

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53580; File No. SR-NASD-2006-040)

March 30, 2006

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change to Expand NASD's Order Audit Trail System Exemptive Authority to Include Recording Requirements

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4² thereunder, notice is hereby given that on March 28, 2006, the National Association of Securities Dealers, Inc. ("NASD") 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 NASD. The Commission is publishing this notice and order to solicit comments on the proposed rule change from interested persons and to approve the proposal on an accelerated basis.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

NASD is proposing to expand NASD's current Order Audit Trail System (OATS) exemptive authority to include recording requirements. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in [brackets].³

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6950. Order Audit Trail System

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The proposed changes indicated herein are based on rule text approved by the SEC on September 28, 2005, which become effective on May 8, 2006. See Securities Exchange Act Release No. 52521 (September 28, 2005), 70 FR 57909 (October 4, 2005) (File No. SR-NASD-00-23).

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6955. Order Data Transmission Requirements

(a) through (c) No Change.

[(d) Exemptions]

[(1) Pursuant to the Rule 9600 Series, the staff, for good cause shown after taking into consideration all relevant factors, may exempt, subject to specified terms and conditions, a member from the order data transmission requirements of this Rule for manual orders, if such exemption is consistent with the protection of investors and the public interest, and the member meets the following criteria:]

[(A) the member and current control affiliates and associated persons of the member have not been subject within the last five years to any final disciplinary action, and within the last ten years to any disciplinary action involving fraud;]

[(B) the member has annual revenues of less than \$2 million;]

[(C) the member does not conduct any market making activities in Nasdaq Stock Market equity securities;]

[(D) the member does not execute principal transactions with its customers (with limited exception for principal transactions executed pursuant to error corrections); and]

[(E) the member does not conduct clearing or carrying activities for other firms.]

[(2) An exemption provided pursuant to this paragraph (d) shall not

exceed a period of two years. At or prior to the expiration of a grant of exemptive relief under this paragraph (d), a member meeting the criteria set forth in paragraph (d)(1) may request, pursuant to the Rule 9600 Series, a subsequent exemption, which will be considered at the time of the request, consistent with the protection of investors and the public interest.]

[(3) This paragraph shall be in effect until May 8, 2011.]

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6958. Exemption to the Order Recording and Data Transmission Requirements

(a) Pursuant to the Rule 9600 Series, the staff, for good cause shown after taking into consideration all relevant factors, may exempt, subject to specified terms and conditions, a member from the recording and order data transmission requirements of Rules 6954 and 6955, respectively, for manual orders, if such exemption is consistent with the protection of investors and the public interest, and the member meets the following criteria:

(1) the member and current control affiliates and associated persons of the member have not been subject within the last five years to any final disciplinary action, and within the last ten years to any disciplinary action involving fraud;

(2) the member has annual revenues of less than \$2 million;

(3) the member does not conduct any market making activities in Nasdaq Stock Market equity securities;

(4) the member does not execute principal transactions with its customers (with limited exception for principal transactions executed pursuant to error corrections); and

(5) the member does not conduct clearing or carrying activities for other firms.

(b) An exemption provided pursuant to this Rule shall not exceed a period of two years. At or prior to the expiration of a grant of exemptive relief under this Rule, a member meeting the criteria set forth in paragraph (a) above may request, pursuant to the Rule 9600 Series, a subsequent exemption, which will be considered at the time of the request, consistent with the protection of investors and the public interest.

(c) This Rule shall be in effect until May 8, 2011.

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9600. PROCEDURES FOR EXEMPTIONS

9610. Application

(a) Where to File

A member seeking exemptive relief as permitted under Rules 1021, 1050, 1070, 2210, 2315, 2320, 2340, 2520, 2710, 2720, 2790, 2810, 2850, 2851, 2860, Interpretive Material 2860-1, 3010(b)(2), 3020, 3150, 3210, 3230, 3350, 695[5]8, 8211, 8212, 8213, 11870, or 11900, or Municipal Securities Rulemaking Board Rule G-37 shall file a written application with the appropriate department or staff of NASD and provide a copy of the application to the Office of General Counsel of NASD.

(b) and (c) No Change.

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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 III 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 September 28, 2005, the SEC approved amendments to the OATS Rules (NASD Rules 6950 through 6957) which, among other things, implement the final phase of OATS (OATS Phase III) relating to manual orders and permit NASD to grant exemptive relief from the OATS reporting requirements for manual orders.⁴ The amendments become effective on May 8, 2006. The new exemptive authority permits NASD to grant exemptive relief only to those members that meet specified criteria.⁵ The narrow scope is generally intended to permit NASD to grant relief only to smaller member firms where the reporting of such information would be unduly burdensome or where temporary relief from the rules (in the form of additional time to achieve compliance) would permit the member to avoid unnecessary expense or hardship.

NASD's exemptive authority is further limited in that it only permits NASD to

⁴ Id.

⁵ At a minimum, members must meet the following criteria to be eligible to request an exemption to the OATS reporting requirements for manual orders: (1) the member and current control affiliates and associated persons of the member have not been subject within the last five years to any final disciplinary action, and within the last ten years to any disciplinary action involving fraud; (2) the member has annual revenues of less than \$2 million; (3) the member does not conduct any market making activities in Nasdaq Stock Market equity securities; (4) the member does not execute principal transactions with its customers (with limited exceptions for error corrections); and (5) the member does not conduct clearing or carrying activities for other firms.

relieve members of their obligations to report OATS information to NASD on a daily basis. Thus, while members that are granted an exemption are exempt from reporting or submitting information required under the OATS Rules to NASD, such members must still record and electronically maintain all information required under the OATS Rules. Certain smaller member firms that meet the criteria to request an exemption from the reporting requirements have raised concerns about having to comply with the OATS recording requirements. Specifically, such firms have indicated that even if they ultimately are granted an exemption from the reporting requirements, complying with the OATS recording requirements will impose significant burdens and costs on their firms.

NASD understands the concerns raised by these firms and believes that expanding its current exemptive authority to include recording requirements will greatly assist these smaller member firms by providing such firms more time to determine the best mechanism for complying with the OATS requirements. At the same time, NASD does not believe that such an exemption will have a material impact on NASD's regulatory program because members currently are required to capture and maintain much of the data via other NASD and SEC rules (e.g., NASD Rule 3110 and Rule 17a-3 under the Act⁶), and any exemption granted will be for a limited time period.

NASD intends to grant exemptions from the OATS recording and reporting requirements for manual orders for a period of six months to those members that meet the minimum required criteria. This exemptive relief is intended to provide such members additional time to determine and implement an effective mechanism for recording and reporting OATS information to NASD.

⁶ 17 CFR 240.17a-3.

In this regard, NASD has developed several new enhancements to NASD's OATS web interface, which are designed to significantly reduce the OATS recording and reporting burdens for manual firms with limited order volume.⁷ Specifically, the upgrades to the OATS web interface, which is available at no cost to members, will greatly improve usability and reduce the number of fields users are required to enter when recording an OATS event. The enhanced web interface will enable a user to submit the data to OATS, as well as download the data to its own system prior to submission, to allow the user to maintain on its own system a record of events submitted to OATS.⁸

During the six-month exemption period, NASD will be evaluating the enhanced web interface functionality to determine whether it reduces significantly the reporting burdens for smaller member firms. The availability of an effective OATS web interface will be a major factor in NASD's decision to grant further exemptions after the initial six-month exemptive period expires. For this reason, NASD strongly recommends that members granted an exemption contact NASD immediately to begin testing usage of the web interface enhancements. As NASD and member firms gain experience with the web interface, NASD will be in a better position to evaluate and consider the effectiveness of web interface for OATS requirements and whether any future exemptive relief beyond the initial six-month time frame is appropriate. Notwithstanding the effectiveness of web interface, NASD may decide to grant further exemptions to certain smaller member firms

⁷ While the enhanced OATS web interface is designed to reduce significantly the OATS recording and reporting burdens for manual firms with limited order volume, the enhanced web interface is available as a mechanism for recording and reporting OATS information to all eligible member firms, including member firms already required to report to NASD during OATS Phase I and Phase II.

⁸ The testing environment for the web interface enhancements will be available on April 24, 2006, and the production environment will be available on May 8, 2006.

where complying with the OATS recording and reporting requirements for manual orders would impose significant burdens and costs on their firms

The effective date of the proposed rule change would be May 8, 2006, if approved prior to that date; otherwise, the effective date would be the date of SEC approval.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,⁹ which requires, among other things, that NASD 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 believes expanding NASD's OATS exemptive authority would provide smaller member firms additional time to determine an appropriate mechanism for complying with the OATS requirements, while not materially impacting NASD's regulatory oversight.

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

NASD 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, as amended.

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

While NASD did not specifically solicit comment on the proposed rule change, NASD received one written comment letter regarding the scope of the exemptive

⁹ 15 U.S.C. 78q-3(b)(6).

authority set forth in Rule 6955(d).¹⁰ The commenter requests that NASD broaden its current exemptive authority to include recording requirements. Specifically, the commenter argues that NASD's exemptive authority was intended to include the requirement to record information required under the OATS Rules and maintain such information in an electronic format. The commenter contends that its firm, as well as other firms, were confused that the current exemption from the OATS reporting requirements included only the narrow exemption from the requirement to transmit OATS data to NASD. The commenter further contends that the distinction between the transmission requirement and the electronic retention and collection of information was not highlighted nor discussed. As noted above, NASD proposes to expand its OATS exemptive authority to include recording requirements.

III. 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-NASD-2006-040 on the subject line.

Paper comments:

¹⁰ See Letter to Paul J. McKenney, Assistant Director – OATS, NASD, from Bonnie K. Wachtel, CEO, and Wendie L. Wachtel, COO, Wachtel & Co., Inc. dated February 1, 2006.

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

All submissions should refer to File Number SR-NASD-2006-040. 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 inspection and copying in the Commission's Public Reference Room. Copies of the filing also will be available for inspection and copying at the principal office of NASD. 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-NASD-2006-040 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a self-

regulatory organization.¹¹ In particular, the Commission believes that the proposal is consistent with Section 15A(b)(6) of the Act,¹² which requires that the rules of an association 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 NASD's view that the benefits afforded to smaller member firms by the proposed rule change seem to be significant, without materially impacting the regulatory oversight, seems reasonable. Importantly, the Commission notes that smaller firms may be exempt under NASD's current exemptive authority from daily reporting requirements with respect to OATS information under current rules, so the proposed change would not affect the information received by the NASD on a daily basis. Additionally, the NASD notes that member firms that may be eligible for the proposed expanded exemption are required to capture and maintain certain information required by the OATS Rules pursuant to other NASD and Commission rules.¹³

The Commission also notes that the NASD initially plans to limit an exemption available under this proposal to six months and re-evaluate whether to grant further exemptions after the expiration of the six-month period. The Commission believes that by initially limiting the exemption to qualifying member firms to six months, firms may have sufficient time to become familiar with NASD's enhanced web interface and to discuss with NASD any problems encountered.

¹¹ In approving this proposal, the Commission has considered its impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

¹² 15 U.S.C. 78o-3(b)(6).

¹³ See e.g., NASD Rule 3110 and 17 CFR 240.17a-3 and page 6, supra.

Finally, the Commission believes that the NASD's proposed requirement that a firm receiving an exemption under the proposed rule change re-apply after six months and at least every two years should help to ensure that firms applying for the exemption are continuing to meet the exemption requirements.

The Commission understands that the NASD wants to provide members eligible for an exemption adequate notice as to whether they will be required to comply with the OATS recording requirement on May 8, 2006. The Commission believes that allowing accelerated approval of this proposed rule change would give members eligible for the exemption more time to evaluate their options with respect to the OATS Rules and hopefully prevent unnecessary hardships or expense that may otherwise occur without accelerated approval. The Commission, therefore, finds good cause for approving this proposal before the thirtieth day after the publication of notice thereof in the Federal Register.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁴ that the proposed rule change, as amended (SR-NASD-2006-040), is hereby approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁵

Nancy M. Morris,
Secretary

¹⁴ 15 U.S.C. 78s(b)(2).

¹⁵ 17 CFR 200.30-3(a)(12).