

Order Audit Trail System (OATS)

SEC Approves Amendments Regarding OATS Routing Method Code for Intermarket Sweep Orders

Effective Date: February 4, 2008

Executive Summary

Effective February 4, 2008, firms that transmit an intermarket sweep order (ISO), as defined in Regulation NMS, in an OATS-eligible security to another member firm, electronic communications network, non-member or exchange, must record and report the fact that the order was an ISO in their OATS reports.¹ The amendments to the OATS rules are attached to this *Notice* as Exhibit A.

Questions concerning this *Notice* may be directed to the Legal Section, Market Regulation, at (240) 386-5126, or to the Office of General Counsel at (202) 728-8071.

Discussion

NASD Rules 6950 through 6958 (OATS Rules) impose obligations on member firms to record in electronic form and report to OATS on a daily basis certain information regarding orders in NASDAQ-listed securities originated, received, transmitted, modified, canceled or executed by FINRA member firms.² FINRA integrates the OATS information with quote and transaction information to create a time-sequenced record of orders, quotes and transactions. This information is used by FINRA in conducting surveillance and investigations of firms for violations of NASD rules and the federal securities laws.

August 2007

Notice Type

- Guidance

Suggested Routing

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

Key Topic(s)

- Intermarket Sweep Orders
- OATS
- Regulation NMS

Referenced Rules & Notices

- NASD Rules 6950 through 6958 (OATS Rules)
- NTM 06-70
- SEC Rule 611 (Order Protection Rule)

On June 9, 2005, the SEC adopted Regulation NMS, which established new substantive rules designed to modernize and strengthen the regulatory structure of the U.S. equities markets.³ Among other things, Regulation NMS adopted an Order Protection Rule (SEC Rule 611) that requires trading centers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the execution of trades at prices inferior to protected quotations displayed by automated trading centers, subject to applicable exceptions. One of the exceptions from the Order Protection Rule is when the transaction that constitutes a trade-through⁴ is “effected by a trading center that simultaneously routed an intermarket sweep order to execute against the full displayed size of any protected quotation in the NMS stock that was traded through.”⁵

The purpose of the new amendments to the OATS rules is to require firms to record the fact that an order in an OATS-eligible security is an ISO when the firm routes an ISO to another member or non-member firm. Firms will be required to include this information in the Route Report that it submits to OATS by designating ISOs with a routing method code of “I.”⁶ This requirement will ensure that FINRA knows that the order was an ISO and can utilize that information when reviewing audit trails to ensure compliance with Regulation NMS.

The new ISO routing method code applies only to those orders required to be recorded and reported to FINRA pursuant to the OATS Rules. The new requirements do not require firms to submit Route Reports for all ISOs.

Firms are required to use the ISO routing method code of “I” on Route Reports beginning February 4, 2008. However, the routing method code is already currently available for use by firms, and firms are encouraged to use the code on their Route Reports as soon as possible to facilitate FINRA’s ability to determine whether a trade is made in reliance on an ISO exception from the Order Protection Rule.⁷

In addition, FINRA is reminding firms of the current requirement to identify ISOs in OATS New Order Reports. Specifically, NASD Rule 6954(b)(15) requires firms to include in New Order Reports any “special handling requests, specified by [FINRA] for purposes of this Rule.” Pursuant to that provision, the *OATS Reporting Technical Specifications* now include a new special handling code (“ISO”) for ISOs in New Order Reports, which must be used when a firm relies on the exception from the Order Protection Rule for a transaction that “was the execution of an order identified as an intermarket sweep order.”

Endnotes

- 1 Securities Exchange Act Release No. 56003 (July 2, 2007), 72 FR 37287 (July 9, 2007) (SR-NASD-2007-028).
- 2 Beginning on February 4, 2008, member firms also will be required to record and report order information regarding all OTC equity securities, as defined in NASD Rule 6951. *See* Securities Exchange Act Release No. 54585 (October 10, 2006); 71 FR 61112 (October 17, 2006) (SR-NASD-2005-101); NASD *Notice to Members 06-70* (December 2006); *see also* Securities Exchange Act Release No. 55440 (March 9, 2007), 72 FR 12852 (March 19, 2007) (SR-NASD-2007-019).
- 3 Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005).
- 4 A “trade-through” is “the purchase or sale of an NMS stock during regular trading hours, either as principal or agent, at a price that is lower than a protected bid or higher than a protected offer.” *See* 17 CFR 242.600(b)(77).
- 5 *See* 17 CFR 242.611(b)(6). The phrase “intermarket sweep order” is defined in SEC Rule 600(b)(30) as “a limit order for an NMS stock that meets the following requirements: (i) When routed to a trading center, the limit order is identified as an intermarket sweep order; and (ii) Simultaneously with the routing of the limit order identified as an intermarket sweep order, one or more additional limit orders, as necessary, are routed to execute against the full displayed size of any protected bid, in the case of a limit order to sell, or the full displayed size of any protected offer, in the case of a limit order to buy, for the NMS stock with a price that is superior to the limit price of the limit order identified as an intermarket sweep order. These additional routed orders must also be marked as intermarket sweep orders.” The amendments to the OATS Rules adopt this same definition of intermarket sweep order.
- 6 When a member firm transmits an order in an OATS-eligible security to another member, electronic communications network, non-member, or exchange for handling or execution, the routing member is required to submit a Route Report to FINRA. The categories of information that a firm must include in a Route Report are set forth in NASD Rule 6954(c) and in the *OATS Reporting Technical Specifications* published by FINRA.
- 7 For further guidance on the use of the “I” routing method code and the “ISO” special handling code, see “Additional Guidance Regarding the OATS Routing Method Code of ‘I’ and Special Handling Code of ‘ISO,’” which is available on FINRA’s OATS Web page at www.finra.org/RegulatorySystems/OATS/OATSReportIndex/p019397. Firms may also wish to consult the *OATS Reporting Technical Specifications* for further information.

©2007. FINRA. All rights reserved. *Regulatory Notices* 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.

EXHIBIT A

Below is the text of the rule change. New language is underlined; deletions are in brackets.

6950. ORDER AUDIT TRAIL SYSTEM

6951. Definitions

For purposes of the Rule 6950 Series:

(a) through (g) No change.

(h) “Intermarket sweep order” shall have the same meaning as contained in SEC Rule 600(b)(30) adopted pursuant to the Act.

(h) through (n) are designated as (i) through (o).

* * * * *

6954. Recording of Order Information

(a) through (b) No change.

(c) Order Transmittal

Order information required to be recorded under this Rule when an order is transmitted includes the following.

(1) No change.

(2) When a member electronically transmits an order to another member, other than an order transmitted electronically for execution on an Electronic Communications Network:

(A) the transmitting Reporting Member shall record:

(i) through (iv) No change.

(v) the date and time the order is transmitted, [and]

(vi) the number of shares to which the transmission applies,[:] and

(vii) whether the order is an intermarket sweep order;
and

(B) No change.

(3) When a member electronically transmits an order for execution on an Electronic Communications Network:

(A) the transmitting Reporting Member shall record:

(i) through (v) No change.

(vi) the date and time the order is transmitted, [and]

(vii) the number of shares to which the transmission applies, [;] and

(viii) whether the order is an intermarket sweep order; and

(B) No change.

(4) When a member manually transmits an order to another member, other than to an Electronic Communications Network:

(A) the transmitting Reporting Member shall record:

(i) through (vi) No change.

(vii) the number of shares to which the transmission applies, [and]

(viii) for each order to be included in a bunched order, the bunched order route indicator assigned to the bunched order by the Reporting Member, [;] and

(ix) whether the order is an intermarket sweep order; and

(B) No change.

(5) When a member manually transmits an order to an Electronic Communications Network:

(A) the transmitting Reporting Member shall record:

(i) through (vi) No change.

(vii) the number of shares to which the transmission applies, [and]

(viii) for each order to be included in a bunched order, the bunched order route indicator assigned to the bunched order by the Reporting Member, [;] and

(ix) whether the order is an intermarket sweep order; and

(B) No change.

(6) When a member transmits an order to a non-member, including but not limited to a national securities exchange, the Reporting Member shall record:

(A) through (G) No change.

(H) the routed order identifier or other unique identifier required by the non-member receiving the order, as applicable, [and]

(I) identification of the non-member where the trade was transmitted, and[.]

(J) whether the order is an intermarket sweep order.