



February 24, 2009

**Via Electronic Mail:** [rule-comments@sec.gov](mailto:rule-comments@sec.gov)

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

**Re: Proposed Rule Change to Adopt a Modified Sponsored Access Rule; SR-NASDAQ-2008-104**

Dear Ms. Murphy:

The Managed Funds Association (“MFA”)<sup>1</sup> appreciates the opportunity to comment on The NASDAQ Stock Market LLC’s (“Nasdaq”) proposed rule change to adopt a modified Sponsored Access rule (the “Proposed Rule” or “Rule 4611”).<sup>2</sup> Nasdaq has defined “Sponsored Access” as the practice by a member firm (“Sponsoring Member”) of providing access to Nasdaq to another firm or customer (“Sponsored Participant”). MFA members are active users of electronic trading services and some are Sponsored Participants with respect to Nasdaq. MFA believes that direct access is an important trading alternative for its members. MFA supports the efforts of the Securities and Exchange Commission (the “Commission” or the “SEC”) and Nasdaq to adopt appropriate safeguards for sponsored access. MFA has a strong interest in the practical implications of the Proposed Rule, which, among other things, would provide a Sponsoring Member and Nasdaq with: (1) broad authority to examine the books and records of Sponsored Participants; and (2) authority to obtain certain information about the trading activity of Sponsored Participants. We raise several concerns and urge Nasdaq, and any other exchange or market center that adopts similar rules, to include confidentiality safeguards and representations to protect trade information of Sponsored Participants and to confirm that such information will be used exclusively for regulatory purposes.

## **I. Introduction**

The Proposed Rule provides a Sponsoring Member and Nasdaq with broad authority to access books and records and obtain trading information of Sponsored Participants, including reports of all trading activity by Sponsored Participants. (We refer to all Sponsored Participant information provided to a Sponsoring Member or Nasdaq, including corporate information, as

---

<sup>1</sup> MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately \$1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

<sup>2</sup> Exchange Act Release No. 59275 (Jan. 22, 2009); 74 *Fed. Reg.* 5193 (Jan. 29, 2009).

“Trade Data”). The Proposed Rule covers: (1) “Direct Market Access” where the Sponsored Participant’s orders pass through the Sponsoring Member’s systems prior to reaching Nasdaq; (2) “Direct Sponsored Access” where the Sponsored Participant enters orders directly into Nasdaq via a dedicated port provided by the Sponsoring Member; and (3) “Third Party Sponsored 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.<sup>3</sup>

MFA supports the premise that a Sponsoring Member and Nasdaq should have access to all necessary information to allow them to comply with their regulatory requirements, including monitoring for potential illegal activity. Nevertheless, we believe that aspects of the Proposed Rule are overly broad and are not directly tied to the specific trading activities at hand. In addition, we are concerned that the Proposed Rule lacks confidentiality safeguards and controls to protect the Trade Data of Sponsored Participants and to assure investors that the recipients of such information would use it exclusively for regulatory purposes. A market participant’s trading data constitute highly proprietary information that, if made publicly available, could be used to reverse engineer trading strategies. Moreover, access to such data and to a market participant’s books and records could create opportunities for front-running and possibly even insider trading in the case where a Sponsored Participant is an institutional investor or has inside information. Therefore, we respectfully request that Nasdaq clarify the Proposed Rule to require that both the Sponsoring Member who receives Trade Data, as well as any other recipients of the data (*i.e.*, Nasdaq), be required to maintain the confidentiality of such information and to use it exclusively for regulatory purposes, and that such obligations be meaningful and enforceable by a Sponsored Participant.

## **II. The Proposed Rule is Overbroad**

### *i. Sponsored Participant Information*

Sections (d)(3)(B) and (d)(3)(E) of the Proposed Rule require that Direct Sponsored Access and a Third Party Access Sponsored Participants must contractually agree to provide a Sponsoring Member with “access to its books and records promptly upon request” and “complete and current corporate and financial information about the Sponsored Participant.” We are concerned that these provisions are overbroad and not limited to the types of information that are relevant to the scope of access provided to the customer or related to the specific credit and other risk exposures created by Sponsored Access. For example, there is nothing in the proposed language that would allow a Sponsored Participant to decline to provide information to the Sponsoring Member that was utterly unrelated to the Sponsored Participant’s trading activity. We recommend that the scope of financial information provided be negotiated between the Sponsoring Member and the Sponsored Participant, and that the rule state only that Sponsored Participant provide information that is reasonably satisfactory to the Sponsoring Member.

Further, these provisions provide a Sponsoring Member with authority to review potentially sensitive and proprietary information without differentiating between regulatory and trading division employees of the Sponsoring Member. We are particularly concerned that employees of a Sponsoring Member’s proprietary trading division could access and misuse Trade Data to front-run a Sponsored Participant’s trades or to reverse engineer its trading strategy. To

---

<sup>3</sup> 74 *Fed. Reg.* 5195.

limit the potential for misuse of proprietary information, we recommend that Nasdaq limit the scope of access a Sponsoring Member may have with respect Trade Data to information directly related to trading conducted by the Sponsored Participant through Sponsored Access; and, likewise, limit the scope of available corporate and financial information to the specific credit and risk exposures created by Sponsored Access. We also recommend that the Proposed Rule include confidentiality safeguards, as further discussed in section III below.

*ii. Termination Agreements*

Proposed Section (d)(3)(F) of Nasdaq Rule 4611 provides that a Sponsoring Member or Nasdaq may immediately terminate the Sponsored Access if the Sponsored Participant or third party access provider fails to abide by its commitments. We are concerned that this provision is overbroad, fails to distinguish between immaterial and material commitments, and does not allow parties to negotiate grace and cure periods that would have to expire before a contract may be terminated. The standard practice has been for Sponsoring Members and Sponsored Participants to set forth contractually a list of specific events with appropriate grace and cure periods that would have to expire before a Sponsoring Member could unilaterally terminate a Sponsored Access agreement. We believe such practice provides Sponsoring Members and Sponsored Participants with greater clarity and certainty, and reduces the adverse risk of unilateral termination of a Sponsored Access agreement without advance notice. We recommend the Proposed Rule allow Sponsoring Members and Sponsored Participants to contractually agree to termination events, and grace and cure periods. We also believe that any suggested requirement should permit the parties to distinguish between immaterial and material failures and afford the parties the opportunity to discuss disagreements and cure failures. As drafted, the current provision affords no such opportunities.

**III. Confidentiality Safeguards**

*i. We urge Nasdaq to require that Sponsoring Members maintain the confidentiality of Trade Data provided by Sponsored Participants.*

The Proposed Rule specifically provides that Sponsored Participants must provide disclosure of “timely reports of all trading activity” to their Sponsoring Member. This requirement raises confidentiality concerns and the potential for misuse of Trade Data by Sponsoring Members. We believe the Proposed Rule should include confidentiality safeguards and controls to mitigate these risks, and that such obligations should be meaningful and enforceable by a Sponsored Participant.

Typically, Sponsored Participants and Sponsoring Members individually negotiate the information that would be provided for compliance and oversight purposes in connection with a Sponsored Access relationship, as well as the confidential nature of such information. To the extent the Proposed Rule is going to specify the information to be shared by a Sponsored Participant with its Sponsoring Member, we believe it would be reasonable to also standardize the confidentiality expectations for such information.

The Proposed Rule requires Sponsoring Members to receive immediate post-trade execution reports of Sponsored Access trading activity including Participant “identities.”<sup>4</sup> We request that the Proposed Rule clarify that by identity it means the entity signing the Sponsored Access agreement.

Sponsored Participants generally do not provide such detailed market participant information to executing brokers or Sponsoring Members. It raises the potential that a Sponsoring Member (or its employees) could reverse-engineer a market participant’s trading strategy or front-run its orders. We believe the Proposed Rule should provide confidentiality safeguards and controls to protect a Sponsoring Participant’s Trade Data, including the certification by Sponsoring Members that they implement and enforce policies and procedures and maintain information barriers to protect customer information.<sup>5</sup> The Proposal should provide that the Commission, Nasdaq in its self-regulatory capacity, and the Financial Industry Regulatory Authority should be able to audit these procedures.

Accordingly, we recommend the Proposed Rule require a Sponsoring Member to certify that it implements and enforces policies and procedures and maintains information barriers to protect customer information in accordance with these comments.

*ii. We urge Nasdaq to maintain the confidentiality of Trade Data.*

The SEC Release of the Proposed Rule states that Nasdaq would have access to all information necessary to provide effective exchange oversight.<sup>6</sup> We have the highest regard for Nasdaq and appreciate that as a registered securities exchange, it has self-regulatory responsibilities under Section 6 of the Securities Exchange Act of 1934 (the “Exchange Act”). Nonetheless, we believe that the Proposed Rule should have safeguards to ensure that Nasdaq only will use any information that it obtains exclusively for regulatory purposes and that Nasdaq will maintain the confidentiality of such information.

We urge that Nasdaq build into the Proposed Rule confidentiality safeguards and controls. Such safeguards and controls should include certifications that:

- Nasdaq will use Trade Data exclusively for regulatory purposes and will not use it in any commercial way;

---

<sup>4</sup> 74 *Fed. Reg.* 5195. We presume that the term “identities” refers to the Sponsored Participant and not to its underlying customer. If the Proposed Rule actually provides that the Sponsoring Member or Nasdaq itself could have access to the identities of the Sponsored Participant’s underlying customer, MFA expresses grave concerns about the Proposed Rule and its lack of protections of information. MFA strongly supports vigorous enforcement of the federal securities laws, but believes that only regulators should have access to such sensitive information and that they should seek such information through the normal “bluesheeting” process or by subpoena.

<sup>5</sup> We note that proposed section (d)(5)(B) of Rule 4611 provides that “Sponsoring Members shall ensure that compliance personnel receive timely reports of all trading activity by its Sponsored Participants....” We believe that the Proposed Rule’s provisions are too limited to ensure that only compliance personnel receive all sensitive information and that they not share it with others or fail to protect it.

<sup>6</sup> 74 *Fed. Reg.* 5195.

- Nasdaq will make Trade Data available only to officers and employees who are responsible for regulatory functions, directors that are involved in regulatory functions (e.g., an appeal of a disciplinary matter), or agents to the extent necessary to perform the regulatory function for which they have been hired; and
- Nasdaq will implement and enforce policies and procedures, and maintain information barriers between its regulatory division and other business divisions.

To the last point, we believe that strict guidelines should be instituted by Nasdaq, and all exchanges, providing that Trade Data obtained through its regulatory function shall not be used for private, commercial gain. We submit that it is inappropriate for Nasdaq, or any organization with regulatory responsibilities, to use Trade Data obtained through the auspices of its self-regulatory responsibilities for private, commercial purposes. Similarly, we are concerned that Nasdaq mandates in the Proposed Rule that Sponsoring Members possess certain technical capabilities, such as the ability to prevent Sponsored Participants from submitting erroneous orders, among other functions, when it has a strong commercial interest in Sponsoring Members purchasing such capabilities from Nasdaq.<sup>7</sup> We believe greater independence is needed between Nasdaq's regulatory division and other business divisions.

We do not anticipate that it would ever be necessary to release a Sponsored Participant's Trade Data to the public, but, if these controls are not implemented or it otherwise would be necessary to make such a disclosure, we ask that Nasdaq take steps to preserve the confidentiality of that information. For instance, simply keeping the Sponsored Participant's identity confidential (*i.e.*, making information available on a no-names basis) would not be a sufficient protection for highly proprietary trading information. Rather, we believe Nasdaq should only disclose Trade Data to the public only if Trade Data is aggregated with the information of many other market participants, such that the identity and trading strategy of a single market participant cannot be discerned. Finally, we believe that the Commission should be able to audit these confidentiality safeguards and controls.

Accordingly, we recommend that the Proposed Rule require Nasdaq to make periodic certifications to the Commission with respect to its use of a Sponsored Participant's Trade Data, and the policies, procedures and controls it maintains to protect such Trade Data; and that Trade Data will be exclusively used for regulatory purposes. We recommend that Nasdaq also certify that if it discloses Trade Data, it would be disclosed only if aggregated with the information of many other market participants. We further recommend the Proposed Rule and Sponsored Access agreements provide a reference to such certifications.

---

<sup>7</sup> See original SR-2008-104 filing by Edward S. Knight, dated December 30, 2008 (providing that "members could use the Pre-Trade Risk Management tool offered by Nasdaq pursuant to Rule 7016 to satisfy this [Proposed Rule 4611(d)(4)] requirement."). Rule 7016 sets forth the price table for the Pre-Trade Risk Management service. We appreciate that Nasdaq has amended SR-2008-104 and removed the discussion on Rule 7016. Nevertheless, our concern remains that Nasdaq has a commercial interest in requiring members to have the technical functionality that Rule 7016 provides.

#### **IV. Technical Requirements may Limit Market Participation**

Several provisions of the Proposed Rule, such as sections (d)(4)(C), (d)(5)(A) and (d)(5)(B),<sup>8</sup> would require a Sponsoring Member, in order to comply with the requirements, to have certain technical capabilities. We believe that these requirements may inadvertently limit market participation, thereby harming market liquidity.

First, we are concerned that many firms may not have the ability to build the compliance controls required by the Proposed Rule (or in certain instances be forced to purchase additional services from Nasdaq at a premium, as discussed earlier). As a result, the Proposed Rule could reduce the number of execution or trading venues available to market participants and negatively affect the best execution that a market participant or investor receives. Second, we are concerned Sponsoring Members that do not have the technical capability to meet the Proposed Rule's requirements, such as producing end-of-day trading reports, would pass on the burden of complying with the Proposed Rule to Sponsored Participants. This result would greatly increase the cost of trading for Sponsored Participants and could negatively impact their trading ability, as well as reduce overall market liquidity.

We urge Nasdaq to implement the Proposed Rule in a manner that protects market integrity while also preserving the depth and liquidity of the markets. We recommend that Nasdaq conduct a survey of its members' technical capabilities and the projected expense of complying with the Proposed Rule as part of a cost-benefit analysis of the Proposed Rule.<sup>9</sup>

#### **V. Conclusion**

MFA appreciates the opportunity to provide comments on Nasdaq's Proposed Rule regarding Sponsored Access. We support the goal of ensuring that Nasdaq and Sponsoring

---

<sup>8</sup> Proposed Rule 4611(d)(4)(C) requires that a Sponsored Access system 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.

Proposed Rule 4611(d)(5)(A) provides that each Sponsoring Member shall have systemic controls to ensure compliance by the Sponsored Participant with applicable Regulatory Requirements, including but not limited to compliance with rules relating to short selling; trading halts; proper uses of order types; proper use of Intermarket Sweep Orders; trading ahead of customer limit orders; prohibitions against manipulative trading practices, including wash sales and marking the close; restricted lists of securities for purposes of SEC Rule 10b-18; and applicable margin rules.

Proposed Rule 4611(d)(5)(B) provides that each Sponsoring Member shall ensure that compliance personnel receive timely reports of all trading activity by its Sponsored Participants sufficient to permit the Sponsoring Member to comply with applicable Regulatory Requirements, and to monitor for illegal activity such as market manipulation or insider trading. At minimum, the member firm's compliance unit should 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; all information necessary to create and maintain the trading records required by Regulatory Requirements by no later than the end of the trading day.

<sup>9</sup> *Cf.* Section 3(f) of the Exchange Act. We note that this requirement applies to all aspects of self-regulatory organizations' rules.

Members have appropriate safeguards with regard to Sponsored Participants and their activities. But by collecting information and imposing requirements, the Proposed Rule should ensure the integrity of the process and not create any unintended consequences. We respectfully request that the Commission require Nasdaq to limit the scope of certain provisions of the Proposed Rule and to adopt confidentiality safeguards and controls in the Proposed Rule, as discussed above. We also respectfully request that Nasdaq conduct a survey of its members' technical capabilities as part of a cost-benefit analysis of the Proposed Rule.

We would be pleased to meet with the Commission, its staff, or with Nasdaq to further discuss our comments. If the staff has questions or comments, please do not hesitate to call Jennifer Han or the undersigned at (202) 367-1140.

Respectfully submitted,



Stuart J. Kaswell  
Executive Vice President & General Counsel

CC: The Hon. Mary Schapiro, Chairman  
The Hon. Kathleen L. Casey, Commissioner  
The Hon. Elisse B. Walter, Commissioner  
The Hon. Luis A. Aguilar, Commissioner  
The Hon. Troy A. Paredes, Commissioner  
Dr. Erik Sirri, Director  
Division of Trading and Markets  
Daniel Gallagher, Deputy Director  
Division of Trading and Markets  
John Roeser, Assistant Director  
Division of Trading and Markets

Edward S. Knight, Executive Vice President & General Counsel  
The NASDAQ Stock Market LLC