



Securities Industry Association

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January 20, 2005

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

Re: Notice To Members 04-80

Dear Ms. Sweeney:

The Operations Committee (the “Committee”) of the Securities Industry Association (“SIA”)¹ appreciates the opportunity to comment on NASD Notice To Members 04-80, in which the NASD solicits comment on proposed changes to the rules relating to the NASD’s Order Audit Trail System (“OATS”).² OATS imposes 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”).

The NASD proposes to expand significantly members’ reporting obligations, which, we believe, raises serious operational and competitive concerns. The Committees acknowledge the need for a complete and accurate order audit trail but we believe gaps in intermarket trading surveillance should be addressed by the Securities and Exchange Commission (“SEC”) in a comprehensive manner in order to avoid inefficiency, inconsistency, and duplication that can occur when individual self-regulatory organizations (“SROs”) proceed on separate tracks to adopt their own reporting requirements. We note that the SEC currently is soliciting comment on issues concerning

¹ The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker’s Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 780,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated \$209 billion in domestic revenue and \$278 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

² Members of the SIA’s Self-Regulation and Supervisory Practices Committee also provided substantial input on this letter.

self-regulation, including the feasibility of developing robust intermarket order audit trails.³ We believe NASD action on this proposal would effectively preempt that process.

A number of factors, including fragmentation in the trading of securities over the past several years, have led the NASD to identify several enhancements to the current OATS information that would enable the NASD to create a more comprehensive and accurate order and transaction audit trail. Consequently, the NASD is seeking comment on three proposed changes to the OATS Rules, which would require members to record and report: (1) order information relating to exchange-listed and OTC equity securities (OTC Bulletin Board (“OTCBB”) and Pink Sheets); (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 activities. The NASD believes these changes will significantly improve the effectiveness of NASD’s automated surveillance for potential violations of NASD rules and the federal securities laws.

I. Effective Intermarket Surveillance Requires a Comprehensive Approach

The Committee does not question the need for regulators to have audit trails to help facilitate our shared goal of investor protection. Because each SRO has different audit trail requirements, though, the potential for duplicative systems and reporting is high. We are concerned about the costs and inefficiencies associated with multiple regulators requesting duplicative data, all with slightly different requirements and methods for gathering the relevant information.⁴ The duplication of data creates additional cost and reconciliation burdens on member firms at a time when the industry is working toward consolidating data flows.⁵ Although NASD represents that it will coordinate its proposed requirements with those of the New York Stock Exchange (“NYSE”) and other exchanges, to date it does not appear that this has occurred.

The potential for regulatory redundancies in fragmented markets was the subject of a report by the U.S. General Accounting Office (“GAO”) in May 2002.⁶ The GAO

³ Concept Release Concerning Self-Regulation, Securities Exchange Act Release No. 34-50700 (November 18, 2004) (“Concept Release”).

⁴ SIA consistently has voiced the concern that complying with multiple SROs’ different audit trail systems would be burdensome and expensive to implement and administer. *See* letter from Donald D. Kittell, Executive Vice President, SIA, to Jonathan G. Katz, Secretary, SEC, dated June 27, 2003, responding to the SEC’s Concept Release on the Nasdaq Petition Relating to the Regulation of Nasdaq-Listed Securities, Securities Exchange Act Release No. 47849 (May 14, 2003).

⁵ *See also* letter to Jonathan G. Katz, Secretary, SEC, from Noland Cheng, Chairman, Fixed Income Transparency Subcommittee of the SIA Operations Committee, dated December 21, 2000, regarding duplication of systems efforts in connection with the NASD’s TRACE system.

⁶ U.S. General Accounting Office Report to Congressional Committees, “Securities Markets Competition and Multiple Regulators Heighten Concern About Self-Regulation” (May 2002) (“GAO Report”).

Report recommended that the SEC and SROs work together with broker-dealers to implement a formal process for systematically identifying and addressing material regulatory inefficiencies caused by differences in rules and rule interpretations among SROs. Subsequently, a joint NASD and NYSE task force undertook an examination of conflicting rules to determine how the conflicts could be resolved. That process yielded positive results,⁷ and should be employed on a continual basis. In particular, SRO rules regarding audit trails is an area where SRO coordinated efforts could produce compatible systems and reduce duplicative reporting requirements.

We recognize that as trading has become less concentrated in the primary markets and more dispersed across a greater number of trading venues, surveillance of intermarket trading becomes increasingly important. Competition among markets calls into question though whether the SROs should continue to be the appropriate entities to maintain the audit trails.

As competition among markets grows, the markets operated by SROs will come under increasing pressure to attract order flow, which presents conflicts of interest for an SRO when it comes to monitoring the activity of, and enforcing rules against, certain members. As the SEC notes in its recent Concept Release Concerning Self-Regulation, SRO staff may be less inclined to enforce vigorously SRO rules that would cause large liquidity providers to redirect order flow.⁸ Also, SROs may have a tendency to abuse their SRO status by over-regulating members that operate markets that compete with the SRO's own market for order flow.⁹ Even after the NASD divests itself of Nasdaq, the potential conflict of interest will remain due to the multi-year contract that Nasdaq entered into with the NASD to regulate its market. Although the SIA currently is formulating its position in preparing a response to the SEC Concept Release, certain Committee members believe the time has come for a neutral industry utility such as the Depository Trust and Clearing Corporation ("DTCC") to maintain a consolidated order audit trail with the costs of development and maintenance shared across the industry.

In connection with the settlement of an SEC enforcement action in 2000, the options exchanges designed and implemented a consolidated options audit trail system ("COATS"), which enables the options exchanges to reconstruct markets promptly, to conduct effective surveillance, and to enforce order handling, firm quote, trade reporting, and other rules.¹⁰ It is too early to assess the effectiveness of COATS because the system is in the final stage of implementation.¹¹ Nevertheless, before the NASD acts unilaterally

⁷ The NASD and NYSE, for example, agreed upon and adopted a uniform definition of "branch office."

⁸ *Supra* note 2, at 71262.

⁹ *Id.*

¹⁰ See Securities Exchange Act Release No. 43268 (September 11, 2000), at Section IV.B.e.

¹¹ See, e.g., Securities Exchange Act Release No. 50996 (January 7, 2005) approving a proposed rule change by the Chicago Board Options Exchange relating to the final phase of COATS implementation.

to enhance its ability to monitor intermarket activity, consideration should be given to the feasibility of creating a consolidated audit trail for the equity markets leveraging off the existing infrastructure that the industry has developed to accommodate OATS reporting, which represents many years of cooperative effort and investment on the part of the industry and the NASD.¹²

The Committee welcomes the SEC's request for comment on the Concept Release. Specifically, the SEC asks how similar are the order audit trail systems of the NASD and NYSE,¹³ and what the benefits would be of merging them into one consolidated system. We believe there is a real opportunity to eliminate redundancies and infrastructure across SROs, and we urge the NASD to defer action until that process is completed.

II. Issues Presented by Current Proposal

Although we strongly believe that any expansion of OATS should be considered in conjunction with the SEC Concept Release, if the NASD determines to go forward, our concerns with this specific proposal are set out below.

A. Capacity Concerns

Because it is sometimes unlikely that a member will know upon receipt of an order where the order will be executed, NASD members would be required to report to OATS order-related information for all transactions, including transactions in exchange-listed securities, regardless of where the order is ultimately executed. If the order is routed to a non-member or an exchange, NASD members would be required to record and report order events subsequent to the route, *e.g.*, subsequent routing and execution information. OATS reporting also would be required for OTCBB and Pink Sheet securities, as well as for proprietary orders generated during the course of market-making activities. Effectively, OATS would become the consolidated order audit trail for all equity transactions, although other SRO audit trail requirements would continue to exist.

The Committee questions whether the NASD has calculated and planned for the additional systems capacity that such changes would necessitate. In fact, recent changes to the OATS rules combining new order and route reports, as well as frequent instances where the NASD experiences processing delays, suggest that capacity may be an issue at this time. Under the proposal, one firm estimated that its daily OATS submission would

¹² Based on its technological expertise and awareness of the issues, the NASD may be best suited to take a leading role in developing a consolidated order audit trail.

¹³ The NYSE's order audit trail, the Order Tracking System ("OTS") differs in certain significant respects from OATS. While OATS data is reported to the NASD daily, OTS data is reported to the NYSE upon request. Although the regulators request similar data, minor differences require firms to customize the data feed for each SRO. For example, the NYSE requires the exchange turn-around number to be appended to each order.

jump from approximately 400,000 records to over 2,000,000 when listed and proprietary activity is required to be reported. Other firms preliminarily project a four to fivefold increase in the number of records submitted on a daily basis. As the number of records increases, firms will undoubtedly need relief from the requirement to submit reports by 4:00 a.m. on T+1. The number of rejects also will increase exponentially, further straining the system and requiring additional staffing within member firms. It is puzzling why the NASD, which appears to be experiencing capacity issues at current volume levels, would propose a change of such magnitude without so much as a reference to the impact such a change would have on the NASD's and firms' systems capacity.

B. Competitive Issues

We appreciate the NASD's concern that its extensive audit trail data is of limited use for cross-market surveillance because it does not capture relevant data for executions that take place on other markets. The NASD proposes to remedy this situation by requiring members to report order-related information on **all** transactions, including execution data relating to orders routed to non-members and exchanges. Unfortunately, member firms receive no more than an execution report on orders routed away, which the sending firm attempts to tie back to the original order by reference to its own order (branch and sequence) number. Moreover, the systems where the execution "reports" reside generally are separate from, and have different electronic formats than, the firm systems used to capture and record OATS data.

With respect to orders routed away, member firms would have no way of knowing if an order was routed again by the receiving firm or what happened at the away market.¹⁴ Although Rule 6955(c) allows members to enter into reporting agreements with non-members and exchanges, we do not believe this would be a viable method for reporting the data on activity that takes place in other markets because the member would lose control of the recording and reporting but would remain liable for the accuracy of the data. Further, very little firm data would exist to compare and identify exceptions, unless firms duplicated the processes of the reporting entity, which would significantly increase the cost of reporting and, again, raise the question of whether this is the most efficient method of compiling an audit trail.

Aside from the practical problems noted above, the Committee is concerned about the competitive implications of a single SRO acting as the repository for very detailed, customer-specific information on trades executed by its members in competing marketplaces. It is precisely such a conflict of interest that has prompted the SEC to request comment on potential approaches that could improve the operation of securities industry regulation.

¹⁴ In fact, reporting order events subsequent to routing was a key point of contention during the initial implementation of OATS. At that time, the NASD agreed that it was in the best position to match data submitted by different entities relating to a single order using the order identifier.

Finally, SROs that operate markets are responsible for promulgating rules that govern trading in their markets. A thorough review of the trading rules in each market would have to be undertaken to ensure that OATS does not flag as non-compliant transactions that are permissible under the rules of the competing market.

C. Issues Presented by Manual and Proprietary Orders

Expanding OATS to include OTCBB and Pink Sheet securities is problematic and raises issues that the industry has been grappling with since OATS was developed. The nature of this business is manual; orders are routed and executed via telephone. There are very few electronic systems that support the trading of OTCBB and Pink Sheet securities. Consequently, all the required data would have to be manually recorded at all of the locations through which the order may pass, resulting in delays in execution and a high rate of errors as the order information is orally relayed and recorded at multiple points.

The proposed requirement to record and report proprietary trades would represent a significant increase in the number of records submitted by almost all member firms and is duplicative of information already captured in electronic systems. Proprietary trades are executed through the facilities of a marketplace and are reported as such through the marketplace's trade reporting system. For example, trades executed through Nasdaq facilities, *e.g.*, SuperMontage, are automatically reported to the Automated Confirmation Transaction ("ACT") System. In order to get a comprehensive audit trail, proprietary activity in ACT needs merely to be integrated with customer activity received through OATS. It would be much more efficient to integrate records at the SRO level rather than to require individual firms to record and report the massive amount of information relating to proprietary trading.¹⁵

III. Conclusion

The Committee believes a comprehensive order audit trail is essential to serve investor protection goals. To ensure a consistent and comprehensive approach that is fair to all market participants in the increasingly competitive environment, NASD should wait for the results of the Concept Release and, if necessary, coordinate with other regulators to ensure that the system employed minimizes, to the greatest extent possible, duplicative

¹⁵ In a decimalized world, an order may need to be broken up and routed to several venues because quotes are not deep at each price point. In fact, it is not unusual for a 1,000 share order to be executed as ten separate orders of 100 shares each. Many market makers also employ sophisticated routing technology that automatically seeks out liquidity across trading venues. The current proposal is not only burdensome because of the increased number of records that would be required as a result of smaller and more numerous executions, but firms would have to get a daily download of information from vendors operating the smart routing technology, changing the way orders are reported from intra-day to end-of-day and making the process more inefficient and error-prone. Other proposed initiatives, if adopted, will only serve to exacerbate the problem as restrictions on trading through a superior price in another trading center causes trading to become further dispersed over multiple venues. *See* Securities Exchange Act Release No. 34-50870 (December 16, 2004) re-proposing SEC Regulation NMS.

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reporting and infrastructure costs. If regulators determine, after receiving public comment, that OATS could serve as a consolidated audit trail for the equity markets, operational and competitive issues as noted above must be addressed. As noted above, a suggested alternative would be for an industry utility such as DTCC to implement and maintain a consolidated order audit trail on behalf of the SROs.

The NASD acknowledges in the Notice that a proposed rule change must be authorized for filing with the SEC by the NASD Board of Directors and then must be approved by the SEC before becoming effective. In a footnote, the NASD cites to Section 19 of the Securities Exchange Act of 1934 (the "Act"), which permits certain limited types of proposed rule changes to take effect upon filing with the SEC. Although these proposed changes arguably could fall into that category, the Committees strongly believe that the extensive changes that would be required for both members and non-members dictate that any such rule change be filed for notice and comment under Section 19(b)(2) of the Act.

Thank you for the opportunity to comment. If you have any questions, or would like to discuss our comments further, please contact the undersigned or Richard Bommer, Director, Operations, at 212.608.1500.

Sincerely,

Stuart Bowers
Chairman
SIA Operations Committee

CC: Donald D. Kittell
John D. Panchery
Operations Committee