

NASD

November 30, 2005
3:15 p.m. CST

Coordinator Welcome and thank you for standing by. At this time all participants are in a listen-only mode. After the presentation we will conduct a question and answer session. Today's conference is being recorded. If there are any objections, please disconnect at this time.

Now I would like to introduce the first speaker for today's call, Mr. Paul McKenney. Mr. McKenney, you may begin.

P. McKenney Thank you. Good afternoon, everybody, and thank you for your participation in this conference call. This is the first of three calls related to OATS Phase III. Future call dates will be posted to the OATS Web site, but are tentatively scheduled for early February and early April. This call is designed to give firms and service providers an overview of the recent amendments to the OATS rules and to discuss how the rule

amendments will impact firms for the final implementation phase of OATS Phase III. We have some prepared comments, which we expect to take about an hour to go through. We also hope to get some good feedback from you so that the implementation of OATS Phase III can go as smoothly as possible for all involved parties. We value your input and encourage your questions up through and after the implementation dates.

My name is Paul McKenney and I will be your moderator today. I am the Assistant Director of the OATS Operations Team, which includes Wilma George, Lisa Viera, and Robin Woodlon. Shelly Bohlin serves as the Director. This team has been added to the Market Regulation Department's Quality of Market section to provide education and guidance to firms on both the technical and business aspects of OATS. This team is separate and apart from the OATS Compliance Team, which enforces compliance with the OATS rules and is led by Steve Schruefer. We also have with us from our Market Regulation Department, Richard Wallace. From our OATS Technology Team we have Katie Madison and Laura Shoemaker and from our General Counsel's office we have Stephanie Dumont and Andrea Orr.

Phase III amendments impact both manual firms that have never reported to OATS and firms that are currently reporting to OATS. During this call NASD staff will cover the major components of the Phase III amendments, as well as highlight some other technical changes that will be included with the Phase III release scheduled for May 8, 2006. I will provide information on the key implementation dates, discuss the OATS Phase III requirements for manual orders, and describe the expansion of the reporting requirements for intra-firm routes to the trading desk. Lisa Viera will then provide an overview of the provisions contained in the amendments that allow certain firms to either be excluded from the definition of an OATS reporting member or to apply for exemptive relief from the transmission requirements of the OATS rules. Wilma George will present other technical changes that will be included in the Phase III release, but are not directly related to the OATS Phase III amendments. She will also present on OATS transmission methods, clock synchronization, and OATS resources. We will conclude the call with a question and answer session in which we hope to answer as many questions as possible. We do ask that you hold all questions until the Q&A session at the conclusion of the presentation and thank you again for your participation in this call.

The OATS rules are designed to create the lifecycle for orders received in Nasdaq equity securities. OATS tracks the events in the life of an order from origination or receipt through to cancellation or execution. As many of you know, the current requirements of the OATS rules, often referred to as Phase II, have been in effect since August 1999 and apply to all electronic orders. During Phase II an electronic order is defined as any order captured in electronic order routing for execution systems.

There are a number of important milestone dates of which you should be aware: On September 28th of this year the SEC approved SR-NASD-00-23 relating to the OATS rules. As approved the rule amendments implement the reporting requirements for manual orders and provide that members are required to capture both, the time the order is received by the member firm from the customer and the time the order is received by the member's trading desk or trading department if those times are different. The amendments also exclude certain members from the definition of reporting member and permit NASD to grant exemptive relief from the OATS reporting requirements to members that meet specified criteria.

On November 11th of this year NASD published on the NASD OATS Web site the OATS Reporting Technical Specifications, which, among

other things, specify the format in which data must be transmitted to the NASD OATS system upon the implementation of Phase III. Also on November 11th we published a Notice to Members containing interpretive guidance on the new rule requirements.

On March 28, 2006 NASD will make available the code changes required for OATS Phase III in the OATS testing environment so that firms may begin to test their own codes. The test environment will process the data just as the production environment will on the go-live date. The testing environment will be available to firms for six weeks.

On May 8, 2006 OATS Phase III requirements become effective in the production environment. It is on that day that firms must begin sending live data to OATS. Order events submitted that are not compliant with Phase III technical requirements will be rejected and must be repaired and resubmitted within five days.

All of these dates and related documents have been posted to the OATS Phase III Web site, which is located at www.nasd.com/oats/phaseIII.

As stated in the introduction, OATS Phase III requires that all orders in Nasdaq Equity Securities be reported to OATS. This includes, but is not limited to, orders received via telephone, e-mail, Internet, branch offices, and if applicable, instant messenger. This is, of course, in addition to any orders received electronically at the firm.

Reporting requirements for manual orders are the same as for electronic orders with the following exceptions: Routed order IDs are not required to be captured or passed for manually transmitted orders. Routed order IDs have been required for orders routed electronically to other members since March 1999 and for orders routed electronically to ECNs since February 14, 2005. The requirement to capture and pass routed order IDs for electronically routed orders has not changed.

The other exception for manual orders is that the account type code is required only to the extent that it is available. Aside from these two requirements there are no differences in reporting requirements between electronic and manual orders.

Currently the time of receipt for an electronic order is the time an order is captured by a firm's electronic order routing or execution system. In

Phase III the time of receipt for both electronic and manual orders is the time the order is received from the customer.

In addition to capturing the time of receipt at the firm, the OATS rules also require firms to report the time the order is received at the trading desk if it is different from the time of receipt from the customer. Since orders may be routed to multiple locations within the firm prior to reaching the trading desk, the order transmittal requirements have been expanded to include intra-firm routes to the trading desk; therefore a desk report will be required when an order is transmitted to the trading desk or any other desk within a firm. If the time of receipt from the customer and time of transmittal to the trading desk or other desk within the firm occurs within a second, no separate desk report will be required. OATS will not, however, reject desk reports for orders that are received by a desk within a second of the order receipt time.

To accommodate the requirement to submit a desk report when sending an order to another desk within the firm, NASD has enhanced the current desk report by adding the following fields: Shares quantity; desk type code; and desk special handling codes. The desk report can accept up to five special handling codes.

The desk type code is used to identify the desk to which the order was sent. NASD has established and published codes for the following desks: Trading; proprietary; sales; institutional; program trading; international; arbitrage; agency; derivatives; and preferred trading. If there are general desk types you'd like to see included we invite you to submit your request to the OATSPHASEIII@NASD.COM mailbox for staff consideration.

If the full shares quantity of an order is transmitted to another desk on the same date of receipt, firms must report the internal transmission using a new order type report, which includes the new order, combined order route, and combined order execution reports. To accommodate this requirement NASD has added fields allowing desk receipt time, desk-type code, desk special handling codes, and received-by-desk ID to be included on the new order and combination reports. For example, if your firm receives an order or transmits the order to the trading desk and routes the full shares quantity to an ECN, then the firm may use a combined order route report to show receipt of the order, transmission to the trading desk, and the route to the ECN.

Finally, we received several questions on what is considered the trading desk or trading department for purposes of the OATS rules. This term is

intended to refer to the function within the firm that is responsible for executing orders in Nasdaq securities. This function can include a trading system where orders are executed automatically, without trader intervention or the trading department where orders are executed with the assistance of traders.

With that I'd like to turn the presentation over to Lisa Viera, who will discuss the OATS rule amendments, addressing reporting member exclusion and NASD exemptive authority. Lisa?

L. Viera

Thank you, Paul. The recent amendments to OATS provide two ways in which members can be relieved of certain OATS requirements. The first, which is an exclusion from the definition of OATS reporting member, applies to firms with specific business models that, if they were to report to OATS under the current rule, would result in duplicative reporting because another member firm is reporting essentially the same information to NASD. This exclusion from the definition of reporting member relieves a firm from the full recording and reporting requirements of the OATS ruler; however, it does not relieve members from the clock synchronization requirements under Rule 6953.

The second amendment, which grants NASD exemptive authority in certain limited situations is designed to provide relief for small members meeting specific criteria where complying with the full scope of the rules would be unduly burdensome. The exemptive relief only applies to the transmission requirements of the OATS rules. Firms that apply for and are granted exemptive relief must still record and maintain OATS information required under NASD Rule 6954.

Very specific and differing criteria apply in these two situations. We will review both in detail. The first situation is the reporting member exclusion. The Phase III amendments to the OATS rules exclude from the definition of a reporting member firms that meet all four of the following criteria:

The member must engage in a non-discretionary order routing process where the firm immediately routes all of its orders to a single receiving reporting member.

The member cannot direct or maintain control over subsequent routing or execution by the receiving member.

The receiving member must record and report all information under NASD Rule 6954, recording of order information, and 6955, reporting of order information.

Finally, the member must have a written agreement with the receiving reporting member specifying the respective functions and responsibilities of each party.

Let's review in detail each of the four criteria required for the exclusion to the definition of reporting member. The first criteria is the member firm must engage in a non-discretionary order routing process where it immediately routes all of its orders to a single receiving reporting member. If any delay results in the routing of an order due to system problems or other reasons the member with which the order originated would be required to report OATS data. One hundred percent of the firm's orders in Nasdaq securities must be routed to the same reporting member. If the member accepts and routes an order to another venue or executes an order internally that member would be required to report OATS data for all of its orders, including those sent to the receiving reporting member on a non-discretionary basis.

If a member conducts non-market making proprietary business and executes a proprietary trade away from the receiving reporting member then that member would be required to report OATS data for all of its orders, including those sent to the receiving reporting member on a non-discretionary basis. In other words, this is an all-or-none exclusion. An independent decision to route a single order or the actual execution of a single order will disqualify a firm under this criteria and require the firm to report to OATS.

The second criteria that must be met is the member firm does not direct or maintain control over subsequent routing or execution by the receiving member. The member must enter all orders on a non-discretionary basis into the receiving member's system. If the receiving member system provides the ability for the member to direct an order to a venue other than the receiving member for execution and the member directs just one order away from the receiving member the member would be required to report OATS data for all of the orders entered into the receiving member's system. If the member relies on a receiving member or a system provided by the receiving member to determine where the order is routed for execution the member will not be viewed as having direct control over subsequent routing or execution by the receiving member.

The third criteria to qualify for reporting member exclusion is the receiving reporting member must record and report all information under the OATS rules. The reporting member will be required to identify the sending member in each new order report and include a code indicating the sending member is a member that qualifies for exclusion from the definition of OATS reporting member under NASD rule 6951(n). This code, indicating the exclusion, should be included in the member type code field on the new order, combined order route, and combined order execution report. The member type code of "E" must be used in this instance.

Finally, the fourth criteria that must be met for reporting member exclusion is the member firm must have a written agreement with the receiving reporting member specifying the respective functions and responsibilities of each party to affect full compliance with the requirements of the OATS rules. Each party to the agreement must maintain all written documents evidencing the agreement. NASD will be monitoring firms' use of this exclusion closely and may periodically request a copy of any reporting agreements as part of its routine OATS surveillance activities.

Now I'd like to discuss the new exemptive provision. Prior to these amendments NASD did not have authority to grant any exemptions to the OATS requirements. These amendments give NASD the authority to grant exemptive relief from the OATS reporting requirements for manual orders for members that meet the following specified criteria:

The member, current control affiliates, and associated persons have not had a finalized disciplinary action within the last five years and within ten years for fraud.

The member has annual revenue of less than \$2 million.

The member conducts no market making activities.

The member does not execute principal transactions with its customers.

The member does not conduct any clearing or carrying activities.

Also, the member must include a detailed explanation as to why complying with the OATS requirements would be a burden to the firm.

It is important to note that a member that has been granted exemptive relief must continue to record OATS data and retain the order data electronically for three years.

In addition, the clock synchronization requirements continue to apply.

Additional information regarding exemptions and detailed exemption request procedures, including a list of all required documentation, will be published on NASD's OATS Web site by the end of this week.

Exemption requests must be submitted in writing to the NASD Market Regulation Department no later than February 1, 2006 to ensure that the NASD staff can make a determination of exemption status by the May 8th implementation date.

Copies of all exemption requests must be submitted to NASD's Office of General Counsel.

Exemptions shall not exceed a period of two years. Members may request a subsequent exemption at or prior to the expiration of the initial exemption. NASD anticipates that exemptions may be granted for periods

of less than two years depending on the facts and circumstances of each individual firm.

Wilma George will now review other technical changes that are being introduced with the Phase III release. Wilma?

W. George

Thank you, Lisa. Along with the technical changes related to OATS Phase III there are additional technical enhancements of which firms should be aware. First, OATS has added two additional special handling codes of directed orders and time orders. Directed orders are orders that meet the definition of directed order under Rule 600(b)(19) of Regulation NMS, formerly defined under SEC Rule 11Ac-6. That definition specifies that the term directed order shall mean a customer order that the customer specifically instructed the broker or dealer to route to a particular venue for execution. Time orders would include orders that become market or limit price orders at a specified time. In addition to the new special handling code, a new time stamp will be added to the OATS new order, combined order route, cancel replace, and combined order execution reports to capture the trigger time of the order.

OATS has also added new fields to existing order reports. All combined reports, for example, combined order route and combined order execution reports, will now require an order shares quantity field. Member firms must now indicate both, the number of shares of the individual order, as well as the number of shares that were routed or executed.

Finally, the required format for the routed order ID and sent to routed order ID field must not contain, spaces, blanks, or leading zeroes.

Member firms that are required to submit data during Phase III may use the following transmission methods: Internet file transfer, IFT, allows firms to upload data over the Internet. NASD recommends this alternative to member firms receiving more than 20 orders per day.

E-mail allows firms to send files via e-mail. This alternative requires annual certification and user ID and password renewal.

File transfer protocol, FTP, allows firms to submit data directly to NASD via a Savvis private network. Firms must contact Savvis directly to establish a network connection.

The OATS Web Interface allows firms to manually enter order data over the OATS Web Interface. NASD recommends this alternative to small member firms receiving less than ten orders per day.

Third party reporting agents allow member firms with a reporting obligation to contract with clearing firms, service bureaus, and other third party entities to transmit data on the member firm's behalf. Member firms must retain a copy of the reporting agreement and create an order-sending organization, OSO, relationship via the OATS Web interface.

Member firms are reminded that NASD Rule 6953 requires each member firm to synchronize its business clocks that are used for the purposes of recording the date and time of any event that must be recorded pursuant to by-laws or NASD rules. All computer systems and mechanical stamping devices must be synchronized to within three seconds of the National Institute of Standards and Technology, NIST's, atomic clock.

The following resource are available to help member firms answer questions regarding OATS: The OATS Web site, which is located at www.nasd.com/oats and includes frequently asked questions, the OATS Reporting Technical Specifications, Subscriber Manual, the OATS report

index, the OATS registration page, and the OATS Phase III page. In addition, firms may contact the help desk at 1-800-321-NASD. They may also contact NASD Market Regulation at (240)386-5126.

At this time I will turn the program back to Paul McKenney to address questions regarding Phase III reporting.

Note: At this point in the call a Q&A session was held. NASD carefully reviewed the transcript of this Q&A session and has determined that virtually all of the questions raised during the call are addressed in the Phase III FAQ document available on the OATS website. NASD has elected not to publish the actual transcript of the Q&A session to ensure consistency and clarity in the answers provided.

Please refer to the following web page:

http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_015884&ssSourceNodeId=1366) to retrieve OATS Phase III related FAQs.

P. McKenney	We just wanted to wrap up by thanking everybody for their participation. We feel like we got some excellent questions. It also gives us an understanding of what your concerns are.
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I also wanted to let you know that, as I stated at the top of this call, this is the first of three calls related to Phase III that we'll be hosting. The next one is scheduled tentatively for February and then another one scheduled for April.

We are also going to be embarking on a number of road shows around the country. I guess we're going to do about 15 of them in 12 different cities. Those will be starting in mid to late January and going through the first couple of weeks of February. We will have that schedule posted up on the Web within the next week, hopefully. We're pretty much finalized on our locations, so we hope that you'll come out and see us and bring some more questions.

R. Wallace NASD is also doing a technical conference in New York City. I believe it's in January or February. One of the panels on that will be dealing specifically with the challenges of Phase III. You can look for that conference on the Web too.

P. McKenney All right. Thank you so much.

Coordinator Thank you for joining today's conference. That does conclude the call at this time. You may disconnect.