difficult or Impossible

The regulatory void created by direct access affects rule compliance across the board. Examples of important investor protection rules threatened by direct access include:

- Short sales. A broker-dealer may not accept a short sale order unless it makes a pre-trade affirmative determination regarding the availability of the securities for borrowing.[11] With direct access, the sponsoring member knows nothing about the trade in advance and thus cannot perform this required task. Recent emergency rules and SEC orders convey the seriousness of proper order validation for short sales.[12] Failure by the SEC to take action to prevent inappropriate short selling by sponsored participants during periods of turmoil sends a contradictory message to participants in the marketplace.

- Long sales. Broker-dealers are required to ascertain the location of securities to be sold long by a customer before the order is submitted to the market for execution.[13] If the long order is submitted directly to the exchange, the sponsoring member has no opportunity to check on the existence or location of the sponsored participant's long securities.

- Margin rules. A broker-dealer is required to ascertain that its customer has sufficient equity in its account to support a margin transaction (including a short sale). Moreover, broker-dealers also are required to ensure compliance with specific Regulation T or SRO margin rules for day traders. Sponsoring members who permit sponsored participants to make direct access trades have no opportunity to make these determination before the trade is executed.

- Creditworthiness. Under NYSE Rule 123B, the sponsoring member remains responsible to the sponsored participant, and to the other side of the trade, for settlement. Normally a broker-dealer would review its customer orders for size, liquidity, and other factors before undertaking the risks inherent in an execution. With direct access, the sponsoring member has no opportunity to perform this basic risk-management exercise.

- Erroneous trades. A broker-dealer's pre-execution review of its customer orders can reduce the incidence of erroneous trades that may result in sometimes significant market disruption.[14]

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10 *Id*.

11 Rule 203(b) of Regulation SHO.

12 *See* Securities Exchange Act Rel. No. 58572 (Sept 17, 2008).

13 Rule 200(g) of Regulation SHO.

14 Indeed, the high profile examples of extremely large erroneous trades in Tokyo and New York attest to the need for controls to prevent such trades. *See* Andrew Morse and Yuka Hayashi, "Tokyo Market Roiled Again, as Numbers Don't Quite Add Up – Mizuho Errs by Offering Pricey Stock for 1 Yen in $250 Million Mistake," WSJ, at p. A3 (Dec. 9, 2005) (trader mistakenly tried to sell 610,000 shares at one yen a piece in a company instead of selling one share at Y610,000); NYSE Hearing Board Decision 06-220 (Dec. 18, 2006) (order routing system failed to prevent an erroneous transaction to buy $10.8 billion of stocks instead of $10.8 million as intended, causing significant market disruption).

Applying preventative pre-trade measures can reduce the number and significance of clearly erroneous trades. Such desirable controls, however, are not possible with direct access.

- Manipulative trading. Pre-execution review by a broker-dealer can detect and reduce the risk of wash sales, marking the close, and other market practices, whether intentional or unintentional, on the part of the customer, that can have a manipulative effect. The SEC and the self-regulatory organizations have made it clear that in certain areas the broker-dealer is the first line of defense against abusive trading practices.[15] Direct access arrangements, however, make it impossible for a sponsoring member to detect these activities until after the fact.

- Restricted lists. Broker-dealers generally maintain restricted lists to monitor and prevent inappropriate trading in securities of which the customer is the issuer or a control person. Certain issuer or affiliate trades may need to be executed subject to a registration statement, or in compliance with Rule 144 under the Securities Act of 1933, or Rule 10b-18 under the Exchange Act. Customers trading via direct access may be able to avoid these restrictions.

- Regulation NMS. Regulation NMS imposes a variety of duties on broker-dealers that must be performed before or at the time of execution. For example, those routing an intermarket sweep order must ensure that it complies with the various requirements of Rule 611 and the related SEC FAQs.[16] Permitting direct access leaves timely compliance with these measures to unregistered personnel.

B. Oversight by Contractual Agreement Falls Short of Direct Oversight

NYSE Rule 123B places the ultimate responsibility for compliance with the securities laws and rules on the sponsoring member, but it does not explain how the sponsoring member will satisfy these obligations in practice. Instead, NYSE Rule 123B requires the sponsored participant to sign an agreement stating that it will comply with the securities laws. Such contracts only provide the sponsoring member with after-the-fact oversight via contractual remedies – and, only if the problem is discovered. It cannot provide the same level of supervision as real-time oversight of trading activities, as would be imposed if the trades were sent through the broker-dealers own system.

Moreover, such an agreement does not provide the level of investor protection provided by a registered broker-dealer or associated person performing the trading activities. The sponsored participant and its authorized trader are performing functions that have historically been done only by registered personnel of a broker-dealer who satisfy numerous requirements designed to insure the integrity of the markets. The many prophylactic requirements include being free from a statutory disqualification, passing several examinations (including Series 7 and Series 55), being supervised in their trading activities, participating in Regulatory and Firm Elements of Continuing Education and an annual compliance interview or meeting, and being subject to limitations on personal securities transactions, including the purchase of new issues. If the requirements imposed on broker-dealer personnel are

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[15] *See, e.g.*, Remarks by Mary L. Schapiro, President, NASD Regulation, Inc., District 7 Compliance Seminar (Sept. 25, 1997) (urging brokers to be "first line of defense with respect to investor protection").

[16] *See* SEC Division of Market Regulation, Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS (available at http://www.sec.gov/divisions/marketreg/rule611faq.pdf).

relevant and meaningful, there seems to be no justification for permitting non-registered persons to participate on an equal, indeed preferential, basis.

III. The SEC Should Amend the Direct Access Aspect of Nasdaq Rule 4611

The NYSE states in its rule filing that NYSE Rule 123B is identical to Nasdaq Rule 4611. In 2007, Nasdaq amended Rule 4611 to allow sponsored participants to enter orders directly into Nasdaq without passing the order through the sponsoring broker-dealer's systems.[17] For the reasons discussed above, the SEC also should use the authority granted to it in Section 19(c) of the Exchange Act[18] to eliminate the direct access provisions from Rule 4611.

IV. Conclusion

The events of the last few days, which resulted in various SEC emergency orders and Federal Reserve interventions in the market, have clearly demonstrated that leaving entities to regulate and police themselves does not work. These events have unfortunately shown that, when left to their own devices, businesses have repeatedly pushed the boundaries of what is ethical, legal and appropriate. Does the Commission really feel it reasonable that **pre-trade** compliance with SEC Emergency Order Rule 204T, eliminating short selling in financial securities, is best left to those that might have a vested interest in doing otherwise? The entire regulatory framework has been built with the intent of having specific control procedures in place to prevent non-regulated entities from having the same access as regulated entities, as the SEC and other regulatory agencies have limited recourse to oversee such end clients. Weakening the regulatory framework by approving NYSE Rule 123B ─ especially during such tumultuous times in the market ─ cannot be in the best interest of investors and the public.

As the Courts of Appeals have emphasized, the SEC is held to a high standard when reviewing proposed rule changes.[19] The courts have concluded that the SEC must analyze carefully the basis for and effects of a proposed rule to satisfy its statutory obligations.[20] Such a careful analysis of the NYSE and Nasdaq's rule changes will reveal their many deficiencies as compared to the statutory requirements set forth in Section 6 of the Exchange Act. Therefore, we urge the SEC to institute proceedings to disapprove the NYSE's proposal and to amend the Nasdaq's Rule 4611 pursuant to Section 19 of the Exchange Act.

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[17] Securities Exchange Act Rel. No. 55061 (Jan. 8, 2007).

[18] Under Section 19(c) of the Exchange Act, "[t]he Commission, by rule, may abrogate, add to, and delete from the rules of a self-regulatory organization (other than a registered clearing agency) as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization, to conform its rules to requirements of this title and the rules and regulations thereunder applicable to such organization, or otherwise in furtherance of the purposes of this title."

[19] *See*, *e.g.*, *Clement v. SEC*, 674 F.2d 641 (7th Cir. 1982).

[20] *See*, *e.g.*, *Chamber of Commerce of the USA v. SEC*, 412 F.3d 133 (D.C. Cir. 2005); *Timpanaro v. SEC*, 2 F.3d 453 (D.C. Cir. 1993).

Lime Brokerage appreciates the opportunity to express its concerns about the NYSE and Nasdaq rules to the Commission. If you have any questions concerning these comments or would like to discuss these comments further, please feel free to contact me through our Chief Compliance Officer, William St. Laurent, at (212) 219-6092.

Sincerely,

Alistair W. Brown

Alistair Brown
Chief Executive Officer

cc: Chairman Christopher Cox
Commissioner Kathleen L. Casey
Commissioner Elisse B. Walter
Commissioner Luis A. Aguilar
Commissioner Troy A. Paredes
Brian Cartwright, General Counsel, Office of the General Counsel
Erik R. Sirri, Director, Division of Trading and Markets
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