

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-62739; File No. SR-FINRA-2010-044)

August 18, 2010

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

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 August 6, 2010, the 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 and II 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 the Order Audit Trail System (“OATS”) rules to extend the recording and reporting requirements to all NMS stocks, as that term is defined in Rule 600(b)(47) of Regulation NMS,³ and to exclude certain firms that became FINRA members pursuant to NASD IM-1013-1 or NASD IM-1013-2 and the rules of the NYSE and that have limited trading activities.

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

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 17 CFR 242.600(b)(47).

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, the Proposed Rule Change

1. Purpose

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 with respect to orders originated, received, transmitted, modified, canceled, or executed by members relating to OTC equity securities and equity securities listed and traded on The Nasdaq Stock Market, Inc. (“Nasdaq”).⁴ OATS captures this order information and integrates it with quote and transaction information to create a time-sequenced record of orders, quotes, and transactions. This information is then used by FINRA staff to conduct surveillance and investigations of member firms for violations of FINRA rules and federal securities laws.

To enhance the effectiveness of OATS as a regulatory tool, FINRA is proposing to amend the OATS Rules to extend the recording and reporting requirements to all NMS stocks, as

⁴ 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).

that term is defined in Rule 600(b)(47) of Regulation NMS.⁵ The proposed rule change would thus effectively extend the OATS recording and reporting requirements to NMS stocks listed on markets other than Nasdaq (e.g., NYSE, NYSE Amex, and NYSE Arca). By including order information for both OTC equity securities and all NMS stocks in OATS, FINRA would receive a substantial portion of order information for all U.S. equity securities, which would significantly enhance the scope of the order audit trail in the U.S. equity markets. In connection with the expansion of the OATS requirements, FINRA is also proposing to create an exclusion from the definition of “Reporting Member” in FINRA Rule 7410 to exclude certain firms that became FINRA members pursuant to NASD IM-1013-1 or NASD IM-1013-2 and the rules of the NYSE and that have limited trading activities.

Although FINRA members generally are required to report trades to FINRA for all over-the-counter transactions in all NMS stocks⁶ (in addition to OTC equity securities⁷), the OATS Rules do not currently require members to report order information to FINRA for NMS stocks listed on markets other than Nasdaq. As a result, FINRA is unable to recreate, on an automated basis, a complete order and transaction audit trail for all over-the-counter transactions in NMS stocks. Expansion of the OATS requirements to include all NMS stocks would enhance FINRA’s ability to review and examine for member compliance with certain trading rules, including, but not limited to, NASD Rule 2320 (Best Execution and Interpositioning) and NASD IM-2110-2 (Limit Order Protection) [sic].

⁵ 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).

⁶ FINRA Rule 6110.

⁷ See FINRA Rule 6400 Series.

By capturing OATS information for all NMS stocks, FINRA will also be able to expand its existing surveillance patterns to conduct more comprehensive cross-market surveillance, which also is in furtherance of NYSE's recent outsourcing of surveillance and other regulatory functions to FINRA.⁸ Specifically, to have comprehensive surveillance patterns that monitor trading in Nasdaq and NYSE-listed securities across all markets in a consistent manner, it is necessary for FINRA to have the same complement of order, trade, and quote information for these securities. Without OATS information for NYSE-listed securities, FINRA has a less robust data set upon which to monitor activity in NYSE-listed securities and would be forced to continue to have multiple patterns, some less optimal, to surveil for the same activity.

FINRA notes that the Commission has recently published a proposed rule that, if adopted, would ultimately result in a consolidated audit trail for the U.S. securities markets.⁹ FINRA believes that the proposed rule change is necessary notwithstanding the Commission's rule proposal concerning a consolidated audit trail. The consolidated audit trail, as proposed by the Commission, is still in its proposal stage and may be several years away from providing a means by which self-regulatory organizations and the Commission can use the data to surveil the equity markets.¹⁰ In the interim, FINRA believes that extending the OATS recording and reporting requirements to NMS stocks listed on markets other than Nasdaq will greatly enhance

⁸ 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 www.finra.org/Newsroom/NewsReleases/2010/P121622. However, certain gaps will continue to exist (e.g., information relating to orders from non-FINRA member broker-dealers).

⁹ See Securities Exchange Act Release No. 62174 (May 26, 2010), 75 FR 32556 (June 8, 2010).

¹⁰ The Commission has proposed that national securities exchanges and national securities associations would begin submitting data to the central repository required by the proposed rule within one year after effectiveness of the NMS plan and that members would begin submitting data one year later. See *supra* note 9.

its audit trail and its ability to identify illicit trading activity in a more effective and efficient manner.

Moreover, because Reporting Members¹¹ already are reporting order information to OATS regarding Nasdaq and OTC equity securities, they should have the technological framework in place to report information regarding orders in the remaining NMS stocks as well. In addition, those FINRA members that are also member organizations of the NYSE already are recording order information under the NYSE's Order Tracking System ("OTS") rules that is substantially similar to the information required by the OATS Rules.¹² FINRA believes that extending the OATS Rules to NMS stocks listed on markets other than Nasdaq can be accomplished in a comparatively short timeframe and can provide FINRA with order data for these securities much sooner than the consolidated audit trail proposed by the Commission.

Expanding the categories of securities to which the OATS Rules apply to include securities listed on the NYSE or other national securities exchanges, such as those listed on NYSE Amex, would have the ancillary effect of extending the OATS recording and reporting requirements to certain members that became members of FINRA pursuant to NASD IM-1013-1 or IM-1013-2¹³ and the rules of the NYSE.¹⁴ These members generally conduct their trading activities on the floor of an exchange, which is overseen by the relevant exchange. FINRA believes it is appropriate to exclude these firms from the OATS recording and reporting

¹¹ See FINRA Rule 7410(o).

¹² See NYSE Rules 132B, 132C.

¹³ NASD IM-1013-1 and NASD IM-1013-2 establish a waive-in membership application process for certain firms to become FINRA members that were members of the NYSE or NYSE Alternext (n/k/a NYSE Amex) but were not members of the National Association of Securities Dealers, Inc. See Securities Exchange Act Release No. 58707 (October 1, 2008), 73 FR 59001 (October 8, 2008); Securities Exchange Act Release No. 56653 (October 12, 2007), 72 FR 59127 (October 18, 2007).

¹⁴ See NYSE Rule 2.

requirements. Consequently, FINRA is proposing to amend the definition of “Reporting Member” in FINRA Rule 7410 so that a member will not be considered a “Reporting Member” with respect to an order if: (i) the firm was approved as a FINRA member pursuant to NASD IM-1013-1 or NASD IM-1013-2; (ii) the firm operates consistent with NASD IM-1013-1 or NASD IM-1013-2, including limiting its business operations to “permitted floor activities,” as that term is defined in NASD IM-1013-1 and NASD IM-1013-2; and (iii) the order was received by the firm through systems operated and regulated by the NYSE or NYSE Amex.

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 180 days following publication of the Regulatory Notice announcing 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,¹⁵ 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. The proposed rule change is consistent with the Act because it will enhance FINRA’s ability to conduct surveillance and investigations of member firms for violations of FINRA’s rules and federal securities laws.

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.

¹⁵ 15 U.S.C. 78q-3(b)(6).

C. Self-Regulatory Organization’s Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in Notice to Members 04-80 (November 2004).¹⁶ Eight comments were received in response to the Notice.¹⁷ A copy of the Notice is attached as Exhibit 2a. Copies of the comment letters received in response to the Notice are attached as Exhibit 2b.¹⁸ Seven commenters were generally opposed to the proposed rule change. One commenter generally supported the proposal provided firms could report all equity securities in the same format and there were no redundant reporting responsibilities.¹⁹

One commenter opposed the proposed rule change without additional discussion but noted that the system in place for OATS at the time was inefficient in several ways.²⁰ Two other

¹⁶ Three other proposals were discussed in the Notice. The first involved expanding the OATS requirements to OTC equity securities. The second would require enhanced information, including execution data, relating to orders routed to non-members or exchanges. The third would require members to record and report to OATS proprietary orders generated in the ordinary course of market making activities. The proposal regarding OTC equity securities was approved by the SEC in 2006 and became effective on February 4, 2008. See Securities Exchange Act Release No. 54585 (October 10, 2006), 71 FR 61112 (October 17, 2006); see also Securities Exchange Act Release No. 55440 (March 9, 2007), 72 FR 12852 (March 19, 2007); Notice to Members 06-70 (December 2006). As part of that proposed rule change, FINRA discussed the comments related to the expansion of OATS to OTC equity securities. See SR-NASD-2005-101. Neither of the other two proposals is part of the current proposed rule change. Accordingly, FINRA is not addressing the comments received in response to those proposals.

¹⁷ Letter from Emily Vitale dated November 24, 2004 (“Vitale”); Letter from ML Stern & Co., LLC dated January 14, 2005 (“ML Stern”); Letter from Ameritrade, Inc. dated January 18, 2005 (“Ameritrade”); Letter from Instinet Group dated January 20, 2005 (“Instinet”); Letter from Operations Committee of the Securities Industry Association dated January 20, 2005 (“SIA”); Letter from royalblue Financial Corp. dated January 20, 2005 (“royalblue”); Letter from Jed Bades dated January 20, 2005 (“Bades”); and Letter from The Financial Information Forum dated January 21, 2005 (“FIF”).

¹⁸ The Commission notes that Exhibits 2a and 2b are attached to the filing itself and not to this notice.

¹⁹ See Ameritrade.

²⁰ See ML Stern.

commenters opposed the OATS rules generally, without specifically commenting on any of the proposals.²¹ These commenters cited the additional costs and burdens to member firms of complying with the OATS requirements.

The predominant concern among the commenters with respect to the proposal to extend the OATS Rules to securities traded on markets other than Nasdaq regarded the potential regulatory duplication that could occur by expanding OATS to include NYSE-listed equity securities²² because NYSE maintains its own rules regarding the retention and reporting of order information in its OATS Rules.²³ As noted above, FINRA now has regulatory responsibility for performing the market surveillance and enforcement functions previously conducted by NYSE Regulation. It is FINRA's understanding that NYSE will propose to retire OATS upon the expansion of OATS to all NMS stocks.

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.

²¹ See Bandes, Vitale.

²² See Ameritrade, FIF, Instinet, SIA, royalblue.

²³ See NYSE Rules 132B, 132C.

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 No. SR-FINRA-2010-044 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 No. SR-FINRA-2010-044. 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 Web site (<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 Web site 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 No. SR-FINRA-2010-044 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.²⁴

Florence E. Harmon
Deputy Secretary

²⁴ 17 CFR 200.30-3(a)(12).