

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-63311; File No. SR-FINRA-2010-044)

November 12, 2010

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving a Proposed Rule Change Relating to the Expansion of the Order Audit Trail System to All NMS Stocks

I. Introduction

On August 6, 2010, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> a proposed rule change to amend its Order Audit Trail System rules to extend the recording and reporting requirements to all NMS stocks and to exclude certain firms that have limited trading activities. The proposed rule change was published for comment in the Federal Register on August 25, 2010.<sup>2</sup> The Commission received three comment letters on the proposed rule change.<sup>3</sup> FINRA responded to these comment letters in a letter dated October 28, 2010.<sup>4</sup> This order approves the proposed rule change.

II. Description of Proposal

FINRA Rules 7410 through 7470 (the “OATS Rules”) impose obligations on FINRA members to record in electronic form and report to FINRA, on a daily basis, certain information

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

<sup>2</sup> See Securities Exchange Act Release No. 62739 (August 18, 2010), 75 FR 52380.

<sup>3</sup> See letter from Steve Allread, Equity Trader, Cutter Company, to Commission, dated September 10, 2010 (“Cutter Letter”); letter from Joan Conley, Senior Vice President and Corporate Secretary, Nasdaq OMX Group, Inc., to Elizabeth M. Murphy, Secretary, Commission, dated September 15, 2010 (“Nasdaq Letter”); and letter from Manisha Kimmel, Executive Director, Financial Information Forum, to Elizabeth M. Murphy, Secretary, Commission, dated September 17, 2010 (“FIF Letter”).

<sup>4</sup> See letter from Brant K. Brown, Associate General Counsel, FINRA, to Elizabeth M. Murphy, Secretary, Commission, dated October 28, 2010 (“FINRA Response”).

with respect to orders originated, received, transmitted, modified, canceled, or executed by members in OTC equity securities and equity securities listed and traded on The Nasdaq Stock Market, Inc. (“Nasdaq”).<sup>5</sup> This information is used by FINRA staff to oversee the markets and to determine if members are complying with FINRA’s rules.

FINRA is proposing to extend the OATS recording and reporting requirements to cover all NMS securities.<sup>6</sup> FINRA is also proposing to exclude from the definition of “Reporting Member”<sup>7</sup> in FINRA Rule 7410 certain firms that became FINRA members pursuant to NASD IM-1013-1 (Membership Waive-In Process for Certain New York Stock Exchange Member Organizations), or NASD IM-1013-2 (Membership Waive-In Process for Certain NYSE Alternext US LLC<sup>8</sup> Member Organizations), and the rules of the NYSE,<sup>9</sup> and that engage in the floor activities permitted in NASD IM-1013-1 and IM-1013-2 and receive orders through systems operated and regulated by the NYSE or NYSE Amex.

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<sup>5</sup> As amended by SR-FINRA-2010-003, FINRA Rule 7410 defines an “OTC equity security” for purposes of the OATS Rules as an equity security that is not an NMS stock, except that the term does not include restricted equity securities and direct participation programs, as those terms are defined in FINRA Rule 6420. See Securities Exchange Act Release No. 61979 (April 23, 2010), 75 FR 23316 (May 3, 2010) (Order Approving File No. SR-FINRA-2010-003).

<sup>6</sup> Rule 600(b)(47) of Regulation NMS defines “NMS stock” as “any NMS security other than an option.” 17 CFR 242.600(b)(47). An “NMS security” is defined as “any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.” 17 CFR 242.600(b)(46).

<sup>7</sup> A “reporting member” is defined in FINRA Rule 7410(o) as a member that receives or originates an order and has an obligation to record and report information under Rules 7440 and 7450.

<sup>8</sup> In March 2009, NYSE Alternext US LLC changed its name to NYSE Amex LLC (“NYSE Amex”). See Securities Exchange Act Release No. 59575 (March 13, 2009), 74 FR 11803 (March 19, 2009).

<sup>9</sup> See NYSE Rule 2.

### III. Discussion of Comment Letters

The Commission received three comment letters on the proposed rule change and FINRA responded to these comments.<sup>10</sup> One commenter, FIF, supported the proposal, but specified a variety of terms and provisions that it believed should be incorporated by FINRA in its expansion of OATS.<sup>11</sup> Specifically, FIF suggested that FINRA ensure that the terms currently used in the Order Tracking System (OTS) Rules are harmonized with those used in the OATS Rule and noted, for example, that account types currently are treated differently by NYSE and FINRA. The commenter suggested using the “FIX” protocol to ensure standardization. FIF also requested that FINRA take into consideration that certain FINRA member firms do not have MPIDs, which are required for OATS reporting, and that FINRA configure OATS to accept symbols under the different Nasdaq and NYSE symbology plans.

FIF suggested that FINRA enhance its capacity and processing bandwidth to accommodate the millions of additional OATS reports it would receive under the proposed rule to ensure timely processing of files and error free testing. FIF also requested that FINRA extend the deadline to submit reports due to the additional volume of reports that would be required. FIF also requested an extension of the current time frame for members to repair and resubmit OATS rejections.<sup>12</sup>

FINRA responded to these comments by stating that it is currently reviewing OATS for potential efficiencies and will consider the issues raised with respect to revising its reporting and rejection repair and resubmission deadlines, as well as capacity limitations. FINRA believes that a phased-in approach for inclusion of NMS stocks in OATS is acceptable.

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<sup>10</sup> See supra notes 3 and 4.

<sup>11</sup> See FIF Letter, supra note 3.

<sup>12</sup> See FIF Letter, supra note 3.

FIF also requested that FINRA adopt an exemption for, or provide additional time for inclusion in OATS of, convertible and non-convertible preferred stock listed on the NYSE explaining that these securities managed by firms' Fixed Income Desks and systems and may not be easily reportable on existing platforms.

FINRA responded that NYSE's current OTS rules do not contain an exemption for preferred stock, and therefore, members are already required to capture order information for these securities. Consequentially, FINRA does not believe that preferred stock should be exempted from OATS, or that it should provide additional time for implementation of the requirement.

Another commenter questioned the regulatory usage of the data that currently is required to be submitted to OATS.<sup>13</sup> In response, FINRA explained that it currently uses OATS data to conduct surveillance and investigations of its members, and that the expansion of this data to include NMS securities traded on other exchanges would enhance FINRA's ability to surveil its members' trading activity across multiple markets.

The third commenter, Nasdaq, argued that the timing of the OATS proposal, in light of the Commission's proposed consolidated audit trail, is an effort by FINRA to make OATS the default consolidated audit trail choice for the industry, and submitted questions for FINRA regarding the cost, timing and use of its proposal.<sup>14</sup> In response, FINRA stated that its proposal is not intended to replace the Commission's consolidated audit trail proposal, and that FINRA views it instead as an effort to improve its own regulatory oversight. It recognized that the proposal may impose costs on its members, but believes that most of those affected would

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<sup>13</sup> See Allread Letter, supra note 3.

<sup>14</sup> See Nasdaq Letter, supra note 3.

already have in place the OTS infrastructure, which would allow them to adopt the proposed changes quickly.

#### IV. Commission Findings

The Commission has carefully reviewed the proposed rule change, the comments received, and FINRA's response to the comments, and finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.<sup>15</sup> In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Act,<sup>16</sup> which, among other things, requires that FINRA rules 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 Commission believes that the proposed rule change, by requiring members to record and report order information for all NMS stocks, not just those securities listed on Nasdaq or traded over-the-counter, will enhance FINRA's market surveillance and investigative capabilities. FINRA has stated that it is currently unable to view a complete order and transaction audit trail for all over-the-counter transactions in NMS stocks; thus, the proposed expansion of surveillance to NMS stocks listed on non-Nasdaq markets should enhance FINRA's oversight of the U.S. equity markets.

The Commission believes the proposed rule change is a positive step toward a cross-market audit trail. The Commission views FINRA's proposed expansion of OATS as an interim measure that will improve FINRA's regulatory capabilities by broadening its oversight. The

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<sup>15</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>16</sup> 15 U.S.C. 78o-3(b)(6).

Commission notes that FINRA’s proposal will also remove redundancies, as FINRA has represented that OTS is expected to be retired by NYSE upon the expansion of OATS.

Additionally, the Commission agrees that FINRA’s amendment to its definition of “Reporting Members” is appropriate, as it excludes from the OATS recording and reporting requirements those members who conduct a floor business through NYSE and NYSE Amex and who are currently not subject to OTS, but to the requirements of NYSE Rule 123 and NYSE Amex Equities Rule 123 (Record of Orders).<sup>17</sup> By exempting these members from the OATS requirements, FINRA is not altering their current audit trail obligations.<sup>18</sup> The Commission believes that FINRA’s proposed amendment to Rule 7410 is appropriate as these members would continue to be required to record and report information under NYSE Rule 123 and NYSE Amex Equities Rule 123, and would continue to be subject to FINRA regulation.

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<sup>17</sup> NYSE Rule 123 and NYSE Amex Equities Rule 123 pertain to orders or commitments or obligations to trade originated on or transmitted to the floor of each exchange.

<sup>18</sup> These members would be subject to FINRA’s oversight, as FINRA assumed the market surveillance and enforcement functions of NYSE Regulation, Inc. in June 2010, pursuant to a multi-party regulatory services agreement with NYSE Regulation, Inc., NYSE, NYSE Amex, and NYSE Arca. See “FINRA and NYSE Euronext Complete Agreement for FINRA to Perform NYSE Regulation’s Market Oversight Functions,” FINRA News Release (June 14, 2010), available at <http://www.finra.org/Newsroom/NewsReleases/2010/P121622>.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>19</sup> that the proposed rule change (SR-FINRA-2010-044), be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>20</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>19</sup> 15 U.S.C. 78s(b)(2).

<sup>20</sup> 17 CFR 200.30-3(a)(12).