

February 4, 2004

Katherine A. England
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-2004-023 - Amendments to Order Audit Trail System Rules
Relating to Execution Reports**

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find 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 M. Dumont, Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8176. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Barbara Z. Sweeney
Senior Vice President
and Corporate Secretary

Enclosures

File No. SR-NASD-2004-023

Consists of 55 Pages

February 4, 2004

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) of the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to amend NASD Rule 6954(d) to require that members record and report the execution price and firm capacity in Order Audit Trail System (“OATS”) Execution Reports. 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. through 6953. No Change.

6954. Recording of Order Information

(a) through (c) No Change.

(d) Order Modifications, Cancellations, and Executions

Order information required to be recorded under this Rule when an order is modified, canceled, or executed includes the following.

(1) and (2) No Change.

(3) When a Reporting Member executes an order, in whole or in part, the

Reporting Member shall record:

(A) through (G) No Change.

(H) the date and time of execution₁[and]

(I) the execution price,

(J) the capacity in which the member executed the transaction, and

(K) the national securities exchange or facility operated by a registered securities association where the trade was reported.

* * * * *

(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, Inc. at its meeting on July 30, 2003, which authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to its Subsidiaries. The NASD Board of Governors had an opportunity to review the proposed rule change at its meeting on July 31, 2003. No other action by 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.

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 90 days following publication of the Notice to Members announcing Commission

approval to provide members adequate time for any technological or system changes required by the proposed rule change.

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

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

(a) Purpose

On March 6, 1998, the SEC approved NASD Rules 6950 through 6957 (“OATS Rules”).¹ OATS provides a substantially enhanced body of information regarding orders and transactions that improves NASD’s ability to conduct surveillance and investigations of member firms for potential violations of NASD rules and the federal securities laws.

When the OATS Rules initially were adopted, it was determined that NASD would obtain execution price and firm capacity information from trading information rather than information submitted to OATS. At that time, the vast majority of trading in Nasdaq securities was reported through Nasdaq’s Automated Confirmation Transaction Service (“ACT”).² Members are required to input order identifier information into ACT trade reports, and NASD systematically matches the ACT trade reports with corresponding OATS reports to obtain certain trade-related information including execution price and firm capacity. Similarly, members using the NASD Alternative Display Facility (“ADF”) Trade Reporting and Comparison Service (“TRACS”) are

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

² ACT is an automated system owned and operated by Nasdaq that captures transaction information on a real-time basis.

required to record OATS order identifier information in TRACS trade reports, which also is then matched with OATS information to obtain execution price and firm capacity.

Recently, however, this “ACT/TRACS matching” process has become more and more limited, in part because a percentage of trades in Nasdaq securities are no longer reported to ACT or TRACS. Further, if there are any errors in the linking information provided to ACT, TRACS or OATS, the ACT/TRACS matching process is hindered.

In June 2002, NASD issued Notice to Members 02-31 soliciting comments from members and other interested parties on four proposed changes to the OATS rules, one of which was intended to address the potential gaps in the audit trail associated with the ACT/TRACS matching process. Commenters that provided substantive comments about the four proposals generally opposed the proposals. The commenters’ primary concern was that service bureaus and member firms already have spent a significant amount of time and resources in complying with OATS. Commenters indicated that current OATS reporting has reached a stage where it appears to be working well and commenters, therefore, opposed making any significant changes, particularly at a time when there currently are a number of other regulatory initiatives placing demands on members’ technological resources.

In response to concerns raised by commenters, NASD staff now is proposing only a subset of one of the four proposals, which the staff views as the most critical to addressing potential gaps in the audit trail information currently collected by NASD. Specifically, NASD is proposing to amend the OATS Rules to require members to record and report two additional fields, execution price and firm capacity, as part of the OATS Execution Report. Because the proposal adds two

additional data elements that typically are accessible with the other information required in an OATS Execution Report, the staff does not believe that the proposed rule change will be overly burdensome to members. Further, by having this data reported directly in the OATS Execution Report, the staff will not have to rely on accessing or matching the trade report to obtain these two data elements.

(b) Statutory Basis

NASD 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 NASD'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. NASD believes that the proposed rule change will enhance OATS information and will improve NASD's ability to conduct surveillance and investigations relating to compliance with NASD and other applicable rules.

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

NASD 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

NASD published for comment in Notice to Members 02-31 (June 2002) ("Notice") four proposed changes to the OATS Rules. Ten comment letters were received in response to the

Notice. A copy of the Notice is attached as Exhibit 2. Copies of the comment letters received in response to the Notice are attached as Exhibit 3.

Specifically, the Notice requested comment on four proposals, which would require that members: (1) record and report execution price, capacity, ACT control number and a special circumstances indicator as part of their OATS Execution Reports, but would rescind the requirement that members record and report an identical order identifier (referred to as the branch/sequence number) on the OATS Execution Report and the related ACT trade report (“Execution Report Proposal”); (2) report the execution time rather than prior reference price (“.PRP”) time or allocation time in OATS Execution Reports; (3) record and report for OATS purposes the route of the proprietary order if they comply with the SEC Limit Order Display Rule by routing a proprietary order in place of a customer order to another market, electronic communications networks (“ECN”) or market maker; and (4) provide the trading desk receipt time via a Desk Report in addition to the electronic system time reported as their order receipt time on New Order Reports in those instances when those times differ by more than one second.

The proposed rule change in this filing is two components of the Execution Report Proposal described above. Three commenters supported and seven opposed that proposal. It is important to note that the proposed rule change, however, does not require the recording and reporting of the ACT control number as required under the Execution Report Proposal, which several commenters indicated would be the most burdensome component of that proposal. A general description of the comments is described in the Purpose section.

6. Extension of Time Period for Commission Action

NASD 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.
2. NASD Notice to Members 02-31 (June 2002).
3. Comment letters received in response to NASD Notice to Members 02-31 (June 2002).

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

NASD, INC.

BY: _____
Barbara Z. Sweeney,
Senior Vice President and Corporate Secretary

Date: February 4, 2004

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-2004-023)

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 Relating to Execution Reports

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”), 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. 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 is proposing to amend NASD Rule 6954(d) to require that members record and report the execution price and firm capacity in Order Audit Trail System (“OATS”) Execution Reports. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

* * * * *

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

NASD SYSTEMS AND PROGRAMS

6950. ORDER AUDIT TRAIL SYSTEM

6951. through 6953. No Change.

6954. Recording of Order Information

(a) through (c) No Change.

(d) Order Modifications, Cancellations, and Executions

Order information required to be recorded under this Rule when an order is modified, canceled, or executed includes the following.

(1) and (2) No Change.

(3) When a Reporting Member executes an order, in whole or in part, the Reporting Member shall record:

(A) through (G) No Change.

(H) the date and time of execution,¹ and]

(I) the execution price,

(J) the capacity in which the member executed the transaction, and

(K) the national securities exchange or facility operated by a registered securities association where the trade was reported.

* * * * *

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 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 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

(1) Purpose

On March 6, 1998, the SEC approved NASD Rules 6950 through 6957 (“OATS Rules”).³ OATS provides a substantially enhanced body of information regarding orders and transactions that improves NASD’s ability to conduct surveillance and investigations of member firms for potential violations of NASD rules and the federal securities laws.

When the OATS Rules initially were adopted, it was determined that NASD would obtain execution price and firm capacity information from trading information rather than information submitted to OATS. At that time, the vast majority of trading in Nasdaq securities was reported through Nasdaq’s Automated Confirmation Transaction Service (“ACT”).⁴ Members are required to input order identifier information into ACT trade reports, and NASD systematically matches the ACT trade reports with corresponding OATS reports to obtain certain trade-related information including execution price and firm capacity. Similarly, members using the NASD Alternative Display Facility (“ADF”) Trade Reporting and Comparison Service (“TRACS”) are required to record OATS order identifier information in TRACS trade reports, which also is then matched with OATS information to obtain execution price and firm capacity.

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

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

Recently, however, this “ACT/TRACS matching” process has become more and more limited, in part because a percentage of trades in Nasdaq securities are no longer reported to ACT or TRACS. Further, if there are any errors in the linking information provided to ACT, TRACS or OATS, the ACT/TRACS matching process is hindered.

In June 2002, NASD issued Notice to Members 02-31 soliciting comments from members and other interested parties on four proposed changes to the OATS rules, one of which was intended to address the potential gaps in the audit trail associated with the ACT/TRACS matching process. Commenters that provided substantive comments about the four proposals generally opposed the proposals. The commenters’ primary concern was that service bureaus and member firms already have spent a significant amount of time and resources in complying with OATS. Commenters indicated that current OATS reporting has reached a stage where it appears to be working well and commenters, therefore, opposed making any significant changes, particularly at a time when there currently are a number of other regulatory initiatives placing demands on members’ technological resources.

In response to concerns raised by commenters, NASD staff now is proposing only a subset of one of the four proposals, which the staff views as the most critical to addressing potential gaps in the audit trail information currently collected by NASD. Specifically, NASD is proposing to amend the OATS Rules to require members to record and report two additional fields, execution price and firm capacity, as part of the OATS Execution Report. Because the proposal adds two additional data elements that typically are accessible with the other information required in an OATS Execution Report, the staff does not believe that the proposed rule change will be overly

burdensome to members. Further, by having this data reported directly in the OATS Execution Report, the staff will not have to rely on accessing or matching the trade report to obtain these two data elements.

(2) Statutory Basis

NASD 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 NASD'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. NASD believes that the proposed rule change will enhance OATS information and will improve NASD's ability to conduct surveillance and investigations relating to compliance with NASD and other applicable rules.

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

NASD 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

NASD published for comment in Notice to Members 02-31 (June 2002) ("Notice") four proposed changes to the OATS Rules. Ten comment letters were received in response to the Notice. A copy of the Notice is attached as Exhibit 2. Copies of the comment letters received in response to the Notice are attached as Exhibit 3.

Specifically, the Notice requested comment on four proposals, which would require that members: (1) record and report execution price, capacity, ACT control number and a special circumstances indicator as part of their OATS Execution Reports, but would rescind the requirement that members record and report an identical order identifier (referred to as the branch/sequence number) on the OATS Execution Report and the related ACT trade report (“Execution Report Proposal”); (2) report the execution time rather than prior reference price (“.PRP”) time or allocation time in OATS Execution Reports; (3) record and report for OATS purposes the route of the proprietary order if they comply with the SEC Limit Order Display Rule by routing a proprietary order in place of a customer order to another market, electronic communications networks (“ECN”) or market maker; and (4) provide the trading desk receipt time via a Desk Report in addition to the electronic system time reported as their order receipt time on New Order Reports in those instances when those times differ by more than one second.

The proposed rule change in this filing is two components of the Execution Report Proposal described above. Three commenters supported and seven opposed that proposal. It is important to note that the proposed rule change, however, does not require the recording and reporting of the ACT control number as required under the Execution Report Proposal, which several commenters indicated would be the most burdensome component of that proposal. A general description of the comments is described in the Purpose section.

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, including whether the proposed rule change is consistent with the act. 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. Comments may also be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. SR-XXXX-XXXX-XX. This file number should be included on the subject line if e-mail is used. To help us process and review comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. 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 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).

Margaret H. McFarland
Deputy Secretary