

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-49439; File No. SR-NASD-2004-023)

March 17, 2004

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and  
Amendment No. 1 Thereto by National Association of Securities Dealers, Inc. To Amend  
Order Audit Trail System Rules Relating to Execution Reports

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on February 5, 2004, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. On March 11, 2004, NASD filed Amendment No. 1 to the proposed rule change.<sup>3</sup> 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. The text of the proposed rule appears below. Proposed new text is in italics. Deleted text is in brackets.

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NASD SYSTEMS AND PROGRAMS

**6950. ORDER AUDIT TRAIL SYSTEM**

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See letter from Barbara Z. Sweeney, Senior Vice President and Corporate Secretary, NASD to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated March 10, 2004 (“Amendment No. 1”). Amendment No. 1 replaces the proposed rule change in its entirety.

6951. through 6953. No Changes.

**6954. Recording of Order Information**

(a) through (c) No Changes.

**(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,<sup>2</sup>[ and]

(I) the execution price,

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

(e.g., agency, principal or riskless principal), and

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

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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 Commission approved NASD Rules 6950 through 6957 (“OATS Rules”).<sup>4</sup> NASD represents that OATS provides a substantially enhanced body of information regarding orders and transactions that NASD believes improves its 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 (i.e., the capacity in which the member acted for purposes of the transaction, for example, on an agency, principal or riskless principal basis) information from trading information rather than from 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”).<sup>5</sup> 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.

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<sup>4</sup> See Securities Exchange Act Release No. 39729 (March 6, 1998), 63 FR 12559 (March 13, 1998) (SR-NASD-97-56).

<sup>5</sup> ACT is an automated system owned and operated by Nasdaq that captures transaction information on a real-time basis.

NASD believes that recently, however, the “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. Furthermore, NASD believes that 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. NASD represents that 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. NASD represents that 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 now is proposing only a subset of one of the four proposals, which NASD 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 proposed rule change adds two additional data elements that typically are accessible with the other information required in an OATS Execution Report, NASD does not believe that the proposed rule change will be overly burdensome

to members. Furthermore, by having this data reported directly in the OATS Execution Report, NASD believes that it 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,<sup>6</sup> 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 also 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 impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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 proposals to the OATS Rules. The comment period expired on July 10,

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<sup>6</sup> 15 U.S.C. 78q-3(b)(6).

2002. Ten comment letters were received in response to the Notice.<sup>7</sup> Copies of the Notice and the comment letters have been provided to the Commission. Of the 10 letters, three were in favor of the proposed rule change and seven were opposed to the proposed rule change. The majority of the commenters expressed concern that the proposed rule change was unnecessarily burdensome.

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.

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<sup>7</sup> Comment letters were received from Allen J. Thomas, Vice President, Manager of Trade Processing, A.G. Edwards & Sons, Inc.; Andrea Psoras; Thomas Murphy, Vice President, Bishop, Rosen & Co., Inc.; Kevin M. Foley, Bloomberg Tradebook LLC; W. Leo McBlain, Chairman, Financial Information Forum; Michele Samuelson, Compliance Trading Specialist, First Allied Securities, Inc.; Gregory M. Power, Vice President, Jefferies & Company, Inc.; John L. Keeley, Jr., Keeley Investment Corp.; David Wells, Program Trading Corp.; and Cindy D. Foster, SunGuard Trading Systems.

The proposed rule change is two components of the Execution Report Proposal described above. NASD believes that it is important to note that the proposed rule change 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 NASD 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, NW, Washington, DC 20549-0609. Comments may also be submitted electronically at the following e-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. SR-NASD-2004-023. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your 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 File No. SR-NASD-2004-023 and should be submitted by [insert date 21 days from date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>8</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>8</sup> 17 CFR 200.30-3(a)(12).