

April 19, 2000

Katherine A. England, Esq.
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: **File No. SR-NASD-00-23** Amendments to Order Audit Trail System Rules

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed is the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Stephanie Dumont, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8176; e-mail Stephanie.Dumont@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Joan Conley
Senior Vice President
and Corporate Secretary

Enclosures

File No. SR-NASD-00-23
Consists of 37 Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) under the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD” or “Association”), through its wholly owned subsidiary, NASD Regulation, Inc. (“NASD Regulation”), is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to amend NASD Rules 6951, 6954 and 9610 and to add a new Rule 6958. The proposed rule change would: (1) provide that the time of order origination and receipt for an electronic order is the time the order is captured by a member’s electronic order-routing or execution system, and for a manual order, is the time the order is received by the member’s trading desk or trading department for execution or routing purposes; (2) exclude certain members from the definition of “Reporting Member” for those orders that meet specified conditions and are recorded and reported to the Order Audit Trail System (“OATS”) by another member; (3) require any receiving reporting member, including electronic communications networks (“ECNs”), that receive, electronically or manually, routed orders, to capture and report a routed order identifier; and (4) permit NASD Regulation to grant exemptive relief from the OATS rules under certain circumstances.

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

NASD SYSTEMS AND PROGRAMS

6950. ORDER AUDIT TRAIL SYSTEM

6951. Definitions

For purposes of Rules 6950 through 695[7]8:

(a) through (m) No Change.

(n) “Reporting Member” shall mean a member that receives or originates an order and has an obligation to record and report information under Rules 6954 and 6955. A member shall not be considered a Reporting Member in connection with an order, if the following conditions are met:

(1) the member engages in a non-discretionary order routing process, pursuant to which it immediately routes, by electronic or other means, all of its orders to a receiving Reporting Member;

(2) the member does not direct and does not maintain control over subsequent routing or execution by the receiving Reporting Member;

(3) the receiving Reporting Member records and reports all information required under Rules 6954 and 6955 with respect to the order; and

(4) the member has a written agreement with the receiving Reporting Member specifying the respective functions and responsibilities of each party to effect full compliance with the requirements of Rules 6954 and 6955.

6952. Applicability No Change.

6953. Synchronization of Member Business Clocks No Change.

6954. Recording of Order Information

(a) No Change.

(b) Order Origination and Receipt

Unless otherwise indicated, the following order information must be recorded under this Rule when an order is received or originated. For purposes of this Rule, the order origination and receipt time for an electronic order is the time the order is captured by a member's electronic order-routing or execution system, and for a manual order, is the time the order is received by the member's trading desk or trading department for execution or further routing purposes.

(1) through (18) No Change.

(c) Order Transmittal

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

(1) and (2) 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) the fact that the order was transmitted to an Electronic

Communications Network,

(ii) the order identifier assigned to the order by the Reporting Member,

(iii) the market participant symbol assigned by the Association to the

Reporting Member,

(iv) the market participant symbol assigned by the Association to the member to which the order is transmitted,

(v) the date the order was first originated or received by the Reporting Member,

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

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

(B) the receiving Reporting Member operating the Electronic Communications Network shall record:

(i) the fact that the order was received by an Electronic Communications Network,

(ii) the order identifier assigned to the order by the member that transmits the order,

(iii) [(ii)] the market participant symbol assigned by the Association to the transmitting Reporting Member, and

(iv) [(iii)] other information items in Rule 6954(b) that apply with respect to such order, which must include information items (1), (2), (3), (6), (7), (8), (10), (11), (12), (13), (15), and (16).

(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) the fact that the order was transmitted manually,
 - (ii) the order identifier assigned to the order by the Reporting Member,
 - (iii) the market participant symbol assigned by the Association to the Reporting Member,
 - (iv) the market participant symbol assigned by the Association to the member to which the order is transmitted,
 - (v) the date the order was first originated or received by the Reporting Member,
 - (vi) the date and time the order is transmitted,
 - (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

(B) the receiving Reporting Member shall record, in addition to all other information items in Rule 6954(b) that apply with respect to such order:

- (i) the fact that the order was received manually,[and]

(ii) the order identifier assigned to the order by the member that transmits the order, and

(iii) [(ii)] the market participant symbol assigned by the Association to the member that transmits the order.

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

(A) the transmitting Reporting Member shall record:

(i) the fact that the order was transmitted manually,

(ii) the order identifier assigned to the order by the Reporting Member,

(iii) the market participant symbol assigned by the Association to the Reporting Member,

(iv) the market participant symbol assigned by the Association to the member to which the order is transmitted,

(v) the date the order was first originated or received by the Reporting Member,

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

(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

(B) the receiving Reporting Member shall record:

(i) the fact that the order was received manually,

(ii) the order identifier assigned to the order by the member that transmits the order,

(iii) [ii]the market participant symbol assigned by the Association to the transmitting Reporting Member, and

(iv) [(iii)] other information items in Rule 6954(b) that apply with respect to such order, which must include information items (1), (2), (3), (6), (7), (8), (10), (11), (12), (13), (15), and (16).

(6) No Change.

(d) No Change.

6955 to 6957 No Change.

6958. Exemptions

Pursuant to the Rule 9600 Series, the staff, for good cause shown after taking into consideration all relevant factors, may exempt any member or transaction, or any class of members or transactions, either unconditionally or on specified terms, from any or all of the provisions of Rules 6952, 6953, 6954, 6955 and 6957 if it determines that such exemption is consistent with the purposes of such Rules, the protection of investors, and the public interest.

9600. PROCEDURES FOR EXEMPTIONS

9610. Application

(a) Where to File

A member seeking an exemption from Rule 1021, 1022, 1070, 2210, 2320, 2340, 2520, 2710, 2720, 2810, 2850, 2851, 2860, Interpretive Material 2860-1, 3010(b)(2), 3020, 3210, 3230, 3350, 6952, 6953, 6954, 6955, 6957, 8211, 8212, 8213, 11870, or 11900, Interpretive Material 2110-1, or Municipal Securities Rulemaking Board Rule G-37 shall file a written application with the appropriate department or staff of the Association and provide a copy of the application to the Office of General Counsel of NASD Regulation.

(b) and (c) No Change.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation at its meeting on March 29, 2000, which authorized the filing of the rule change with the SEC. The Nasdaq Stock Market has been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries. The NASD Board of Governors had an opportunity to review the proposed rule change at its meeting on March 30, 2000. No other action by the NASD is necessary for the filing of the proposed rule

change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt amendments to NASD Rules without recourse to the membership for approval.

The NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Stephanie M. Dumont, Assistant General Counsel, NASD Regulation, Office of General Counsel, at (202) 728-8176.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Background

On March 6, 1998, the SEC approved NASD Order Audit Trail System ("OATS") Rules 6950 through 6957.¹ OATS provides a substantially enhanced body of information regarding orders and transactions that improves NASD Regulation's ability to conduct surveillance and investigations of member firms for violations of federal securities laws and Association rules. In addition, OATS is intended to fulfill one of the undertakings contained in the order issued by the SEC relating to the settlement of an enforcement action against the NASD for failure to adequately enforce its rules.² Pursuant to the SEC Order, OATS was required, at a minimum, to: (1) provide an accurate, time-sequenced record of orders and transactions, beginning with the receipt of an order at the first point of

¹ See Exchange Act Release No. 39729 (March 6, 1998).

² See In the Matter of National Association of Securities Dealers, Inc., Exchange Act Release No. 37538 (August 8, 1996); Administrative Proceeding File No. 3-9056 ("SEC Order").

contact between the broker/dealer and the customer or counterparty and further documenting the life of the order through the process of execution; and (2) provide for market-wide synchronization of clocks used in connection with the recording of market events.³

In general, OATS imposes obligations on member firms to record in electronic form and to report to NASD Regulation on a daily basis certain information with respect to orders originated, received, transmitted, modified, canceled, or executed (“reportable events”) by NASD members relating to equity securities traded on The Nasdaq Stock Market, Inc. (“Nasdaq”). OATS also requires member firms to synchronize their business clocks and continually to keep them synchronized with a specific time designated by the Association. OATS captures this order information reported by NASD members and integrates it with quote information and transaction information reported to the Automated Confirmation Transaction Service (“ACT”)⁴ to provide the Association with an accurate, time-sequenced record of orders, quotes and transactions.

In addition to Rules 6950 through 6957, NASD Rule 3110 imposes recordkeeping requirements on NASD members that are obligated to record and report information to the NASD under the OATS rules. Such members are required to record, with respect to an order that is received or executed at the members' trading department, the identification of each registered person who receives an order directly from a customer and the identification of each person who executes an order at a market maker's trading desk. In addition, Rule 3110 requires members to record the identification

³ Id.

⁴ ACT is an automated system owned and operated by Nasdaq that captures transaction information in real-time.

of the department of the member that originated an order that is transmitted manually to another department within a member.

The effective dates for OATS requirements are set forth in Rule 6957, which provides for different phases of implementation. All members were required to synchronize their computer system clocks and all mechanical clocks that record times for regulatory purposes by August 7, 1998, and July 1, 1999, respectively. In addition, the implementation schedule required that electronic orders received at the trading department of a member that is a market maker in the subject securities and those received by electronic communications networks (“ECNs”) be entered into OATS as of March 1, 1999 (“Phase One”). Not all information relating to electronic orders received by market makers was required to be reported to OATS during Phase One. Information items relating to all electronic orders, however, was required to be reported to OATS by August 1, 1999 (“Phase Two”).

As of October 31, 2000, the OATS rules will apply to all manual orders (“Phase Three”).⁵ With respect to manual orders and all orders received by ECNs, however, the data required to be electronically recorded and transmitted to the OATS is limited to information that is expected to be readily available at the trading desk.⁶

⁵ The original effective date for Phase Three was July 31, 2000. On March 9, 2000, NASD Regulation filed a proposed amendment with the SEC for immediate effectiveness to delay the implementation date of Phase Three to October 31, 2000 (See SR-NASD-00-09). The purpose of this extension was to provide NASD Regulation adequate time to analyze and consider the proposed changes described herein, in particular, those affecting Phase Three recording and reporting requirements.

⁶ Specifically, with respect to manual orders, information item (18) (type of account for which the order is submitted) of Rule 6954(b) would be required to be reported only to the extent that such information item is available. Information items (4) (identification of any department or the identification number of any terminal where an order is received) and (5) (identification of the department of the member originating an order) of Rule 6954(b) and information items under (1) (recordkeeping requirements for orders transmitted to another department within the member) specified in Rule 6954(c) would not be required to be recorded and reported with respect to manual orders. In addition, information items (4) (identification of any department or identification

The books and records requirements, set forth in Rule 3110(h)(1)(A) and (B), pertaining to the identification of the registered representative who receives an order directly from a customer and the identification of each registered person who executes the order, was effective on March 1, 1999. The recordkeeping requirements, set forth in Rule 3110(h)(1)(C), applicable to orders originated by a member and manually transmitted to another department within the member firm, also become effective on October 31, 2000.

Since the implementation of OATS requirements, NASD Regulation staff has been closely reviewing OATS activities with the goal of identifying ways in which to improve OATS and enhance the effectiveness of OATS as a regulatory tool. In this regard, NASD Regulation has identified certain changes to OATS that it believes will enhance NASD Regulation's automated surveillance for compliance with trading and market making rules such as the NASD's Limit Order Protection Interpretation, the SEC's Order Handling Rules and a member firm's best execution obligations. These rule changes will, at the same time, eliminate the reporting of duplicative information and reduce the regulatory burdens on member firms, particularly certain smaller member firms.

Change to Time of Receipt of Order

Rule 6954 requires certain identifying information to be recorded at various critical points during the life of an order. In addition to uniquely identifying the order, this information assists NASD Regulation in carrying out its regulatory responsibilities with respect to that order. In general, the

number of any terminal where an order is received), (5) (the identification of the department of the member that originates the order), (9) (the designation of the order as a short sale), (14) (any request by a customer that an order not be displayed or that a block size order be displayed, pursuant to SEC Rule 11Ac1-4(c)), (17) (the identification of the order as related to a Program Trade or an Index Arbitrage Trade), and (18) (the type of

required information items relate to: (1) the origin of an order (i.e., in-house, customer, or another member); (2) whether the member relies upon a Reporting Agent to fulfill its reporting obligations; (3) how the order was received (i.e., manually or electronically); (4) the terms of the order; (5) whether the order was transmitted for execution to another department within the member (other than to the trading department), to another member, or to an ECN, and how it was transmitted (i.e., manually or electronically); and (6) whether the order was modified, canceled, or executed.

Currently under the requirements of Phase Two, which only apply to electronic orders, OATS rules require that the time of receipt be the time an order is received by a firm's electronic order handling system. This definition of time of receipt 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.

Once the OATS rules are fully phased in (Phase Three - October 31, 2000), manual orders, whether recorded at a market maker trading desk or at another location, will be fully subject to all the recording and reporting requirements. Because only one time of receipt is reported for each order, the time recorded and reported to OATS will be the time the firm receives the order from a customer.⁷ Although the actual time a manual order is received by a firm is useful for certain regulatory purposes, it is of little value to NASD Regulation's Market Regulation Department's automated surveillance for identifying potential violations of NASD IM 2110-2 (the limit order protection rule), SEC Rule 11Ac1-

account for which the order is submitted) specified in Rule 6954(b) would not be required to be recorded and reported by ECNs receiving orders either electronically or manually.

⁷ If an order is received and then immediately entered into an electronic system, the time the order is captured by such system has been interpreted to be the time of receipt.

4 (limit order display rule), and NASD Rule 2320 (best execution obligations). The more useful time is the time the order is received by the trading desk or trading department.

Accordingly, NASD Regulation is proposing that the OATS rules be amended such that the time of receipt required to be recorded and reported by a member firm to OATS is the time a manual order is received by the member firm's trading desk or trading department for execution or further routing purposes. In addition to changing the definition of time of receipt for manual orders, the proposed rule change also would codify the staff's current position that the order origination and receipt time for an electronic order is the time the order is captured by a member's electronic order-routing or execution system. As noted above, NASD Regulation staff believes that this time is a close substitute for the time an electronic order is received by the trading desk or trading department.

NASD Regulation believes that the time the order is received at the trading desk or trading department is the most relevant time and will provide the best indicator for NASD Regulation's automated surveillance systems to review for compliance with applicable rules. In addition, the proposed rule change will reduce the burden of reprogramming reporting systems for Phase Three requirements, as well as the cost of manually inputting these times for orders not directly inputted into an electronic order handling system, while still substantially fulfilling the undertakings contained in the SEC Order.

Notwithstanding this proposed rule change to the OATS rules, NASD Regulation recognizes the importance of capturing the time the order was actually received from the customer to determine if there are any inordinate delays in transmitting the order to the trading desk. In this regard, all firms must continue to capture and retain the time an order was received from a customer (if different than the time

the order was entered into an electronic system) under SEC Rule 17a-3(a)(6). This information is available to NASD Regulation staff as part of its investigatory process and is used during field examinations of member firms to determine, among other things, how promptly the firm transmits its orders for execution.

Exclusion from OATS Reporting for Certain Members

Certain members engage in a non-discretionary order routing process whereby, immediately after receipt of a customer order, the member routes the order, by electronic or other means, to another member (“receiving member”) for further routing or execution at the receiving member’s discretion. Currently, the OATS rules require both the member with which the order originated and the receiving member to create and report new order reports and possibly route reports. This results in the receipt of duplicative information by OATS. Therefore, NASD Regulation is proposing that the OATS rules be amended to require, in such instances, that only the receiving member report OATS data. Under the proposed rule change, a member would not be required to report OATS data regarding an order, if the following conditions are met:

- (1) the member engages in a non-discretionary order routing process, pursuant to which it immediately routes, by electronic or other means, all of its orders to a receiving Reporting Member;⁸
- (2) the member does not direct or maintain control over subsequent routing or execution by the receiving Reporting Member;

⁸ If any delay results in the routing of an order due to systems problems or other reasons, the member with which the order originated would be required to report OATS data.

(3) the receiving Reporting Member records and reports all information required under Rules 6954 and 6955 with respect to the order; and

(4) the member has a written agreement with the receiving Reporting Member specifying the respective functions and responsibilities of each party to effect full compliance with the requirements of Rules 6954 and 6955.

In addition to eliminating the reporting of duplicative information to OATS, the proposed rule change will reduce the regulatory burdens on members, particularly smaller members, that route all their orders to another Reporting Member by means of a non-discretionary order routing process, for execution or further routing purposes.⁹

Capturing Routed Order Information

OATS has the capability of tracking the history of an order by linking such orders across firms through the use of a routed order identifier. If the order does not contain a routed order identifier, the order cannot be linked to subsequent actions, such as further routing or execution by other firms or Nasdaq systems. In this regard, the complete history of a significant percentage of orders are not tracked because the OATS rules do not require any receiving Reporting Member to capture and report a routed order identifier if the order is routed to it manually. OATS rules also do not require ECNs to capture and report a routed order identifier for orders routed to the ECN manually or electronically. Given the current level of participation of ECNs, the linking of these orders is essential if OATS is to capture the life cycle of orders for Nasdaq securities. Therefore, NASD Regulation is proposing that

⁹ This exclusion would not change a member's requirement to capture and retain the time an order was received from a customer under SEC Rule 17a-3(a)(6).

firms and ECNs be required to capture and report the transmitting Reporting Member's unique identifier for all routed orders. NASD Regulation anticipates a "phase-in" period for implementation of this proposed rule change to provide adequate time for necessary systems and procedures changes.

Exemptive Relief

Finally, NASD Regulation is proposing new Rule 6958 and an amendment to Rule 9610(a) to permit NASD Regulation to grant exemptive relief to members from the OATS rules under the procedures set forth under the Rule 9600 series. Since the implementation of OATS, numerous situations have arose where the OATS rules require that member firms provide information to OATS where such information is not relevant to the Association's needs, collection of such information would be unduly burdensome, or where temporary relief from the rules would allow member firms to comply at a later date without unnecessary expense or hardship.

(b) Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The NASD Regulation believes that, under the proposed rule change, OATS will continue to provide a substantially enhanced body of information regarding orders and transactions and will improve NASD Regulation's ability to conduct surveillance and investigations of member firms for violations of Association's and other applicable rules.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

6. Extension of Time Period for Commission Action

NASD Regulation does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD Regulation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD REGULATION, INC.

BY: _____
Joan Conley
Senior Vice President and Corporate Secretary

Date: April 19, 2000

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-00-23)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Amendments to Order Audit Trail System Rules

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on , the National Association of Securities Dealers, Inc. (“NASD”), through its wholly owned subsidiary, NASD Regulation, Inc. (“NASD Regulation”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF
SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD Regulation is proposing to amend Rules 6951, 6954 and 9610 and to add a new Rule 6958 of the National Association of Securities Dealers, Inc. (“NASD” or “Association”), to: (1) provide that the time of order origination and receipt for an electronic order is the time the order is captured by a member’s electronic order-routing or execution system, and for a manual order, is the time the order is received by the member’s trading desk or trading department for execution or routing

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

purposes; (2) exclude certain members from the definition of “Reporting Member” for those orders that meet specified conditions and are recorded and reported to the Order Audit Trail System (“OATS”) by another member; (3) require any receiving reporting member, including electronic communications networks (“ECNs”), that receive, electronically or manually, routed orders, to capture and report a routed order identifier; and (4) permit NASD Regulation to grant exemptive relief from the OATS rules under certain circumstances. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

NASD SYSTEMS AND PROGRAMS

6950. ORDER AUDIT TRAIL SYSTEM

6951. Definitions

For purposes of Rules 6950 through 695[7]8:

(a) through (m) No Change.

(n) “Reporting Member” shall mean a member that receives or originates an order and has an obligation to record and report information under Rules 6954 and 6955. A member shall not be considered a Reporting Member in connection with an order, if the following conditions are met:

(1) the member engages in a non-discretionary order routing process, pursuant to which it immediately routes, by electronic or other means, all of its orders to a receiving Reporting Member;

(2) the member does not direct and does not maintain control over subsequent routing or execution by the receiving Reporting Member;

(3) the receiving Reporting Member records and reports all information required under Rules 6954 and 6955 with respect to the order; and

(4) the member has a written agreement with the receiving Reporting Member specifying the respective functions and responsibilities of each party to effect full compliance with the requirements of Rules 6954 and 6955.

6952. Applicability No Change.

6953. Synchronization of Member Business Clocks No Change.

6954. Recording of Order Information

(a) No Change.

(b) Order Origination and Receipt

Unless otherwise indicated, the following order information must be recorded under this Rule when an order is received or originated. For purposes of this Rule, the order origination and receipt time for an electronic order is the time the order is captured by a member's electronic order-routing or execution system, and for a manual order, is the time the order is received by the member's trading desk or trading department for execution or further routing purposes.

(1) through (18) No Change.

(c) Order Transmittal

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

(1) and (2) 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) the fact that the order was transmitted to an Electronic

Communications Network,

(ii) the order identifier assigned to the order by the Reporting Member,

(iii) the market participant symbol assigned by the Association to the

Reporting Member,

(iv) the market participant symbol assigned by the Association to the

member to which the order is transmitted,

(v) the date the order was first originated or received by the Reporting

Member,

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

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

(B) the receiving Reporting Member operating the Electronic Communications

Network shall record:

(i) the fact that the order was received by an Electronic

Communications Network,

(ii) the order identifier assigned to the order by the member that

transmits the order,

(iii) [(ii)] the market participant symbol assigned by the Association to the transmitting Reporting Member, and

(iv) [(iii)] other information items in Rule 6954(b) that apply with respect to such order, which must include information items (1), (2), (3), (6), (7), (8), (10), (11), (12), (13), (15), and (16).

(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) the fact that the order was transmitted manually,

(ii) the order identifier assigned to the order by the Reporting Member,

(iii) the market participant symbol assigned by the Association to the Reporting Member,

(iv) the market participant symbol assigned by the Association to the member to which the order is transmitted,

(v) the date the order was first originated or received by the Reporting Member,

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

(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

(B) the receiving Reporting Member shall record, in addition to all other information items in Rule 6954(b) that apply with respect to such order:

(i) the fact that the order was received manually,[and]

(ii) the order identifier assigned to the order by the member that transmits the order, and

(iii) [(ii)] the market participant symbol assigned by the Association to the member that transmits the order.

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

(A) the transmitting Reporting Member shall record:

(i) the fact that the order was transmitted manually,

(ii) the order identifier assigned to the order by the Reporting Member,

(iii) the market participant symbol assigned by the Association to the Reporting Member,

(iv) the market participant symbol assigned by the Association to the member to which the order is transmitted,

(v) the date the order was first originated or received by the Reporting Member,

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

(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

(B) the receiving Reporting Member shall record:

(i) the fact that the order was received manually,

(ii) the order identifier assigned to the order by the member that transmits the order,

(iii) [ii] the market participant symbol assigned by the Association to the transmitting Reporting Member, and

(iv) [(iii)] other information items in Rule 6954(b) that apply with respect to such order, which must include information items (1), (2), (3), (6), (7), (8), (10), (11), (12), (13), (15), and (16).

(6) No Change.

(d) No Change.

6955 to 6957 No Change.

6958. Exemptions

Pursuant to the Rule 9600 Series, the staff, for good cause shown after taking into consideration all relevant factors, may exempt any member or transaction, or any class of members or transactions, either unconditionally or on specified terms, from any or all of the provisions of Rules 6952, 6953, 6954, 6955 and 6957 if it determines that such exemption is consistent with the purposes of such Rules, the protection of investors, and the public interest.

9600. PROCEDURES FOR EXEMPTIONS

9610. Application

(a) Where to File

A member seeking an exemption from Rule 1021, 1022, 1070, 2210, 2320, 2340, 2520, 2710, 2720, 2810, 2850, 2851, 2860, Interpretive Material 2860-1, 3010(b)(2), 3020, 3210, 3230, 3350, 6952, 6953, 6954, 6955, 6957, 8211, 8212, 8213, 11870, or 11900, Interpretive Material 2110-1, or Municipal Securities Rulemaking Board Rule G-37 shall file a written application with the appropriate department or staff of the Association and provide a copy of the application to the Office of General Counsel of NASD Regulation.

(b) and (c) No Change.

II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD Regulation included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below.

NASD Regulation has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) **Purpose**

Background

On March 6, 1998, the SEC approved NASD Order Audit Trail System ("OATS") Rules 6950 through 6957.³ OATS provides a substantially enhanced body of information regarding orders and transactions that improves NASD Regulation's ability to conduct surveillance and investigations of member firms for violations of federal securities laws and Association rules. In addition, OATS is intended to fulfill one of the undertakings contained in the order issued by the SEC relating to the settlement of an enforcement action against the NASD for failure to adequately enforce its rules.⁴ Pursuant to the SEC Order, OATS was required, at a minimum, to: (1) provide an accurate, time-sequenced record of orders and transactions, beginning with the receipt of an order at the first point of

³ See Exchange Act Release No. 39729 (March 6, 1998).

⁴ See In the Matter of National Association of Securities Dealers, Inc., Exchange Act Release No. 37538 (August 8, 1996); Administrative Proceeding File No. 3-9056 ("SEC Order").

contact between the broker/dealer and the customer or counterparty and further documenting the life of the order through the process of execution; and (2) provide for market-wide synchronization of clocks used in connection with the recording of market events.⁵

In general, OATS imposes obligations on member firms to record in electronic form and to report to NASD Regulation on a daily basis certain information with respect to orders originated, received, transmitted, modified, canceled, or executed (“reportable events”) by NASD members relating to equity securities traded on The Nasdaq Stock Market, Inc. (“Nasdaq”). OATS also requires member firms to synchronize their business clocks and continually to keep them synchronized with a specific time designated by the Association. OATS captures this order information reported by NASD members and integrates it with quote information and transaction information reported to the Automated Confirmation Transaction Service (“ACT”)⁶ to provide the Association with an accurate, time-sequenced record of orders, quotes and transactions.

In addition to Rules 6950 through 6957, NASD Rule 3110 imposes recordkeeping requirements on NASD members that are obligated to record and report information to the NASD under the OATS rules. Such members are required to record, with respect to an order that is received or executed at the members' trading department, the identification of each registered person who receives an order directly from a customer and the identification of each person who executes an order at a market maker's trading desk. In addition, Rule 3110 requires members to record the identification

⁵ Id.

⁶ ACT is an automated system owned and operated by Nasdaq that captures transaction information in real-time.

of the department of the member that originated an order that is transmitted manually to another department within a member.

The effective dates for OATS requirements are set forth in Rule 6957, which provides for different phases of implementation. All members were required to synchronize their computer system clocks and all mechanical clocks that record times for regulatory purposes by August 7, 1998, and July 1, 1999, respectively. In addition, the implementation schedule required that electronic orders received at the trading department of a member that is a market maker in the subject securities and those received by electronic communications networks (“ECNs”) be entered into OATS as of March 1, 1999 (“Phase One”). Not all information relating to electronic orders received by market makers was required to be reported to OATS during Phase One. Information items relating to all electronic orders, however, was required to be reported to OATS by August 1, 1999 (“Phase Two”).

As of October 31, 2000, the OATS rules will apply to all manual orders (“Phase Three”).⁷ With respect to manual orders and all orders received by ECNs, however, the data required to be electronically recorded and transmitted to the OATS is limited to information that is expected to be readily available at the trading desk.⁸

⁷ The original effective date for Phase Three was July 31, 2000. On March 9, 2000, NASD Regulation filed a proposed amendment with the SEC for immediate effectiveness to delay the implementation date of Phase Three to October 31, 2000 (See SR-NASD-00-09). The purpose of this extension was to provide NASD Regulation adequate time to analyze and consider the proposed changes described herein, in particular, those affecting Phase Three recording and reporting requirements.

⁸ Specifically, with respect to manual orders, information item (18) (type of account for which the order is submitted) of Rule 6954(b) would be required to be reported only to the extent that such information item is available. Information items (4) (identification of any department or the identification number of any terminal where an order is received) and (5) (identification of the department of the member originating an order) of Rule 6954(b) and information items under (1) (recordkeeping requirements for orders transmitted to another department within the member) specified in Rule 6954(c) would not be required to be recorded and reported with respect to manual orders. In addition, information items (4) (identification of any department or identification

The books and records requirements, set forth in Rule 3110(h)(1)(A) and (B), pertaining to the identification of the registered representative who receives an order directly from a customer and the identification of each registered person who executes the order, was effective on March 1, 1999. The recordkeeping requirements, set forth in Rule 3110(h)(1)(C), applicable to orders originated by a member and manually transmitted to another department within the member firm, also become effective on October 31, 2000.

Since the implementation of OATS requirements, NASD Regulation staff has been closely reviewing OATS activities with the goal of identifying ways in which to improve OATS and enhance the effectiveness of OATS as a regulatory tool. In this regard, NASD Regulation has identified certain changes to OATS that it believes will enhance NASD Regulation's automated surveillance for compliance with trading and market making rules such as the NASD's Limit Order Protection Interpretation, the SEC's Order Handling Rules and a member firm's best execution obligations. These rule changes will, at the same time, eliminate the reporting of duplicative information and reduce the regulatory burdens on member firms, particularly certain smaller member firms.

Change to Time of Receipt of Order

Rule 6954 requires certain identifying information to be recorded at various critical points during the life of an order. In addition to uniquely identifying the order, this information assists NASD Regulation in carrying out its regulatory responsibilities with respect to that order. In general, the

number of any terminal where an order is received), (5) (the identification of the department of the member that originates the order), (9) (the designation of the order as a short sale), (14) (any request by a customer that an order not be displayed or that a block size order be displayed, pursuant to SEC Rule 11Ac1-4(c)), (17) (the identification of the order as related to a Program Trade or an Index Arbitrage Trade), and (18) (the type of

required information items relate to: (1) the origin of an order (i.e., in-house, customer, or another member); (2) whether the member relies upon a Reporting Agent to fulfill its reporting obligations; (3) how the order was received (i.e., manually or electronically); (4) the terms of the order; (5) whether the order was transmitted for execution to another department within the member (other than to the trading department), to another member, or to an ECN, and how it was transmitted (i.e., manually or electronically); and (6) whether the order was modified, canceled, or executed.

Currently under the requirements of Phase Two, which only apply to electronic orders, OATS rules require that the time of receipt be the time an order is received by a firm's electronic order handling system. This definition of time of receipt 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.

Once the OATS rules are fully phased in (Phase Three - October 31, 2000), manual orders, whether recorded at a market maker trading desk or at another location, will be fully subject to all the recording and reporting requirements. Because only one time of receipt is reported for each order, the time recorded and reported to OATS will be the time the firm receives the order from a customer.⁹ Although the actual time a manual order is received by a firm is useful for certain regulatory purposes, it is of little value to NASD Regulation's Market Regulation Department's automated surveillance for identifying potential violations of NASD IM 2110-2 (the limit order protection rule), SEC Rule 11Ac1-

account for which the order is submitted) specified in Rule 6954(b) would not be required to be recorded and reported by ECNs receiving orders either electronically or manually.

⁹ If an order is received and then immediately entered into an electronic system, the time the order is captured by such system has been interpreted to be the time of receipt.

4 (limit order display rule), and NASD Rule 2320 (best execution obligations). The more useful time is the time the order is received by the trading desk or trading department.

Accordingly, NASD Regulation is proposing that the OATS rules be amended such that the time of receipt required to be recorded and reported by a member firm to OATS is the time a manual order is received by the member firm's trading desk or trading department for execution or further routing purposes. In addition to changing the definition of time of receipt for manual orders, the proposed rule change also would codify the staff's current position that the order origination and receipt time for an electronic order is the time the order is captured by a member's electronic order-routing or execution system. As noted above, NASD Regulation staff believes that this time is a close substitute for the time an electronic order is received by the trading desk or trading department.

NASD Regulation believes that the time the order is received at the trading desk or trading department is the most relevant time and will provide the best indicator for NASD Regulation's automated surveillance systems to review for compliance with applicable rules. In addition, the proposed rule change will reduce the burden of reprogramming reporting systems for Phase Three requirements, as well as the cost of manually inputting these times for orders not directly inputted into an electronic order handling system, while still substantially fulfilling the undertakings contained in the SEC Order.

Notwithstanding this proposed rule change to the OATS rules, NASD Regulation recognizes the importance of capturing the time the order was actually received from the customer to determine if there are any inordinate delays in transmitting the order to the trading desk. In this regard, all firms must

continue to capture and retain the time an order was received from a customer (if different than the time the order was entered into an electronic system) under SEC Rule 17a-3(a)(6). This information is available to NASD Regulation staff as part of its investigatory process and is used during field examinations of member firms to determine, among other things, how promptly the firm transmits its orders for execution.

Exclusion from OATS Reporting for Certain Members

Certain members engage in a non-discretionary order routing process whereby, immediately after receipt of a customer order, the member routes the order, by electronic or other means, to another member (“receiving member”) for further routing or execution at the receiving member’s discretion. Currently, the OATS rules require both the member with which the order originated and the receiving member to create and report new order reports and possibly route reports. This results in the receipt of duplicative information by OATS. Therefore, NASD Regulation is proposing that the OATS rules be amended to require, in such instances, that only the receiving member report OATS data. Under the proposed rule change, a member would not be required to report OATS data regarding an order, if the following conditions are met:

- (1) the member engages in a non-discretionary order routing process, pursuant to which it immediately routes, by electronic or other means, all of its orders to a receiving Reporting Member;¹⁰
- (2) the member does not direct or maintain control over subsequent routing or execution by the receiving Reporting Member;

¹⁰ If any delay results in the routing of an order due to systems problems or other reasons, the member with which the order originated would be required to report OATS data.

(3) the receiving Reporting Member records and reports all information required under Rules 6954 and 6955 with respect to the order; and

(4) the member has a written agreement with the receiving Reporting Member specifying the respective functions and responsibilities of each party to effect full compliance with the requirements of Rules 6954 and 6955.

In addition to eliminating the reporting of duplicative information to OATS, the proposed rule change will reduce the regulatory burdens on members, particularly smaller members, that route all their orders to another Reporting Member by means of a non-discretionary order routing process, for execution or further routing purposes.¹¹

Capturing Routed Order Information

OATS has the capability of tracking the history of an order by linking such orders across firms through the use of a routed order identifier. If the order does not contain a routed order identifier, the order cannot be linked to subsequent actions, such as further routing or execution by other firms or Nasdaq systems. In this regard, the complete history of a significant percentage of orders are not tracked because the OATS rules do not require any receiving Reporting Member to capture and report a routed order identifier if the order is routed to it manually. OATS rules also do not require ECNs to capture and report a routed order identifier for orders routed to the ECN manually or electronically. Given the current level of participation of ECNs, the linking of these orders is essential if OATS is to capture the life cycle of orders for Nasdaq securities. Therefore, NASD Regulation is proposing that

¹¹ This exclusion would not change a member's requirement to capture and retain the time an order was received from a customer under SEC Rule 17a-3(a)(6).

firms and ECNs be required to capture and report the transmitting Reporting Member's unique identifier for all routed orders. NASD Regulation anticipates a "phase-in" period for implementation of this proposed rule change to provide adequate time for necessary systems and procedures changes.

Exemptive Relief

Finally, NASD Regulation is proposing new Rule 6958 and an amendment to Rule 9610(a) to permit NASD Regulation to grant exemptive relief to members from the OATS rules under the procedures set forth under the Rule 9600 series. Since the implementation of OATS, numerous situations have arose where the OATS rules require that member firms provide information to OATS where such information is not relevant to the Association's needs, collection of such information would be unduly burdensome, or where temporary relief from the rules would allow member firms to comply at a later date without unnecessary expense or hardship.

(b) Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The NASD Regulation believes that, under the proposed rule change, OATS will continue to provide a substantially enhanced body of information regarding orders and transactions and will improve NASD Regulation's ability to conduct surveillance and investigations of member firms for violations of Association's and other applicable rules.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- A. by order approve such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in

accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD.

All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Jonathan G. Katz
Secretary