SUGGESTED ROUTING

Legal and Compliance

Market Making

Operations

Senior Management

Trading

KEY TOPICS

Order Audit Trail System

REQUEST FOR COMMENT **ACTION REQUESTED BY JULY 10, 2002**

Order Audit Trail System

NASD Seeks Comment on Proposed Changes to the OATS Rules

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). Specifically, NASD staff is seeking comment on four proposals, which would require that members:

- record and report execution price, capacity, Automated Confirmation Transaction Service (ACT) control number, and a special circumstances indicator as part of their OATS Execution Reports, but would rescind the requirement that members record and report an identical order identifier (referred to as the branch/sequence number) on the OATS Execution Report and the related ACT trade report;
- report the execution time rather than prior reference price (".PRP") time or allocation time in OATS Execution Reports;
- record and report for OATS purposes the route of a proprietary order if they comply with the SEC Limit Order Display Rule by routing that proprietary order in place of a customer order to another market, electronic communications networks (ECN), or market maker; and
- provide the trading desk receipt time via a Desk Report in addition to the electronic system receipt time reported as their order receipt time on New Order Reports, in those instances when those times differ by more than one second.

Questions concerning this *Notice* should be directed to: the Market Regulation Department at 240-386-5126 or the Office of General Counsel at (202) 728-8071.

Request for Comment

NASD requests comment on the proposed changes relating to the OATS Rules. Comments must be received by July 10, 2002. 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 in written comments
- e-mailing written comments to *pubcom@nasd.com*
- submitting written comments online on our Web Site (*www.nasdr.com*)

Written comments submitted via hard copy should be mailed to:

Barbara Z. Sweeney
NASD
Office of the Corporate Secretary
1735 K Street, NW
Washington, DC 20006-1500

Important Note: The only comments that will be considered are those submitted in writing by mail, our Web Site, or by e-mail.

Before becoming effective, any rule change developed as a result of responses received to this *Notice* must by approved by the NASD Regulation Board of Directors and Securities and Exchange Commission.

Background and Discussion

NASD staff is considering several amendments to the OATS Rules that are intended to enhance the data provided by OATS, without imposing significant new burdens on reporting members.

The staff seeks comment from members and other interested parties on any or all of the proposals described below. In particular, the staff seeks comment regarding the burdens and/or technological benefits to members of the proposals.

Proposed Changes to OATS Execution Reports

Members currently are not required to record and report execution price or firm capacity on OATS Execution Reports. When the OATS Rules initially were adopted, it was determined that NASD would obtain price and capacity information from ACT trade reports that have been matched with corresponding OATS reports (known as the "ACT matching process"). Members have raised concerns about the time and effort necessary to enter an identical branch/sequence number in the ACT trade report and the OATS Execution Report, both of which are necessary for the ACT matching process. In addition, the ACT matching process can be limited because members are not able to enter order identifier information into ACT when, for example, market makers' quotes are accessed via a Nasdaq Execution System, when odd lot orders are executed, or where transactions are not reported through ACT.

To address these issues and concerns, NASD is soliciting comment on a proposal that would require members to record and report the execution price, firm capacity and the ACT control number, if applicable, on OATS Execution Reports. With these additional data elements, OATS would no longer need to systematically match the OATS Execution Report to the related ACT trade report.[1] In the event any additional information that was not provided in the OATS

Execution Report was needed, such as contra party, NASD would have the ability to access this information from the ACT trade report through the use of the ACT control number. In addition to reducing the data processing necessary to conduct the ACT matching process, NASD staff believes that the proposed changes would reduce OATS compliance burdens on members, given that they no longer would be required to input an identical branch/sequence number on both the OATS Execution Report and the related ACT trade report.

The staff also is proposing an additional field for OATS Execution Reports, which would indicate whether there were any "special circumstances" related to a transaction, such as .PRP trades, capacity reallocations trades, etc. Trades may be executed and reported to ACT under a variety of special circumstances, and certain information may be provided on the ACT trade report that is not otherwise reported to OATS, such as the .PRP time or the allocation time. By having a "special circumstances" indicator in the OATS Execution Report, the staff would be able to identify those trades for which the staff may need to obtain additional information directly from ACT.

Proposed Change Relating to .PRP Time and Capacity Reallocation Trades

The staff also is soliciting comment on the time that is reported to OATS for .PRP trades and capacity reallocation trades. Currently, under an interpretation to the OATS Rules, members are required to report the .PRP time or allocation time, as applicable, in Execution Reports. Instead, the proposal would require members to provide the actual execution time, rather than the .PRP time or allocation time, in OATS Execution Reports. Because members currently report the .PRP time and the allocation time in ACT reports, reporting the actual execution time in OATS will provide NASD with more complete information and would eliminate the need for NASD inquiries to members to obtain execution times on these types of trades.

Proposed Change Relating to Routes of Proprietary Orders for Limit Order Display Purposes

Rule 11Ac1-4 under the Securities Exchange Act of 1934 (the "Limit Order Display Rule") generally requires market makers immediately to display in their bid or offer both the price and the full size of each customer limit order that would improve their quoted price in a particular security. In addition, market makers that have a bid or offer that is equal to the national best bid or offer are obligated to reflect in their quote the size of a customer limit order that is priced equal to that bid or offer and represents more than a de minimis change in the size of their quotation. Rules 11Ac1-4(c)(5) and (6) permit, under specified conditions, a market maker to fulfill its obligations under the rule by delivering a customer limit order to another market, an ECN or another market maker, rather than display the order in its own quote. In an interpretation of these exceptions, the SEC stated that a member also may fulfill its display obligation for a customer limit order by routing an order for its own account, rather than the customer's order, to another market, an ECN or another market maker. Once the displayed proprietary order is executed,

in whole or in part, the customer order must be executed accordingly.

Currently, the term "order," as defined in the OATS Rules, does not include a proprietary transaction originated by a trading desk in the ordinary course of a member's market making activities. Therefore, market makers that comply with the Limit Order Display Rule in the manner described above are not required to record and report for OATS purposes the route of the proprietary order to another market, ECN, or market maker in place of the customer order. As a result, the Market Regulation Department exception report system produces a number of "false positives" regarding violations of the Limit Order Display Rule because it appears to the system that the customer limit order was not routed for display purposes.

NASD staff, therefore, is soliciting comment on a proposal that would require members to record and report to OATS proprietary orders sent by a market maker to another market, ECN or, market maker where the proprietary orders represent customer orders for the purposes of complying with the Limit Order Display Rule. This would be accomplished by requiring firms to record and report to OATS a Route Report for the customer order, as if the customer order, instead of the proprietary order, was routed. The member would be required to populate an additional field on the Route Report indicating that the route was proprietary. The member also would continue to submit an Execution Report to OATS representing the customer order executed by the member. Under the proposal, members would be required to match this OATS Execution Report to any ACT report submitted for the execution of the customer order (*e.g.*, riskless principal, regulatory report, etc.) by including an identical branch/sequence number on the member's OATS Execution Report and the member's related ACT report (or under the proposed changes to the Execution Report described above, the ACT Control Number on the OATS Execution Report).

OATS Order Receipt Time for New Order Reports

Members are required to record and report on their New Order Reports the time an order was originated or received by the member ("Order Receipt Time"). With respect to electronic orders, NASD staff has interpreted the Order Receipt Time to be the time the member entered the order into the member's electronic order routing or trading system ("electronic system time"), as applicable. The staff concluded that this definition of Order Receipt Time is a close substitute for the time an order is received by the trading desk because routing through the electronic system to the trading desk is usually nearly instantaneous.

Through several recent reviews for member compliance with the Limit Order Display Rule, it has come to the staff's attention that there have been instances in which the time an order is captured by an electronic system is significantly different than the time the order is received by the trading desk.[2] Specifically, in response to NASD staff inquiries, members have provided evidence that the time the order reached a place at the member where it could be displayed or executed was different than the time the order was entered into the member's electronic order routing system, which was the Order Receipt Time reported to OATS. In many of these instances, members were able to evidence their compliance with the Limit Order Display Rule, but only after an alert for a

potential Display Rule violation had been generated and the NASD staff had initiated a formal inquiry.

Accordingly, NASD staff is soliciting comment on a proposed amendment that would require members to record and report a Desk Report that would provide the time the order was received by the trading desk, in those instances where the difference between the electronic system time and the trading desk time was one second or greater. Members also would be required to populate a new field as part of the Desk Report, which would indicate that the Desk Report represented trading desk information. Members would continue to provide the electronic system time as the Order Receipt Time on their New Order Reports. The staff requests input from members and other interested parties on the technological implications and burdens of this proposal, including the one-second standard for the need to generate a Desk Report to denote the time of receipt at the trading desk.

ENDNOTES

1 This electronic "linking" requires members to input the identical execution time to the second and branch/sequence number, among other things, in both the OATS Execution Report and the related ACT trade report. If these data elements do not match exactly, NASD is unable to link systematically the two reports. The resulting unmatched OATS Execution Report is then flagged by NASD as a potential violation of the OATS Rules and the member may be subject to disciplinary action.

2 It is important to note that such delays in the handling of orders may raise significant concerns regarding a member's compliance with its best execution obligations for those orders.

ATTACHMENT A

Request for Comment Form

We have provided below a form that members and other interested parties may use in addition to 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 July 10, 2002. Members and interested parties can submit their comments using the following methods:

- mailing in this form with attached comments
- mailing in written comments
- e-mailing written comments to *pubcom@nasd.com*
- submitting comments online at our Web Site (*www.nasdr.com*)

This form and/or written comments should be mailed to:

Barbara Z. Sweeney
NASD
Office of the Corporate Secretary
1735 K Street, NW
Washington, DC 20006-1500

Proposed Changes to OATS Rules

The staff requests input from members and other interested parties on any or all of the four 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.

1. Do you support the proposal that would require that members record and report execution price, capacity, Automated Confirmation Transaction Service (ACT) control number, and a special circumstances indicator as part of their OATS Execution Reports?

◯ Yes ◯ No ◯ See my attached written comments

2. Do you support the proposal that would require that members report the execution time rather than .PRP time or allocation time in OATS Execution Reports?

◯ Yes ◯ No ◯ See my attached written comments

3. Do you support the proposal that would require members that comply with the SEC Limit Order Display Rule by routing a proprietary order in place of a customer order to another market, ECN or market maker, record and report for OATS purposes the route of the proprietary order?

◯ Yes ◯ No ◯ See my attached written comments

4. Do you support the proposal that would require that members provide the trading desk time via a Desk Report in addition to the electronic system time as their order receipt time on New Order Reports in those instances when those times differ by more than one second?

◯ Yes ◯ No ◯ See my attached written comments

Contact Information

Name: _____

Firm: _____

Address: _____

City/State/Zip: _____

Phone: _____

E-Mail: _____

Are you:

◯ An NASD Member

◯ An Investor

◯ A Registered Representative

◯ Other: _____