

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52581; File No. SR-NASD-2005-101)

October 11, 2005

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change Relating to Expansion of OATS Reporting Requirements to OTC Equity Securities

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 August 25, 2005, 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, II and III 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.

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

NASD is proposing to amend NASD Rules 6951 and 6952 to require members to record and report to the Order Audit Trail System (“OATS”) order information relating to OTC equity securities. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

* * * * *

6950. Order Audit Trail System

6951. Definitions

For purposes of Rules 6950 through 6957:

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

(a) through (i) No change.

(j) “Order” shall mean any oral, written, or electronic instruction to effect a transaction in a Nasdaq Stock Market equity security or OTC equity security that is received by a member from another person for handling or execution, or that is originated by a department of a member for execution by the same or another member, other than any such instruction to effect a proprietary transaction originated by a trading desk in the ordinary course of a member's market making activities.

(k) “Order Audit Trail System” shall mean the automated system owned and operated by the Association that is designed to capture order information reported by members for integration with trade [information reported to the Nasdaq Market Center] and quotation information [disseminated by members in order] to provide the Association with an accurate time sequenced record of orders and transactions.

(l) “OTC equity security” shall mean:

(1) any equity security that is not listed on The Nasdaq Stock Market or a national securities exchange;

(2) any equity security that is listed on one or more regional stock exchanges and does not qualify for dissemination of transaction reports via the facilities of the Consolidated Tape; or

(3) any Direct Participation Program as defined in Rule 6910 that is not listed on The Nasdaq Stock Market or a national securities exchange.

[(1)] (m) “Program Trade” shall mean a trading strategy involving the related purchase or sale of a group of 15 or more securities having a total market value of \$1 million or more, as further defined in New York Stock Exchange Rule 80A.

[(m)] (n) “Reporting Agent” shall mean a third party that enters into any agreement with a member pursuant to which the Reporting Agent agrees to fulfill such member's obligations under Rule 6955.

[(n)] (o) “Reporting Member” shall mean a member that receives or originates an order and has an obligation to record and report information under Rules 6954 and 6955.

6952. Applicability

(a) through (b) No change.

(c) Unless otherwise indicated, the requirements of Rules 6953 through 6957 shall apply to all executed or unexecuted orders [for equity securities traded in The Nasdaq Stock Market].

* * * * *

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 IV 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

NASD Rules 6950 through 6957 (the “OATS Rules”) impose obligations on member firms to record in electronic form and report to NASD on a daily basis certain information with respect to orders originated, received, transmitted, modified, canceled or executed by NASD members relating to equity securities listed and traded on The Nasdaq Stock Market, Inc.

(“Nasdaq”). 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 critical to NASD in conducting surveillance and investigations of member firms for violations of NASD rules and federal securities laws.

To enhance the effectiveness of OATS as a regulatory tool, NASD is proposing to amend the OATS Rules to require members to record and report order information relating to OTC equity securities. For purposes of the proposed rule change, an “OTC equity security” is defined as (1) any equity security that is not listed on Nasdaq or a national securities exchange; (2) any equity security that is listed on one or more regional stock exchanges and does not qualify for dissemination of transaction reports via the facilities of the Consolidated Tape; or (3) any Direct Participation Program as defined in NASD Rule 6910 that is not listed on Nasdaq or a national securities exchange. This definition would include, inter alia, equity securities quoted on the OTC Bulletin Board Service and the Pink Sheets Electronic Quotation Service.

Currently, the OATS requirements do not apply to OTC equity securities and as a result, NASD is unable to recreate, on an automated basis, an order and transaction audit trail for these securities. NASD believes that expansion of OATS requirements to these securities would enhance its ability to review and examine for member compliance with certain trading rules, including, but not limited to, NASD Rule 2320 (Best Execution and Interpositioning), NASD Rule 6541 (Limit Order Protection) and NASD Rule 3320 (Offers at Stated Prices). NASD recognizes that the trading in OTC equity securities is often more manual than Nasdaq securities and this may result in additional burdens on member firms to capture this data electronically. NASD, however, believes capturing and reporting this information electronically to NASD is critical to NASD’s surveillance program.

In recognition of the technological and systems changes the proposed rule change will require, NASD is proposing an effective date of 120 days following publication of revised OATS Technical Specifications, which will be published no later than 60 days following Commission approval. The effective date will be announced in a Notice to Members.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,³ 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 the proposed rule change is consistent with the Act because it will enhance NASD's ability to conduct surveillance and investigations of member firms for violations of NASD's rules and federal securities laws.

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

The proposed rule change was published for comment in NASD's Notice to Members 04-80 (November 2004) ("NTM"). In the NTM, NASD solicited comment from members regarding

³ 15 U.S.C. 78o-3(b)(6).

several proposals, only one of which is encompassed by the proposed rule change.⁴ Eight comment letters were received with respect to this proposal in response to the NTM.⁵

Two commenters expressed support for the proposal to expand OATS requirements to OTC equity securities.⁶ One commenter noted that it would not be difficult to extend OATS reporting to such securities.⁷ Another commenter noted that such a change would be relatively straightforward, but indicated that service bureaus will need adequate time to make the required system changes.⁸ One commenter stated that expanding OATS requirements to OTC equity securities would be problematic because the nature of that business is manual, not electronic.⁹ The commenter indicated that the proposal would require manual recording of data at all

⁴ Three other proposals were discussed in the NTM, but are not part of this proposed rule change. The first would require members to record and report to OATS order information relating to exchange-listed 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. NASD is still analyzing these proposals and therefore is not proposing amendments related to these proposals at this time. Accordingly, NASD is not addressing herein the comments received in response to these three proposals.

⁵ See letters from Emily Vitale dated November 24, 2004; Joseph P. Traba on behalf of ML Stern & Co., LLC dated January 14, 2005 (“ML Stern Letter”); Caroline F. Langner, Director, Corporate Compliance, Ameritrade, Inc. dated January 18, 2005 (“Ameritrade Letter”); Deborah Mittelman, First Vice President, Instinet Group dated January 20, 2005; Stuart Bowers, Chairman, Operations Committee of the Securities Industry Association dated January 20, 2005 (“SIA Letter”); Jess Haberman, Chief Compliance Officer and Vice President, royalblue Financial Corporation dated January 20, 2005 (“royalblue Letter”); Jed Bandes dated January 20, 2005 (“Bandes Letter”); and Rob Schroeder, FIF Program Director, The Financial Information Forum dated January 21, 2005 (“FIF Letter”).

⁶ See Ameritrade Letter and royalblue Letter.

⁷ See royalblue Letter.

⁸ See FIF Letter.

⁹ See SIA Letter.

locations through which the order may pass, which would result in delays in executions and a high rate of errors if order information is communicated orally.¹⁰

One commenter noted the significant burdens of the proposal and suggested that NASD allow at least six months for implementation of the proposed rule change.¹¹ Another commenter noted the other significant industry initiatives that require management and development resources and requested a reasonable time to implement the proposed changes.¹² Two commenters opposed the OATS rules generally, without specifically commenting on any of the proposals.¹³ These commenters cited the additional costs and burdens to member firms of complying with the OATS requirements.¹⁴

Although it understands that the proposed rule change may impose additional costs and burdens on members, in part due to the more manual nature of trading in OTC equity securities, NASD believes that this additional OATS data is critical to NASD's surveillance and regulatory program. To address the concerns raised by commenters, as described above, NASD has proposed an extended implementation period, which NASD believes will provide members adequate time to make the necessary technological and systems changes.

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

Within 35 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

¹⁰ Id.

¹¹ See Ameritrade Letter.

¹² See FIF Letter.

¹³ See ML Stern Letter and Bandes Letter.

¹⁴ Id.

the self-regulatory organization consents, the Commission will:

(A) by order approve 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-NASD-2005-101 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number SR-NASD-2005-101. 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-2005-101 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

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

Jill M. Peterson,
Assistant Secretary

¹⁵ 17 CFR 200.30-3(a)(12).