

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-65692; File No. SR-FINRA-2011-063)

November 4, 2011

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change Relating to Amendments to the 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 October 28, 2011, Financial Industry Regulatory Authority, Inc. (“FINRA”) 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 FINRA. 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

FINRA is proposing to amend (i) Rules 5320 and 7440 to require that members report to the Order Audit Trail System (“OATS”) information barriers put into place by the member in reliance on Supplementary Material .02 to Rule 5320; (ii) Rule 7440 to require that members report customer instructions regarding the display of a customer’s limit order in any OATS-eligible security; and (iii) Rule 7450 to codify the specific time OATS reports must be transmitted to FINRA.

The text of the proposed rule change is available on FINRA’s website at <http://www.finra.org>, at the principal office of FINRA and at the Commission’s Public Reference Room.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

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

In its filing with the Commission, FINRA 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. FINRA 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, Proposed Rule Change

1. Purpose

FINRA is proposing two changes to the order recording requirements in Rule 7440 of the OATS rules to reflect two recent amendments to other FINRA rules. First, the proposed rule change requires members relying on the “No-Knowledge Exception” in Supplementary Material .02 to Rule 5320 (Prohibition Against Trading Ahead of Customer Orders) to report information to OATS regarding the information barriers adopted by the member in reliance on the exception. The proposed rule change also adds this requirement into Supplementary Material .02 of Rule 5320. Second, the proposed rule change extends the existing requirement to reflect on OATS reports a customer’s instruction regarding display of the customer’s limit orders. The requirement currently applies only to limit orders involving NMS stocks; the proposed rule change extends the requirement to all OATS-eligible securities.

FINRA is also proposing amendments to Rule 7450 to codify the specific time by which OATS reports must be transmitted to FINRA.

(1) Customer Order Protection

First, FINRA is proposing to require members to identify on OATS reports information barriers that the member has in place in reliance on the No-Knowledge Exception in Supplementary Material .02 to Rule 5320.

On February 11, 2011, the SEC approved FINRA's proposed rule change to consolidate NASD Rule 2111 and IM-2110-2 into new FINRA Rule 5320.³ Under Rule 5320, a member that accepts and holds an order in an equity security from its own customer, or a customer of another broker-dealer, without immediately executing the order is prohibited from trading that security on the same side of the market for its own proprietary account at a price that would satisfy the customer order unless the member immediately thereafter executes the customer order up to the size and at the same, or better, price at which the member traded for its proprietary account. The No-Knowledge Exception in Supplementary Material .02 to Rule 5320 provides that if a firm implements and uses an effective system of internal controls—such as appropriate information barriers—that operate to prevent one trading unit from obtaining knowledge of customer orders held by a separate trading unit, those other trading units may trade in a proprietary capacity at prices that would satisfy the customer orders held by the separate, walled-off trading unit.⁴

When FINRA originally proposed Rule 5320, members claiming the No-Knowledge Exception would have been required to assign and use a unique market participant identifier (“MPID”) for any walled-off market-making desk.⁵ In response to commenters' concerns with the proposed MPID requirement, FINRA amended the proposal to delete the unique MPID

³ See Securities Exchange Act Release No. 63895 (February 11, 2011), 76 FR 9386 (February 17, 2011).

⁴ The Commission notes that the No-Knowledge Exception in Supplementary Material .02 to FINRA Rule 5320 contains different procedures for OTC equity securities.

⁵ See Securities Exchange Act Release No. 61168 (December 15, 2009), 74 FR 68084 (December 22, 2009).

requirement, but stated that it intended to examine alternative means of achieving the same regulatory objective of being able to determine on an automated basis those customer orders that are received from walled-off desks.⁶ The proposed rule change accomplishes the objective by adding provisions to the No-Knowledge Exception and to Rule 7440 that require firms relying on the exception to identify the information barriers to FINRA in their OATS reports.⁷

Through the use of OATS, FINRA will be able to ascertain, on an automated basis, those firms claiming the No-Knowledge Exception. This will reduce the potential for “false positive” alerts by allowing FINRA to account for the existence of information barriers when running automated surveillance patterns designed to identify inappropriate trading ahead of customer orders. FINRA believes that the new requirements will substantially reduce the number of “false positives” that are identified through automated surveillance patterns by being able to account for information barriers when trading ahead may otherwise be indicated.

(2) Limit Order Display

Rule 7440(b)(14) requires OATS Reporting Members to identify “any request by a customer that an order not be displayed, or that a block size order be displayed, pursuant to Rule 604(b) of SEC Regulation NMS.”⁸ These customer requests are identified in the OATS system

⁶ See Securities Exchange Act Release No. 63895 (February 11, 2011), 76 FR 9386 (February 17, 2011).

⁷ Members are permitted to report this information to OATS on a voluntary basis. See OATS Reporting Technical Specifications, at iii (ed. May 3, 2011); see also OATS for all NMS Stocks Frequently Asked Questions, Question 12, available at www.finra.org/oats. FINRA has encouraged members to do so to avoid “false positive” results that can be caused by automated surveillance patterns aggregating trading data without regard to information barriers that firms have put in place pursuant to the No-Knowledge Exception. See Regulatory Notice 11-24, n.12 (May 2011). The proposed rule change would make reporting of the information mandatory for those members relying on the No-Knowledge Exception.

⁸ Rule 604 of SEC Regulation NMS generally requires OTC market makers in NMS stocks to display customer limit orders that would improve the market maker’s published bid or

through a “Customer Instruction Flag” that indicates whether the customer has requested that the firm handle its limit order in a specified way. Because of the reference in Rule 7440(b)(14) to SEC Regulation NMS, members are only required to populate the Customer Instruction Flag when the order involves a security subject to SEC Regulation NMS.

On June 22, 2010, the Commission approved Rule 6460,⁹ which became effective on May 9, 2011.¹⁰ Rule 6460 generally requires OTC market makers to display a customer limit order in an OTC equity security held by the OTC market maker that is at a price that would improve the bid or offer of such OTC market maker in such security or that would represent more than a de minimis change in relation to the size associated with the OTC market maker's bid or offer. Rule 6460(b) includes exceptions to the display requirement for OTC equity securities that mirror the exceptions in Rule 604(b) of SEC Regulation NMS.¹¹

FINRA is proposing to require that OATS Reporting Members indicate on all OATS reports for customer limit orders, including OTC equity securities, whether the customer has instructed the member not to display the limit order or to display a limit order of block size. As a result, OATS Reporting Members would be required to populate the Customer Instruction Flag for all limit orders, not just those involving NMS stocks. Use of the Customer Instruction Flag for all limit orders reported to OATS will notify FINRA that a customer has requested display of

offer (either by price or size). See 17 CFR 242.604(a)(2). Rule 604(b)(2) of SEC Regulation NMS excepts from the display requirement any customer limit order that is placed by a customer who expressly requests that the order not be displayed. See 17 CFR 242.604(b)(2). Rule 604(b)(4) of SEC Regulation NMS excepts from the display requirement any customer limit order of block size unless the customer requests that the order be displayed. See 17 CFR 242.604(b)(4).

⁹ See Securities Exchange Act Release No. 62359 (June 22, 2010), 75 FR 37488 (June 29, 2010).

¹⁰ See Regulatory Notice 10-42 (September 2010).

¹¹ See FINRA Rule 6460(b)(2), (b)(4).

a limit order that would not otherwise be required to be displayed under applicable rules as well as avoid potential “false positives” generated by customer limit orders that are not being displayed due to the customer’s request.

(3) Order Data Transmission Requirements

Rule 7450 requires members to report order information recorded pursuant to Rule 7440. Paragraph (a) of the rule imposes the general requirement that members report applicable order information to FINRA that the member is required to record by Rule 7440. Paragraph (b) of the rule addresses the form the order data must take and the timing of order reports. Paragraph (c) concerns the use of reporting agent agreements that a member may use to allow a third party to report information to OATS on behalf of the member. The proposed rule change amends paragraph (b) of Rule 7450 to codify the specific time OATS reports must be transmitted to FINRA, which is the same time that currently is required under the OATS Reporting Technical Specifications, as described in more detail below.

Rule 7450(b) provides that, generally, reports should be transmitted on the day of the order event unless information is not available.¹² In addition, if the member aggregates information, the information must be transmitted “during such business hours as may be prescribed by FINRA.”

The proposed rule change would update the language in the rule, which has not been changed substantially since it was adopted in 1998, and codify a specific deadline that members

¹² FINRA announced that OATS reports would be marked late if submitted after 8:00 a.m. Eastern Time on the calendar day following the OATS Business Day on which the order event occurred in the May 3, 2011 edition of the OATS Reporting Technical Specifications. See OATS Reporting Technical Specifications, at 8-1 (ed. May 3, 2011). Previously, OATS reports were marked late if received after 5:00 a.m. Eastern Time. See OATS Reporting Technical Specifications, at 8-1 (ed. November 8, 2010); Letter from

must meet. When the rule language was adopted, and before OATS reporting was implemented in 1999, the rule language acknowledged that firms could choose to report OATS data to FINRA on a rolling basis throughout the day, or reports could be aggregated into one or more transmissions and submitted “during such business hours as may be prescribed by [FINRA].” This rule language further reflected the fact that, at the time the rules were proposed, issues involving the capacity of OATS and technological changes could affect the manner and timing of transmitting order information to OATS. In its initial filing with the Commission, FINRA noted:

Based on further development of the Order Audit System and determinations relating to system capacity and other factors, NASDR will prescribe the hours during which information may be transmitted. The prescribed hours likely will extend past the end of the trading day. The proposal contemplates that all Order information, along with corresponding ACT data that has been integrated with such information, will be available to NASDR staff at the beginning of the trading day following the day on which the information has been transmitted.¹³

FINRA (then NASDR) began testing the capabilities of its systems in August 1998 in anticipation of the implementation of Phase One of OATS in early 1999.¹⁴ In the November 30, 1998 version of the OATS Reporting Technical Specifications, FINRA prescribed that, for purposes of OATS reporting, an OATS business day would begin after the close of the Nasdaq Stock Market on one market day (4:00:01 p.m. Eastern Time) and end with the close of the Nasdaq Stock Market on the next market day (4:00:00 p.m. Eastern Time). Orders received during an OATS business day would be required to be submitted to OATS by 4:00:00 a.m.

Brant Brown, Associate General Counsel, FINRA, to Elizabeth Murphy, Secretary, SEC (October 28, 2010) relating to SR-FINRA-2010-044.

¹³ See Securities Exchange Act Release No. 38990 (August 28, 1997), 62 FR 47096, 47103 (September 5, 1997) (Notice of Filing of Proposed Rule Change SR-NASD-97-56).

¹⁴ See SR-NASD-97-56, Amendment No. 4; NASD Special Notice to Members 98-33 (March 1998).

Eastern Time the following calendar day.¹⁵ This was intended to provide firms with adequate time to aggregate data files and transmit them to FINRA before the beginning of the next trading day.

FINRA is proposing to replace the current rule language regarding the timing of OATS transmissions to FINRA with a specific requirement. Under the proposed rule, all order events that occur on a particular OATS Business Day must be transmitted to FINRA by 8:00 a.m. Eastern Time on the calendar day following the end of the OATS Business Day. For purposes of the rule, an “OATS Business Day” begins at 4:00:01 p.m. Eastern Time on one market day and ends at 4:00:00 p.m. Eastern Time on the next market day.¹⁶ FINRA is retaining the exception for information that is not available by the time the report must be transmitted; in such cases, the report must be transmitted on the day that the information becomes available.¹⁷

¹⁵ See NASD Notice to Members 99-04 (January 1999). FINRA extended the time from 4:00 a.m. Eastern Time to 5:00 a.m. Eastern Time in 2007 connection with the expansion of OATS to OTC equity securities. See August 21, 2007 Addendum to OATS Reporting Technical Specifications (ed. August 6, 2007).

¹⁶ Thus, for example, assuming no holidays, if an order is received at 5:00:00 p.m. Eastern Time on Wednesday, the order event occurs on the OATS Business Day ending Thursday at 4:00:00 p.m. Eastern Time. Receipt of the order (and any subsequent event(s) regarding the order until Thursday at 4:00:00 p.m. Eastern Time) must be reported by 8:00:00 a.m. on Friday. Order events occurring on market days during regular market hours (i.e., before 4:00:01 p.m. Eastern Time) are reported by 8:00:00 a.m. Eastern Time on the following calendar day.

¹⁷ This provision was initially intended to address circumstances where complete information is not available at the time an order report must be submitted (for example, where an order is executed over the course of multiple days, and the total execution information is not available on the same day the order is received). See Securities Exchange Act Release No. 38990 (August 28, 1997), 62 FR 47096 (September 5, 1997). The provision was amended in 2006 to also address circumstances where a firm has traded a security that has not been assigned a symbol and can report the information only after a symbol has been requested, which must be done promptly, and assigned. See Securities Exchange Act Release No. 54585 (October 10, 2006), 71 FR 61112 (October 17, 2006); Notice to Members 06-70 (December 2006).

The effective date of the proposed rule change will be no later than 120 days after Commission approval.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹⁸ which requires, among other things, that FINRA 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. FINRA believes that the proposed rule change will enhance FINRA's automated surveillance systems by providing customer instruction information relating to limit orders and significantly reducing the incidence of "false positive" results caused by identifying permitted trading activity in automated surveillance patterns. By reducing "false positive" results, FINRA can focus its resources on trading activity that has properly been identified as warranting further regulatory scrutiny, thus promoting just and equitable principles of trade and protecting investors and the public interest. FINRA also believes that codifying the time by which OATS reports must be submitted will promote just and equitable principles of trade by ensuring that all members are aware of their reporting obligations.

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

FINRA 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.

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.

¹⁸ 15 U.S.C. 78o-3(b)(6).

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 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 or disapprove 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. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2011-063 on the subject line.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2011-063. 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, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). 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 website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2011-063 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁹

Kevin M. O'Neill
Deputy Secretary

¹⁹ 17 CFR 200.30-3(a)(12).