



Financial Industry Regulatory Authority

October 28, 2010

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

**Re: SR-FINRA-2010-044 — Proposed Rule Change Relating to the Expansion of the Order Audit Trail System to all NMS Stocks — Response to Comments**

Dear Ms. Murphy:

The Financial Industry Regulatory Authority, Inc. (“FINRA”) hereby responds to the comment letters received by the Securities and Exchange Commission (“Commission” or “SEC”) in response to the publication in the *Federal Register* of Notice of Filing of SR-FINRA-2010-044.<sup>1</sup> The purpose of the proposed rule change is to extend FINRA’s Order Audit Trail System (“OATS”) rules (“OATS Rules”) to all NMS stocks. The Commission received three comment letters on SR-FINRA-2010-044.<sup>2</sup>

FIF generally supported the proposal to expand OATS to all NMS stocks but raised some concerns regarding implementation. FIF specifically requests an exemption, or additional implementation time, for convertible and non-convertible preferred stock listed on the New York Stock Exchange (“NYSE”). FIF suggests that these securities are managed by most firms in the fixed income desks and systems and “may not be easily reportable on existing platforms.” FIF also states that these securities are essentially considered to be bond instruments and have been exempted from portions of Regulation NMS.<sup>3</sup> FINRA does not believe it is appropriate to exempt, or provide

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<sup>1</sup> See Securities Exchange Act Release No. 62739 (Aug. 18, 2010), 75 Fed. Reg. 52,380 (Aug. 25, 2010).

<sup>2</sup> Letter from Manisha Kimmel, Executive Director, Financial Information Forum, to Elizabeth Murphy, Secretary, U.S. Securities and Exchange Commission (Sept. 17, 2010) (“FIF”); Letter from Joan Conley, Senior Vice President and Corporate Secretary, NASDAQ OMX Group, Inc., to Elizabeth Murphy, Secretary, U.S. Securities and Exchange Commission (Sept. 15, 2010) (“Nasdaq”); Letter from Steve Allread, Equity Trader, Cutter Company, to the Commission (Sept. 10, 2010) (“Cutter”).

<sup>3</sup> FIF did not offer a citation for its proposition that “the SEC exempted Non Convertible Preferred from Regulation NMS.” FINRA is aware that non-convertible preferred securities have been exempted from certain provisions of Regulation NMS; however, other provisions continue to apply. See Securities

additional time for, preferred stock at this time. FINRA notes that preferred stock listed on Nasdaq or traded over the counter is not exempt from the OATS Rules, and transactions in preferred stock are subject to the same trade reporting obligations as other securities. In addition, the NYSE's Order Tracking System ("OTS") rules contain no exemption for preferred stock, thus NYSE member organizations are already required to capture order information regarding preferred stock.<sup>4</sup>

In addition to raising concerns regarding the proposed rule change's impact on NYSE-listed preferred stock, FIF suggests an extension of the time permitted to file OATS reports until 5:00 p.m. on T+1,<sup>5</sup> and beginning the five-day repair window from the time a firm receives a rejection rather than from the submission of the order.<sup>6</sup> Finally, FIF recommends that FINRA enhance its capacity and processing bandwidth for its test and production sites. FINRA notes that FIF's concerns are generally focused on implementation aspects of the proposed rule change rather than the substance of the proposed rule change, which FIF supports. FINRA is already evaluating the systems supporting OATS reporting to identify potential efficiencies in both the submission and reject/repair processes as well as capacity-related issues and will consider the issues raised by FIF, among others, as it develops an implementation approach pending SEC approval of the proposed rule change.

Nasdaq poses several questions that it suggests can "assist the Commission in determining whether this proposal provides meaningful benefit to regulation or whether investors would be better served by the Commission proceeding with its original plans for a new and comprehensive audit trail." As an initial matter, FINRA does not believe these are mutually exclusive options. As described in detail in the filing, FINRA's proposal to expand OATS to all NMS stocks is designed to address the fact that FINRA has a less robust data set upon which to monitor activity in NYSE-listed securities as compared to Nasdaq-listed securities and, without such data,

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Exchange Act Release No. 57621 (Apr. 4, 2008), 73 Fed. Reg. 19,270 (Apr. 9, 2008) (exempting non-convertible preferred securities from Rule 611(a) of Regulation NMS); Letter from Richard R. Lindsey, Director, Division of Market Regulation, SEC, to Roger D. Blanc, Willkie, Farr & Gallagher (July 31, 1997) (exempting preferred securities from what is now Rule 602 of Regulation NMS).

<sup>4</sup> See NYSE Rule 132B.

<sup>5</sup> Currently, reportable order events that occur during a particular OATS Business Day must be reported by 05:00:00 Eastern Time the following calendar day. See *OATS Reporting Technical Specifications*, at 8-1 (ed. Aug. 30, 2010). An OATS Business Day begins at 16:00:01 Eastern Time on one market day and ends at 16:00:00 Eastern Time on the next market day. *Id.*

<sup>6</sup> See *OATS Reporting Technical Specifications*, at 8-2 (ed. Aug. 30, 2010).

would be forced to continue to have multiple patterns, some less optimal, to surveil for the same activity. The proposal, as clearly articulated in the filing, is not, and was not intended to be, a replacement for the Commission's efforts in moving toward a truly consolidated audit trail. FINRA does not believe that it is in the best interests of investors or the U.S. equity markets not to pursue more comprehensive regulatory information simply because there is a proposed rule that may later encompass similar information, particularly when the proposal is at least two years away from full implementation. In short, FINRA sees no reason why approval of the proposed rule change, even if it is viewed as an interim measure, would necessarily result in the cessation of the Commission's efforts to establish a consolidated audit trail across markets. FINRA recommends the Commission do both and believes that such action is fully consistent with the purpose and goals of the Exchange Act and the Commission's desire to enhance audit trails.

Nasdaq also raises concerns about FINRA's "competitive positioning" of OATS and suggests to the Commission that it ask a number of questions of FINRA before approving FINRA's proposal. First, FINRA has not and does not view OATS (or any of its audit trails) in terms of competitive advantage. Unlike exchanges or technology vendors that may have competitive or profit-making motivations regarding the collection and consolidation of audit trail data, FINRA's goal is simple: how can FINRA best perform its regulatory and oversight functions and further investor protection. In proposing to expand the OATS Rules to include all NMS stocks, a step that FINRA had commenced consideration of several years ago,<sup>7</sup> FINRA is simply seeking to raise the level of oversight of order handling regarding all NMS stocks to the level currently given orders involving Nasdaq and OTC equity securities. As FINRA pointed out in the filing, 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.

Nasdaq also expressed concerns regarding the potential cost to the industry of the proposed rule change and implementation of the changes. One commenter other than Nasdaq speculated that some firms may be burdened by the proposed rule change and incur costs (e.g., by hiring additional staff) if the proposed rule change is approved.<sup>8</sup> FINRA recognizes that the proposal may impose additional costs on its member firms; however, FINRA does not believe the potential burdens outweigh the need for extending the OATS requirements to all NMS stocks. Extending the OATS Rules to cover orders in all NMS stocks will significantly enhance the effectiveness of OATS as a regulatory tool by expanding the scope of the order audit trail in the U.S. equity markets. As noted in the filing, FINRA believes that most of the firms that will be

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<sup>7</sup> See NASD *Notice to Members* 04-80 (Nov. 2004).

<sup>8</sup> See Cutter.

affected by the proposed extension of OATS already have the infrastructure in place to adjust to the proposed rule change relatively quickly and efficiently. Moreover, as FIF noted in its comment letter, the proposed rule change will reduce regulatory duplication on those firms that are currently complying with the OATS Rules and the OTS requirements currently imposed by the NYSE if, as anticipated, the NYSE retires the OTS.

Regarding implementation, FINRA believes that a six-month timeframe after publication of a *Regulatory Notice* is reasonable. FINRA notes that FIF also stated in its comment letter that a six month implementation time, followed by a phased in approach, from the release of the *OATS Reporting Technical Specifications* would be sufficient.<sup>9</sup>

Nasdaq and Cutter also raise questions regarding more general points concerning OATS. Cutter questions the use of OATS data by FINRA and the overall need for order data in regulating broker-dealers and the securities markets. Nasdaq asks about the anticipated use of new data and FINRA's surveillance patterns. As stated in our filing, FINRA staff uses order information from OATS to conduct surveillance and investigations of member firms for violations of numerous FINRA rules and federal securities laws. Expanded OATS data that includes order information for all NMS stocks (as well as OTC equity securities) is critical to FINRA's cross-market surveillance initiatives, and FINRA intends to incorporate the expanded OATS data into existing automated surveillance patterns as soon as practicable. Indeed, the Commission's consolidated audit trail proposal emphasized the importance of order information across markets in regulating the securities markets and market participants.<sup>10</sup> Hence, FINRA disagrees with Nasdaq's categorization of OATS data as being of "limited use" and a similar implication from Cutter. Although Cutter suggests that relying on trade reporting information could be simpler, FINRA cannot surveil for compliance with its rules based solely on execution information. For example, with respect to member firm compliance with order handling rules, FINRA would not know whether a proprietary order in a particular security was initiated before or after receipt of a customer order in the same security without comprehensive order data.

Cutter also states that issues involving OATS compliance could affect vendor selection by broker-dealers. FINRA agrees with the commenter that firms must

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<sup>9</sup> FINRA anticipates publishing the revised version of the *OATS Reporting Technical Specifications* at the same time as the *Regulatory Notice* announcing the SEC's approval of the proposed rule change (i.e., approximately 60 days following SEC approval).

<sup>10</sup> See Securities Exchange Act Release No. 62174 (May 26, 2010), 75 Fed. Reg. 32,556 (June 8, 2010).

separate their decision-making regarding execution quality offered by vendors from services related to OATS reporting, and considerations of cost savings or compliance assistance in the area of OATS should not inappropriately affect a firm's routing decisions. However, the fact that different vendors may offer different services at different prices (issues over which FINRA has no control) does not obviate FINRA's need to receive order data so that it can surveil its members for appropriate order handling and compliance with applicable rules and laws.

Following discussions with SEC staff, FINRA would also like to provide additional details on the audit trail data that will result if the proposed rule change is approved and OTS is eliminated.<sup>11</sup> The proposed rule change would exempt from the OATS requirements orders received by firms that waived into FINRA membership pursuant to NASD IM-1013-1 or IM-1013-2 and that limit their business operations to "permitted floor activities" as defined in those rules when the orders are received by the member through systems operated and regulated by the NYSE or NYSE Amex. Although these orders would not be required to be reported to OATS under the proposed rule change, much of the information regarding these orders once they are routed to the exchange would be captured in an NYSE or NYSE Amex system. Both the NYSE and NYSE Amex have rules in place requiring that floor members or member organizations enter details of an order into an NYSE or NYSE Amex electronic system before the order can be represented on the Floor.<sup>12</sup> These rules also require that execution information be captured in an NYSE or NYSE Amex system after the order has been executed.<sup>13</sup> Consequently, FINRA will receive OATS information on orders up to and including the point at which an order is routed to the NYSE (or NYSE Amex). Following the route to the exchange, an NYSE or NYSE Amex system will contain the order and execution information required under applicable NYSE and NYSE Amex rules.<sup>14</sup> To the extent an order is received through

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<sup>11</sup> FINRA does not currently receive OTS data from the NYSE, and, in fact, the NYSE does not receive OTS data on a regular basis. Rather, the OTS rules function as a recordkeeping requirement with an obligation on firms to produce the data upon request by the NYSE, as opposed to OATS which is a recordkeeping and reporting system. Thus, the proposed rule change would only expand the amount of audit trail information FINRA receives; no information that FINRA currently receives will be lost as a result of the rule changes.

<sup>12</sup> See NYSE Rule 123(e); NYSE Amex Equity Rule 123(e).

<sup>13</sup> See NYSE Rule 123(f); NYSE Amex Equity Rule 123(f).

<sup>14</sup> This is not dissimilar to the way orders are currently handled with respect to orders for Nasdaq securities. OATS information is required up to and including the point at which the order is routed to Nasdaq's Singlebook

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means other than through an NYSE or NYSE Amex system (e.g., on the telephone), the orders would be subject to the OATS requirements because they would not meet the third prong of the proposed exemption requiring that orders be received by the member through systems operated and regulated by the NYSE or NYSE Amex. Consequently, information about the order would either be captured by an NYSE or NYSE Amex system or be reported to OATS.

FINRA believes that the foregoing fully responds to the issues raised by the commenters. Please feel free to contact me at (202) 728-6927 if you have any questions.

Sincerely,

A handwritten signature in blue ink that reads "Brant K. Brown". The signature is written in a cursive, flowing style.

Brant K. Brown  
Associate General Counsel

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system. After the order is routed, Nasdaq's Singlebook system contains the order and execution information required under applicable Nasdaq rules.