

Required fields are shown with yellow backgrounds and asterisks.

Page 1 of * <input type="text" value="57"/>	SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 Form 19b-4	File No.* SR - <input type="text" value="2010"/> - * <input type="text" value="044"/> Amendment No. (req. for Amendments *) <input type="text"/>
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Proposed Rule Change by Financial Industry Regulatory Authority  
Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial * <input checked="" type="checkbox"/>	Amendment * <input type="checkbox"/>	Withdrawal <input type="checkbox"/>	Section 19(b)(2) * <input checked="" type="checkbox"/>	Section 19(b)(3)(A) * <input type="checkbox"/>	Section 19(b)(3)(B) * <input type="checkbox"/>
			Rule		
Pilot <input type="checkbox"/>	Extension of Time Period for Commission Action * <input type="checkbox"/>	Date Expires * <input type="text"/>	<input type="checkbox"/> 19b-4(f)(1)	<input type="checkbox"/> 19b-4(f)(4)	
			<input type="checkbox"/> 19b-4(f)(2)	<input type="checkbox"/> 19b-4(f)(5)	
			<input type="checkbox"/> 19b-4(f)(3)	<input type="checkbox"/> 19b-4(f)(6)	

Exhibit 2 Sent As Paper Document <input type="checkbox"/>	Exhibit 3 Sent As Paper Document <input type="checkbox"/>
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**Description**  
Provide a brief description of the proposed rule change (limit 250 characters, required when Initial is checked \*).

**Contact Information**  
Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name \*  Last Name \*

Title \*

E-mail \*

Telephone \*  Fax

**Signature**  
Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized officer.

Date

By

(Name \*) (Title \*)

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

**Form 19b-4 Information (required)**

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

**Exhibit 1 - Notice of Proposed Rule Change (required)**

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

**Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications**

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Exhibit Sent As Paper Document

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

**Exhibit 3 - Form, Report, or Questionnaire**

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Exhibit Sent As Paper Document

Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

**Exhibit 4 - Marked Copies**

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

**Exhibit 5 - Proposed Rule Text**

Add Remove View

The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

**Partial Amendment**

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

**1. Text of Proposed Rule Change**

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> Financial Industry Regulatory Authority, Inc. (“FINRA”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to amend FINRA Rule 7410 to extend the recording and reporting requirements in FINRA’s Order Audit Trail System (“OATS”) Rules to include all NMS stocks and to exclude certain FINRA members from the definition of “Reporting Member.” The proposed rule change also amends FINRA Rule 7470 to conform the OATS exemptive provision to the expansion of the OATS requirements to all NMS stocks.

The text of the proposed rule change is attached as Exhibit 5.

(b) Not applicable.

(c) Not applicable.

**2. Procedures of the Self-Regulatory Organization**

At its meeting on July 14, 2010, the Board of Governors of FINRA authorized the filing of the proposed rule change with the SEC. The exemptive provisions of the proposed rule change have been approved by the General Counsel of FINRA (or his officer designee) pursuant to delegated authority. No other action by FINRA is necessary for the filing of the proposed rule change.

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 180 days following publication of the Regulatory Notice announcing Commission approval.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

**3. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change**

(a) Purpose

FINRA Rules 7410 through 7470 (the “OATS Rules”)<sup>2</sup> impose obligations on FINRA members to record in electronic form and report to FINRA on a daily basis certain information with respect to orders originated, received, transmitted, modified, canceled, or executed by members relating to OTC equity securities and equity securities listed and traded on The Nasdaq Stock Market, Inc. (“Nasdaq”).<sup>2</sup> OATS captures this order information and integrates it with quote and transaction information to create a time-sequenced record of orders, quotes, and transactions. This information is then used by FINRA staff to conduct surveillance and investigations of member firms for violations of FINRA rules and federal securities laws.

To enhance the effectiveness of OATS as a regulatory tool, FINRA is proposing to amend the OATS Rules to extend the recording and reporting requirements to all NMS stocks, as that term is defined in Rule 600(b)(47) of Regulation NMS.<sup>3</sup> The proposed rule change would thus effectively extend the OATS recording and reporting requirements to NMS stocks listed on markets other than Nasdaq (e.g., NYSE, NYSE

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<sup>2</sup> As amended by SR-FINRA-2010-003, FINRA Rule 7410 defines an “OTC equity security” for purposes of the OATS Rules as an equity security that is not an NMS stock, except that the term does not include restricted equity securities and direct participation programs, as those terms are defined in FINRA Rule 6420. See Securities Exchange Act Release No. 61979 (April 23, 2010), 75 FR 23316 (May 3, 2010) (Order Approving File No. SR-FINRA-2010-003).

<sup>3</sup> Rule 600(b)(47) of Regulation NMS defines “NMS stock” as “any NMS security other than an option.” 17 CFR 242.600(b)(47). An “NMS security” is defined as “any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.” 17 CFR 242.600(b)(46).

Amex, and NYSE Arca). By including order information for both OTC equity securities and all NMS stocks in OATS, FINRA would receive a substantial portion of order information for all U.S. equity securities, which would significantly enhance the scope of the order audit trail in the U.S. equity markets. In connection with the expansion of the OATS requirements, FINRA is also proposing to create an exclusion from the definition of “Reporting Member” in FINRA Rule 7410 to exclude certain firms that became FINRA members pursuant to NASD IM-1013-1 or NASD IM-1013-2 and the rules of the NYSE and that have limited trading activities.

Although FINRA members generally are required to report trades to FINRA for all over-the-counter transactions in all NMS stocks<sup>4</sup> (in addition to OTC equity securities<sup>5</sup>), the OATS Rules do not currently require members to report order information to FINRA for NMS stocks listed on markets other than Nasdaq. As a result, FINRA is unable to recreate, on an automated basis, a complete order and transaction audit trail for all over-the-counter transactions in NMS stocks. Expansion of the OATS requirements to include all NMS stocks would enhance FINRA’s ability to review and examine for member compliance with certain trading rules, including, but not limited to, NASD Rule 2320 (Best Execution and Interpositioning) and NASD IM-2110-2 (Limit Order Protection).

By capturing OATS information for all NMS stocks, FINRA will also be able to expand its existing surveillance patterns to conduct more comprehensive cross-market surveillance, which also is in furtherance of NYSE’s recent outsourcing of surveillance

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<sup>4</sup> FINRA Rule 6110.

<sup>5</sup> See FINRA Rule 6400 Series.

and other regulatory functions to FINRA.<sup>6</sup> Specifically, to have comprehensive surveillance patterns that monitor trading in Nasdaq and NYSE-listed securities across all markets in a consistent manner, it is necessary for FINRA to have the same complement of order, trade, and quote information for these securities. Without OATS information for NYSE-listed securities, FINRA has a less robust data set upon which to monitor activity in NYSE-listed securities and would be forced to continue to have multiple patterns, some less optimal, to surveil for the same activity.

FINRA notes that the Commission has recently published a proposed rule that, if adopted, would ultimately result in a consolidated audit trail for the U.S. securities markets.<sup>7</sup> FINRA believes that the proposed rule change is necessary notwithstanding the Commission's rule proposal concerning a consolidated audit trail. The consolidated audit trail, as proposed by the Commission, is still in its proposal stage and may be several years away from providing a means by which self-regulatory organizations and the Commission can use the data to surveil the equity markets.<sup>8</sup> In the interim, FINRA believes that extending the OATS recording and reporting requirements to NMS stocks listed on markets other than Nasdaq will greatly enhance its audit trail and its ability to

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<sup>6</sup> See "FINRA and NYSE Euronext Complete Agreement for FINRA to Perform NYSE Regulation's Market Oversight Functions," FINRA News Release (June 14, 2010), available at [www.finra.org/Newsroom/NewsReleases/2010/P121622](http://www.finra.org/Newsroom/NewsReleases/2010/P121622). However, certain gaps will continue to exist (e.g., information relating to orders from non-FINRA member broker-dealers).

<sup>7</sup> See Securities Exchange Act Release No. 62174 (May 26, 2010), 75 FR 32556 (June 8, 2010).

<sup>8</sup> The Commission has proposed that national securities exchanges and national securities associations would begin submitting data to the central repository required by the proposed rule within one year after effectiveness of the NMS plan and that members would begin submitting data one year later. See *supra* note 7.

identify illicit trading activity in a more effective and efficient manner.

Moreover, because Reporting Members<sup>9</sup> already are reporting order information to OATS regarding Nasdaq and OTC equity securities, they should have the technological framework in place to report information regarding orders in the remaining NMS stocks as well. In addition, those FINRA members that are also member organizations of the NYSE already are recording order information under the NYSE's Order Tracking System ("OTS") rules that is substantially similar to the information required by the OATS Rules.<sup>10</sup> FINRA believes that extending the OATS Rules to NMS stocks listed on markets other than Nasdaq can be accomplished in a comparatively short timeframe and can provide FINRA with order data for these securities much sooner than the consolidated audit trail proposed by the Commission.

Expanding the categories of securities to which the OATS Rules apply to include securities listed on the NYSE or other national securities exchanges, such as those listed on NYSE Amex, would have the ancillary effect of extending the OATS recording and reporting requirements to certain members that became members of FINRA pursuant to NASD IM-1013-1 or NASD IM-1013-2<sup>11</sup> and the rules of the NYSE.<sup>12</sup> These members

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<sup>9</sup> See FINRA Rule 7410(o).

<sup>10</sup> See NYSE Rules 132B, 132C.

<sup>11</sup> NASD IM-1013-1 and NASD IM-1013-2 establish a waive-in membership application process for certain firms to become FINRA members that were members of the NYSE or NYSE Alternext (n/k/a NYSE Amex) but were not members of the National Association of Securities Dealers, Inc. See Securities Exchange Act Release No. 58707 (October 1, 2008), 73 FR 59001 (October 8, 2008); Securities Exchange Act Release No. 56653 (October 12, 2007), 72 FR 59127 (October 18, 2007).

<sup>12</sup> See NYSE Rule 2.

generally conduct their trading activities on the floor of an exchange, which is overseen by the relevant exchange. FINRA believes it is appropriate to exclude these firms from the OATS recording and reporting requirements. Consequently, FINRA is proposing to amend the definition of “Reporting Member” in FINRA Rule 7410 so that a member will not be considered a “Reporting Member” with respect to an order if: (i) the firm was approved as a FINRA member pursuant to NASD IM-1013-1 or NASD IM-1013-2; (ii) the firm operates consistent with NASD IM-1013-1 or NASD IM-1013-2, including limiting its business operations to “permitted floor activities,” as that term is defined in NASD IM-1013-1 and NASD IM-1013-2; and (iii) the order was received by the firm through systems operated and regulated by the NYSE or NYSE Amex.

As noted in Item 2 of this filing, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 180 days following publication of the Regulatory Notice announcing Commission approval.

(b) Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>13</sup> which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The proposed rule change is consistent with the Act because it will enhance FINRA’s ability to conduct surveillance and investigations of member firms for violations of FINRA’s rules and federal securities laws.

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<sup>13</sup> 15 U.S.C. 78q-3(b)(6).

**4. Self-Regulatory Organization’s Statement on Burden on Competition**

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

**5. Self-Regulatory Organization’s Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others**

The proposed rule change regarding the expansion of the OATS Rules was published for comment in Notice to Members 04-80 (November 2004).<sup>14</sup> Eight comments were received in response to the Notice.<sup>15</sup> A copy of the Notice is attached as Exhibit 2a. A copy of the index to comment letters received in response to the Notice is attached as Exhibit 2b, and copies of the comment letters received in response to the Notice are attached as Exhibit 2c. Seven commenters were generally opposed to the

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<sup>14</sup> Three other proposals were discussed in the Notice. The first involved expanding the OATS requirements to OTC equity securities. The second would require enhanced information, including execution data, relating to orders routed to non-members or exchanges. The third would require members to record and report to OATS proprietary orders generated in the ordinary course of market making activities. The proposal regarding OTC equity securities was approved by the SEC in 2006 and became effective on February 4, 2008. See Securities Exchange Act Release No. 54585 (October 10, 2006), 71 FR 61112 (October 17, 2006); see also Securities Exchange Act Release No. 55440 (March 9, 2007), 72 FR 12852 (March 19, 2007); Notice to Members 06-70 (December 2006). As part of that proposed rule change, FINRA discussed the comments related to the expansion of OATS to OTC equity securities. See SR-NASD-2005-101. Neither of the other two proposals is part of the current proposed rule change. Accordingly, FINRA is not addressing the comments received in response to those proposals.

<sup>15</sup> Letter from Emily Vitale dated November 24, 2004 (“Vitale”); Letter from ML Stern & Co., LLC dated January 14, 2005 (“ML Stern”); Letter from Ameritrade, Inc. dated January 18, 2005 (“Ameritrade”); Letter from Instinet Group dated January 20, 2005 (“Instinet”); Letter from Operations Committee of the Securities Industry Association dated January 20, 2005 (“SIA”); Letter from royalblue Financial Corp. dated January 20, 2005 (“royalblue”); Letter from Jed Bandes dated January 20, 2005 (“Bandes”); and Letter from The Financial Information Forum dated January 21, 2005 (“FIF”).

proposed rule change. One commenter generally supported the proposal provided firms could report all equity securities in the same format and there were no redundant reporting responsibilities.<sup>16</sup>

One commenter opposed the proposed rule change without additional discussion but noted that the system in place for OATS at the time was inefficient in several ways.<sup>17</sup> Two other commenters opposed the OATS rules generally, without specifically commenting on any of the proposals.<sup>18</sup> These commenters cited the additional costs and burdens to member firms of complying with the OATS requirements.

The predominant concern among the commenters with respect to the proposal to extend the OATS Rules to securities traded on markets other than Nasdaq regarded the potential regulatory duplication that could occur by expanding OATS to include NYSE-listed equity securities<sup>19</sup> because NYSE maintains its own rules regarding the retention and reporting of order information in its OTS Rules.<sup>20</sup> As noted above, FINRA now has regulatory responsibility for performing the market surveillance and enforcement functions previously conducted by NYSE Regulation. It is FINRA's understanding that NYSE will propose to retire OTS upon the expansion of OATS to all NMS stocks.

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<sup>16</sup> See Ameritrade.

<sup>17</sup> See ML Stern.

<sup>18</sup> See Bandes, Vitale.

<sup>19</sup> See Ameritrade, FIF, Instinet, SIA, royalblue.

<sup>20</sup> See NYSE Rules 132B, 132C.

**6. Extension of Time Period for Commission Action**

FINRA does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.<sup>21</sup>

**7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)**

Not applicable.

**8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission**

Not applicable.

**9. Exhibits**

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 2a. Notice to Members 04-80 (November 2004)

Exhibit 2b. Index of the comment letters received in response to Notice to Members 04-80.

Exhibit 2c. Copies of the comment letters received in response to Notice to Members 04-80.

Exhibit 5. Proposed changes to rule text.

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<sup>21</sup> 15 U.S.C. 78s(b)(2).

**EXHIBIT 1**

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34- ; File No. SR-FINRA-2010-044)

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change Relating to the Expansion of the Order Audit Trail System to All NMS Stocks

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on , Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to amend the Order Audit Trail System (“OATS”) rules to extend the recording and reporting requirements to all NMS stocks, as that term is defined in Rule 600(b)(47) of Regulation NMS,<sup>3</sup> and to exclude certain firms that became FINRA members pursuant to NASD IM-1013-1 or NASD IM-1013-2 and the rules of the NYSE and that have limited trading activities.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> 17 CFR 242.600(b)(47).

The text of the proposed rule change is available on FINRA's Web site at <http://www.finra.org>, at the principal office of FINRA and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

FINRA Rules 7410 through 7470 (the "OATS Rules") impose obligations on FINRA members to record in electronic form and report to FINRA on a daily basis certain information with respect to orders originated, received, transmitted, modified, canceled, or executed by members relating to OTC equity securities and equity securities listed and traded on The Nasdaq Stock Market, Inc. ("Nasdaq").<sup>4</sup> OATS captures this order information and integrates it with quote and transaction information to create a time-sequenced record of orders, quotes, and transactions. This information is then used

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<sup>4</sup> As amended by SR-FINRA-2010-003, FINRA Rule 7410 defines an "OTC equity security" for purposes of the OATS Rules as an equity security that is not an NMS stock, except that the term does not include restricted equity securities and direct participation programs, as those terms are defined in FINRA Rule 6420. See Securities Exchange Act Release No. 61979 (April 23, 2010), 75 FR 23316 (May 3, 2010) (Order Approving File No. SR-FINRA-2010-003).

by FINRA staff to conduct surveillance and investigations of member firms for violations of FINRA rules and federal securities laws.

To enhance the effectiveness of OATS as a regulatory tool, FINRA is proposing to amend the OATS Rules to extend the recording and reporting requirements to all NMS stocks, as that term is defined in Rule 600(b)(47) of Regulation NMS.<sup>5</sup> The proposed rule change would thus effectively extend the OATS recording and reporting requirements to NMS stocks listed on markets other than Nasdaq (e.g., NYSE, NYSE Amex, and NYSE Arca). By including order information for both OTC equity securities and all NMS stocks in OATS, FINRA would receive a substantial portion of order information for all U.S. equity securities, which would significantly enhance the scope of the order audit trail in the U.S. equity markets. In connection with the expansion of the OATS requirements, FINRA is also proposing to create an exclusion from the definition of “Reporting Member” in FINRA Rule 7410 to exclude certain firms that became FINRA members pursuant to NASD IM-1013-1 or NASD IM-1013-2 and the rules of the NYSE and that have limited trading activities.

Although FINRA members generally are required to report trades to FINRA for all over-the-counter transactions in all NMS stocks<sup>6</sup> (in addition to OTC equity securities<sup>7</sup>), the OATS Rules do not currently require members to report order

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<sup>5</sup> Rule 600(b)(47) of Regulation NMS defines “NMS stock” as “any NMS security other than an option.” 17 CFR 242.600(b)(47). An “NMS security” is defined as “any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.” 17 CFR 242.600(b)(46).

<sup>6</sup> FINRA Rule 6110.

<sup>7</sup> See FINRA Rule 6400 Series.

information to FINRA for NMS stocks listed on markets other than Nasdaq. As a result, FINRA is unable to recreate, on an automated basis, a complete order and transaction audit trail for all over-the-counter transactions in NMS stocks. Expansion of the OATS requirements to include all NMS stocks would enhance FINRA's ability to review and examine for member compliance with certain trading rules, including, but not limited to, NASD Rule 2320 (Best Execution and Interpositioning) and NASD IM-2110-2 (Limit Order Protection).

By capturing OATS information for all NMS stocks, FINRA will also be able to expand its existing surveillance patterns to conduct more comprehensive cross-market surveillance, which also is in furtherance of NYSE's recent outsourcing of surveillance and other regulatory functions to FINRA.<sup>8</sup> Specifically, to have comprehensive surveillance patterns that monitor trading in Nasdaq and NYSE-listed securities across all markets in a consistent manner, it is necessary for FINRA to have the same complement of order, trade, and quote information for these securities. Without OATS information for NYSE-listed securities, FINRA has a less robust data set upon which to monitor activity in NYSE-listed securities and would be forced to continue to have multiple patterns, some less optimal, to surveil for the same activity.

FINRA notes that the Commission has recently published a proposed rule that, if adopted, would ultimately result in a consolidated audit trail for the U.S. securities

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<sup>8</sup> See "FINRA and NYSE Euronext Complete Agreement for FINRA to Perform NYSE Regulation's Market Oversight Functions," FINRA News Release (June 14, 2010), available at [www.finra.org/Newsroom/NewsReleases/2010/P121622](http://www.finra.org/Newsroom/NewsReleases/2010/P121622). However, certain gaps will continue to exist (e.g., information relating to orders from non-FINRA member broker-dealers).

markets.<sup>9</sup> FINRA believes that the proposed rule change is necessary notwithstanding the Commission's rule proposal concerning a consolidated audit trail. The consolidated audit trail, as proposed by the Commission, is still in its proposal stage and may be several years away from providing a means by which self-regulatory organizations and the Commission can use the data to surveil the equity markets.<sup>10</sup> In the interim, FINRA believes that extending the OATS recording and reporting requirements to NMS stocks listed on markets other than Nasdaq will greatly enhance its audit trail and its ability to identify illicit trading activity in a more effective and efficient manner.

Moreover, because Reporting Members<sup>11</sup> already are reporting order information to OATS regarding Nasdaq and OTC equity securities, they should have the technological framework in place to report information regarding orders in the remaining NMS stocks as well. In addition, those FINRA members that are also member organizations of the NYSE already are recording order information under the NYSE's Order Tracking System ("OTS") rules that is substantially similar to the information required by the OATS Rules.<sup>12</sup> FINRA believes that extending the OATS Rules to NMS stocks listed on markets other than Nasdaq can be accomplished in a comparatively short

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<sup>9</sup> See Securities Exchange Act Release No. 62174 (May 26, 2010), 75 FR 32556 (June 8, 2010).

<sup>10</sup> The Commission has proposed that national securities exchanges and national securities associations would begin submitting data to the central repository required by the proposed rule within one year after effectiveness of the NMS plan and that members would begin submitting data one year later. See supra note 9.

<sup>11</sup> See FINRA Rule 7410(o).

<sup>12</sup> See NYSE Rules 132B, 132C.

timeframe and can provide FINRA with order data for these securities much sooner than the consolidated audit trail proposed by the Commission.

Expanding the categories of securities to which the OATS Rules apply to include securities listed on the NYSE or other national securities exchanges, such as those listed on NYSE Amex, would have the ancillary effect of extending the OATS recording and reporting requirements to certain members that became members of FINRA pursuant to NASD IM-1013-1 or IM-1013-2<sup>13</sup> and the rules of the NYSE.<sup>14</sup> These members generally conduct their trading activities on the floor of an exchange, which is overseen by the relevant exchange. FINRA believes it is appropriate to exclude these firms from the OATS recording and reporting requirements. Consequently, FINRA is proposing to amend the definition of “Reporting Member” in FINRA Rule 7410 so that a member will not be considered a “Reporting Member” with respect to an order if: (i) the firm was approved as a FINRA member pursuant to NASD IM-1013-1 or NASD IM-1013-2; (ii) the firm operates consistent with NASD IM-1013-1 or NASD IM-1013-2, including limiting its business operations to “permitted floor activities,” as that term is defined in NASD IM-1013-1 and NASD IM-1013-2; and (iii) the order was received by the firm through systems operated and regulated by the NYSE or NYSE Amex.

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<sup>13</sup> NASD IM-1013-1 and NASD IM-1013-2 establish a waive-in membership application process for certain firms to become FINRA members that were members of the NYSE or NYSE Alternext (n/k/a NYSE Amex) but were not members of the National Association of Securities Dealers, Inc. See Securities Exchange Act Release No. 58707 (October 1, 2008), 73 FR 59001 (October 8, 2008); Securities Exchange Act Release No. 56653 (October 12, 2007), 72 FR 59127 (October 18, 2007).

<sup>14</sup> See NYSE Rule 2.

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 180 days following publication of the Regulatory Notice announcing Commission approval.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>15</sup> which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The proposed rule change is consistent with the Act because it will enhance FINRA's ability to conduct surveillance and investigations of member firms for violations of FINRA's rules and federal securities laws.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in Notice to Members 04-80 (November 2004).<sup>16</sup> Eight comments were received in response to the Notice.<sup>17</sup> A

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<sup>15</sup> 15 U.S.C. 78o-3(b)(6).

<sup>16</sup> Three other proposals were discussed in the Notice. The first involved expanding the OATS requirements to OTC equity securities. The second would require enhanced information, including execution data, relating to orders routed to non-members or exchanges. The third would require members to record and report to OATS proprietary orders generated in the ordinary course of market making

copy of the Notice is attached as Exhibit 2a. Copies of the comment letters received in response to the Notice are attached as Exhibit 2b. Seven commenters were generally opposed to the proposed rule change. One commenter generally supported the proposal provided firms could report all equity securities in the same format and there were no redundant reporting responsibilities.<sup>18</sup>

One commenter opposed the proposed rule change without additional discussion but noted that the system in place for OATS at the time was inefficient in several ways.<sup>19</sup> Two other commenters opposed the OATS rules generally, without specifically commenting on any of the proposals.<sup>20</sup> These commenters cited the additional costs and burdens to member firms of complying with the OATS requirements.

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activities. The proposal regarding OTC equity securities was approved by the SEC in 2006 and became effective on February 4, 2008. See Securities Exchange Act Release No. 54585 (October 10, 2006), 71 FR 61112 (October 17, 2006); see also Securities Exchange Act Release No. 55440 (March 9, 2007), 72 FR 12852 (March 19, 2007); Notice to Members 06-70 (December 2006). As part of that proposed rule change, FINRA discussed the comments related to the expansion of OATS to OTC equity securities. See SR-NASD-2005-101. Neither of the other two proposals is part of the current proposed rule change. Accordingly, FINRA is not addressing the comments received in response to those proposals.

<sup>17</sup> Letter from Emily Vitale dated November 24, 2004 (“Vitale”); Letter from ML Stern & Co., LLC dated January 14, 2005 (“ML Stern”); Letter from Ameritrade, Inc. dated January 18, 2005 (“Ameritrade”); Letter from Instinet Group dated January 20, 2005 (“Instinet”); Letter from Operations Committee of the Securities Industry Association dated January 20, 2005 (“SIA”); Letter from royalblue Financial Corp. dated January 20, 2005 (“royalblue”); Letter from Jed Bandes dated January 20, 2005 (“Bandes”); and Letter from The Financial Information Forum dated January 21, 2005 (“FIF”).

<sup>18</sup> See Ameritrade.

<sup>19</sup> See ML Stern.

<sup>20</sup> See Bandes, Vitale.

The predominant concern among the commenters with respect to the proposal to extend the OATS Rules to securities traded on markets other than Nasdaq regarded the potential regulatory duplication that could occur by expanding OATS to include NYSE-listed equity securities<sup>21</sup> because NYSE maintains its own rules regarding the retention and reporting of order information in its OTS Rules.<sup>22</sup> As noted above, FINRA now has regulatory responsibility for performing the market surveillance and enforcement functions previously conducted by NYSE Regulation. It is FINRA's understanding that NYSE will propose to retire OTS upon the expansion of OATS to all NMS stocks.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

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<sup>21</sup> See Ameritrade, FIF, Instinet, SIA, royalblue.

<sup>22</sup> See NYSE Rules 132B, 132C.

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](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2010-044 on the subject line.

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-FINRA-2010-044. 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 Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. 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-FINRA-2010-044 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>23</sup>

Florence E. Harmon

Deputy Secretary

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<sup>23</sup> 17 CFR 200.30-3(a)(12).

Exhibit 2a

# Notice to Members

NOVEMBER 2004

## SUGGESTED ROUTING

Internal Audit  
Legal & Compliance  
Operations  
Registered Representatives  
Senior Management  
Systems  
Trading

## KEY TOPICS

OATS

## REQUEST FOR COMMENT

### Order Audit Trail System (OATS)

NASD Seeks Comment on Proposed Changes to the OATS Rules; **Comment Period Expires January 20, 2005**

#### Executive Summary

NASD is issuing this *Notice to Members* to solicit comments from members and other interested parties on proposed changes to the OATS Rules (Rules 6950 through 6957). The OATS Rules impose obligations on member firms to record in electronic form and report to NASD on a daily basis certain information with respect to orders originated or received by NASD members relating to securities listed and traded on The Nasdaq Stock Market, Inc. (NASDAQ). NASD staff is seeking comment on three proposed changes to the OATS Rules, which would require members to record and report to OATS:

- Order information relating to exchange-listed and OTC equity securities (OTC Bulletin Board (OTCBB) and Pink Sheets);
- Enhanced information, including execution data, relating to orders routed to non-members or exchanges; and
- Order information relating to proprietary orders generated during the course of market-making activities.

NASD believes this additional information will enable NASD to create a more comprehensive and accurate order and transaction audit trail and significantly improve the effectiveness of NASD's automated surveillance for potential violations of NASD rules and the federal securities laws.

04-80

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## Action Requested

NASD encourages all interested parties to comment on these three proposals. Comments must be received by January 20, 2005. Members and interested persons can submit their comments using the following methods:

- ✦ Mailing in Attachment A—Request for Comment Form—along with written comments;
- ✦ Mailing comments in hard copy to the address below;
- ✦ E-mailing written comments to *pubcom@nasd.com*; or

To help NASD process and review comments more efficiently, persons commenting on this proposal should use only one method; however, if a person wishes to submit comments using both the Request for Comment Form and one of the other methods listed above, he or she should indicate that in the submissions. The Request for Comment Form and/or comments sent by hard copy should be mailed to:

Barbara Z. Sweeney  
Office of the Corporate Secretary  
NASD  
1735 K Street, N.W.  
Washington, D.C. 20006-1500

**Important Notes:** The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the NASD Web site. Generally, comments will be posted on the NASD Web site one week after the end of the comment period.<sup>1</sup>

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the NASD Board, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.<sup>2</sup>

## Questions/Further Information

As noted above, hard copy comments should be mailed to Barbara Z. Sweeney. Questions concerning this *Notice* may be directed to the Legal Section, Market Regulation, at (240) 386-5126; or Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8071.

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## Background and Discussion

The OATS Rules impose obligations on member firms to record in electronic form and report to NASD on a daily basis certain information with respect to orders originated or received by NASD members relating to securities listed and traded on NASDAQ. OATS captures this order information reported by NASD members to create a time-sequenced record of orders and transactions. This information is critical to NASD staff in conducting surveillance and investigations of member firms for violations of federal securities laws and NASD rules.

Given a number of factors, including the fragmentation in the trading of securities over the past several years and the need to enhance NASD's automated surveillance program, NASD staff has identified several enhancements to the current OATS information that would enable it to create a more comprehensive and accurate order and transaction audit trail. These proposed changes would significantly enhance NASD's ability to surveil for potential violations of NASD rules and the federal securities laws. NASD staff believes that continued effective automated surveillance will be difficult to achieve without the proposed expansion of order information captured by OATS, as described herein.

Therefore, NASD is soliciting comment on three proposed changes to the OATS Rules. The proposed changes would require members to record and report to OATS (1) order information relating to orders and transactions in exchange-listed and OTC equity securities; (2) enhanced information, including execution data, relating to orders routed to non-members or exchanges; and (3) order information relating to proprietary orders generated during the course of market-making.

### **1. Proposed Changes to Expand OATS Requirements to Apply to Orders and Transactions in Exchange-Listed and OTC Equity Securities.**

Because OATS requirements do not apply to exchange-listed or OTC equity securities, NASD staff currently is unable to recreate on an automated basis an order and transaction audit trail for these securities and is therefore unable to conduct certain automated surveillance for exchange-listed and OTC equity securities comparable to the current automated surveillance program it has established for trading in Nasdaq securities. For example, expansion of the OATS requirements to exchange-listed and OTC equity securities would enhance NASD staff's ability to review and examine, on a more automated basis, for compliance with Limit Order Protection (IM-2110-2), the duty of best execution (Rule 2320), Short Sales (SEC Rule 10a-1), and the Limit Order Display Rule (SEC Rule 11Ac1-4), among others. As a result, NASD is soliciting comment on a proposal to extend the OATS requirements to order activity and transactions in these securities.

Under the proposal, NASD members would be required to report to OATS order-related activities for exchange-listed securities, irrespective of whether the order is ultimately executed over-the-counter or on or through an exchange. Because it is sometimes unlikely that a member knows upon receipt of an order where the order will be executed, NASD members would need to report such information to OATS regardless of how the order is ultimately handled or where it is executed. As described in more detail below, if NASD does not have a complete picture of the trading by an NASD member, including executions on or through an exchange, potential violations may be missed. However, given that the NYSE has established its own Order Tracking System (OTS), NASD staff will work to coordinate any proposed requirements relating to NYSE securities with the OTS requirements to minimize the potential for duplicative reporting of order information. To the extent that other exchanges have established comparable order audit trail systems, NASD would endeavor to coordinate its proposed requirements with those exchanges as well.

## **2. Proposed Changes to Enhance the OATS Information Reported for Orders Routed to Exchanges or Non-Members.**

Currently, members that route orders to non-members or exchanges for execution are not required to provide OATS information beyond the route to that non-member or exchange.<sup>3</sup> As a result, NASD does not receive automated data for the portion of a member's trading activities that occurs on or through a non-member or exchange. NASD staff has determined that gaps can exist in its automated surveillance of member activities when NASD does not receive a complete picture of the member's order and trading activity. Accordingly, NASD is soliciting comment on a proposal to require members to record and report to OATS order events relating to orders routed to non-members or exchanges.

In particular, NASD is soliciting comment on the scope of order-related information that members have access to with respect to orders they have routed to non-members and exchanges. To ensure that NASD can link and recreate the entire lifecycle of the order, NASD members would need to report to OATS order events relating to orders routed to non-members or exchanges, including, but not limited to, new order, subsequent routing and execution information. Such information would be necessary in conducting automated surveillance for member compliance with NASD rules and the federal securities laws, including Limit Order Protection. NASD seeks input on what information relating to the handling of a member's order by a non-member or exchange currently is accessible to the member and, as applicable, the burdens associated with obtaining and reporting additional information to OATS. In this context, NASD is sensitive to self-regulatory organization (SRO) jurisdictional issues and is not seeking information about conduct that is clearly outside its jurisdiction and within the jurisdiction of the routed exchange, such as specialist or floor broker activity.

As permitted today under Rule 6955(c), members would be able to enter into reporting agent agreements with a non-member or exchange to report OATS information on the member's behalf. However, the member remains liable for the proper reporting and accuracy of data reported on the member's behalf by a reporting agent.

### 3. Proposed Changes to Eliminate Current Exceptions for Market Makers.

Members currently are not required to report to OATS proprietary orders generated during the course of market-making. Although certain information such as trade report information may be available for market making trades, NASD does not receive automated information on the entire lifecycle of a market-making proprietary order. For example, market-making proprietary orders that do not result in executions or are executed on exchanges or through non-members currently are not captured by or provided to NASD on an automated basis. This information can be particularly important where a proprietary order is routed in place of a pending customer order. Because members currently are not required to report this information to OATS, NASD staff does not always have a complete picture of a member's order and trading activities. NASD believes that this information pertaining to proprietary orders of market makers is critical for surveillance purposes, including reviews for compliance with the Limit Order Protection Rule, the Limit Order Display Rule, and Firm Quote Requirements (NASD Rule 3320 and SEC Rule 11Ac1-1(c)). NASD therefore is soliciting comment on a proposal that would require members to report to OATS information relating to proprietary orders generated during the course of market-making.

### Endnotes

1. See *Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or e-mail addresses, will not be edited from submissions. Persons commenting on this proposal should submit only information that they wish to make publicly available.
2. Section 19 of the Securities Exchange Act of 1934 (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See Exchange Act Section 19 and rules thereunder.
3. NASD does receive OATS information for certain orders that are executed on an exchange, but it depends on whether the order is routed to the exchange for handling and execution or if the order is executed by the member and only trade reported to the exchange. Under the first scenario, the member would provide OATS information relating to the new order and the route of the order to an exchange, but would not provide OATS information regarding the ultimate execution of the order. With respect to an order that is executed by a member and then reported to an exchange, the member would be required to record and report to OATS new order and execution information. See *The OATS Report December 2002 (OATS Reporting Responsibilities for Orders Routed to, or Executions Reported on, Other Securities Exchanges)*, available at [www.nasd.com](http://www.nasd.com).

©2004. NASD. All rights reserved. *Notices to Members* attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.

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## ATTACHMENT A

### Request for Comment Form

We have provided below a form that members and other interested parties may use in addition to or in lieu of written comments. This form is intended to offer a convenient way to participate in the comment process, but does not cover all aspects of the proposal described in the Notice. We therefore encourage members and other interested parties to review the entire Notice and provide written comments, as necessary.

### Instructions

Comments must be received by January 20, 2005. Members and interested persons can submit their comments using the following methods:

- ✦ Mailing in Attachment A—Request for Comment Form—along with written comments;
- ✦ Mailing comments in hard copy to the address below;
- ✦ E-mailing written comments to [pubcom@nasd.com](mailto:pubcom@nasd.com); or

To help NASD process and review comments more efficiently, persons commenting on this proposal should use only one method; however, if a person wishes to submit comments using both the Request for Comment Form and one of the other methods listed above, he or she should indicate that in the submissions. The Request for Comment Form and/or comments sent by hard copy should be mailed to:

Barbara Z. Sweeney  
Office of the Corporate Secretary  
NASD  
1735 K Street, N.W.  
Washington, D.C. 20006-1500

**Important Notes:** The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the NASD Web site. Generally, comments will be posted on the NASD Web Site one week after the end of the comment period.

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the NASD Board, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.

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## Proposed Changes to OATS Rules

The staff requests input from members and other interested parties on any or all of the three proposed changes to the OATS Rules described in this *Notice*. In particular, the staff seeks comment on the technological implications and burdens of each of the proposals.

### Expansion of OATS to Exchange-Listed and OTC Equity Securities

1. Do you support the proposal that would require that members record and report OATS information for exchange-listed and OTC equity securities?  
 Yes    No    See my attached written comments.
2. What are the technological implications and burdens associated with this proposal?
3. Is the data you record and maintain to comply with the NYSE's OTS requirements in a similar form as the data you maintain for NASD OATS purposes? What additional changes would be necessary to enable members to submit the NYSE OTS data to NASD OATS?

### Expansion of OATS to Orders Routed to Non-Members or Exchanges

4. Do you support the proposal that would require that members record and report OATS order events relating to orders routed to non-members or exchanges?  
 Yes    No    See my attached written comments.
5. Describe the scope and type of order-related information that a member currently has access to when it has routed an order to a non-member or exchange. For example, if an order is routed to and then executed by a non-member, what execution information is provided to the member that routed the order? Does the member typically have knowledge of whether the order was further routed by the non-member or exchange, and if so, what level of detail is provided to the member?
6. What are the technological implications and burdens associated with this proposal, including requirements that potentially could expand the scope of information provided by non-members and exchanges to members that have routed orders to them?

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### Expansion of OATS to Market Making Proprietary Orders

7. Do you support the proposal that would require that members record and report OATS information for OATS proprietary orders generated during the course of market-making?

- Yes     No     See my attached written comments.

8. What are the technological implications and burdens associated with this proposal?

### Implementation

9. NASD anticipates proposing a "phase-in" period for implementation of any of the proposals described herein to provide members with adequate time for necessary system and procedural modifications. What amount of time do you believe is adequate for implementation of the proposals?

### Contact Information

Name: \_\_\_\_\_

Firm: \_\_\_\_\_

Address: \_\_\_\_\_

City/State/Zip: \_\_\_\_\_

Phone: \_\_\_\_\_

E-mail: \_\_\_\_\_

### Are you:

An NASD Member

An Investor

A Registered Representative

Other: \_\_\_\_\_

\_\_\_\_\_

**EXHIBIT 2b**

**Alphabetical List of Written Comments**

1. Raymond C. Baker, ML Stern & Co., LLC (January 14, 2005)
2. Jed Bandes (January 20, 2005)
3. Stuart Bowers, Securities Industry Association (SIA) (January 20, 2005)
4. The Financial Information Forum (January 21, 2005)
5. Jess Haberman, Royalblue Financial Corporation (January 20, 2005)
6. Caroline F. Langner, Ameritrade, Inc. (January 18, 2005)
7. Deborah Mittleman, Instinet Group (January 20, 2005)
8. Emily Vitale (November 24, 2004)

**Exhibit 2c**

Industry Professionals > Regulation > Notices > Comments

**Comments on NASD Notice to Members 04-80**

Attn: Barbara Z. Sweeney

Order Audit Trail System (OATS)

NASD Seeks Comment on Proposed Changes to the OATS Rules; Comment Period Expires January 20, 2005

Attachment A - comment form

1. No
2. The system is not efficient as related to open orders, order changes, and order cancellations.
3. Our provider ADP/SIS would have to update their system to comply.
4. No
5. N/A - This applies to our vendor.
6. N/A
7. Yes
8. N/A - This applies to our vendor.
9. Again, we would have to defer to our vendor as it applies to them complying with these changes.

Contact Information

Raymond C. Baker or Joseph P. Traba  
ML Stern & Co., LLC  
8350 Wilshire Blvd  
Beverly Hills, CA 90211  
Bakerr@mlstern.com or trabaj@mlstern.com

NASD Member, Investor, & Registered Representative



Industry Professionals > Regulation > Notices > Comments

## **Comments on NASD Notice to Members 04-80**

Barbara Sweeny:

Please consider this my comment regarding OATS. My personal belief is that the entire system should be scrapped. It gives the appearance that you are helping the public but we all know the only reason for its existence is to enhance your revenue at the expense of B/D's. Any other so called enhancement to this system that costs B/D's more money, is a wast!

Jed Bandes  
727-799-9922 Office  
727-799-3869 Fax



**Securities Industry Association**

120 Broadway • New York, NY 10271-0080 • (212) 608-1500 • Fax: (212) 968-0690

January 20, 2005

Barbara Z. Sweeney  
Office of the Corporate Secretary  
NASD  
1735 K Street, N.W.  
Washington, D.C. 20006-1500

Re: Notice To Members 04-80

Dear Ms. Sweeney:

The Operations Committee (the “Committee”) of the Securities Industry Association (“SIA”)<sup>1</sup> appreciates the opportunity to comment on NASD Notice To Members 04-80, in which the NASD solicits comment on proposed changes to the rules relating to the NASD’s Order Audit Trail System (“OATS”).<sup>2</sup> OATS imposes obligations on member firms to record in electronic form and report to NASD on a daily basis certain information with respect to orders originated or received by NASD members relating to securities listed and traded on The Nasdaq Stock Market, Inc. (“Nasdaq”).

The NASD proposes to expand significantly members’ reporting obligations, which, we believe, raises serious operational and competitive concerns. The Committees acknowledge the need for a complete and accurate order audit trail but we believe gaps in intermarket trading surveillance should be addressed by the Securities and Exchange Commission (“SEC”) in a comprehensive manner in order to avoid inefficiency, inconsistency, and duplication that can occur when individual self-regulatory organizations (“SROs”) proceed on separate tracks to adopt their own reporting requirements. We note that the SEC currently is soliciting comment on issues concerning

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<sup>1</sup> The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker’s Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 780,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated \$209 billion in domestic revenue and \$278 billion in global revenues. (More information about SIA is available on its home page: [www.sia.com](http://www.sia.com).)

<sup>2</sup> Members of the SIA’s Self-Regulation and Supervisory Practices Committee also provided substantial input on this letter.

Barbara Z. Sweeney  
January 20, 2005  
Page 2

self-regulation, including the feasibility of developing robust intermarket order audit trails.<sup>3</sup> We believe NASD action on this proposal would effectively preempt that process.

A number of factors, including fragmentation in the trading of securities over the past several years, have led the NASD to identify several enhancements to the current OATS information that would enable the NASD to create a more comprehensive and accurate order and transaction audit trail. Consequently, the NASD is seeking comment on three proposed changes to the OATS Rules, which would require members to record and report: (1) order information relating to exchange-listed and OTC equity securities (OTC Bulletin Board (“OTCBB”) and Pink Sheets); (2) enhanced information, including execution data, relating to orders routed to non-members or exchanges; and (3) order information relating to proprietary orders generated during the course of market-making activities. The NASD believes these changes will significantly improve the effectiveness of NASD’s automated surveillance for potential violations of NASD rules and the federal securities laws.

#### **I. Effective Intermarket Surveillance Requires a Comprehensive Approach**

The Committee does not question the need for regulators to have audit trails to help facilitate our shared goal of investor protection. Because each SRO has different audit trail requirements, though, the potential for duplicative systems and reporting is high. We are concerned about the costs and inefficiencies associated with multiple regulators requesting duplicative data, all with slightly different requirements and methods for gathering the relevant information.<sup>4</sup> The duplication of data creates additional cost and reconciliation burdens on member firms at a time when the industry is working toward consolidating data flows.<sup>5</sup> Although NASD represents that it will coordinate its proposed requirements with those of the New York Stock Exchange (“NYSE”) and other exchanges, to date it does not appear that this has occurred.

The potential for regulatory redundancies in fragmented markets was the subject of a report by the U.S. General Accounting Office (“GAO”) in May 2002.<sup>6</sup> The GAO

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<sup>3</sup> Concept Release Concerning Self-Regulation, Securities Exchange Act Release No. 34-50700 (November 18, 2004) (“Concept Release”).

<sup>4</sup> SIA consistently has voiced the concern that complying with multiple SROs’ different audit trail systems would be burdensome and expensive to implement and administer. *See* letter from Donald D. Kittell, Executive Vice President, SIA, to Jonathan G. Katz, Secretary, SEC, dated June 27, 2003, responding to the SEC’s Concept Release on the Nasdaq Petition Relating to the Regulation of Nasdaq-Listed Securities, Securities Exchange Act Release No. 47849 (May 14, 2003).

<sup>5</sup> *See also* letter to Jonathan G. Katz, Secretary, SEC, from Noland Cheng, Chairman, Fixed Income Transparency Subcommittee of the SIA Operations Committee, dated December 21, 2000, regarding duplication of systems efforts in connection with the NASD’s TRACE system.

<sup>6</sup> U.S. General Accounting Office Report to Congressional Committees, “Securities Markets Competition and Multiple Regulators Heighten Concern About Self-Regulation” (May 2002) (“GAO Report”).

Barbara Z. Sweeney  
January 20, 2005  
Page 3

Report recommended that the SEC and SROs work together with broker-dealers to implement a formal process for systematically identifying and addressing material regulatory inefficiencies caused by differences in rules and rule interpretations among SROs. Subsequently, a joint NASD and NYSE task force undertook an examination of conflicting rules to determine how the conflicts could be resolved. That process yielded positive results,<sup>7</sup> and should be employed on a continual basis. In particular, SRO rules regarding audit trails is an area where SRO coordinated efforts could produce compatible systems and reduce duplicative reporting requirements.

We recognize that as trading has become less concentrated in the primary markets and more dispersed across a greater number of trading venues, surveillance of intermarket trading becomes increasingly important. Competition among markets calls into question though whether the SROs should continue to be the appropriate entities to maintain the audit trails.

As competition among markets grows, the markets operated by SROs will come under increasing pressure to attract order flow, which presents conflicts of interest for an SRO when it comes to monitoring the activity of, and enforcing rules against, certain members. As the SEC notes in its recent Concept Release Concerning Self-Regulation, SRO staff may be less inclined to enforce vigorously SRO rules that would cause large liquidity providers to redirect order flow.<sup>8</sup> Also, SROs may have a tendency to abuse their SRO status by over-regulating members that operate markets that compete with the SRO's own market for order flow.<sup>9</sup> Even after the NASD divests itself of Nasdaq, the potential conflict of interest will remain due to the multi-year contract that Nasdaq entered into with the NASD to regulate its market. Although the SIA currently is formulating its position in preparing a response to the SEC Concept Release, certain Committee members believe the time has come for a neutral industry utility such as the Depository Trust and Clearing Corporation ("DTCC") to maintain a consolidated order audit trail with the costs of development and maintenance shared across the industry.

In connection with the settlement of an SEC enforcement action in 2000, the options exchanges designed and implemented a consolidated options audit trail system ("COATS"), which enables the options exchanges to reconstruct markets promptly, to conduct effective surveillance, and to enforce order handling, firm quote, trade reporting, and other rules.<sup>10</sup> It is too early to assess the effectiveness of COATS because the system is in the final stage of implementation.<sup>11</sup> Nevertheless, before the NASD acts unilaterally

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<sup>7</sup> The NASD and NYSE, for example, agreed upon and adopted a uniform definition of "branch office."

<sup>8</sup> *Supra* note 2, at 71262.

<sup>9</sup> *Id.*

<sup>10</sup> See Securities Exchange Act Release No. 43268 (September 11, 2000), at Section IV.B.e.

<sup>11</sup> See, e.g., Securities Exchange Act Release No. 50996 (January 7, 2005) approving a proposed rule change by the Chicago Board Options Exchange relating to the final phase of COATS implementation.

Barbara Z. Sweeney  
January 20, 2005  
Page 4

to enhance its ability to monitor intermarket activity, consideration should be given to the feasibility of creating a consolidated audit trail for the equity markets leveraging off the existing infrastructure that the industry has developed to accommodate OATS reporting, which represents many years of cooperative effort and investment on the part of the industry and the NASD.<sup>12</sup>

The Committee welcomes the SEC's request for comment on the Concept Release. Specifically, the SEC asks how similar are the order audit trail systems of the NASD and NYSE,<sup>13</sup> and what the benefits would be of merging them into one consolidated system. We believe there is a real opportunity to eliminate redundancies and infrastructure across SROs, and we urge the NASD to defer action until that process is completed.

## **II. Issues Presented by Current Proposal**

Although we strongly believe that any expansion of OATS should be considered in conjunction with the SEC Concept Release, if the NASD determines to go forward, our concerns with this specific proposal are set out below.

### **A. Capacity Concerns**

Because it is sometimes unlikely that a member will know upon receipt of an order where the order will be executed, NASD members would be required to report to OATS order-related information for all transactions, including transactions in exchange-listed securities, regardless of where the order is ultimately executed. If the order is routed to a non-member or an exchange, NASD members would be required to record and report order events subsequent to the route, *e.g.*, subsequent routing and execution information. OATS reporting also would be required for OTCBB and Pink Sheet securities, as well as for proprietary orders generated during the course of market-making activities. Effectively, OATS would become the consolidated order audit trail for all equity transactions, although other SRO audit trail requirements would continue to exist.

The Committee questions whether the NASD has calculated and planned for the additional systems capacity that such changes would necessitate. In fact, recent changes to the OATS rules combining new order and route reports, as well as frequent instances where the NASD experiences processing delays, suggest that capacity may be an issue at this time. Under the proposal, one firm estimated that its daily OATS submission would

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<sup>12</sup> Based on its technological expertise and awareness of the issues, the NASD may be best suited to take a leading role in developing a consolidated order audit trail.

<sup>13</sup> The NYSE's order audit trail, the Order Tracking System ("OTS") differs in certain significant respects from OATS. While OATS data is reported to the NASD daily, OTS data is reported to the NYSE upon request. Although the regulators request similar data, minor differences require firms to customize the data feed for each SRO. For example, the NYSE requires the exchange turn-around number to be appended to each order.

jump from approximately 400,000 records to over 2,000,000 when listed and proprietary activity is required to be reported. Other firms preliminarily project a four to fivefold increase in the number of records submitted on a daily basis. As the number of records increases, firms will undoubtedly need relief from the requirement to submit reports by 4:00 a.m. on T+1. The number of rejects also will increase exponentially, further straining the system and requiring additional staffing within member firms. It is puzzling why the NASD, which appears to be experiencing capacity issues at current volume levels, would propose a change of such magnitude without so much as a reference to the impact such a change would have on the NASD's and firms' systems capacity.

## B. Competitive Issues

We appreciate the NASD's concern that its extensive audit trail data is of limited use for cross-market surveillance because it does not capture relevant data for executions that take place on other markets. The NASD proposes to remedy this situation by requiring members to report order-related information on **all** transactions, including execution data relating to orders routed to non-members and exchanges. Unfortunately, member firms receive no more than an execution report on orders routed away, which the sending firm attempts to tie back to the original order by reference to its own order (branch and sequence) number. Moreover, the systems where the execution "reports" reside generally are separate from, and have different electronic formats than, the firm systems used to capture and record OATS data.

With respect to orders routed away, member firms would have no way of knowing if an order was routed again by the receiving firm or what happened at the away market.<sup>14</sup> Although Rule 6955(c) allows members to enter into reporting agreements with non-members and exchanges, we do not believe this would be a viable method for reporting the data on activity that takes place in other markets because the member would lose control of the recording and reporting but would remain liable for the accuracy of the data. Further, very little firm data would exist to compare and identify exceptions, unless firms duplicated the processes of the reporting entity, which would significantly increase the cost of reporting and, again, raise the question of whether this is the most efficient method of compiling an audit trail.

Aside from the practical problems noted above, the Committee is concerned about the competitive implications of a single SRO acting as the repository for very detailed, customer-specific information on trades executed by its members in competing marketplaces. It is precisely such a conflict of interest that has prompted the SEC to request comment on potential approaches that could improve the operation of securities industry regulation.

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<sup>14</sup> In fact, reporting order events subsequent to routing was a key point of contention during the initial implementation of OATS. At that time, the NASD agreed that it was in the best position to match data submitted by different entities relating to a single order using the order identifier.

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January 20, 2005  
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Finally, SROs that operate markets are responsible for promulgating rules that govern trading in their markets. A thorough review of the trading rules in each market would have to be undertaken to ensure that OATS does not flag as non-compliant transactions that are permissible under the rules of the competing market.

### C. Issues Presented by Manual and Proprietary Orders

Expanding OATS to include OTCBB and Pink Sheet securities is problematic and raises issues that the industry has been grappling with since OATS was developed. The nature of this business is manual; orders are routed and executed via telephone. There are very few electronic systems that support the trading of OTCBB and Pink Sheet securities. Consequently, all the required data would have to be manually recorded at all of the locations through which the order may pass, resulting in delays in execution and a high rate of errors as the order information is orally relayed and recorded at multiple points.

The proposed requirement to record and report proprietary trades would represent a significant increase in the number of records submitted by almost all member firms and is duplicative of information already captured in electronic systems. Proprietary trades are executed through the facilities of a marketplace and are reported as such through the marketplace's trade reporting system. For example, trades executed through Nasdaq facilities, *e.g.*, SuperMontage, are automatically reported to the Automated Confirmation Transaction ("ACT") System. In order to get a comprehensive audit trail, proprietary activity in ACT needs merely to be integrated with customer activity received through OATS. It would be much more efficient to integrate records at the SRO level rather than to require individual firms to record and report the massive amount of information relating to proprietary trading.<sup>15</sup>

### III. Conclusion

The Committee believes a comprehensive order audit trail is essential to serve investor protection goals. To ensure a consistent and comprehensive approach that is fair to all market participants in the increasingly competitive environment, NASD should wait for the results of the Concept Release and, if necessary, coordinate with other regulators to ensure that the system employed minimizes, to the greatest extent possible, duplicative

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<sup>15</sup> In a decimalized world, an order may need to be broken up and routed to several venues because quotes are not deep at each price point. In fact, it is not unusual for a 1,000 share order to be executed as ten separate orders of 100 shares each. Many market makers also employ sophisticated routing technology that automatically seeks out liquidity across trading venues. The current proposal is not only burdensome because of the increased number of records that would be required as a result of smaller and more numerous executions, but firms would have to get a daily download of information from vendors operating the smart routing technology, changing the way orders are reported from intra-day to end-of-day and making the process more inefficient and error-prone. Other proposed initiatives, if adopted, will only serve to exacerbate the problem as restrictions on trading through a superior price in another trading center causes trading to become further dispersed over multiple venues. *See* Securities Exchange Act Release No. 34-50870 (December 16, 2004) re-proposing SEC Regulation NMS.

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reporting and infrastructure costs. If regulators determine, after receiving public comment, that OATS could serve as a consolidated audit trail for the equity markets, operational and competitive issues as noted above must be addressed. As noted above, a suggested alternative would be for an industry utility such as DTCC to implement and maintain a consolidated order audit trail on behalf of the SROs.

The NASD acknowledges in the Notice that a proposed rule change must be authorized for filing with the SEC by the NASD Board of Directors and then must be approved by the SEC before becoming effective. In a footnote, the NASD cites to Section 19 of the Securities Exchange Act of 1934 (the "Act"), which permits certain limited types of proposed rule changes to take effect upon filing with the SEC. Although these proposed changes arguably could fall into that category, the Committees strongly believe that the extensive changes that would be required for both members and non-members dictate that any such rule change be filed for notice and comment under Section 19(b)(2) of the Act.

Thank you for the opportunity to comment. If you have any questions, or would like to discuss our comments further, please contact the undersigned or Richard Bommer, Director, Operations, at 212.608.1500.

Sincerely,

Stuart Bowers  
Chairman  
SIA Operations Committee

CC: Donald D. Kittell  
John D. Panchery  
Operations Committee

**Background:**

The NASD has issued a Notice to Members to solicit comments from members and other interested parties on proposed changes to the OATS Rules (Rules 6950 through 6957). The OATS Rules impose obligations on member firms to record in electronic form and report to NASD on a daily basis certain information with respect to orders originated or received by NASD members relating to securities listed and traded on The NASDAQ Stock Market, Inc. (NASDAQ). NASD staff is seeking comment on three proposed changes to the OATS Rules, which would require members to record and report to OATS:

- Order information relating to exchange-listed and OTC equity securities (OTC Bulletin Board (OTCBB) and PinkSheets);
- Enhanced information, including execution data, relating to orders routed to non-members or exchanges
- Order information relating to proprietary orders generated during the course of market-making activities.

**FIF Opinion:**

The FIF welcomes the opportunity to comment on these proposed rule changes. One general comment is that having two separate processes to report orders, OATS for NASDAQ products, and OTS for NYSE Listed products is overly burdensome in that it will be very costly to maintain multiple systems and infrastructures to perform essentially the same function. Additionally, having a single security that may be reportable in either OTS or OATS would produce a complicated reporting structure, and further complicates books and records and audit requirements. Based on a discussion at a recent FIF Service Bureau Meeting, and the documents produced at our August 11 workshop we have the following comments:

- Inclusion of OTC BB (Pink Sheets) issues is relatively straightforward, but would present a change on how reporting is done.
  - o Service Bureaus will need adequate time to make the required system changes.
- How will information routed to non-members be reported to OATS?
  - o Any time a that service bureau needs to create an OATS report on an order that did not originate in its system, it results in significant data integrity and synchronization issues. These are the same issues discussed when reporting orders that include multiple OSO's. During the August FIF Workshop, the issues were raised in regards to orders routed from a service bureau to trade order management systems for execution. In this scenario, the orders are being routed to a non-member for execution, but the same underlying issues and problems are present.
    1. Who is responsible for reporting non-member orders? (The Service Bureau who does not have the detailed information, or the non-member firm, who does not report to the NASD)

2. How will the service bureau collect the required information about the non-member orders (Is there a standard file layout, and process in mind)?
  3. How will the member or the services bureau validate information received from the non-member?
  4. What will the impact be on supervisory responsibilities of the member firm
- What order information relating to proprietary orders (or market making activity) is required?
    - In many instances order information is not entered in trade order management systems, only execution details are available. In this regard, systems and trading business practices will have to be modified to allow the entry of order information on all proprietary orders. What are the specific order details that will need to be reported?
  - Other Issues
    - o Detailed specifications will allow us the opportunity to more adequately assess the impact of the proposed changes. We also believe that consideration should be given to other significant industry initiatives such as the SEC Reg. NMS, Reg. Sho, and Reg. SRO proposals that require the attention of the same management and development resources. In addition, we suggest that the NASD provide the industry with reasonable time frames to implement the required changes.

**Next Steps:**

We look forward to meeting to discuss these points, and to work cooperatively with the NASD on technical and implementation issues.

**About the Financial Information Forum (FIF)**

The Financial Information Forum (FIF) addresses the issues that impact the market data and securities processing industry - providing a collaborative environment for subscribers to benefit from technology, regulatory, and market innovations. Financial institutions, vendors, and exchanges are encouraged to subscribe to the Financial Information Forum.



Industry Professionals > Regulation > Notices > Comments

## Comments on NASD Notice to Members 04-80

January 20, 2005

Barbara Z. Sweeney  
Office of the Corporate Secretary  
NASD  
1735 K Street, N.W.  
Washington, D.C. 20006-1500

RE: NASD Request for Comment on Proposed Changes to the OATS Rules (NTM 04-80)

Dear Ms. Sweeney:

royalblue Financial Corp. ("royalblue") thanks the NASD for the opportunity to provide comments on proposed changes to the OATS Rules. royalblue is an international technology provider of trading solutions and is a registered Order Sending Organization whose software is used to create and transmit OATS reports on behalf of over 30 Member Firms.

The NASD's staff proposes three changes to the OATS rules:

1. Order information relating to exchange-listed and OTC equity securities. The staff proposes that OATS requirements be extended to exchange listed and OTC equity securities.

Technically it would not be difficult to extend OATS reporting to non-Nasdaq securities. This would, however, possibly duplicate and conflict with the New York Stock Exchange's Order Trail System ("OTS") requirements. It is worth noting that the Securities and Exchange Commission (the "Commission") in its Concept Release concerning Self-Regulation dated November 18, 2004, discusses conflicting and duplicative regulation.

2. Enhance OATS Information Reported for Orders Routed to Exchanges or Non-Members

The staff proposes that OATS Execution Reports be created for orders routed to Exchanges and other non-Members (New Order and Route reports are already created).

These additional requirements would necessitate new development and would not be a trivial undertaking. We urge the staff to consider instead obtaining any needed additional regulatory information directly from the

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Exchanges or through the auspices of the Intermarket Surveillance Group ("ISG"). We understand that the NASD and Exchanges are full members of the ISG and that such cooperative efforts are its purpose. We also urge the staff to consider how often additional information is required surrounding routes to non-members and whether such information can be obtained otherwise than by requiring member firms to expend considerable resources developing new OATS reports.

3. Proposed changes to eliminate current Exceptions for Market Makers  
Proprietary orders generated during the course of market making are entered into Nasdaq Workstation-like interfaces that directly access the market and transmit order messages to the Nasdaq Market Center, ECNs and Exchanges. We understand the staff already has access to the messages transmitted to the Nasdaq Market Center. The staff already receives OATS reports from ECNs. To the extent additional information is required from Exchanges we urge the staff to consider obtaining that information directly from the Exchanges or through the auspices of the ISG. In addition, it should be pointed out that the distinction between orders and quotes is no longer clear. The Nasdaq Market displays unexecuted orders as quotes (unless IOC). Would quote updates then be subject to the proposed OATS rules?

These changes in particular would require significant development work, including developing the means to capture and store the messages noted above.

> Regards,  
>  
> Jess Haberman  
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>  
> Chief Compliance Officer and Vice President  
> royalblue financial corporation  
>  
> <mailto:jess.haberman@fidessa.com>  
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>

Commentary to NTM 04-80 by Ameritrade, Inc.

**1. Do you support the proposal that would require that members record and report OATS information for exchange-listed and OTC equity securities?**

Yes. Ameritrade supports the proposal so long as firms are allowed to report all equities in the same format. Firms with OTS and OATS reporting obligations should be given the option of selecting either the OTS or OATS reporting format. Firms should also be permitted to transmit all equity reports to a single repository and not be burdened with duplicate reporting obligations. The cost to support dual reporting systems would be extraordinary and would create an undue burden on firms to support the ever-changing technology enhancements inherent to such systems.

Ameritrade believes a single repository for the collection of OATS, OTS, COATS and other audit trail information would best serve the industry. It is the Firm's belief that a single repository would allow for increased regulatory efficiency and provide for uniform reporting specifications thereby allowing for the accurate collection of data while minimizing the risk of increased expenses which may be passed on to the investing public.

- 2. What are the technological implications and burdens associated with this proposal?** If OATS reporting for exchange-listed and OTC securities follow the same technical specifications as the current OATS technology requirements and firms are required to report transactions to NASD alone, only minimal enhancements would be necessary. If listed and OTC securities are required to be reported in a different format significant and costly technological enhancements would be required. These enhancements would include but not be limited to database redesign, application development, interface development, system architecture changes, extensive testing and a significant diversion of resources that may otherwise enhance the client trading experience.
- 3. Is the data you record and Maintain to comply with NYSE's OTS requirements in a similar form as the data you maintain for NASD OATS purposes? What additional changes would be necessary to enable members to submit to the NYSE OTS data to NASD OATS?** NASD should not burden members with unnecessarily redundant and costly reporting responsibilities. If members have OTS and OATS reporting responsibilities, NASD and NYSE

should coordinate their efforts and develop a method of exchanging member data in order to mitigate the unnecessary expense that would be borne by the entire broker-dealer community and ultimately passed on to individual investors through increased commissions and fees. In the event that such coordination is not possible, NASD and NYSE should modify their systems to accept both formats in order to reduce the burden on broker-dealers and individual investors. However, the point cannot be lost that duplicative systems reporting information in multiple formats is labor intensive and resource negligent. Regulatory agencies must bear in mind the most appropriate use of member firms' technology resources.

4. **Do you support the proposal that would require that members record and report OATS order events relating to orders routed to non-members or exchanges?** No. Although member firms currently report NW and RT reports for non-members, the reliance on a member to collect and further disseminate all aspects of reporting essentially turns the member into the repository. This places an undue regulatory burden on Members and exposes Members to potential regulatory violations in circumstances that extend far beyond their reasonable control while providing no impetus for non-members to agree and implement an industry standard. While Ameritrade appreciates NASD's sensitivity to SRO jurisdictional issues, until the industry can define a single reporting standard and a single repository, the increased burden posed by this question should not be considered.
5. **Describe the scope and type of order-related information that a member currently has access to when it has routed an order to a non-member or exchange. For example, if an order is routed to and then executed by a non-member, what execution information is provided to the member that routed the order? Does the member typically have knowledge of whether the order was further routed by the non-member or exchange, and if so, what level of detail is provided to the member?** Typically, non-Members provide a minimal level of information consisting of the number of shares executed and execution price. Additional message traffic consisting of UR Out messages, UR Stopped Messages and other administrative messages are received, however, we do not receive any information regarding whether a non-member or exchange further routed an order.
6. **What are the technological implications and burdens associated with this proposal, including requirements that potential could expand the scope of information provided by non-members and exchanges to members that have routed orders to them?** Imposing reporting obligations for non-Members on Members would represent an overwhelming technical challenge resulting in extraordinary expenses to the broker dealer community. Numerous enhancements would be required to support such a change including but not limited to the following. 1) Our Order Management System and the Order Management Systems of the non-Member destinations to which we route orders would have to be rewritten to transmit and capture data currently not being reported or captured.

2) Routing interfaces and communication standards such as FIX Protocol and CMS would have to be redesigned to include data not currently being reported. 3) OATS reporting applications would have to be reprogrammed to capture and report information currently not being captured or reported. 4) Databases and storage devices would have to be reprogrammed and expanded to capture the additional data. 5) Extensive testing of all applications and complete regression testing of all affected systems would be required. 6) Numerous technology resources would have to be redirected from client experience enhancing and efficiency generating projects. 7) Extraordinary development expenses associated with such an endeavor would ultimately be passed on to individual investors through higher commissions and fees or through the inability to gain efficiencies that could lower commissions and fees.

Ameritrade recognizes the potential benefits of a complete audit trail that includes non-Member information, however the burden of making such changes would be extraordinary and we ask that serious consideration be given to the industry-wide financial consequences of meeting such an objective.

7. **Do you support the proposal that would require that members record and report OATS information for OATS proprietary orders generated during the course of market-making?** No commentary provided.
8. **What are the technological implications and burdens associated with this proposal?** Please refer to commentary provided above as it relates to technological implications.
9. **NASD anticipates proposing a “phase-in” period for implementation of any of the proposals described herein to provide members with adequate time for necessary system and procedural modifications. What amount of time do you believe is adequate for implementation of the proposals?** Ameritrade believes it would be prudent to provide at least six months for firms to implement the changes required to report Exchange-Listed and OTC securities using OATS technical specifications. Such a time period would provide adequate time for development and testing.

Ameritrade also believes it would take at least 36 months to make the necessary system enhancements and adequately test the changes necessary to report non-Member information to OATS.

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**Are you:**

An NASD Member YES

An Investor

A Registered Representative YES

Other:

# INSTINET GROUP

January 20, 2005

Ms. Barbara Z. Sweeney  
Office of the Corporate Secretary  
NASD  
1735 K Street, N.W.  
Washington, DC 20006

Re: Notice to Members 04-80, Proposed Changes to the OATS Rules

Dear Ms. Sweeney:

Instinet Group Incorporated (“Instinet Group”) is pleased to offer its comments on NASD Notice to Members 04-80 (the “NTM”), in which the NASD seeks comment on several proposed modifications to rules regarding the NASD’s Order Audit Trail System (“OATS”), intended to enable NASD to create a more comprehensive and accurate audit trail and improve the effectiveness of NASD’s automated surveillance for potential violations of NASD rules and federal securities laws. Instinet Group, through affiliates, is the largest global electronic agency securities broker and has been providing investors with electronic trading solutions and execution services for more than thirty-five years. We operate our two main businesses through Instinet, LLC<sup>1</sup> and Inet ATS, Inc. (“INET”)<sup>2</sup>.

While Instinet Group supports the underlying goal of establishing a complete, accurate order and trade audit trail, we believe that the proposals outlined by the NASD raise significant policy, competitive and operational issues and are not the best answer to the current problems that impair comprehensive surveillance. On a fundamental level, we note that many of the issues raised by the NASD are addressed in the Securities and Exchange Commission’s Concept Release Concerning Self-Regulation (“Concept

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<sup>1</sup> Instinet, the Unconflicted Institutional Broker, gives its customers the opportunity to use its sales-trading expertise and advanced technology tools to interact with global securities markets, improve trading and investment performance and lower overall trading costs. Instinet acts solely as an agent for its customers, including institutional investors, such as mutual funds, pension funds, insurance companies and hedge funds. Additional information regarding Instinet, LLC can be found at <http://www.instinet.com>.

<sup>2</sup> INET, the electronic marketplace, provides its U.S. broker-dealer customers one of the most robust liquidity pools in Nasdaq equities, substantial liquidity in U.S. exchange-listed securities, and routing access to other major U.S. trading venues. Additional information regarding INET can be found at <http://www.inetats.com>.

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Release”).<sup>3</sup> We believe that consideration of the NTM should be postponed until the larger issues surrounding self-regulation have been fully discussed in the context of the Concept Release and the Commission determines whether any revisions to the existing self-regulatory structure ultimately are necessary in light of such discussion.

If the NASD proceeds with its request notwithstanding the pending outcome of the Concept Release, Instinet Group has additional specific concerns with the proposals. Instinet Group questions whether a market center should be the central surveillance mechanism for brokers and other market centers with which it competes. We are also concerned about extensive duplication of audit trail reporting that would result from adoption of these proposals and the additional development and support resources that firms would need to expend to maintain multiple reporting systems. From an operational perspective, Instinet Group is concerned that the NASD’s already overtaxed systems will not be able to handle the additional burden of processing data for securities not currently reported to OATS, and that additional burdens will be placed on member firms.

**I. Market-wide Questions Regarding Intermarket Regulation must be Answered Prior to Implementing Specific Solutions**

The optimal mechanism for SROs to adequately regulate their members given today’s fragmented market structure has been the topic of much discussion over the past few years. In May of 2002 the General Accounting Office issued a report focused on the potentially duplicative nature of SRO regulation given the increasingly fragmented market structure.<sup>4</sup> The following year the SEC sought comment on a petition filed by Nasdaq that also addressed issues relating to the trading of securities on market centers regulated by different SROs.<sup>5</sup> Most recently, the SEC published the Concept Release, which devotes a significant portion of its discussion to intermarket surveillance and the inefficiencies of the multiple SRO model.<sup>6</sup>

Although the topics of multiple SROs and intermarket regulation have been widely discussed, the industry and regulators remain uncertain of the most effective path forward. The Concept Release requests comment on the level of inefficiency caused by multiple SROs overseeing the activities of the same members, the extent to which fragmentation has caused gaps in intermarket trading surveillance, the effectiveness of the Intermarket Surveillance Group, the industry organization created in 1983 to coordinate intermarket surveillance among the SROs, and even the efficacy of merging the New York Stock Exchange (“NYSE”) OTS and NASD OATS audit trails. In light of the ongoing nature of this discussion (the comment period for the Concept Release does

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<sup>3</sup> Securities Exchange Act Release No. 34-50700 (November 18, 2004)

<sup>4</sup> U.S. General Accounting Office Report to Congressional Committees, “Securities Markets Competition and Multiple Regulators Heighten Concern about Self-Regulation” (May 2004) (“GAO Report”)

<sup>5</sup> Concept Release: Request for Comment on Nasdaq Petition Relating to the Regulation of Nasdaq-Listed Securities, Exchange Act Release No. 47489 (May 14, 2003)

<sup>6</sup> Concept Release at 71264, 71265

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not end until March 8, 2005), it is imprudent for the NASD to implement changes at this time that could become unnecessary or worse, in conflict with the ultimate approach taken by the SEC.

## **II. Specific Issues with NASD Proposal**

Although Instinet Group strongly urges the NASD to postpone implementation of the proposals outlined in the NTM in anticipation of action on the Concept Release, we outline specific concerns with the proposals here.

### ***Competitive Issues Exist when SROs Operate Competing Market Centers***

Instinet Group is concerned with an expansion of its requirement to provide order and execution information to the NASD based on competitive issues. NASD in addition to regulating market centers such as INET, operates its own market center, the ADF, and remains the largest single shareholder in NASDAQ. The NASD's ADF and NASDAQ compete directly with INET for orderflow from broker-dealers. OATS information specifies, among many other attributes of orders, the identity of the broker-dealer client that has submitted an order. We believe there are significant competitive implications if members such as INET must provide a competitor with additional information about customer activity on a competing market center.

### ***Duplication of Audit Trail Reporting Requirements will be Overly Burdensome***

The NASD's proposals call for the inclusion of information related to orders in exchange-listed securities as well as orders routed to non-members or exchanges, to enable it to perform certain automated surveillance for these securities. In addition to the competitive concerns raised above, Instinet Group believes that there will be significant burdens placed upon NASD members to comply with these provisions, creating duplicative reporting to multiple SROs. Although the NASD states that they will attempt to minimize the potential for duplicative order reporting, the various systems operated by the multiple SROs currently regulating trading of exchange-listed securities are so divergent that it would be extremely difficult for the NASD to develop a system which would avoid significant duplication of effort in order to comply with the requirement that OATS also receive this data. A comparison between OTS and OATS, for example, highlights many differences in the file formats, mechanisms of transmission of data and the nature of the reporting (OTS is on-request where OATS is a daily requirement).

The proposed requirement would also place a significant new burden on an NASD member that trades only exchange-listed securities. One of Instinet Group's broker-dealer subsidiaries, Harborview, LLC ("Harborview"), for example, is a member of both NASD and NYSE and is therefore subject to regulation by both SROs. Harborview deals exclusively with exchange-listed securities and therefore has no OATS reporting mechanism today. Under the proposed rule changes, Harborview would not

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only need to maintain its current OTS, DPTR and other NYSE reporting systems, but would be required to develop new OATS reporting capabilities to provide the same information to the NASD, albeit in a slightly different format. This would be a costly undertaking from both a development and support perspective, with no appreciable surveillance or regulatory benefit.<sup>7</sup>

### ***Capacity and other Operational Concerns***

In June 2004, NASD Notice to Members 04-46 (the "Notice") was published, implementing mandatory changes to OATS reporting. As a result of this change, members must utilize more compressed reporting formats to reflect orders that are received and subsequently routed, executed or canceled in full on the same day. According to the Notice, the changes are intended to reduce the number of data records submitted by firms, in response to a recent significant increase in OATS volume. It is clear from this Notice, as well as from frequent operational issues experienced by the NASD, that the capacity of the OATS system is straining to process current volumes.

Instinet Group is therefore concerned that NASD has not adequately considered the capacity implications of implementing its proposals to expand OATS to cover exchange-listed, OTC, and Pink Sheet stocks and additional information on orders routed to non-members and exchanges as well as proprietary trading activity. Expanding INET's reporting to cover these additional items, for example, would increase its reporting volume by approximately 50%. That would result in an average increase of over 15 million records per day from INET alone. The NTM does not indicate that NASD is taking any steps to address the capacity needs that will result from these proposals. Instinet Group urges the NASD to clarify their plans in this area.

The NTM's proposal relating to additional information to be provided relating to orders routed to exchanges or non-members poses operational challenges to members. Once orders are routed, subsequent communication between the member and the destination market center or firm are generally limited to execution reports or cancellations. It is impractical to expect members to report to NASD on detailed actions such as subsequent routing since they do not have access to that information. Reporting Agent arrangements will not suffice to remedy this situation, assuming they will exist, since firms retain the ultimate responsibility for the accuracy of the data, yet will have no mechanism with which to validate the information provided to NASD by the destination market center.

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<sup>7</sup> Although NASD points out in the NTM that members can enter into reporting agent agreements with non-members or exchanges to report OATS information, it is unknown at this time whether NYSE, for example, will provide such a service or whether it would be appropriate for Instinet Group to utilize such a service. In addition, as the notice also points out, the ultimate responsibility for OATS reporting still lies with the member firm, meaning that supervisory processes for OATS would still be necessary at Harborview, LLC.

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When orders are routed to non-members or exchanges, those orders become subject to the rules governing those members or exchanges. It is unclear how NASD will program its systems to take all of the different rules of all the other SROs into account when performing surveillance. For example, the short sale rule currently has different “flavors” under different SROs, and in some cases does not exist at all. It is unclear whether reporting information to NASD on these orders will trigger “false positives” when the NASD performs surveillance on those orders. If a significant number of “false positives” are generated, a burden on firms’ compliance and technology resources will be unnecessarily created. Clearly a significant effort will be required on the part of the NASD to keep track of rule changes on other SROs and keep their surveillance systems in lock step with them. Instinet Group urges NASD to clarify their plans in this area.

### **III. Conclusion**

Instinet Group believes that there are significant issues in the areas of multiple SRO regulation and surveillance of intermarket trading activity. We are pleased that the SEC has initiated the evaluation of appropriate measures to be taken to address these issues, most notably by issuing its Concept Release. Instinet Group believes that any proposals to address issues highlighted in the Concept Release should be shelved until the conclusion of the SEC’s process. The solutions to the marketwide issues addressed in the Concept Release should be solved through this inclusive process rather than by implementing an SRO-specific solution. We look forward to working with the NASD, SEC and others to improve the quality of regulation in the equity markets.

We appreciate the opportunity to comment and would be pleased to discuss any of the comments in this letter. If we can be of further assistance in this regard, please do not hesitate to contact the undersigned at 212-310-7862.

Yours Sincerely,

Deborah Mittelman  
First Vice President



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### **Comments on NASD Notice to Members 04-80**

Good afternoon, I wanted to express my concern with the reporting requirements being suggested for OATS reporting. We are a small firm and will find it very difficult to be able to report transactions as suggested same day. Our volume does not justify an outside servicer, yet we do not have a "trading desk" which monitors our trades real time, or a staff a people to devote to watching a WEB page for data entry. Our clearing firm seems to be backing out of the reporting process which will require us to take a more active role in the transmission of info. I realize we are responsible and we do monitor our trading activity to ensure proper trade execution. I also realize the world is changing; it is just unfortunate that the good usually wind up paying for the mistakes of a few.

**EXHIBIT 5**

Exhibit 5 shows the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

\* \* \* \* \*

**7000. CLEARING, TRANSACTION AND ORDER DATA REQUIREMENTS,  
AND FACILITY CHARGES**

\* \* \* \* \*

**7400. ORDER AUDIT TRAIL SYSTEM**

**7410. Definitions**

For purposes of the Rule 7400 Series:

(a) through (c) No Change.

[(d) “Nasdaq Market Center” shall mean the service provided by Nasdaq that, among other things, provides for the reporting of transactions in Nasdaq securities.]

(e) through (i) redesignated as (d) through (h)

(i) “NMS stock” shall have the same meaning as contained in Rule 600(b)(47) of SEC Regulation NMS.

(j) “Order” shall mean any oral, written, or electronic instruction to effect a transaction in an NMS stock [equity security listed on the Nasdaq Stock Market] or an OTC equity security that is received by a member from another person for handling or execution, or that is originated by a department of a member for execution by the same or another member, other than any such instruction to effect a proprietary transaction originated by a trading desk in the ordinary course of a member's market making activities.

(k) "Order Audit Trail System" shall mean the automated system owned and operated by FINRA that is designed to capture order information in NMS stocks [equity securities listed on the Nasdaq Stock Market] and OTC equity securities reported by members for integration with trade and quotation information to provide FINRA with an accurate time sequenced record of orders and transactions.

(l) through (n) No Change.

(o) "Reporting Member" shall mean a member that receives or originates an order and has an obligation to record and report information under Rules 7440 and 7450.

(1) A member shall not be considered a Reporting Member in connection with an order, if the following conditions are met:

(1) through (4) redesignated as (A) through (D)

(2) A member shall not be considered a Reporting Member in connection with an order if:

(A) the member was approved as a member pursuant to NASD IM-1013-1 or NASD IM-1013-2;

(B) the member operates consistent with NASD IM-1013-1 or NASD IM-1013-2, including limiting its business operations to "permitted floor activities," as that term is defined in NASD IM-1013-1 and NASD IM-1013-2; and

(C) the order was received by the member through systems operated and regulated by the New York Stock Exchange or NYSE Amex.

\* \* \* \* \*

**7470. Exemption to the Order Recording and Data Transmission Requirements**

(a) Pursuant to the Rule 9600 Series, the staff, for good cause shown after taking into consideration all relevant factors, may exempt, subject to specified terms and conditions, a member from the recording and order data transmission requirements of Rules 7440 and 7450, respectively, for manual orders, if such exemption is consistent with the protection of investors and the public interest, and the member meets the following criteria:

(1) through (2) No Change.

(3) the member does not conduct any market making activities in NMS stocks [Nasdaq Stock Market equity securities] or OTC equity securities;

(4) through (5) No Change.

(b) through (c) No Change.

\* \* \* \* \*