Notice to Members

INFORMATIONAL

Alternative Trading Systems that Trade Security Futures

SEC Approves New Rule and Rule Amendments Concerning Audit Trail and Trading Halt Requirements for ATSs that Trade Security Futures; **Effective Date: March 31, 2003**

Executive Summary

On January 27, 2003, the Securities and Exchange Commission (SEC) approved rule changes by NASD pertaining to coordinated surveillance, audit trails, and trading halts for Alternative Trading Systems (ATSs) that trade security futures. Specifically, these rule changes: (1) create new Rule 3115 to establish recordkeeping requirements for ATSs that trade security futures; and (2) amend NASD Rule 3340 to prohibit members (including ATSs) and associated persons from effecting any transaction or publishing a bid and/or unpriced indication of interest for a security future when there is a regulatory trade halt in effect. The rules are set forth in Attachment A. They become effective on March 31, 2003.

Questions/Further Information

Questions concerning this *Notice* may be directed to the Office of General Counsel, NASD Regulatory Policy and Oversight: Gary L. Goldsholle, Associate General Counsel, (202) 728-8104; or Patricia Albrecht, Assistant General Counsel, (202) 728-8026; or NASD Market Regulation Department, Futures Policy, De'Ana Dow, Director and Chief Counsel, (240) 386-5120.

Discussion

The Commodity Futures Modernization Act of 2000 (CFMA)[1] requires NASD, as a registered securities association, to meet several requirements with respect to preparing for the trading of security futures[2] by ATSs.[3] Specifically, the CFMA requires NASD to have rules in place that require ATSs to: (1) have audit trails necessary to facilitate coordinated surveillance; and (2) coordinate trading halts with markets trading the underlying securities and markets trading related securities.[4]

Audit Trail Information

To meet the requirements of the CFMA with respect to audit trails, NASD has created new NASD Rule 3115, which requires ATSs to record and report audit trail information on security futures on a T+1 basis in the form in which NASD prescribes. Because there are no ATSs currently trading security futures, NASD has not yet prescribed the particular manner by which an ATS should report the audit trail information. An ATS that intends to trade security futures should contact the NASD Market Regulation Department, Futures Policy, for specific information on the format and means to report information. The reports will be designed to facilitate NASD's sharing of the information with members of the Intermarket Surveillance Group, an organization whose purpose is to coordinate surveillance among financial markets.

The requirements under new Rule 3115 are based upon the required elements of the audit trail rule under Regulation ATS Rule 302, the SEC's recordkeeping rule for ATSs, which requires ATSs to report and record similar information for other securities transactions.[5] The similarity between these rules should allow ATSs to use their existing reporting templates, with few necessary adjustments, to record and report the audit trail information on security futures transactions. Rule 3115 requires that ATSs record and report, at a minimum, the following information:

- the date and time that the order was received;

- the security futures product name and symbol;

- the number of share contracts to which the order applies;

- an identification of the order as related to a program trade or an index arbitrage trade as defined in New York Stock Exchange Rule 80A;

- if the order is a buy or sell order;

- if the order is a market order, limit order, stop order, stop limit order, or other type of order;

- any limit or stop price prescribed by the order;

- the date on which the order expires and, if the time in force is less than one day, the time when the order expires;

- the time limit during which the order is in force;

- any instructions to modify or cancel the order;

- the date and time that the order was executed;

- unit price at which the order was executed; excluding commissions, mark-ups, or mark-downs;

- the size of the executed order;

- the identity of the ATS's subscribers that were intermediaries or parties in the transaction; and

- an account identifier that relates the order back to the account owner.

Rule 3115 also requires ATSs to preserve the records required by Rule 3115 in accordance with SEC Rule 17a-4(b), which requires preservation of records for at least three years, the first two years in an easily accessible place.[6]

Trading Halts

With respect to coordinated trading halts, NASD has amended Rule 3340, its trading halt rule. Currently, NASD Rule 3340 prohibits broker/dealers and associated persons from effecting a transaction or publishing a quotation, a priced bid and/or offer, an unpriced indication of interest (including "bid wanted" and "offer wanted" and name only indications), or a bid or offer accompanied by a modifier to reflect unsolicited customer interest, in any security as to which a trading halt is currently in effect. NASD has amended this rule by adding paragraph (b), which places on member firms (including ATSs) and associated persons the same restrictions regarding: (a) any future on a single stock when the underlying stock is subject to a regulatory trading halt; and (b) any future on a narrow-based securities index when one or more underlying securities that constitute 50 percent or more of the market capitalization of the index are subject to a regulatory trading halt. By limiting application of new NASD Rule 3340(b) to regulatory trading halts, NASD is excluding halts resulting from events such as an order imbalance or a systems failure.

Effective Date

These rule changes become effective on March 31, 2003.

Endnotes

1   The CFMA was signed into law on December 21, 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

2   Section 3(a)(55) of the Securities Exchange Act of 1934 ("Exchange Act") defines a "security future" as a contract of sale for future delivery of a single security or of a narrow-based security index. Security futures are defined as "securities under the Exchange Act, thus making the federal securities laws generally applicable to them." *See* Exchange Act Section 3(a)(10); 15 U.S.C. 78c(a)(10).

3   ATSs generally are systems that maintain a marketplace for bringing together purchasers and sellers of securities or otherwise perform the functions commonly performed by a securities exchange and do not perform self-regulatory functions. *See* Regulation ATS Rule 300(a), 17 CFR 242.300(a); Exchange Act Rel. No. 40760 (Dec. 8, 1998), 63 FR 70844 (Dec. 22, 1998).

4   Exchange Act Section 6(h)(5); 15 U.S.C. 78f(h)(5).

5   17 CFR 242.302(c).

6   17 CFR 240.17a-4(b).

ATTACHMENT A

New language is underlined; deletions are in brackets.

3100. BOOKS AND RECORDS, AND FINANCIAL CONDITION

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3115. Requirements for Alternative Trading Systems to Record and Transmit Order and Execution Information for Security Futures

(a) Alternative Trading Systems' Recording Requirements

(1) Each alternative trading system that accepts orders for security futures (as defined in section 3(a)(55) of the Act) shall record each item of information described in paragraph (b) of this Rule. For purposes of this Rule, the term "order" includes a broker/dealer's proprietary quotes that are transmitted to an alternative trading system.

(2) Alternative trading systems shall record each item of information required to be recorded under this Rule in such form as is prescribed by the Association from time to time.

(3) Maintaining and Preserving Records

(A) Each alternative trading system shall maintain and preserve records of the information required to be recorded under this Rule for the period of time and accessibility specified in SEC Rule 17a-4(b).

(B) The records required to be maintained and preserved under this Rule may be immediately produced or reproduced on "micrographic media" as defined in SEC Rule 17a-4(f)(1)(i) or by means of "electronic storage media" as defined in SEC Rule 17a-4(f)(1)(ii) that meet the conditions set forth in SEC Rule 17a-4(f) and may be maintained and preserved for the required time in that form.

(b) Information to be Recorded. The records required pursuant to paragraph (a) of this Rule shall contain, at a minimum, the following information for every order:

(1) Date and time (expressed in terms of hours, minutes, and seconds) that the order was received;

(2) Security future product name and symbol;

(3) Number of [share] contracts to which the order applies;

(4) An identification of the order as related to a program trade or an index arbitrage trade as defined in New York Stock Exchange Rule 80A;

(5) The designation of the order as a buy or sell order;

(6) The designation of the order as a market order, limit order, stop order, stop limit order, or other type of order;

(7) Any limit or stop price prescribed by the order;

(8) The date on which the order expires and, if the time in force is less than one day, the time when the order expires;

(9) The time limit during which the order is in force;

(10) Any instructions to modify or cancel the order;

(11) Date and time (expressed in terms of hours, minutes, and seconds) that the order was executed;

(12) Unit price at which the order was executed; excluding commissions, mark-ups or mark-downs;

(13) Size of the order executed;

(14) Identity of the alternative trading system's subscribers that were intermediaries or parties in the transaction; and

15 An account identifier that relates the order back to the account owner(s).

(c) Reporting Requirements

(1) General Requirement

Alternative trading systems shall report information required to be recorded under this Rule to the Association on the next business day following the date the alternative trading system accepted the order or executed the trade, or at such other time period as the Association shall specify.

(2) Method of Transmitting Data

Alternative trading systems shall transmit this information in such form as prescribed by the Association.

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3300. TRADING

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3340. Prohibition on Transactions, Publication of Quotations, or Publication of Indications of Interest During Trading Halts

(a) No member or person associated with a member shall, directly or indirectly, effect any transaction or publish a quotation, a priced bid and/or offer, an unpriced indication of interest (including "bid wanted" and "offer wanted" and name only indications), or a bid or offer, accompanied by a modifier to reflect unsolicited customer interest, in any security as to which a trading halt is currently in effect. If ADF closes trading in Nasdaq securities pursuant to its authority under Rule 4120A(a)(2), members would not be prohibited from trading through other markets for which trading is not halted.

(b) No member or person associated with a member shall, directly or indirectly, effect any transaction or publish a quotation, a priced bid and/or offer, an unpriced indication of interest (including "bid wanted" and "offer wanted" and name only indications), or a bid or offer, accompanied by a modifier to reflect unsolicited customer interest, in:

(1) a future for a single security when the underlying security has a regulatory trading halt that is currently in effect; and

(2) a future on a narrow-based security index when one or more underlying securities that constitute 50% or more of the market capitalization of the index has a regulatory trading halt that is currently in effect.