

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50409; File No. SR-NASD-2004-137)

September 17, 2004

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Amendments to the OATS Rules to Require that ECNs Capture Routed Order Identifier Information

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 September 13, 2004, 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 to solicit comments on the proposed rule change from interested persons. For the reasons discussed below, the Commission is granting accelerated approval of the proposed rule change.

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

NASD is proposing to amend NASD Rule 6954 to require that electronic communications networks (“ECNs”) that electronically receive routed orders capture and report the transmitting member’s unique identifier (routed order identifier) to NASD’s Order Audit Trail System (“OATS”). Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are 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.

**6951 through 6953 No Change.**

**6954. Recording of Order Information**

(a) and (b) No Change.

(c) Order Transmittal

Order information required to be recorded under this Rule when an order is transmitted includes the following.

(1) and (2) No Change.

(3) When a member electronically transmits an order for execution on an Electronic Communications Network:

(A) No Change.

(B) the receiving Reporting Member operating the Electronic Communications Network shall record:

(i) the fact that the order was received by an Electronic Communications Network,

(ii) the order identifier assigned to the order by the member that transmits the order,

(iii) [(ii)] the market participant symbol assigned by the Association to the transmitting Reporting Member, and

(iv) [(iii)] other information items in Rule 6954(b) that apply with respect to such order, which must include information items (1), (2), (3), (6), (7), (8), (10), (11), (12), (13), (15), and (16).

(4) through (6) No Change.

(d) 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

**Background**

On March 6, 1998, the SEC approved NASD Rules 6950 through 6957 (“OATS Rules”).<sup>3</sup> OATS provides a substantially enhanced body of information regarding orders and transactions that the NASD believes improves its ability to conduct surveillance and investigations of member firms for potential violations of NASD rules and the federal securities laws. In addition, OATS is intended to fulfill one of the undertakings contained in the order issued by the SEC relating to the settlement of an enforcement action against the NASD for failure to adequately enforce its rules.<sup>4</sup> Pursuant to the SEC Order, OATS is required, at a minimum, to: (1) provide an accurate, time-sequenced record of orders and transactions,

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<sup>3</sup> See Securities Exchange Act Release No. 39729 (March 6, 1998), 63 FR 12559 (March 13, 1998).

<sup>4</sup> See In the Matter of National Association of Securities Dealers, Inc., Exchange Act Release No. 37538 (August 8, 1996); Administrative Proceeding File No. 3-9056 (“SEC Order”).

beginning with the receipt of an order at the first point of contact between the broker/dealer and the customer or counterparty and further documenting the life of the order through the process of execution; and (2) provide for market-wide synchronization of clocks used in connection with the recording of market events.<sup>5</sup>

Since the implementation of OATS, NASD represents that its staff has been closely reviewing OATS activities with the goal of identifying ways in which to improve OATS and enhance the effectiveness of OATS as a regulatory tool. In this regard, NASD identified several changes to OATS that it believed would enhance NASD's automated surveillance for compliance with trading and market making rules such as the NASD's Limit Order Protection Interpretation, the SEC's Order Handling Rules and a member firm's best execution obligations. NASD proposed these changes in SR-NASD-00-23, which remains pending at the SEC.<sup>6</sup>

Pursuant to discussions with SEC staff, NASD now is proposing separately a portion of one of the proposed changes in SR-NASD-00-23, specifically the proposed change to require ECNs that electronically receive routed orders to capture and report a routed order identifier. SR-NASD-00-23, in part, proposes to require that any receiving reporting member, including ECNs, that receive routed orders, electronically or manually, capture and report a routed order

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<sup>5</sup> Id.

<sup>6</sup> See Securities Exchange Act Release No. 43344 (September 26, 2000), 65 FR 59038 (October 3, 2000). As currently proposed, SR-NASD-00-23 generally would: (1) provide that the time of order origination and receipt for an electronic order is the time the order is captured by a member's electronic order-routing or execution system; for a manual order that is fewer than 10,000 shares, the time of order origination and receipt is the time the order is received by the member's trading desk or trading department for execution or routing purposes; and for a manual order that is 10,000 shares or greater, the time of order origination and receipt is the time the order is received by the member from the customer; (2) exclude certain members from the definition of "Reporting Member" for those orders that meet specified conditions and are recorded and reported to the OATS by another member; (3) require any receiving reporting member, including ECNs, that receive, electronically or manually, routed orders, to capture and report a routed order identifier; and (4) permit NASD to grant exemptive relief from the OATS reporting requirements for manual orders to members that meet specified criteria.

identifier.<sup>7</sup> This rule filing is intended to withdraw the portion of that proposal in SR-NASD-00-23 that would require ECNs to capture and report a routed order identifier for electronic orders and is proposing it herein. SR-NASD-00-23 would continue to propose that any receiving reporting member, including ECNs, capture and report a routed order identifier for manual orders that it receives.

### **Description of Proposal**

The use of a routed order identifier reported through OATS permits NASD to track the history of orders routed between firms on an automated basis. If the order does not contain a routed order identifier, the order cannot be linked on an automated basis to subsequent actions, such as further routing or execution by other firms or Nasdaq systems. Given the current level of participation of ECNs in the trading of Nasdaq securities, NASD represents that the lack of a routed order identifier for these electronic orders results in NASD staff having to recreate manually the lifecycle history for a substantial number of orders. Accordingly, NASD is proposing that ECNs that electronically receive routed orders capture and report a routed order identifier. To provide members adequate time for any technological or system changes required by the proposed rule change, NASD is proposing an implementation date for this proposed requirement of 90 days following publication of a Notice to Members, which will be published no later than 60 days from the date of this approval order.

#### 2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD's rules be designed to

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<sup>7</sup> Currently, a routed order identifier is only required to be captured for routed orders received electronically

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.<sup>8</sup> NASD believes that the proposed rule change will enhance NASD's ability to conduct surveillance and investigations of member firms for violations of NASD's and other applicable rules.

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

Written comments on the proposed rule change were solicited by the Commission in response to SR-NASD-00-23, which proposed several changes relating to OATS requirements.<sup>9</sup> The Commission received 13 comment letters from 12 commenters in response to the Federal Register publication of SR-NASD-00-23.<sup>10</sup> The proposed rule change described in this filing relates to only a portion of one of the four proposals in SR-NASD-00-23, specifically, the proposal that would require that ECNs that electronically receive routed orders capture and report a routed order identifier. The comments on that proposal are summarized below.

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by Reporting Members that are not ECNs.

<sup>8</sup> 15 U.S.C. 78o-3(b)(6).

<sup>9</sup> See supra note 6.

<sup>10</sup> Comment letters were submitted by the following: Krys Boyle Freedman & Sawyer, P.C. on behalf of Rocky Mountain Securities & Investments, Inc.; Mitchell Securities Corporation of Oregon; Storch & Brenner, LLP; A.G. Edwards & Sons, Inc.; Instinet Corporation; First Options of Chicago; Morgan Stanley Dean Witter; Securities Industry Association, Ad Hoc Committee; Weeden & Co., L.P.; Financial Information Forum; Pershing Division of Donaldson, Lufkin & Jenrette Securities Corporation; and two letters submitted by Wachtel & Co., Inc.

While a number of commenters opposed the proposed requirement in SR-NASD-00-23 that members be required to capture and report a routed order identifier for orders routed manually, only one commenter, Instinet Corporation ("Instinet"), specifically opposed the proposed requirement to capture and report a routed order identifier for orders routed electronically to ECNs. Among other things, Instinet noted that the original OATS proposal expressly excluded ECNs from the routed order identifier requirements in acknowledgment of the unique characteristics of ECNs and the significant unmerited operational burdens such requirements would impose on ECNs. Instinet indicated that to add a routed order identifier field would require reconfiguration of thousands of customer interfaces and redesign of the framework of the existing brokerage mechanisms. Further, requiring ECN customers to input a routed order identifier would impede speed, efficiency and innovation and is not counterbalanced by any regulatory benefit.

The use of a routed order identifier reported through OATS permits NASD to track the history of orders routed between firms on an automated basis. If the order does not contain a routed order identifier, the order cannot be linked on an automated basis to subsequent actions, such as further routing or execution by other firms or Nasdaq systems. As noted in the Purpose section of this filing, given the current level of participation of ECNs in the trading of Nasdaq securities, the lack of a routed order identifier for these electronic orders results in NASD staff having to recreate manually the lifecycle history for a substantial number of orders.

Subsequent to the submission of its comment letter, Instinet changed its business model and is no longer operating as an ECN.<sup>11</sup> Accordingly, as a non-ECN broker/dealer, Instinet is

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<sup>11</sup> In September 2002, Instinet merged with The Island ECN, Inc (Island ECN). As part of the merger, Instinet's ECN business migrated to Inet ATS, Inc. (Inet), which formerly was Island ECN.

required under current OATS rules to capture routed order identifier information for electronic orders. On July 13, 2004, NASD staff spoke with a representative from Instinet, who indicated that the concerns raised in its October 25, 2000 letter are no longer an issue for Instinet, given its change in business model. In addition, on August 30, 2004 NASD staff discussed the proposal with a representative from Inet who indicated that the proposed requirement to capture a routed order identifier for electronic orders would require technological changes to Inet's current systems, but would not be overly burdensome if adequate time is provided for implementation. Accordingly, NASD believes that any burdens that do exist are outweighed by the regulatory benefits of capturing the lifecycle of these orders on an automated basis and is therefore proposing the rule change described herein.

### 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](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2004-137 on the subject line.

#### Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.



All submissions should refer to File Number SR-NASD-2004-137. 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 Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal offices of the 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-2004-137 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 national securities

association.<sup>12</sup> In particular, the Commission finds that proposed rule change is consistent with Section 15A(b)(6) of Act, which requires, among other things, that NASD's 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.<sup>13</sup> Specifically, the Commission believes that the proposed rule change should enhance OATS information and improve NASD's ability to conduct effective surveillance and timely investigations relating to compliance with NASD and other applicable rules in an efficient manner.

The Commission notes that Instinet commented on this proposed change in response to the notice of SR-NASD-00-23.<sup>14</sup> At that time, Instinet argued that the proposal to require ECNs to capture and report a routed order identifier for orders routed electronically to ECNs would cause significant unmerited operational burdens to be placed on ECNs and that requiring ECN customers to input a routed order identifier would impede speed, efficiency and innovation.

Since that time, given recent changes in the Nasdaq market, NASD represents that its inability, without a routed order identifier, to link an order on an automated basis to subsequent action requires NASD staff to recreate manually the lifecycle history for the significant number of ECN orders. Consequently, NASD contacted Instinet to discuss Instinet's concerns raised by the proposed rule change. According to NASD, Instinet explained that as it was no longer operating as an ECN, the concerns it expressed previously no longer applied it. NASD next

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<sup>12</sup> In approving this proposed rule change, the Commission has considered its impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

<sup>13</sup> 15 U.S.C. 78o-3(b)(6).

<sup>14</sup> See note 6, supra.

spoke with representatives of Inet,<sup>15</sup> about the issues originally raised by Instinet. Again according to NASD, while Inet explained that the proposed requirement to capture a routed order identifier for electronic orders would require the ECN to make technological changes, it did not believe these changes would be overly burdensome as long as NASD allowed an adequate implementation period. Accordingly, the Commission believes that the regulatory benefits to be derived from the greater automation provided by the proposed rule change should outweigh the burden imposed on ECNs.

Because this proposal was previously noticed for public comment as part of NASD-00-23,<sup>16</sup> and, as described above, NASD has adequately responded to comments received on the proposal, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act,<sup>17</sup> for approving the proposed rule change prior to the thirtieth day after the date of publication of notice thereof in the Federal Register. The proposed rule change will become effective 90 days following publication of a Notice to Members, which will be published no later than 60 days from the date of this approval order.

#### V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>18</sup> that the proposed rule change (SR-NASD-2004-137) is hereby approved on an accelerated basis.

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

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<sup>15</sup> See note, 11, *supra*.

<sup>16</sup> See note 6, *supra*.

<sup>17</sup> 15 U.S.C. 78s(b)(2).

<sup>18</sup> 15 U.S.C. 78s(b)(2).

authority.<sup>19</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>19</sup> 17 CFR 200.30-3(a)(12).