SIFMA
Securities Industry and
Financial Markets Association

February 26, 2009

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Exchange Act Release No. 59275; File No. SR-NASDAQ-2008-104; Sponsored Access

Dear Ms. Murphy:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on Securities Exchange Act ("Exchange Act") Release No. 59275, in which the Securities and Exchange Commission (the "SEC" or "Commission") requests comments on a proposal by The NASDAQ Stock Market LLC ("NASDAQ") to amend its sponsored access rule, specifically NASDAQ Rule 4611(d) (the "Proposal"). In the Proposal, NASDAQ proposes to define the scope of what it would consider to be a "sponsored access" arrangement. It further proposes to define the relevant parties – thus, the broker-dealer that sponsors a client or other counterparty's direct access to an exchange would be a "Sponsoring Member," and the sponsored client/counterparty would the "Sponsored Participant." In furtherance of a broad obligation that Sponsoring Members be responsible for the conduct of their Sponsored Participants, the Proposal would impose substantive obligations on the Sponsoring Member in three different areas – Contractual Provisions, Financial Controls and Regulatory Controls – as discussed below.

SIFMA strongly believes that having a good, consistent, predictable and practical rule is critically important to the industry. Therefore, in addition to considering our views as expressed in this letter, we would strongly encourage the SEC, the Financial Industry Regulatory Authority

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington, D.C. and London, and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

("FINRA"), NASDAQ and other exchanges that permit sponsored access to convene a meeting with representatives of the industry to discuss the Proposal before it is acted upon.

I. Background

SIFMA and its constituent firms understand that the Proposal is not just an ordinary rule filing; rather, it is intended to establish a uniform legal and regulatory framework for all sponsored access arrangements, extant and prospectively, and irrespective of the destination exchange. We are therefore very interested in ensuring that the rule set that results from this process appropriately balances regulatory concerns (such as ensuring market integrity and minimizing systemic risk) with those of sponsoring broker-dealers, the clients and counterparties for whom they sponsor access, and the destination exchanges themselves. We believe all such parties have obligations in ensuring that sponsored access arrangements are conducted responsibly and consistent with applicable laws and rules, but that the regulatory framework that the Proposal purports to establish should not be so burdensome or unrealistic as to disincentivize the continued evolution of this important business.

Coincident with increasing market fragmentation and developments in technology and telecommunications, the past decade has witnessed revolutionary changes in the manner in which institutional investors interact with broker-dealers and market centers. The market driven evolution of these businesses has allowed a variety of diverse business models to evolve. These market forces have contributed to a successful client offering, in response to client needs, that has increased competition and market efficiency while lowering execution costs. Following are some of the highlights of these advancements:

- *Electronic order routing* via proprietary or third party front-end systems from clients' trading desks to broker-dealers' order management systems for manual handling by sales traders and position traders.

- The development by many broker-dealers of proprietary, *algorithmic strategies* (typically, smart order routing technology, often in tandem with one or more alternative trading systems) into which electronically or telephonically placed orders are directed.

- *Direct market access* ("DMA") arrangements, whereby clients' electronic, self-directed orders pass through the routing broker-dealer's trading technology infrastructure (including, if applicable, pre-trade risk controls) with little or no human intervention on their way to the destination markets, under the routing broker's name.

- *Sponsored access arrangements* ("Sponsored Access"), which generally take two forms:

    - *Third party direct sponsored access* ("TPSA") arrangements, whereby clients' electronic, self-directed orders are routed through a third party vendor or service bureau on their way to destination markets under the sponsoring broker-dealer's

name, without passing through the sponsoring broker's trading technology infrastructure.

- *Direct sponsored access* ("DSA") arrangements, whereby clients' electronic, self-directed orders are routed directly to the destination markets under the sponsoring broker-dealer's name, without passing through the sponsoring broker's trading technology infrastructure or that of any third party.

  Notwithstanding that clients' orders do not pass through their infrastructure in connection with Sponsored Access arrangements, sponsoring broker-dealers have been operating under the general understanding that they are responsible for the activity of their clients whose access they sponsor

Most relevant to the current discussion are DMA and Sponsored Access arrangements, which enable sophisticated institutional investors to self-direct the routing and execution of their orders to exchange markets electronically and with minimum broker intervention, without themselves having to register as broker-dealers and become members of exchanges.[2] This access enables them, among other things, to reduce the amount of time it takes to route and execute orders, and to reduce their transaction costs – both of which greatly assist those clients in successfully executing their business strategies and satisfying their own best execution obligations.

Before any rule specifically required it, most broker-dealers began performing rigorous "on-boarding" checks of clients in connection with both DMA and Sponsored Access arrangements. This due diligence is often heightened for DSA and TPSA clients; indeed, most firms are more particular in permissioning the clients for which they are willing to enter into DSA and TPSA arrangements due to the increased attendant risks the broker-dealers bear. In addition, firms have developed contractual arrangements that impose obligations on clients. These contracts have typically taken the form of electronic trading agreements and evolved to incorporate, or be supplemented by addenda covering, terms and conditions associated with Sponsored Access arrangements. Broker-dealers have used these agreements (and/or addenda) to impose various obligations on their clients, including those to maintain the security of systems used to access markets under the member's name, to properly train authorized users of such systems, and to comply with applicable laws and rules. Moreover, member firms have developed certain systemic controls to monitor whether various trading limits imposed on clients are observed and particular rules are being complied with.

Thus, as the electronic trading business has progressed in response to client demands, member firms, for their own protection, have voluntarily developed, individually and through SIFMA, various contractual and systemic means that also serve the end of market integrity. While firms acknowledge that perhaps these protocols and tools are not perfect, and that practices among

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[2] Direct access to exchanges is also used by registered broker-dealers through the sponsorship of other broker-dealers to obtain rapid access to exchanges of which they are not themselves members, and to leverage volume and other kinds of benefits that sponsoring member firms enjoy through their membership of such exchanges.

industry participants do vary, they want to emphasize that the market on its own, for commercial, risk management and franchise protection reasons, has advanced significantly the risk management effort – and prior to the exchanges promulgating rules specific to the practice of direct access. Moreover, firms had been working in good faith with FINRA on a set of best practices to guide these businesses as they continued to grow and innovate. Indeed, we believe that such guidelines, as drafted, would have been more effective than existing exchange rules and the Proposal in addressing the relative responsibilities of all the various parties involved in DMA and Sponsored Access arrangements (and even with any new arrangements not yet developed).

Nonetheless, over the past couple of years, the exchange markets that allow sponsored access adopted separate rule sets designed to govern, for the most part, the contractual relationships between sponsoring broker-dealers and clients and other counterparties for which they sponsor direct access to such exchanges in connection with sponsored access arrangements. These rules set forth minimum standards of oversight on the part of such members to promote market integrity and prudent risk management.[3] These rule sets unfortunately deviate from one exchange to the next, creating inconsistencies, confusion and a host of disparate requirements. In some cases, the definitional scope of the rule is either too expansive or simply unclear. Accordingly, the firms applaud any effort on the part of the exchanges, the Commission and FINRA to establish an approach to Sponsored Access arrangements that is clear, uniform and consistently interpreted and enforced, so that all broker-dealers who sponsor their clients' direct access to exchanges pursuant to such arrangements are on level footing as far as their regulatory and contractual obligations are concerned. However, for the reasons stated below, while we believe the Proposal is an important and helpful first step, we note the following issues raised by this particular Proposal.

II. Discussion

The main points we wish to make in response to the Proposal are as follows, each of which is described in greater detail herein:

- Exchange rules governing sponsored access arrangements should be clear, uniform and consistently interpreted and enforced to ensure a level playing field.

- The Proposal's express, detailed provisions should be limited exclusively to Sponsored Access arrangements as defined above, *i.e.*, those in which Sponsored Participant orders do not flow through a Sponsoring Member's trading technology infrastructure prior to reaching NASDAQ – meaning, either DSA or TPSA, but not DMA or any other electronic order routing or execution arrangement that involves orders passing through a broker-dealer's infrastructure prior to reaching a destination market.[4]

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[3] *See, e.g.*, in addition to NASDAQ Rule 4611(d), NYSE Arca Rule 7.29; NYSE Rule 123B, Supplementary Material .30; BATS Rule 11.3.

[4] At least one firm believes that the rule should exclude TPSA from the scope of this rule. This firm believes the

- As described above, Sponsoring Members accept the notion that they are responsible for the activities of the clients whose direct access to exchanges they sponsor. Given their acceptance of such responsibility, the firms believe the rule set governing sponsored access should provide more flexibility than the Proposal would provide in the manner in which they conduct due diligence, contract with clients and restrict/monitor client activity.

- The Contractual Provisions portion of the Proposal includes burdensome document production requirements for which the underlying regulatory objective is, at best, unclear.

- The Financial Controls portion of the Proposal fails to take into account that pure DSA arrangements do not allow for the "prevention" or "rejection" of orders, as opposed to the immediate, post-execution monitoring of activity.

- Some firms believe that the Financial Controls portion of the Proposal should provide definitive guidelines to all prospective Sponsoring Members regarding such Members' obligations to maintain risk controls in connection with their sponsored access products tantamount to those that would be applied to such Members' other trading activities (whether they be voice, electronic, DMA or otherwise) as a means for reducing systemic risks.

- The Regulatory Controls portion of the Proposal is unnecessary given the provision stated clearly up front in Rule 4611(d) that Sponsoring Members bear the responsibility for their Sponsored Participants' activity. Further, the articulated standard of "ensuring" compliance is inconsistent with the longstanding standard placed on broker-dealers of having policies, procedures and controls that are "reasonably designed" to achieve compliance.

Proposal should be limited exclusively to sponsored access arrangements in which Sponsored Participant orders do not flow through a Sponsoring Member's infrastructure or that of another third party that they can control through contracts, due diligence, certification or otherwise (*e.g.*, a service bureau, vendor, or other system or technology provider, which also can include another broker-dealer acting in such capacity, provided it has the necessary and appropriate compliance and supervisory tools when acting on behalf of the sponsoring broker) prior to reaching an exchange – which would mean DSA only. In this context, this firm believes that DMA and TPSA should be treated similarly and fall outside the scope of the rule, insofar as what has been purportedly the real concern of the SEC, FINRA and the exchanges is DSA where there is virtually no buffer, filter or other supervisory monitor or control that can be implemented or controlled by the Sponsoring Member between the client and the exchange. This firm further states that if TPSA were included within the scope of the rule, legitimate service bureau arrangements would be unfairly discriminated against in favor of firms who own, rather than license, the appropriate prophylactic infrastructure for their DMA offerings. Stated another way, there really is little distinction between DMA and TPSA. The difference is only that in the case of TPSA a firm chooses to rent its infrastructure from a vendor rather than build its own; there is no reason that that infrastructure cannot have all the regulatory and supervisory controls that a firm's own proprietarily owned and controlled DMA platform would have. It appears to this firm that DSA would raise more concerns from a regulatory perspective, and so that is where the pressure should be applied, not to DMA and TPSA.

- The Commission, in its orders approving exchange rules on sponsored access, should state that the exchanges also bear some responsibility in connection with sponsored access arrangements, particularly in promoting market integrity and managing systemic risk.

A. Sponsored Access Should be Defined Narrowly

In contrast to current practice and the widely held industry understanding of the term, the Proposal would define "sponsored access" to incorporate, *without exclusion*, three types of access:

- **Direct Market Access** – where self-directed orders from the Sponsored Participant pass through the Sponsoring Member's infrastructure prior to entering the NASDAQ marketplace;

- **Direct Sponsored Access** – where self-directed orders from Sponsored Participants are routed and entered directly into NASDAQ through a dedicated port provided by the Sponsoring Member; and

- **Third Party Sponsored Access** – where a third party (such as a vendor, service bureau or the destination exchange) provides technology for the Sponsored Participant to access NASDAQ pursuant to an arrangement with a Sponsoring Member.

NASDAQ's proposed definition of "sponsored access" is unnecessarily expansive and unclear, and the non-exclusivity of the definition would create significant uncertainty as to the scope of the provisions. Read literally, for example, one could interpret the definition to cover merely the routing of an order electronically by a client to a broker. We believe that all arrangements whereby a client or other counterparty routes an order, electronically or otherwise, *to or through the broker taking responsibility for the order* are comprehensively covered under existing laws and regulations. That would include DMA, given that orders and executions in connection with DMA arrangements flow through the broker-dealer's infrastructure for purposes of capturing details for books and records and implementing appropriate pre- and post-trade controls. Overlaying a separate regulatory regime under those circumstances is unnecessary and only creates uncertainty. As noted above, the electronic trading businesses that involve orders flowing through broker-dealers' infrastructure are relatively mature businesses at this point, and the regulatory regime that attaches to them is appropriate, well understood by the industry, and effective in its current form.

On the other hand, SIFMA acknowledges that true Sponsored Access – which we would define narrowly, as described above, to encompass only those arrangements where orders *do not flow* through a sponsoring broker's infrastructure prior to accessing the destination market for execution (*i.e.*, currently, DSA and TPSA) – is different, and concedes that heightened scrutiny on the part of the Sponsoring Members, the exchanges and the regulators is appropriate. Thus, the firms do not disagree with NASDAQ's determination that there be reasonable contractual

provisions addressing certain important concepts or that firms employ appropriate financial and regulatory controls to foster robust supervisory oversight. But in assessing the level of detail that needs to be incorporated into rules addressing Sponsored Access, we believe that the SEC, FINRA and exchanges should recognize as a threshold matter the Sponsoring Members' acceptance of the notion that the activities of their Sponsored Participants are their responsibility, which from a regulatory standpoint should offer some comfort that a natural discipline already exists to conduct this business in a manner that promotes market integrity, financial responsibility and regulatory compliance and minimizes systemic risks. With that said, the firms have concerns about particular details of the proposed requirements, which are addressed more fully in subsequent sections of this letter.

B. Contractual Provisions Are Inflexible and Unrealistic

Under the Proposal, only DSA and TPSA arrangements would require agreements between the Sponsoring Member and Sponsored Participant that contain certain contractual provisions, including:

- Representations that all applicable federal securities laws and exchange rules will be complied with;
- The Sponsored Participant will provide the Sponsoring Member with access to its books and records;
- Trading activity will remain within financial limits set by the Sponsoring Member;
- The Sponsored Participant must make certain commitments pertaining to security and access to NASDAQ as well as provide requisite training for use of the system;
- The Sponsored Participant must provide the Sponsoring Member with access to current and complete corporate and financial records; and
- The agreement must be terminable immediately if the Sponsored Participant or a third party access provider fails to honor its commitments.

We are concerned that the Contractual Provisions section of the Proposal imposes, directly and perhaps indirectly, unnecessary additional obligations on Sponsoring Members that if approved would hinder the efficient conduct of the Sponsored Access business. We believe any provisions in NASDAQ's rule covering contractual relationships need to incorporate the extensive work that has already been done voluntarily by the industry (as described above) and otherwise be flexible, workable, sustainable and commercially realistic.

The Proposal requires that sponsored access arrangements be memorialized through contractual relationships between Sponsoring Members and Sponsored Participants and, in connection with TPSA arrangements, between third party vendors/service bureaus and both Sponsoring Members

and Sponsored Participants. The Proposal specifies what would have to be incorporated into such agreements. Although some of what would be required may already be covered in existing electronic trading agreements and/or addenda specific to sponsored access arrangements, the Proposal would mandate additional, and highly problematic, provisions that would not ordinarily be found in these or any other agreements between broker-dealers and clients or arms length counterparties; indeed, they are more suggestive of agreements between regulators and regulated entities. First, the Proposal would require that Sponsored Participants agree to make their books and records available to the Sponsoring Member upon request. Second, the Proposal would require that the Sponsored Participant provide the Sponsoring Member with *complete and current* corporate and financial information about the Sponsored Participant.

It is not clear from the Proposal what objective NASDAQ purports to advance by requiring such information to be provided to Sponsoring Members, but we have a general concern that Sponsoring Members' having access to such general corporate and financial information and other books and records (whether or not requested) of Sponsored Participants, most of which would have nothing to do with sponsored access activity conducted through that Sponsoring Member, could result in an expectation of responsibility or liability on the part of the Sponsoring Member where no such liability has historically attached. These sweeping document production requirements seemingly confer authority on Sponsoring Members that only a *bona fide* regulator historically has been or should be able to exercise. To provide sell-side market participants with this authority would represent a significant change and evoke strong objections from Sponsored Participants of all types. There is a significant difference between, on one hand, a Sponsoring Member's taking responsibility for the trading activity that a Sponsored Participant does under that Member's sponsorship and, on the other hand, in essence deputizing the Sponsoring Member to monitor such Participant's activities generally. We acknowledge that the Proposal does not specify that as the objective underlying these document requirements, but the absence of any explanation for them causes us to speculate that this is one possible motivation.

In addition, these additional requirements, even if pared back, do not take into account the particularities of the relationships between Sponsoring Members and Sponsored Participants, but rather operate in a one-size-fits-all manner that tries to encompass all types of Sponsored Participants and could restrict the operation and overall use of these agreements. In some cases, the Sponsored Participant may itself be a broker-dealer (and therefore a competitor) of the Sponsoring Member. In other cases, the Sponsored Participant may be an institutional client with highly confidential and proprietary trading models (and who may think of the Sponsoring Member as a potential competitor). As such, Sponsored Participants may hesitate to enter into Sponsored Access agreements if they are uncomfortable producing information that Sponsoring Members would be required to obtain from them.

We recommend, therefore, that the Contractual Provisions section of the Proposal be reduced to a general obligation on the part of Sponsoring Members to obtain from Sponsored Participants reasonable and relevant books and records information (relating to actual business conducted through that Member) in line with the Sponsoring Member's reasonable policies and procedures.

C. Obligations under Financial Controls Provisions Are Unclear

The Proposal includes several provisions regarding "Financial Controls," which would apply to all types of sponsored access arrangements as defined under the Proposal. Specifically, proposed Rule 4611(d)(4) would require:

- That each Sponsoring Member 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; and

- That, at a minimum, the Sponsored Access system would be required to:

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

    - Prevent Sponsored Participants from trading products that the Sponsored Participant or Sponsoring Member is restricted from trading.

    - 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.

We believe the Financial Controls provisions should be amended or clarified so that they are consistent with current regulatory practice. In their current form, the Financial Controls provisions raise a number of practical issues for the operation of Sponsored Access arrangements, and appear to impose obligations on Sponsoring Members that would go beyond the analogous obligations in connection with transactions executed by member firms for their customers or introducing firms.

As a threshold matter, and as we note below with respect to the Regulatory Controls provisions, the Proposal would impose in essence a strict liability standard on Sponsoring Members by requiring them to "prevent" certain types of trades in all cases. We believe the appropriate standard would be to require Sponsoring Members' systems to be "reasonably designed to prevent" those types of trades. Further, we believe that meaningful guidance is required on what could constitute the "reasonably designed to prevent" standard so as to minimize any competitive disparity between firms.

Our specific comments on the Financial Controls provisions are as follows:

- **Prevention of Order Entry.** The Financial Controls provisions mandate that Sponsoring Members under certain circumstances prevent orders from Sponsored Participants from being entered. While that is an attainable standard under a DMA arrangement (which, as noted above, we believe should be outside the scope of the Proposal anyway), it is impossible under a pure DSA arrangement. The most that a Sponsoring Member could

do is either (1) obtain a contractual commitment from the Sponsored Participant that it will adhere to all financial controls that the Sponsoring Member imposes on it, coupled with post-execution surveillance by the Sponsoring Member to verify compliance, or (2) require that all orders of Sponsored Participants must be filtered through a third party vendor or service bureau (which presumably could include the exchange itself), which would then be contractually responsible to the Sponsoring Member for enforcing the trading and credit limits that the Sponsoring Member imposes. In other words, it is unclear to us whether NASDAQ's intention is to eliminate DSA altogether; if that is the case, then the Proposal needs to state that explicitly in order to provide firms the proper notice in order to comment specifically on that concept. We would argue, however, that Sponsoring Members (again, bearing responsibility for their Sponsored Participants' activities through their own reasonable policies and procedures governing the business) should have the flexibility to implement either approach to enforcing such trading and other limits.

- **Controls Designed to Prevent Systemic Risk.** There is significant concern among some firms that allowing too general a standard in how Sponsored Participants' trading activity is monitored and controlled by Sponsoring Members could result in some Members, no longer constrained by their own systems capacity, allowing trading by Sponsored Participants well in excess of the credit and risk controls that such Member would otherwise place on that Participant's trading if it were flowing through the Member's own infrastructure. There is a belief among these firms that a lack of definitive and tangible constraints on the overall trading activity of Sponsored Participants would insert a significant amount of systemic risk into the market, with potentially dangerous results. These firms are concerned that, without clear guidelines for the establishment and maintenance of both counterparty-specific and enterprise-wide credit and risk controls in the context of sponsored access, some Members may allow Sponsored Participants to trade well in excess of that client's traditional risk limits as well as the Sponsoring Member's own capital maintenance requirements. Under these circumstances, a potential "disaster scenario" would be one (or multiple) Sponsoring Members allowing almost unencumbered trading activity and market access, thereby accumulating significant counterparty exposures to the sponsoring exchanges well in excess of their risk capacity. Under such a scenario, were a significant amount of these trades to fail, the sponsoring exchanges and, by extension, the overall market, may be left with significant financial exposures that could adversely impact all trading activity in the market. Accordingly, these members urge that NASDAQ consider providing definitive guidelines applicable to all prospective Sponsoring Members regarding such Members' obligations to maintain risk controls in connection with their sponsored access products tantamount to those that would be applied to such Members' other trading activities (whether they be voice, electronic, DMA or otherwise) as a means for reducing such systemic risks.

- **Product Limitations.** The provision limiting a Sponsored Participant to trading the products that a Sponsoring Member is permitted to trade should be clarified or amended. Such a limitation is understandable if a Sponsoring Member is not authorized or equipped to trade and supervise activity in certain types of securities products. For example, if a Sponsoring Member is not authorized to trade options and surveil activity therein, it would make sense that a Sponsored Participant should not be able to trade options through a Sponsored Access arrangement with that member firm. However, the provision also could be read to prevent a Sponsored Participant from effecting certain types of transactions simply because the Sponsoring Member is prohibited under then-existing circumstances from doing to. For example, a Sponsoring Member whose parent company's stock is publicly traded is restricted from buying and selling that stock for its own account, but there is no reason that a Sponsored Participant should be subject to the same trading restrictions provided the Sponsoring Member is acting as the Sponsoring Participant's agent (which is always the case with Sponsored Access arrangements). Furthermore, the provision could be read to require a Sponsoring Member to prevent a Sponsored Participant from engaging in transactions that can be effected via the Sponsored Member but are not permissible for the Sponsored Participant for whatever reason. It is unreasonable to expect a Sponsoring Member to monitor a Sponsored Participant's ongoing compliance with its own internal policies regarding the types of securities it is permitted to trade.

D. Regulatory Controls Provisions Are Unnecessary Given Current Realities

The Proposed Rule Change includes two specific provisions regarding "Regulatory Controls." Specifically, proposed Rule 4611(d)(5) would require:

- That each Sponsoring Member have systemic controls to *ensure* compliance by the Sponsored Participant with applicable Regulatory Requirements, defined to include, but not be limited to, 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; and

- That each Sponsoring Member *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 such as market manipulation or insider trading. At a minimum, the member firm's compliance unit would have to receive immediate, post-trade execution reports of trading activity of its 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 Regulatory Requirements by no later than the end of the trading day.

As a threshold matter, we agree that Sponsoring Members maintain ultimate responsibility for the conduct of their Sponsored Participants on NASDAQ. However, we believe the Proposal in its current form would create confusion as to the scope of those obligations and would impose impractical burdens that unnecessarily expand the Sponsoring Member's regulatory obligations. In particular, the Proposal would effectively require Sponsoring Members to become guarantors of their Sponsored Participants' compliance with Regulatory Requirements. In our view, this obligation would go well beyond the analogous obligations imposed on member firms with respect to their customers or introducing firms.

Additionally, the Proposal is unclear as to whether the Regulatory Controls obligations would attach before or after execution of an order by a Sponsored Participant. It would be inconsistent with current regulatory requirements to suggest that a Sponsoring Member have the ability to block every transaction by a Sponsored Participant that has the potential to violate a Regulatory Requirement. Member firms are forced by necessity to conduct their regulatory surveillance with respect to a number of important market integrity issues (*e.g.*, insider trading and manipulative trading practices, including wash sales and marking the close) on a post-trade basis, using exception reports and responding to red flags that may present themselves.

Moreover, the practical realities of Sponsored Access arrangements could make compliance with the Regulatory Controls provisions impracticable, if not impossible. In a DSA arrangement, the Sponsoring Member would be unable to impose regulatory controls on a Sponsored Participant prior to execution. The Sponsoring Member only would be able to impose regulatory controls on a post-trade basis in such an arrangement because the orders are submitted outside the Sponsoring Member's systems. In a DMA arrangement, a Sponsoring Member would be able to impose certain regulatory obligations on a pre-trade basis because the Sponsored Participant's orders are transmitted through the Member's systems. Even in those arrangements, however, the Sponsoring Member would be unable to impose certain regulatory controls until it received execution reports. In light of the foregoing concerns, we recommend that the Proposal be amended to eliminate any Regulatory Requirement, with which compliance can only be reasonably monitored on a post-execution basis. This would include, for example, monitoring for possible insider trading and manipulative activity. To the extent that that activity can only be monitored post-execution, oversight of such activities, and broker-dealers' obligations in that regard, are already covered under existing federal and state securities laws/rules and SRO rules. As noted previously, the focus of any sponsored access rule should be limited to those areas that may not be sufficiently defined under an existing regulatory framework.

In addition to these general comments, we have a number of specific comments on the Regulatory Controls provisions.

- **Standard of Compliance.** Under the Proposal, Sponsoring Members would be required to have systemic controls to "ensure" compliance by Sponsored Participants with Regulatory Requirements, and to "ensure" that compliance personnel receive timely reports of trading activity by Sponsored Participants. A regulatory requirement to "ensure" performance is impracticable and inconsistent with similar requirements under other applicable regulations and SRO rules. In our view, the requirements should be that

member firms have "systemic controls reasonably designed to prevent violations by Sponsored Participants of Regulatory Requirements," and that member firms "establish policies and procedures reasonably designed to provide timely delivery to member firms of reports of trading activity by Sponsored Participants." These suggested standards are well known to broker-dealers and provide a known frame of reference when designing controls and implementing policies and procedures.[5]

- **Scope of Regulatory Requirements.** We believe the term "Regulatory Requirements," as defined nonexclusively by a laundry list of seemingly random regulatory requirements, will create confusion as to the nature of member firms' obligations under the proposed rule. In this regard, we note that the term Regulatory Requirements would be defined broadly under the Proposal as "all applicable federal securities laws and rules and [NASDAQ] rules, including but not limited to the NASDAQ Certificate of Incorporation, Bylaws, Rules and procedures with regard to the NASDAQ Market Center." Given this broad definition, we see no need to include a list of specific regulatory items in the provisions of proposed Rule 4611(d)(5). At a minimum, in some cases it is not clear what NASDAQ's intentions and expectations were in including those specific obligations.

  As examples of our concerns, without limitation, we note the following:

  1. Short Sales. We believe NASDAQ should clarify that the requirements under proposed Rule 4611 would not create obligations on Sponsoring Members in addition to those applicable pursuant to Regulation SHO under the Exchange Act. In particular, Sponsoring Members should be permitted to continue to rely on Sponsored Participants to properly mark sell orders as short or long and to comply with applicable locate and delivery requirements.

  2. Margin Requirements. It is unclear under the Proposal what was intended by the inclusion of the requirement that the Sponsoring Member ensure compliance with margin requirements. In particular, we are unclear how application of the margin rules in the context of sponsored access arrangements differs from their application in connection with more traditional order placement/entry and execution scenarios. We therefore request additional guidance from NASDAQ in order to comment more meaningfully on this requirement.

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[5] *See, e.g.*, Rule 611 of Regulation NMS under the Exchange Act (providing that "[a] trading center shall establish, maintain, and enforce *written policies and procedures that are reasonably designed to prevent trade-throughs* on that trading center of protected quotations in NMS stocks…" emphasis added); FINRA Rule 3010 (providing that "[e]ach member shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is *reasonably designed to achieve compliance with applicable securities laws and regulations*, and with applicable [FINRA] Rules" (emphasis added)).

3. Restricted Lists for Purposes of Rule 10b-18 under the Exchange Act. In our view, including Rule 10b-18 as a specific consideration in this regard is unnecessary and inappropriate. Rule 10b-18 is an issuer safe harbor and therefore not susceptible to violations per se. Therefore, an issuer could purchase its securities outside of Rule 10b-18 without necessarily committing a violation of applicable securities laws. Further, we believe it is highly unlikely that an issuer would use a Sponsored Access arrangement to conduct a repurchase of its own shares and, even if an issuer did so, it should not be the responsibility of the Sponsoring Member to police the issuer's compliance in this regard, unless on a post-trade basis the Sponsoring Member has reason to believe through surveillance or otherwise that the issuer was trying to manipulate the price of its stock.

- **Delivery of Post-Trade Reports.** NASDAQ should revise the Proposal to provide that the post-trade surveillance and audit reports required under proposed Rule 4611(d)(5)(B) could be delivered to "applicable supervisory personnel" at the Sponsoring Member rather than to "compliance personnel." Under current practice, it is commonplace for supervisory personnel within member firms to have primary responsibility for monitoring trading activity (often supplemented by reviews by compliance departments which may occur on a T+1 basis). These supervisory controls should not be displaced simply because orders are received through a Sponsored Access arrangement. In addition, the requirement to provide "immediate" post-trade execution reports is impractical and unnecessary. By requiring such reports to be received by Sponsoring Members immediately post-trade, Rule 4611(d)(5)(B) could be read to effectively require the Sponsoring Member to conduct real-time surveillance of Sponsored Participants' trading activity, which would go well beyond current regulatory expectations of broker-dealers in supervising their own trading activities and those of their customers and introducing firms. Moreover, the requirement to provide such reports immediately could be interpreted to require a Sponsoring Member to take immediate action in every case of a potential violation of a Regulatory Requirement. As noted above, under current regulatory practice, member firms rely on such things as exception reports and red flag reviews to conduct regulatory surveillance. Accordingly, we suggest that the Sponsoring Member be required to receive "prompt," rather than "immediate," reports.

E. Exchanges Permitting Sponsored Access Should Bear Regulatory Responsibilities

As previously mentioned, Sponsoring Members agree that, to the extent they engage in DSA or TPSA, they should bear responsibility for the activity of their Sponsored Participant clients. We recognize the importance of doing so from the standpoint of the broker-dealer's role in promoting market integrity, minimizing systemic risk and managing its own risks. Notwithstanding, we believe strongly that the exchanges must also bear their share of responsibility where that is concerned as well (beyond just their role in overseeing broker-dealers to ensure they are complying with their obligations). The exchanges are all for-profit, commercial enterprises, and enjoy substantial benefits from the order flow they receive as a

result of sponsored access arrangements. They understand the appetite of many institutional clients for minimal latency, and therefore have implemented numerous systemic solutions to reduce routing and execution times to that end. But for their willingness to accept order flow directly from institutions, non-member broker-dealers, and the like under the names of sponsoring member firms, there would be no sponsored access arrangements. Therefore, the firms believe that the exchanges, too, must own some level of responsibility for ensuring that sponsored order flow does not have a detrimental impact on the market as a whole.[6] This could take the form of imposing filters at the exchange level (if not otherwise filtered by another third party prior to arrival at the exchange) to enforcing trading limits and running orders through other types of checks (*e.g.*, relating to trading halts, proper use of order types, etc.). But, at the end of the day, we think it is inappropriate for any exchange that promotes or derives benefits from sponsored access arrangements to avoid responsibility in ensuring the safe and efficient conduct of such business. Therefore, we believe the Commission in its approval order of the Proposal and other exchange sponsored access rule filings should include a statement that reflects or describes the obligations of exchanges in this regard.

We think it is important to note that NASDAQ's Pre-trade Risk Management ("PRM") tool is not available for all routing and execution protocols to NASDAQ (*e.g.*, NASDAQ's "OUCH protocol). Therefore, to the extent that the SEC does not mandate that exchanges employ some sort of pre-trade risk management tool as a condition to providing sponsored access (at least as a backstop in the absence of another third party vendor serving a similar role), one might expect Sponsored Participants to resist, and move their business away from, Sponsoring Members that prudently require use of such a risk management tool. This has the potential for creating an uneven playing field, and would result in a "race to the bottom."

That said, we believe the SEC should be mindful of the fact that exchanges are for-profit enterprises that have their own, affiliated routing broker-dealers and in many cases are competitors of their members who are engaged in electronic routing and trading. In that vein, the SEC should caution that the exchanges' rules be designed to protect market integrity and not convey any form of an unfair advantage to such exchanges – for example, by mandating use of their own risk management tools to the exclusion of independent third parties' for which their ability to charge fees would be unconstrained by any competition.

F. All Exchange Sponsored Access Rules Should Go Live Simultaneously

The firms request, to the extent that the NASDAQ sponsored access rule that is ultimately approved by the SEC forms the basis for so-called "copycat" rule filings on the part of the other exchanges that provide for sponsored access, that all such rules carry the same implementation or effective date. Having all such rules go live at the same time will promote the consistency in

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[6] We note that the U.K. Financial Services Authority recently expressed a similar sentiment, although were not specific in how exchanges (or broker-dealers for matter) should carry out their responsibilities. *See* Financial Services Authority, Markets Division: Newsletter on Market Conduct and Transaction Reporting Issues, Issue No. 30, November 2008, at page 10.

practice and protocol that the industry has long been seeking. In addition, the implementation date for such rules should reflect that, depending on the details of the ultimate final rules, firms may need some lead time to effect systems changes, allow for testing where necessary, alter agreements, and update policies and procedures. Finally, to ensure uniformity and harmony between and among the exchanges' sponsored access rule sets, SROs should be strongly discouraged from independently deviating from the approved NASDAQ rule text. The unilateral use of different terms and definitions would breed confusion and undermine the goal of regulatory certainty among market participants.

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We would be pleased to discuss these comments in greater detail with the FINRA staff. I can be reached in this regard at 202-962-7300 or at avlcek@sifma.org.

Sincerely,

Ann Vlcek
Managing Director and
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