

Notice to Members

NOVEMBER 2004

SUGGESTED ROUTING

Internal Audit
Legal & Compliance
Operations
Registered Representatives
Senior Management
Systems
Trading

KEY TOPICS

OATS

REQUEST FOR COMMENT

Order Audit Trail System (OATS)

NASD Seeks Comment on Proposed Changes to the OATS Rules; **Comment Period Expires January 20, 2005**

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). The OATS Rules impose obligations on member firms to record in electronic form and report to NASD on a daily basis certain information with respect to orders originated or received by NASD members relating to securities listed and traded on The Nasdaq Stock Market, Inc. (NASDAQ). NASD staff is seeking comment on three proposed changes to the OATS Rules, which would require members to record and report to OATS:

- ▶ Order information relating to exchange-listed and OTC equity securities (OTC Bulletin Board (OTCBB) and Pink Sheets);
- ▶ Enhanced information, including execution data, relating to orders routed to non-members or exchanges; and
- ▶ Order information relating to proprietary orders generated during the course of market-making activities.

NASD believes this additional information will enable NASD to create a more comprehensive and accurate order and transaction audit trail and significantly improve the effectiveness of NASD's automated surveillance for potential violations of NASD rules and the federal securities laws.

Action Requested

NASD encourages all interested parties to comment on these three proposals. Comments must be received by January 20, 2005. 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 comments in hard copy to the address below;
- ♦ E-mailing written comments to pubcom@nasd.com; or

To help NASD process and review comments more efficiently, persons commenting on this proposal should use only one method; however, if a person wishes to submit comments using both the Request for Comment Form and one of the other methods listed above, he or she should indicate that in the submissions. The Request for Comment Form and/or comments sent by hard copy should be mailed to:

Barbara Z. Sweeney
Office of the Corporate Secretary
NASD
1735 K Street, N.W.
Washington, D.C. 20006-1500

Important Notes: The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the NASD Web site. Generally, comments will be posted on the NASD Web site one week after the end of the comment period.¹

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the NASD Board, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.²

Questions/Further Information

As noted above, hard copy comments should be mailed to Barbara Z. Sweeney. Questions concerning this *Notice* may be directed to the Legal Section, Market Regulation, at (240) 386-5126; or Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8071.

Background and Discussion

The OATS Rules impose obligations on member firms to record in electronic form and report to NASD on a daily basis certain information with respect to orders originated or received by NASD members relating to securities listed and traded on NASDAQ. OATS captures this order information reported by NASD members to create a time-sequenced record of orders and transactions. This information is critical to NASD staff in conducting surveillance and investigations of member firms for violations of federal securities laws and NASD rules.

Given a number of factors, including the fragmentation in the trading of securities over the past several years and the need to enhance NASD's automated surveillance program, NASD staff has identified several enhancements to the current OATS information that would enable it to create a more comprehensive and accurate order and transaction audit trail. These proposed changes would significantly enhance NASD's ability to surveil for potential violations of NASD rules and the federal securities laws. NASD staff believes that continued effective automated surveillance will be difficult to achieve without the proposed expansion of order information captured by OATS, as described herein.

Therefore, NASD is soliciting comment on three proposed changes to the OATS Rules. The proposed changes would require members to record and report to OATS (1) order information relating to orders and transactions in exchange-listed and OTC equity securities; (2) enhanced information, including execution data, relating to orders routed to non-members or exchanges; and (3) order information relating to proprietary orders generated during the course of market-making.

1. Proposed Changes to Expand OATS Requirements to Apply to Orders and Transactions in Exchange-Listed and OTC Equity Securities.

Because OATS requirements do not apply to exchange-listed or OTC equity securities, NASD staff currently is unable to recreate on an automated basis an order and transaction audit trail for these securities and is therefore unable to conduct certain automated surveillance for exchange-listed and OTC equity securities comparable to the current automated surveillance program it has established for trading in Nasdaq securities. For example, expansion of the OATS requirements to exchange-listed and OTC equity securities would enhance NASD staff's ability to review and examine, on a more automated basis, for compliance with Limit Order Protection (IM-2110-2), the duty of best execution (Rule 2320), Short Sales (SEC Rule 10a-1), and the Limit Order Display Rule (SEC Rule 11Ac1-4), among others. As a result, NASD is soliciting comment on a proposal to extend the OATS requirements to order activity and transactions in these securities.

Under the proposal, NASD members would be required to report to OATS order-related activities for exchange-listed securities, irrespective of whether the order is ultimately executed over-the-counter or on or through an exchange. Because it is sometimes unlikely that a member knows upon receipt of an order where the order will be executed, NASD members would need to report such information to OATS regardless of how the order is ultimately handled or where it is executed. As described in more detail below, if NASD does not have a complete picture of the trading by an NASD member, including executions on or through an exchange, potential violations may be missed. However, given that the NYSE has established its own Order Tracking System (OTS), NASD staff will work to coordinate any proposed requirements relating to NYSE securities with the OTS requirements to minimize the potential for duplicative reporting of order information. To the extent that other exchanges have established comparable order audit trail systems, NASD would endeavor to coordinate its proposed requirements with those exchanges as well.

2. Proposed Changes to Enhance the OATS Information Reported for Orders Routed to Exchanges or Non-Members.

Currently, members that route orders to non-members or exchanges for execution are not required to provide OATS information beyond the route to that non-member or exchange.³ As a result, NASD does not receive automated data for the portion of a member's trading activities that occurs on or through a non-member or exchange. NASD staff has determined that gaps can exist in its automated surveillance of member activities when NASD does not receive a complete picture of the member's order and trading activity. Accordingly, NASD is soliciting comment on a proposal to require members to record and report to OATS order events relating to orders routed to non-members or exchanges.

In particular, NASD is soliciting comment on the scope of order-related information that members have access to with respect to orders they have routed to non-members and exchanges. To ensure that NASD can link and recreate the entire lifecycle of the order, NASD members would need to report to OATS order events relating to orders routed to non-members or exchanges, including, but not limited to, new order, subsequent routing and execution information. Such information would be necessary in conducting automated surveillance for member compliance with NASD rules and the federal securities laws, including Limit Order Protection. NASD seeks input on what information relating to the handling of a member's order by a non-member or exchange currently is accessible to the member and, as applicable, the burdens associated with obtaining and reporting additional information to OATS. In this context, NASD is sensitive to self-regulatory organization (SRO) jurisdictional issues and is not seeking information about conduct that is clearly outside its jurisdiction and within the jurisdiction of the routed exchange, such as specialist or floor broker activity.

As permitted today under Rule 6955(c), members would be able to enter into reporting agent agreements with a non-member or exchange to report OATS information on the member's behalf. However, the member remains liable for the proper reporting and accuracy of data reported on the member's behalf by a reporting agent.

3. Proposed Changes to Eliminate Current Exceptions for Market Makers.

Members currently are not required to report to OATS proprietary orders generated during the course of market-making. Although certain information such as trade report information may be available for market making trades, NASD does not receive automated information on the entire lifecycle of a market-making proprietary order. For example, market-making proprietary orders that do not result in executions or are executed on exchanges or through non-members currently are not captured by or provided to NASD on an automated basis. This information can be particularly important where a proprietary order is routed in place of a pending customer order. Because members currently are not required to report this information to OATS, NASD staff does not always have a complete picture of a member's order and trading activities. NASD believes that this information pertaining to proprietary orders of market makers is critical for surveillance purposes, including reviews for compliance with the Limit Order Protection Rule, the Limit Order Display Rule, and Firm Quote Requirements (NASD Rule 3320 and SEC Rule 11Ac1-1(c)). NASD therefore is soliciting comment on a proposal that would require members to report to OATS information relating to proprietary orders generated during the course of market-making.

Endnotes

1. See *Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or e-mail addresses, will not be edited from submissions. Persons commenting on this proposal should submit only information that they wish to make publicly available.
2. Section 19 of the Securities Exchange Act of 1934 (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See Exchange Act Section 19 and rules thereunder.
3. NASD does receive OATS information for certain orders that are executed on an exchange, but it depends on whether the order is routed to the exchange for handling and execution or if the order is executed by the member and only trade reported to the exchange. Under the first scenario, the member would provide OATS information relating to the new order and the route of the order to an exchange, but would not provide OATS information regarding the ultimate execution of the order. With respect to an order that is executed by a member and then reported to an exchange, the member would be required to record and report to OATS new order and execution information. See *The OATS Report December 2002 (OATS Reporting Responsibilities for Orders Routed to, or Executions Reported on, Other Securities Exchanges)*, available at www.nasd.com.

©2004. 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.

ATTACHMENT A

Request for Comment Form

We have provided below a form that members and other interested parties may use in addition to or in lieu of 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 January 20, 2005. 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 comments in hard copy to the address below;
- ◆ E-mailing written comments to pubcom@nasd.com; or

To help NASD process and review comments more efficiently, persons commenting on this proposal should use only one method; however, if a person wishes to submit comments using both the Request for Comment Form and one of the other methods listed above, he or she should indicate that in the submissions. The Request for Comment Form and/or comments sent by hard copy should be mailed to:

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Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the NASD Board, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.

Proposed Changes to OATS Rules

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

Expansion of OATS to Exchange-Listed and OTC Equity Securities

1. Do you support the proposal that would require that members record and report OATS information for exchange-listed and OTC equity securities?
☐ Yes ☐ No ☐ See my attached written comments.
2. What are the technological implications and burdens associated with this proposal?
3. Is the data you record and maintain to comply with the NYSE's OTS requirements in a similar form as the data you maintain for NASD OATS purposes? What additional changes would be necessary to enable members to submit the NYSE OTS data to NASD OATS?

Expansion of OATS to Orders Routed to Non-Members or Exchanges

4. Do you support the proposal that would require that members record and report OATS order events relating to orders routed to non-members or exchanges?
☐ Yes ☐ No ☐ See my attached written comments.
5. Describe the scope and type of order-related information that a member currently has access to when it has routed an order to a non-member or exchange. For example, if an order is routed to and then executed by a non-member, what execution information is provided to the member that routed the order? Does the member typically have knowledge of whether the order was further routed by the non-member or exchange, and if so, what level of detail is provided to the member?
6. What are the technological implications and burdens associated with this proposal, including requirements that potentially could expand the scope of information provided by non-members and exchanges to members that have routed orders to them?

Expansion of OATS to Market Making Proprietary Orders

7. Do you support the proposal that would require that members record and report OATS information for OATS proprietary orders generated during the course of market-making?

☐ Yes ☐ No ☐ See my attached written comments.

8. What are the technological implications and burdens associated with this proposal?

Implementation

9. NASD anticipates proposing a "phase-in" period for implementation of any of the proposals described herein to provide members with adequate time for necessary system and procedural modifications. What amount of time do you believe is adequate for implementation of the proposals?

Contact Information

Name: _____

Firm: _____

Address: _____

City/State/Zip: _____

Phone: _____

E-mail: _____

Are you:

☐ An NASD Member

☐ An Investor

☐ A Registered Representative

☐ Other: _____
