

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-61345; File No. SR-NASDAQ-2008-104)

January 13, 2010

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing of Amendment Nos. 2 and 3 and Order Granting Accelerated Approval to Proposed Rule Change, as Modified by Amendment Nos. 1, 2, and 3 Thereto, to Adopt a Modified Sponsored Access Rule

I. Introduction

On December 30, 2008, The NASDAQ Stock Market LLC (“Nasdaq” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to modify its rule governing electronic access to the Exchange’s order execution systems. On January 28, 2009, Nasdaq filed Amendment No. 1 to the proposed rule change. The proposed rule change, as modified by Amendment No. 1, was published for comment in the Federal Register on January 29, 2009.³ The Commission received thirteen comment letters on the proposal.⁴ On October 19, 2009, Nasdaq filed Amendment No. 2 to the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 59275 (January 22, 2009), 74 FR 5193.

⁴ Letters to Elizabeth M. Murphy, Secretary, Commission, from Harvey Cloyd, Chief Executive Officer, Electronic Transaction Clearing, Inc., dated February 5, 2009 (“ETC Letter”); John Jacobs, Director of Operations, Lime Brokerage LLC, dated February 17, 2009 (“Lime I Letter”); Manisha Kimmel, Executive Director, Financial Information Forum, dated February 19, 2009 (“FIF Letter”); Ted Myerson, President, FTEN, Inc., dated February 19, 2009 (“FTEN I Letter”); Michael A. Barth, Executive Vice President, OES Market Group, dated February 23, 2009 (“OES Letter”); Jeff Bell, Executive Vice President, Clearing and Technology Group, Wedbush Morgan Securities, dated February 23, 2009 (“Wedbush Letter”); Stuart J. Kaswell, Executive Vice President & General Counsel, Managed Funds Association, dated February 24, 2009 (“MFA Letter”); Ann Vlcek, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association (“SIFMA”), dated February 26, 2009 (“SIFMA I Letter”), Nicole Harner Williams, Vice President, Associate General Counsel, Penson Financial

proposed rule change and responded to the comment letters. On October 23, 2009, Nasdaq filed Amendment No. 3 to the proposed rule change. This notice and order provides notice of filing of Amendment Nos. 2 and 3, and grants accelerated approval to the proposed rule change, as modified by Amendment Nos. 1, 2, and 3.

II. Description of the Proposed Rule Change, as Modified by Amendment Nos. 1, 2, and 3 Thereto

The Exchange proposes to modify Nasdaq Rule 4611 to improve its existing regulatory framework governing the manner in which a Nasdaq member provides access to other entities to Nasdaq order execution systems through the use of the member firm's market participant identifier ("MPID").⁵ Nasdaq notes that the proposal is designed to ensure a member firm is assuming full responsibility for its customers' trading activity and has effective financial and regulatory controls in place to protect market participants from systemic risk and preserve the integrity of the marketplace.

Under the proposal, a Nasdaq member that enters into an arrangement with another person or entity (e.g., a customer, another member, or a non-member broker-dealer) to provide that person with access to Nasdaq or otherwise allow such person to route its orders to Nasdaq

Services, Inc., dated February 27, 2009 ("Penson Letter"); Samuel F. Lek, Chief Executive Officer, Lek Securities Corporation, dated June 15, 2009 ("Lek Letter"); letter to David S. Shillman, Associate Director, Division of Trading and Markets ("Division"), James A. Brigagliano, Associate Director, Division, and A. Duer, Meehan, Associate Director, Office of Compliance Inspections and Examinations, Commission, from Gary LaFever, Chief Corporate Development Officer, FTEN, Inc., dated April 29, 2009 ("FTEN II Letter"); letter to James Brigagliano, Co-Acting Director, David Shillman, Associate Director, John Roeser, Assistant Director, Marc McKayle, Special Counsel, Division, Commission, from John Jacobs, Chief Operations Officer, Lime Brokerage LLC, dated June 30, 2009 ("Lime II Letter"); and letter to David S. Shillman, Associate Director, Division, from Ann Vlcek, Managing Director and Associate General Counsel, SIFMA, dated November 23, 2009 ("SIFMA II Letter").

⁵ The following description incorporates changes proposed by Nasdaq in Amendment Nos. 1, 2, and 3. See Section IV, infra, for a discussion of the changes proposed in Amendment Nos. 2 and 3.

using the member's MPID shall do so through either a Sponsored Access System or a Member System, as defined in the rule.⁶ A Sponsored Access System is defined as any system that applies pre- and post-trade financial and regulatory controls set forth in proposed sections (d)(4) and (d)(5) of Rule 4611 and that is not administered and controlled solely by the Sponsoring Member.⁷ A Member System is defined as any system administered and controlled solely by the Sponsoring Member and that applies the pre- and post-trade financial and regulatory controls set forth in proposed sections (d)(4) and (d)(5) of Rule 4611.⁸

Members that provide such access are responsible for all trading conducted pursuant to that arrangement to the same extent as trading directly conducted by the member for customers. The member is responsible for implementing policies and procedures for supervising and monitoring the trading effected pursuant to the arrangement to ensure that it is in compliance with all applicable federal securities laws and rules and Nasdaq rules. This obligation applies irrespective of the manner in which orders pursuant to such arrangements reach Nasdaq.

The proposal defines the two types of access a member provides to another person or entity to access Nasdaq, Sponsored Access and Direct Market Access.⁹ Sponsored Access is defined as the practice by a member ("Sponsoring Member") of providing access to Nasdaq to another person, firm, or customer ("Sponsored Participant") whereby the Sponsored Participant enters orders into Nasdaq using a Sponsored Access System but the orders do not pass through a Member System prior to reaching Nasdaq. Direct Market Access is defined as the practice by a Sponsoring Member of providing access to Nasdaq to another person, firm, or customer

⁶ See Amendment Nos. 2 and 3.

⁷ See Amendment No. 2.

⁸ Id.

⁹ Id.

(“Sponsored Participant”) whereby the Sponsored Participant makes decisions regarding order routing and order entry but the orders pass through a Member System prior to reaching Nasdaq.

The proposal requires Sponsoring Members that provide Direct Market Access to, at a minimum, comply with the financial controls and regulatory controls set forth in proposed sections (d)(4) and (d)(5) of Rule 4611. In addition, the proposal requires Sponsoring Members that provide Sponsored Access to, at a minimum, comply with the contractual provisions, financial controls, and regulatory controls set forth in proposed sections (d)(3), (d)(4), and (d)(5) of Rule 4611.

A. Contractual Provisions

Pursuant to proposed section (d)(3) of Rule 4611, a Sponsoring Member that provides Sponsored Access shall execute and maintain agreements with each Sponsored Participant containing the following commitments:

- All trading activity by the Sponsored Participant shall comply with all applicable federal securities laws and rules and Exchange rules, including but not limited to the Nasdaq Certificate of Incorporation, Bylaws, Rules and procedures with regard to the Nasdaq Market Center (“Regulatory Requirements”).
 - The Sponsored Participant shall promptly upon request provide the Sponsoring Member with access to such books and records and financial information that is necessary to allow the Sponsoring Member to comply with its regulatory obligations with respect to activity of the Sponsored Participant within the Sponsored Access arrangement, and otherwise cooperate with the Sponsoring Member in furtherance of the Sponsoring Member’s compliance with applicable Regulatory Requirements.
- Information provided by Sponsored Participants to Sponsoring Members pursuant to

such requests shall be maintained as confidential by the Sponsoring Member, provided that such information shall be available to Nasdaq upon request for regulatory purposes.¹⁰

- The Sponsored Participant shall maintain its trading activity within the credit, product or other financial limits specified by the Sponsoring Member.
- The Sponsored Participant shall maintain all technology permitting sponsored access to Nasdaq in a physically secure manner and may not permit unauthorized individuals to use or obtain access to Nasdaq. Sponsored Participant shall familiarize its authorized individuals with the Regulatory Requirements and will provide appropriate training prior to use or access to Nasdaq.
- The Sponsored Participant shall agree that the Sponsoring Member or Nasdaq may immediately terminate the Sponsored Access if the Sponsoring Member or Nasdaq determines that continuing such access poses serious risk to the Sponsoring Member or to the integrity of the market.

In addition, a Sponsoring Member that provides Sponsored Access shall execute and maintain agreements with each third party (“Third Party Provider”) that provides a Sponsored Access System to Sponsored Participants for accessing Nasdaq.¹¹ The agreements shall specify which of the financial and regulatory controls stated in proposed sections (d)(4) and (d)(5) are satisfied by the technology provided, and contain the following commitments:

- Third Party Providers shall promptly upon request provide the Sponsoring Member with access to such books and records and financial information that is necessary to allow the Sponsoring Member to comply with its regulatory obligations with respect

¹⁰ Id.

¹¹ Id.

to activity of the Sponsored Participant within the Sponsored Access arrangement, and otherwise cooperate with the Sponsoring Member in furtherance of Sponsoring Member's compliance with applicable Regulatory Requirements. Information provided by Sponsored Participants to Sponsoring Members pursuant to such requests shall be maintained as confidential by the Sponsoring Member, provided that such information shall be available to Nasdaq upon request for regulatory purposes.

- Third Party Providers shall maintain all technology permitting Sponsored Access to Nasdaq in a physically secure manner and may not permit unauthorized individuals to use or obtain access to Nasdaq.
- Third Party Providers shall agree that Nasdaq or its agent may audit the Sponsored Access System and that the Sponsoring Member or Nasdaq may immediately terminate the Sponsored Access if the Sponsored Participant or Third Party Provider fails to abide by its commitments.

B. Financial Controls

Under proposed section (d)(4) of Rule 4611, each Sponsoring Member shall establish adequate procedures and controls that permit it to effectively monitor and control the Sponsored Access or Direct Market Access to systemically limit the Sponsoring Member's financial exposure. At a minimum, the Member System or Sponsored Access System shall be reasonably designed to:¹²

- Prevent each Sponsored Participant from entering orders that in aggregate exceed appropriate pre-set credit thresholds. Sponsoring Members may also set finely-tuned credit thresholds by sector, security or otherwise.

¹²

Id.

- Prevent Sponsored Participants from trading products that the Sponsoring Member is restricted from trading or that the Sponsored Participant is restricted from trading for reasons specific to the Sponsored Participant.
- Prevent Sponsored Participants from submitting erroneous orders by providing for the rejection of orders that exceed certain price or size parameters, on an order-by-order basis or over a short period of time, or that indicate duplicative orders.

C. Regulatory Controls

Under proposed section (d)(5), each Sponsoring Member shall establish adequate procedures and controls reasonably designed to permit it to effectively monitor and control compliance with Regulatory Requirements.¹³ Specifically, each Sponsoring Member shall have systemic controls reasonably designed to ensure compliance by the Sponsored Participant with all applicable Regulatory Requirements.

In addition, each Sponsoring Member shall ensure that appropriate supervisory personnel receive and review 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 such as market manipulation or insider trading. At a minimum, appropriate supervisory personnel should receive immediate post-trade execution reports of trading activity of all Sponsored Participants, including their identities, all required audit trail information by no later than the end of the trading day, and all information necessary to create and maintain the trading records required by applicable Regulatory Requirements by no later

¹³

Id.

than the end of the trading day. Appropriate supervisory personnel shall review execution reports immediately and all other reports promptly.¹⁴

III. Discussion and Commission's Findings

After careful review of the proposed rule change, as amended, the comment letters, and Nasdaq's response to the comment letters, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.¹⁵ In particular, the proposal is consistent with Section 6(b)(5) of the Act,¹⁶ which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

Specifically, the Commission believes that Nasdaq's proposed rule change should clarify and strengthen a Sponsoring Member's obligations to control risks when it provides customers access to Nasdaq's execution facilities, whether through Direct Market Access or Sponsored Access. The Nasdaq proposed rule change would require a Sponsoring Member that offers Direct Market Access or Sponsored Access to establish effective procedures and controls to systemically limit its financial exposure and comply with applicable Regulatory Requirements, in the manner set forth therein. Sponsoring Members providing Sponsored Access would also be required to comply with certain contractual provisions.

¹⁴ Id.

¹⁵ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

¹⁶ 15 U.S.C. 78f(b)(5).

Generally, Nasdaq’s proposed rule change amends Nasdaq Rule 4611(d) to: (1) define categories of electronic access and explicitly include Direct Market Access and Sponsored Access; (2) require certain specific systemic financial and regulatory controls; (3) require certain contractual commitments for Sponsored Access; and (4) require the real-time receipt and timely review of relevant trade activity reports. The Commission believes that the proposal should help reduce the risks that arise when a Sponsoring Member provides a Sponsored Participant with access to Nasdaq.

Currently, Nasdaq Rule 4611(d), which governs sponsored access to Nasdaq’s order execution systems, is substantially similar to sponsored access rules adopted by the other national securities exchanges.¹⁷ However, Nasdaq proposes to modify Rule 4611(d) to clarify and strengthen the risk controls required by Sponsoring Members providing electronic access to Nasdaq’s order execution systems.

The Commission received thirteen comment letters on Nasdaq’s proposal, as modified by Amendment No. 1 (“Original Proposal”).¹⁸ Most commenters offered general support for Nasdaq’s proposal, but raise various issues regarding specific aspects of the proposal.¹⁹ Three commenters believe that Nasdaq’s proposal is either unnecessary because Nasdaq’s current access rule is adequate or that the proposal should be limited to apply only to Sponsored

¹⁷ See, e.g., New York Stock Exchange LLC Rule 123B.30 and NYSE Arca, Inc. Rule 7.29(b).

¹⁸ See supra note 4.

¹⁹ See FIF Letter, FTEN I Letter, Wedbush Letter, MFA Letter, SIFMA I Letter, and Lek Letter.

Access.²⁰ One commenter noted concerns about Sponsored Access and suggested that Nasdaq's proposal does not go far enough to address Sponsored Access.²¹

A. Definition of Sponsored Access and Scope of the Proposal

In the Original Proposal, the definition of Sponsored Access included three categories of access: (1) Direct Market Access, where the Sponsored Participant's orders pass through the Sponsoring Member's systems prior to reaching Nasdaq; (2) Sponsored access, where the Sponsored Participant enters orders directly into Nasdaq via a dedicated port provided by the Sponsoring Member ("Direct Sponsored Access" or "DSA"); and (3) direct access where a service bureau or other third party provides Sponsored Participants with technology to access Nasdaq under the auspices of and via an arrangement with the Sponsoring Member ("Third Party Sponsored Access" or "TPSA").

Four commenters question whether the proposal properly defines Sponsored Access and whether the rule is overly broad.²² Two commenters suggest that the definition of Sponsored Access should be limited to DSA and TPSA.²³ These commenters believe that Direct Market Access is already effectively regulated under existing laws and regulations. One commenter expresses concern that the proposal would modify the contractual obligations imposed on Direct Market Access arrangements.²⁴ The two other commenters recommend that the rule be limited to DSA.²⁵

²⁰ See ETC Letter, OES Letter, and Penson Letter.

²¹ See Lime I Letter.

²² See ETC Letter, FIF Letter, SIFMA I Letter, and Penson Letter.

²³ See FIF Letter and SIFMA I Letter.

²⁴ See FIF Letter.

²⁵ See ETC Letter and Penson Letter.

Nasdaq agrees, in part, that the proposed rule should focus on Sponsored Access arrangements and amends the proposal in three ways. First, Nasdaq adds prefatory language to Rule 4611(d) to clearly articulate the responsibility of all members to have policies and procedures reasonably designed to regulate all orders that it enters into Nasdaq systems under its own MPID(s) regardless of the order entry and access arrangement. Second, Nasdaq amends Rule 4611(d)(1) to distinguish between Sponsored Access and Direct Market Access to eliminate the distinction set forth in the original proposal between Direct Sponsored Access and Third Party Sponsored Access. Third, Nasdaq defines Member System and Sponsored Access System to ensure that all DMA and Sponsored Access arrangements are effectively regulated by a system that provides adequate regulatory and financial controls.

While Nasdaq concedes that regulatory obligations for Direct Market Access are generally understood in uniform manner, it acknowledges that the same could not be stated with respect to Sponsored Access as Sponsoring Members could hold differing views of what that responsibility requires. Because it is critical to establish a clear understanding of the regulatory and financial controls required in all access arrangements, Nasdaq determined that both Direct Market Access and Sponsored Access should be addressed by the rule. Nasdaq stated that the key to proper regulation of both Sponsored Access and Direct Market Access are the regulatory and financial controls set forth in proposed Rule 4611(d)(4) and (5). Nasdaq believes that Nasdaq members providing Direct Market Access may already operate Member Systems that provide the regulatory and financial controls set forth in proposed subsections (d)(4) and (d)(5), but the proposal could serve to clarify the obligations of members in Direct Market Access arrangements – and bolster market confidence in the integrity and security of the market – without imposing additional obligations.

Some commenters express concern regarding the apparent scope of the proposal, and two commenters believe that the rule should take into account differences between a Sponsored Participant that is a non-broker-dealer, non-exchange member, or an exchange member.²⁶ Specifically, one commenter believes that Sponsored Participants that are non-broker-dealers should be subject to the highest level of due diligence and oversight because they are unregulated entities. This commenter noted that Sponsored Participants that are non-member broker-dealers should be subject to policies and procedures to ensure that their trading is consistent with the exchange rules without requiring the Sponsoring Member to be responsible for non-exchange regulatory requirements. The commenter further noted that regulation of Sponsored Participants that are member broker-dealers was duplicative and unnecessary.²⁷ Another commenter expressed that the proposal could impose duplicative regulatory requirements on the Sponsoring Member and Sponsored Participant, if the Sponsored Participant is a broker-dealer.²⁸ Nasdaq responded that it believes that it is the responsibility of each Sponsoring Member to have policies and procedures reasonably designed to control the risks of all orders that it enters into Nasdaq systems under its own MPID(s) regardless of the order entry and access arrangement. Accordingly, Nasdaq's proposal would apply to Sponsoring Members regardless of whether the Sponsored Participant is a broker-dealer, non-broker-dealer, or non-member broker-dealer.

Nasdaq's proposal, as modified by Amendment Nos. 1, 2, and 3 ("Final Proposal"), requires that members that provide electronic access to Nasdaq to another person or entity using the member's MPID must do so through either a Sponsored Access System or a Member System.

²⁶ See Wedbush Letter and Penson Letter.

²⁷ See Wedbush Letter.

²⁸ See Penson Letter.

A Sponsored Access System is defined as any system that applies pre- and post-trade financial and regulatory controls set forth in the rule and that is not administered and controlled solely by the Sponsoring Member.²⁹ A Member System is defined as any system administered and controlled solely by the Sponsoring Member and that applies the pre- and post-trade financial and regulatory controls set forth in the rule. In addition, the proposal makes clear that members that provide such access are responsible for all trading conducted pursuant to that arrangement to the same extent as trading directly conducted by the member for customers.

The Final Proposal defines the two types of electronic access a member provides to another person or entity to access Nasdaq: (1) Sponsored Access, whereby the Sponsored Participant enters orders into Nasdaq using a Sponsored Access System but the orders do not pass through a Member System prior to reaching Nasdaq; and (2) Direct Market Access, whereby the Sponsored Participant makes decisions regarding order routing and order entry but the orders pass through a Member System prior to reaching Nasdaq. A member that provides Sponsored Access must, at a minimum, comply with the contractual provisions, financial controls, and regulatory controls set forth in the rule. A member that provides Direct Market Access must, at a minimum, comply with the financial controls and regulatory controls set forth in the rule.

The Commission shares Nasdaq's concern that unfettered access by customers of member firms to trading systems presents serious risks to the market and its participants.³⁰ The Commission believes that it is consistent with the Act for Nasdaq to require that access to its market occur through systems that apply appropriate financial and regulatory controls to address

²⁹ See Amendment No. 2.

³⁰ See SIFMA I Letter, Lime I Letter, FTEN I Letter, and Lek Letter.

the risks of the activity. In addition, the Commission agrees that these requirements should exist whether the Sponsored Participant is a non-broker-dealer, a non-member broker-dealer, or a member broker-dealer. The Commission believes this is appropriate because in all instances, the Sponsoring Member assumes, at a minimum, the intra-day financial risks incurred as a result of trading under its MPID. Further, the Sponsoring Member is uniquely positioned to prevent erroneous trades and comply with Exchange rules and other applicable Regulatory Requirements.

B. Contractual Provisions

Several commenters object to the contractual provisions that Nasdaq proposed to apply to Sponsored Access arrangements.³¹ Two commenters object to the requirement that Sponsoring Members execute contracts with Third Party Providers that require Third Party Providers to sign detailed agreements with each Sponsored Participant.³² One commenter argues that, in the case of TPSA, the burden of compliance and related contractual obligations should remain with the Sponsoring Member, rather than with the third-party service bureau as the Original Proposal suggests.³³ Another commenter contends that requiring Third Party Providers to execute contracts with Sponsored Participants containing the specified provisions is unduly burdensome, not justified by the benefits, and redundant of the existing obligations of the Sponsoring Member.³⁴

Nasdaq agrees that the Original Proposal was needlessly burdensome in requiring Third Party Providers to execute with each Sponsored Participant a contract containing the detailed

³¹ See SIFMA I Letter, FIF Letter, MFA Letter, and ETC Letter.

³² See FIF Letter and ETC Letter.

³³ See FIF Letter.

³⁴ See ETC Letter.

provisions proposed in Rule 4611(d)(3). Accordingly, in the Final Proposal Nasdaq eliminates the requirement that Third Party Providers execute agreements with Sponsored Participants containing detailed contractual provisions identical to those required between Sponsoring Members and Sponsored Participants. Instead, the Final Proposal requires that the agreement identify the financial and regulatory controls that are satisfied by the technology provided by the third party, and contain commitments appropriately tailored to the relationship with the third party including: (1) limited access to books and records; (2) physical security of technology that accesses Nasdaq; (3) the ability of Nasdaq or its agent to audit the Sponsored Access System; and (4) the ability for the Sponsoring Member or Nasdaq to terminate access to Nasdaq. Nasdaq believes that Sponsoring Members should have individual contractual relationships with all Sponsored Participants and contracts with any Third Party Providers that operate technology that the member utilizes to enable, monitor, or control Sponsored Access or to satisfy the required financial and regulatory controls that should allow Nasdaq or its agent to audit the Sponsored Access System.

Two commenters object to aspects of the Original Proposal that would require Sponsored Participants to make their books and records and corporate and financial information available to the Sponsoring Member upon request.³⁵ One commenter notes that because the proposed contractual provisions implicate sensitive proprietary information, they should be limited to information relevant to oversight of trading activity conducted under the particular Sponsored Access arrangement and that information produced should be maintained as confidential by the Sponsoring Member and regulators.³⁶ In response, Nasdaq agrees that it can achieve effective exchange oversight through more narrowly-tailored contractual

³⁵ See SIFMA I Letter and MFA Letter.

³⁶ See MFA Letter.

provisions between Sponsoring Members and Sponsored Participants. Accordingly, the Final Proposal limits access to the books and records of a Sponsored Participant that are necessary to allow the Sponsoring Member to comply with its regulatory obligations with respect to activity of the Sponsoring Participant within the Sponsored Access arrangement. In addition, the Final Proposal requires that such information received by the Sponsoring Member be maintained as confidential, but available to Nasdaq upon request for regulatory purposes.

The commenter also objects to the requirement that the contract include a provision permitting the Sponsoring Member or Nasdaq to immediately terminate access in the event that the Sponsored Participant or Third Party Provider fails to abide by its contractual commitments.³⁷ The commenter argues that Sponsoring Members and Sponsored Participants have established reasonable grace and cure periods for breaches of sponsorship agreements, and that such terms should be left to those parties.³⁸ Nasdaq agrees that the parties should remain free to negotiate commercial terms but is also aware that these terms are generally designed to protect the parties' commercial interests rather than the interests of Nasdaq and other market participants. Because Nasdaq has a separate interest in maintaining a fair and orderly market, including the ability to limit access by market participants that disrupt the markets or pose systemic risks, Nasdaq amends and limits proposed Rule 4611(d)(3)(v) to protecting Nasdaq's interest in maintaining a fair and orderly market rather than governing commercial terms between the parties. Specifically, the Final Proposal limits the required provision allowing termination of the Sponsored Access arrangement to situations where Nasdaq or the Sponsoring Member determines that a continuation of the arrangement poses serious risk to the Sponsoring Member or to the integrity of the market.

³⁷ Id.

³⁸ Id.

The Commission believes that the proposed contractual provisions required for Sponsored Access, as set forth in the Final Proposal, are consistent with the Act. The Commission notes that the required contractual provisions should facilitate effective oversight of Sponsored Access arrangements by the Sponsoring Member and Nasdaq by assuring Sponsored Participants have contractually committed to provide important information, conduct trading in an appropriate manner and otherwise cooperate with the Sponsoring Member and Nasdaq.

C. Financial Controls

Commenters express several concerns with the financial controls provisions of the Original Proposal, including the view that: (1) the provisions should allow for procedures and controls “reasonably designed” to prevent certain conduct, rather than impose a strict liability standard;³⁹ (2) it is not possible for Sponsoring Members to prevent the entry of orders in a Direct Sponsored Access arrangement;⁴⁰ (3) the financial controls provisions designed to prevent systemic risk are too general;⁴¹ and (4) the product limitation provision should not impose restrictions on Sponsored Participants that are unique to the Sponsoring Member.⁴²

Nasdaq agrees that in a “procedures-based” regime, as Nasdaq proposes to govern Sponsored Access arrangements, such procedures cannot ensure compliance or prevent errors from occurring but should instead be reasonably designed to ensure compliance or prevent errors. Accordingly, Nasdaq amends Rule 4611(d)(4) to require “reasonably designed” procedures and controls.

³⁹ See ETC Letter, Lime I Letter, and SIFMA I Letter.

⁴⁰ See SIFMA I Letter.

⁴¹ Id.

⁴² Id.

Nasdaq’s proposed financial controls provisions would require Sponsoring Members to undertake a creditworthiness determination and to develop monitoring and controls incorporating that determination. Nasdaq notes that it is not dictating how that determination is undertaken or implemented but the provision does require at a minimum that Sponsoring Members have real-time or nearly real-time ability to monitor and control the conduct of Sponsored Participants. Nasdaq adds that it is skeptical of the commenter’s claims that such controls cannot be implemented and that requiring such controls would effectively prohibit Direct Sponsored Access. In fact, Nasdaq asserts that the commenter’s claims are contradicted⁴³ by other comment letters.⁴⁴

Nasdaq states that the product limitation provision is not designed to transfer to Sponsored Participants limitations that are specific to the Sponsoring Members, such as restrictions imposed by Exchange Act Rule 10b-18. The provision requires that Sponsoring Members be qualified to assess Sponsored Participants and limit trading to products for which the Sponsored Participant is qualified.

The Final Proposal requires each Sponsoring Member that provides either Sponsored Access or Direct Market Access to establish adequate procedures and controls that permit it to effectively monitor and control access to systemically limit the Sponsoring Member’s financial exposure. At a minimum, the Member System or Sponsored Access System shall be reasonably designed to prevent each Sponsored Participant from entering orders that in aggregate exceed

⁴³ See Amendment No. 2.

⁴⁴ See FTEN I Letter (“Sponsored Access systems that do not provide pre-trade risk management should no longer be authorized ... systems offered by Exchanges [or] developed in-house by Sponsoring Members and by third parties that provide pre-trade risk management ... [could] be used to provide Sponsored Access). Also see Lime I Letter (“[I]t is critical that the [Sponsoring Member] concurrently monitor, on a real-time basis, the Sponsored Participant’s order placement and trading activity ...”).

appropriate pre-set credit thresholds; prevent Sponsored Participants from trading products that the Sponsoring Member is restricted from trading or that the Sponsored Participant is restricted from trading for reasons specific to the Sponsored Participant; and prevent Sponsored Participants from submitting erroneous orders by providing for the rejection of orders that exceed certain price or size parameters, on an order-by-order basis or over a short period of time, or that indicate duplicative orders.

The Commission believes that the proposed financial controls required for Sponsored Access and Direct Market Access, as set forth in the Final Proposal, are consistent with the Act. The Commission believes that a requirement that each Sponsoring Member establish adequate procedures and controls that permit it to effectively monitor and control the Sponsored Access or Direct Market Access offered by it, to systemically limit the Sponsoring Member's financial exposure, should help reduce the risks associated with such access for the Sponsoring Members as well as other market participants.

D. Regulatory Controls

Commenters express concern regarding the regulatory controls provisions of the Original Proposal, including the view that: (1) the provisions should allow for procedures and controls "reasonably designed" to prevent certain conduct, rather than impose a strict liability standard;⁴⁵ (2) it is not practical for Sponsoring Members to regulate the conduct of Sponsored Participants on a real-time basis given that much current surveillance occurs on a post-trade basis;⁴⁶ (3) use of Sponsored Access Systems that cannot comply with pre-trade oversight and compliance obligations should not be permitted;⁴⁷ (4) providing a non-exclusive list of

⁴⁵ See ETC Letter, Lime I Letter, and SIFMA I Letter.

⁴⁶ See FIF Letter, SIFMA I Letter, and MFA Letter.

⁴⁷ See Lime I Letter and FTEN I Letter.

regulatory requirements will create confusion for market participants;⁴⁸ and (5) post-trade reports should be reviewed by “appropriate supervisory personnel” as defined by the Sponsoring Member.⁴⁹

As with the proposed financial controls, Nasdaq agrees that in a “procedures-based” regime, as Nasdaq proposes to govern Sponsored Access arrangements, such procedures cannot ensure compliance or prevent errors from occurring, and should instead be reasonably designed to ensure compliance or prevent errors. Accordingly, Nasdaq proposes to modify Rule 4611(d)(5)(A) to require “reasonably designed” procedures and controls. However, Nasdaq continues to believe that the regulatory integrity of its market requires that all orders entered by Sponsored Participants be subject to real-time or nearly real-time regulatory controls.⁵⁰ In addition, because Nasdaq agrees that a non-exclusive list of regulatory requirements could cause confusion regarding both the regulatory requirements specifically listed as well as those not listed, a conforming change eliminating the non-exclusive list of regulatory requirements is contained in the Final Proposal.

The Final Proposal requires each Sponsoring Member to establish adequate procedures and controls reasonably designed to permit it to effectively monitor and control compliance with Regulatory Requirements. Specifically, each Sponsoring Member shall have systemic controls reasonably designed to ensure compliance by the Sponsored Participant with all applicable Regulatory Requirements.

⁴⁸ See SIFMA I Letter.

⁴⁹ Id.

⁵⁰ Two commenters opined that the use of Sponsored Access Systems that cannot comply with the pre-trade oversight and compliance obligations should not be permitted. See Lime I Letter and FTEN I Letter.

Nasdaq also agrees with a commenter that firms should be free to designate personnel to review trading activity reports that have the requisite supervisory training and responsibility.⁵¹ Nasdaq believes that “appropriate supervisory personnel” should review trading activity and that execution reports must be reviewed immediately and other reports must reviewed promptly. Accordingly, the proposal requires that each Sponsoring Member shall ensure that appropriate supervisory personnel receive and review 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 such as market manipulation or insider trading. At a minimum, appropriate supervisory personnel should receive immediate post-trade execution reports of trading activity of all Sponsored Participants, including their identities, all required audit trail information by no later than the end of the trading day, and all information necessary to create and maintain the trading records required by applicable Regulatory Requirements by no later than the end of the trading day. Appropriate supervisory personnel shall review execution reports immediately and all other reports promptly.

The Commission believes that the proposed regulatory controls required for Sponsored Access and Direct Market Access, as set forth in the Final Proposal, are consistent with the Act. The Sponsoring Member ultimately is responsible for complying with all Regulatory Requirements to which it is subject in connection with trading activity conducted through use of its MPID. Requiring each Sponsoring Member to establish adequate procedures and controls reasonably designed to permit it to effectively monitor and control order flow sent to Nasdaq for compliance with Regulatory Requirements should help assure that such orders enter Nasdaq’s systems in compliance with Regulatory Requirements. The Commission also notes that in

⁵¹ See SIFMA I Letter.

today's highly automated trading environment, systemic controls are essential to reasonably ensure that orders sent to an exchange comply with Regulatory Requirements. The Commission also believes that requiring receipt and review of post-trade reports by the Sponsoring Member should provide surveillance personnel with important information about potential regulatory violations, and better enable them to investigate, report or halt suspicious or manipulative trading activity. The post-trade execution reports should provide a valuable supplement to the pre-trade risk controls contained in the Final Proposal.

Several commenters note the potential systemic risk posed by Sponsored Access arrangements and the importance to the marketplace of effective regulation of such arrangements.⁵² In response to those commenters, Nasdaq notes that it is working to develop a proposal that would require Sponsoring Members to obtain a unique MPID for each Sponsored Participant. In addition, two commenters stressed that industry regulators should develop a uniform rule and then apply it consistently across all markets and all market participants.⁵³ Nasdaq agrees that the regulation of electronic access should be uniformly regulated as to not create the opportunity for arbitrage between the rules of competing exchanges.

E. Commission Findings

The Commission believes that Nasdaq's proposal is a productive step toward assuring that broker-dealers providing access to the markets, including through Sponsored Access and Direct Market Access arrangements, implement risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of that activity. In particular, Nasdaq's proposal requires Sponsoring Members to implement controls and procedures to address certain key risks, such as the potential breach of a credit limit, the

⁵² See Lime I Letter, Lek Letter, and FTEN I Letter.

⁵³ See SIFMA I Letter and Wedbush Letter.

submission of erroneous orders, and the failure to comply with Regulatory Requirements. The Commission also believes the requirement that a Sponsoring Member receive immediate post-trade execution reports should provide a valuable supplement to the pre-trade risk controls and represents an improvement over the rules and guidance issued by other self-regulatory organizations in this area. The Commission notes, however, that a Nasdaq rule would, of course, apply only to broker-dealers offering Sponsored Access or Direct Market Access to Nasdaq.

In addition, Nasdaq's proposal permits a fair amount of flexibility in the extent to which a Sponsoring Member can delegate the administration and control of its risk management controls to others, and rigor with which the financial controls are applied on a pre-trade basis.

Nevertheless, the Commission believes that Nasdaq's proposal would strengthen the risk management requirements applicable to Nasdaq members that offer Sponsored Access or Direct Market Access, and thereby help address concerns about the risks posed by this activity to the Sponsoring Member and the markets. Accordingly, the Commission believes Nasdaq's proposal is consistent with the Act.

IV. Accelerated Approval of the Proposed Rule Change, as Modified By Amendment Nos. 1, 2, and 3 Thereto

The Commission finds good cause, pursuant to Section 19(b)(2) of the Act,⁵⁴ for approving the proposed rule change, as modified by Amendment Nos. 1, 2, and 3 thereto, prior to the thirtieth day after the date of publication of notice of filing of Amendment Nos. 2 and 3 in the Federal Register.

⁵⁴ 15 U.S.C. 78s(b)(2). Pursuant to Section 19(b)(2) of the Act, the Commission may not approve any proposed rule change, or amendment thereto, prior to the thirtieth day after the date of publication of the notice thereof, unless the Commission finds good cause for so doing.

In Amendment No. 2, Nasdaq responds to comments on the Original Proposal. Several commenters argue that Nasdaq's proposed definition for Sponsored Access is overly broad and expands the scope of what the industry typically defines as Sponsored Access.⁵⁵ In response, Nasdaq limits the definition of Sponsored Access to instances where the Sponsored Participant enters orders directly into Nasdaq using the Sponsoring Member's MPID and the orders do not pass through a Member System before reaching Nasdaq. Nasdaq distinguishes Sponsored Access from Direct Market Access, where an Exchange member provides access to a firm or person that makes decisions on order routing and order entry, but the orders pass through a Member system before reaching Nasdaq. Nasdaq also eliminates the distinction in the Original Proposal between Direct Sponsored Access and Third Party Sponsored Access. Moreover, Nasdaq also defines two different types of systems, Member Systems and Sponsored Access Systems, to ensure that all Direct Market Access and Sponsored Access arrangements are effectively regulated with adequate financial and regulatory controls.

Several commenters also object to a requirement in the Original Proposal that Sponsoring Members execute contracts with Third Party Providers that would require Third Party Providers to in turn sign agreements with each Sponsored Participant.⁵⁶ The commenters believe that this requirement was needlessly burdensome and that the compliance burden should remain only with the Sponsoring Member.⁵⁷ Nasdaq responds by eliminating the requirement that Third Party Providers and Sponsored Participants must sign agreements between them. Nasdaq also modifies the proposal to clearly differentiate between two different types of agreements: those between Sponsoring Members and Sponsored Participants, and those between Sponsoring

⁵⁵ See supra notes 22-25.

⁵⁶ See supra note 32.

⁵⁷ Id.

Members and Third Party Providers. Agreements between Sponsoring Members and Third Party Providers must identify financial and regulatory controls that are satisfied by the Third Party's technology, and must also contain commitments regarding limited access to books and records, physical security of technology, Nasdaq's ability to audit the Sponsored Access system, and the ability for either the Sponsoring Member or Nasdaq to terminate Participant access.

Nasdaq also responds to comments regarding the financial and regulatory controls provisions of the Original Proposal. Commenters argue that the procedures and controls meant to prevent certain conduct should be "reasonably designed," rather than impose a strict liability standard,⁵⁸ and that the regulatory controls provision should not include a non-exclusive list of regulatory requirements that would potentially confuse market participants.⁵⁹ In Amendment No. 2, Nasdaq agrees with both points, and modifies the proposed rule change to require "reasonably designed" procedures and controls, and to eliminate the non-exclusive list of regulatory requirements. Nasdaq also clarifies that trading activity reports would be reviewed by "appropriate supervisory personnel." The Commission finds that Nasdaq's proposed changes in response to commenter concerns in Amendment No. 2 are consistent with the Act.

In Amendment No. 3, Nasdaq modifies language in the proposed rule change to clarify the requirement that when a Sponsoring Member provides another person or entity with access to Nasdaq, it must do so either through a Sponsored Access System or a Member System. By providing such access through either of these two types of systems, Sponsoring Members are responsible for all trading conducted pursuant to that arrangement to the same extent as trading directly conducted by the Member for its customers.⁶⁰ The Commission believes that this

⁵⁸ See supra notes 39-41 and 45.

⁵⁹ See supra note 48.

⁶⁰ See proposed Nasdaq Rule 4611(d).

proposed change sufficiently clarifies the significant responsibilities that the Sponsoring Members must assume for any Sponsored Access arrangements. The Commission believes that Nasdaq's proposed changes in response to commenter concerns in Amendment No. 3 are consistent with the Act.

The changes proposed in Amendment Nos. 2 and 3, discussed above, seek to clarify the operation of the proposal and address commenters concerns regarding the proposal as noticed in the Federal Register on January 29, 2009. The Commission notes that one commenter requests that the proposal, as modified by Amendment Nos. 2 and 3, be published for notice and comment before Commission approval of the proposal.⁶¹ The Commission believes that the changes proposed in Amendment Nos. 2 and 3, discussed above, are designed to address commenters' concerns as raised through the notice and comment process under Section 19(b).⁶² Accordingly, the Commission finds that good cause exists to approve the proposed rule change, as modified by Amendment Nos. 1, 2, and 3 on an accelerated basis.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment Nos. 2 and 3, including whether Amendment Nos. 2 and 3 is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File No. SR-NASDAQ-2008-104 on the subject line.

⁶¹ See SIFMA II Letter.

⁶² See 15 U.S.C. 78s(b).

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASDAQ-2008-104. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASDAQ-2008-104 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁶³ that the proposed rule change (SR-NASDAQ-2008-104), as modified by Amendment Nos. 1, 2, and 3, be, and it hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁶⁴

Florence E. Harmon
Deputy Secretary

⁶³ 15 U.S.C. 78s(b)(2).

⁶⁴ 17 CFR 200.30-3(a)(12).