

INFORMATIONAL

OATS

NASD Regulation Provides Guidance On Order Audit Trail System Rules

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Internal Audit
- Legal and Compliance
- Operations
- Senior Management

KEY TOPICS

- Order Audit Trail System

Executive Summary

NASD Regulation, Inc. (NASDR) is issuing this *Notice to Members* as part of its continuing efforts to provide members with guidance on requirements relating to the Order Audit Trail System (OATS), NASD Rules 6950 through 6957 (the OATS Rules). In particular, NASDR is reminding members of their supervisory responsibilities under the OATS Rules and NASD Rule 3010, which requires members to establish a supervisory system and develop and maintain written supervisory procedures.

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

Background

Members have a variety of ways in which they may comply with the OATS Rules. For example, a member may develop or purchase a proprietary system for OATS reporting; it may enter into a Reporting Agent agreement with another member or other party to report on its behalf under Rule 6955(c); it may manually report OATS information through NASDR's Web interface; or it may use any combination of these and other methods. Under all of these scenarios, the member receiving the order for Nasdaq® securities is responsible for complying with the OATS Rules.

Through its review and examination process, NASDR has found numerous instances where members have not complied with the OATS Rules as a result of technological problems with automated systems or errors on the part of Reporting Agents.

Although members may consider such OATS reporting problems outside their immediate control, the member remains ultimately responsible for OATS compliance and cannot contract or otherwise shift away this responsibility. In such instances, the member's supervisory system becomes crucial to ensure that the OATS requirements are being met. Thus, in accordance with Rule 3010, all members must establish and maintain a supervisory system that is designed to ensure compliance with the OATS Rules.¹ A well designed and implemented supervisory system is particularly important when a member is using a Reporting Agent to comply with the requirements of the OATS Rules to ensure that the third party is conducting OATS activities as agreed upon and in compliance with the rules.

Given the different business models of members and that members can achieve compliance with NASD Rule 3010 through a variety of methods and systems, this *Notice* only addresses some of the general elements that members should consider in assessing the adequacy of their supervisory systems and written supervisory procedures regarding the OATS Rules. NASDR is not mandating any particular type or method of supervision, nor is it intending to provide a checklist of steps that if followed would constitute an adequate supervisory system. NASDR will continue to examine members' supervisory systems and written supervisory procedures and, where appropriate, initiate disciplinary action for failure to adopt, implement, and enforce appropriate supervisory procedures.

Considerations For OATS Supervisory Systems And Procedures

Provided below are recommended steps that members should consider incorporating into their OATS supervisory systems and procedures. Members that use a Reporting Agent to fulfill their reporting obligations also should review their Reporting Agent agreements to specify which, if any, supervisory activities will be performed by the Reporting Agent on behalf of the member. Members remain ultimately responsible for all supervisory activities, and therefore, must periodically review and assess the effectiveness of the Reporting Agent's activities.

- Daily clock synchronization to ensure that all business clocks (both computerized and mechanical stamping devices) are synchronized to within 3 seconds of the National Institute of Standards and Technology's atomic clock
- Daily review of the OATS Web Site to:
 1. Ensure all Firm Order Report (FORE) files are accepted²
 2. Identify and repair rejected Reportable Order Events (ROEs), ensuring repaired ROEs are resubmitted with the appropriate resubmit flag³
 3. Identify any ACT Matching deficiencies
 4. Identify Late Reports
 5. Receive communications from NASDR regarding OATS availability, announcements, software releases, etc.⁴

6. Update and maintain firm contact information
- Periodic reviews of accepted OATS data to ensure⁵:
 1. All reportable events are submitted to OATS
 2. Data fields contain accurate information
 3. ROEs are submitted in the correct time sequence (*e.g.*, executions are not time-stamped prior to the receipt of a new order)
 4. Special Handling Codes are submitted correctly
 5. Account Type Codes are populated correctly
 6. Received Method Codes are populated correctly
 7. Routed Order IDs are passed properly to the Routing Firm from the Receiving Firm
 8. Data is properly reported under the member's MPID

Common OATS Supervisory Deficiencies Noted During Reviews

To assist members in developing adequate supervisory systems and procedures, NASDR staff has compiled below examples of supervisory deficiencies that are found most frequently during the course of OATS compliance reviews. Merely avoiding these practices in no way ensures that a member's supervisory systems or written procedures will be adequate. Avoiding these particular practices, however, may assist members in developing their supervisory systems and procedures.

- The written supervisory procedures merely recite the OATS Rules
- Failure to designate responsible supervisory personnel in the procedures
- Failure to describe the review process adequately
- Failure to document or enforce reviews
- Failure to specify the frequency of reviews
- Failure to monitor adequately the performance of Reporting Agents to which the member has delegated its OATS reporting responsibilities
- Failure to document supervisory systems in the written supervisory procedures
- Failure to update procedures within a reasonable period to reflect new regulatory requirements or procedures
- Failure to preserve and maintain written supervisory procedures that were in effect during past time periods in accordance with SEC Rules 17a-3 and 17a-4

Many of the topics mentioned in this *Notice* are discussed in detail in documents available on the NASDR Web Site. Members can access the documents by going to www.nasdr.com and then clicking on OATS Information under Regulation Systems or by contacting the OATS Help Desk at 1-800-321-NASD.

Endnotes

- 1 In addition, NASD Rule 3010(b) requires each member to establish, maintain, and enforce written supervisory procedures that are reasonably designed to achieve compliance with applicable NASD Rules. *See also NASD Notice to Members 99-45, NASD Provides Guidance On Supervisory Responsibilities (June 1999).*
- 2 Each member should be certain that the number of New Order, Route, and Execution Reports is consistent with the member's expectations.
- 3 Each member should review closely any Reporting Agent agreements into which it has entered to establish whether the member or its Reporting Agent is responsible for the repair and resubmission of any rejected data.
- 4 To ensure it receives all pertinent OATS announcements and other relevant information in a timely manner, each member must add its e-mail address to the Firm Administration page on the OATS Web interface. Although NASDR generally will communicate pertinent OATS information to the membership via e-mail, all announcements and other important information will be made available on the OATS Web Site.
- 5 If a Reporting Agent is submitting data on a member's behalf, it is the member's responsibility periodically to obtain from its Reporting Agent a complete set of OATS data submitted on its behalf in order to perform the above outlined review or to validate that its Reporting Agent is monitoring the accuracy of data submitted on its behalf.

© 2002 National Association of Securities Dealers, Inc. (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.