

December 2, 2005

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: Release No. 34-52581; File No. SR-NASD-2005-101

Dear Mr. Katz:

The Self-Regulation and Supervisory Practices Committee (“Committee”) of the Securities Industry Association (“SIA”)¹ appreciates the opportunity to submit comments in response to the above-referenced rule filing. For the past several years, SIA has worked closely with the Securities and Exchange Commission (“SEC” or “Commission”) and NASD on the design of an order audit trail that can serve as an effective surveillance tool for the NASD in its role overseeing the Nasdaq Stock Market. At every stage, the regulators have paid careful attention to the practical implementation, timing and cost concerns and have sought to strike a balance between burden and benefit.²

The present rule filing seeks to extend OATS Reporting requirements to “OTC equity securities.” The Committee believes that order audit trails like OATS can serve a useful purpose as surveillance tools for securities markets. The decision to implement an order audit trail in a particular securities market should depend on the extent to which regulation of that market requires it. The SEC mandated OATS for the Nasdaq Stock

¹ The Securities Industry Association brings together the shared interests of approximately 600 securities firms to accomplish common goals. SIA’s primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated \$236.7 billion in domestic revenue and an estimated \$340 billion in global revenues. (More information about SIA is available at: www.sia.com.)

² “The [SEC] recognizes that there may be, particularly with respect to manual orders, information items not required to be recorded and reported by the proposal that could prove helpful to the NASD or [SEC] in carrying out their regulatory responsibilities. Nonetheless, the Commission believes that the NASD proposal represents a significant and appropriate effort to satisfy the [SEC] mandate to develop and implement OATS, while attempting to minimize the costs imposed on the industry.” Securities Exchange Act Release No. 39729 (March 6, 1998), 63 FR 12559 at 12568.

Market and other self-regulatory organizations (“SROs”) have mandated order audit trails as well, *e.g.*, New York Stock Exchange, Chicago Board Options Exchange, and other exchanges. To the degree an audit trail is deemed necessary for the NASD’s regulation of other markets, including the OTC equity markets, the Committee believes that the rule should specify which securities and markets fall within the definition of “OTC equity security,” prior to SEC approval. There is currently a good deal of confusion on the part of our members as to how the proposed definition could and should be interpreted in light of: (1) the stated purposes of OATS surveillance, (2) multiple definitions for “OTC security” in the NASD rules today, and (3) what “OTC” is likely to mean in practice once a new market structure model takes form following implementation of Regulation NMS (“Reg NMS”), exchange mergers and the expected cross-listing of Nasdaq and exchange-listed securities.

As a result of the SEC’s September 2005 approval of OATS Phase III, significant compliance and Information Technology (“IT”) resources will be required to meet the Spring 2006 deadline for the extension of OATS reporting to manual orders. Moreover, all brokerage firms currently face the arduous task of implementing Reg NMS at the exchange and broker-dealer levels. The Committee is concerned that requiring OATS reporting for a manually-intensive trading market such as the OTC equity market in the midst of these major initiatives could be the equivalent of mandating decimal conversion in the months leading up to Y2K.

For these reasons, the Committee respectfully requests that the SEC postpone approval of this rule filing until such time as a proper determination of which markets and securities are appropriate for extension of OATS reporting, and the industry can properly devote the personnel and technical resources necessary to achieve compliance.

I. TIMING OF OATS CHANGES

The expansion of order audit trail reporting needs to be considered in the context of the seismic market structure changes that have resulted from the approval of Reg NMS, exchange consolidation efforts, and the new order handling and execution models being implemented at the major securities exchanges. These changes are only now underway and their effects on our markets will not be known for some time. From a practical standpoint, these efforts, along with the related OATS effort described below, are presently consuming all available IT and Compliance resources at equity exchanges and the equity trading divisions of member firms.

The recent SEC Order requiring reporting of manual orders in securities already subject to OATS reporting is a far greater challenge for firms than anything OATS has required up until now. As we noted in previous comment letters and in our discussions with the Commission on OATS Phase III, OATS reporting for electronic orders involved nothing more complex than redirecting to the NASD data that was already systemically captured by firms’ existing systems. In order to be able to report manual orders for OATS, firms have had to build front-end infrastructure to systemically capture order information that previously was captured only on a physical order ticket. This is an enormous undertaking, posing significant infrastructure challenges, including purchasing,

installing, interfacing and testing of the infrastructure for order capture. Both the SEC and NASD recognized these challenges and responded to industry concerns by imposing an unusually long implementation timeline (May of 2006) for participants to come into compliance.

As noted, the infrastructure changes underway have been designed to permit systemic order capture for manual orders in securities for which OATS reporting already applies. This task becomes infinitely more complex as securities are added for which such information must be newly captured. The markets for OTC equity securities are inherently manual by nature and virtually all order information would have to be captured by new front-end systems for practitioners in these markets. Adding to the universe of securities for which front-end system capture could apply could render obsolete all of the work that has been put into production for Phase III compliance, and, literally, drive project planning back to “square one.”

Finally, the SEC is currently in the midst of a far-reaching debate over SRO reform, and issues including the proper role of an SRO for market and member firm regulation remain unresolved. Expanding OATS requirements to new securities could have the effect of prejudging the outcome of those SEC deliberations. What are the OATS implications, for example, when NASDAQ lists NYSE securities for trading? What would be the value to the NASD of order audit trail information if NASD only sees a fraction of the overall market transactions in these securities and an order audit trail already exists? These are threshold issues that should be addressed in the course of considering the expansion of OATS reporting to new securities.

II. SCOPE OF THE DEFINITION OF “OTC SECURITIES”

Committee members are concerned about the undefined scope of “OTC equity security” and the possible expansion of OATS reporting through interpretation. The Committee believes that the current scope of securities subject to OATS reporting appropriately balances costs and benefits and that expanding the scope of OATS reporting requirements ought to be justified on the basis of whether it would enhance NASD’s role as regulator of a particular market. As the SEC explained in the initial Order approving OATS, the NASD committed to developing a surveillance tool in response to the Commission’s 21(a) Report which found that, in the course of its investigation of the NASD, the Commission staff had encountered significant difficulties reconstructing activity in the Nasdaq Market.³ The SEC reasoned that a “comprehensive audit trail, beginning with the time an order is placed and continuing to record the life of the order through the process of execution, is essential to maintaining the integrity of the Nasdaq market.”⁴ The rule approved by the SEC applies to orders “relating to equity securities traded on The Nasdaq Stock Market.”⁵

The industry agreed with the rationale behind imposing an order audit trail for the Nasdaq market and strongly supports NASD having the tools to surveil this market. It

³ Id. at 12560.

⁴ Id. at 12561.

⁵ Id. at 12561.

does not follow, however, that an order audit trail is necessary or appropriate for all markets. From a member firm perspective, an order audit trail imposes on firms that are participants in the relevant market an obligation to affirmatively report information that is already required to be retained pursuant to existing SEC books and records rules. The burden of affirmatively reporting this information to the NASD is not insubstantial, as the industry has sought to explain to the SEC in discussions as to how and when to apply OATS to manual orders in Phase III. Before a regulator can take such a step, it ought to be required to make the case that the accretive value of an order audit trail to the surveillance of these particular markets outweighs the imposition of additional costs and burdens on member firms.

That the SEC did not intend for order audit trail reporting rules to become wholesale replacements for order recordkeeping rules is evident from the multi-year effort of the SEC and the North American Securities Administrators Association to address orders as part of the overhaul of books and records rules that was completed in 2001. Moreover, it was not until a recent OATS rule amendment changing the definition of “receipt time” that OATS even focused on the history of an order prior to the time it entered the Nasdaq Stock Market.

The Committee could support expanding OATS reporting to OTC equity securities, if the scope of securities to be covered is clearly defined and the NASD makes the appropriate justifications for expanding OATS reporting to these securities. On this score, we believe that previous SEC releases and NASD Notices to Members provide guidance on the scope of securities and markets that are at least covered by NASD regulation, generally, if not by OATS, specifically. For example, current NASD guidance makes clear that OATS reporting applies to Nasdaq securities, including convertible bonds, SmallCap Securities and NMS securities, but not “OTC Bulletin Board and OTC Pink Sheets,” among others. We believe the appropriate scope of OATS reporting should include only those securities currently subject to ACT reporting requirements. In crafting an audit surveillance trail, NASD sought to combine information that would be submitted by firms with information on executions that was currently being reported to ACT. Thus, to the degree the NASD already receives transaction reporting information for a particular security, the arguments for applying OATS reporting requirements are more applicable.

In fact, it is our understanding, based on discussions with NASD staff, that despite the broad definition in the proposed rule change, they did not intend to require OATS reporting of OTC options, derivatives or swaps. With respect to foreign securities, NASD staff indicated that trades effected by NASD members in the U.S. would be reportable while OTC trades in foreign securities effected by a foreign affiliate of an NASD member would not. We urge the SEC to make the scope clear if the Commission determines to go forward at this time. In particular, SIA asks that the NASD exclude from the requirements of Rule 6620 transactions executed on a foreign exchange that is an “affiliate member” of the Intermarket Surveillance Group.

Direct Participation Programs (“DPPs”) not listed on the Nasdaq Stock Market or a national securities exchange are explicitly included in the proposed definition of “OTC

equity security.” DPPs generally are sold through a “check and application” process and transactions in these securities are not captured in an automated system. Because the volume in DPPs is low, most firms would be discouraged from offering the product if they were required to build an automated system to facilitate OATS reporting. The Committee believes the NASD should reconsider the necessity of collecting audit trail information on what is effectively subscriptions, not trades.

III. CONCLUSION

For the foregoing reasons, the Committee does not believe that extension of OATS reporting ought to be attempted until such time as current priorities involving equity market infrastructure and the scope of the rule are addressed.

We thank you for the opportunity to provide comments. If you have questions or would like to discuss our comments further, please contact the undersigned or Amal Aly, SIA Vice President and Associate General Counsel at 212.618.0568.

Sincerely,

John Polanin Jr.
Chair, SIA Self-Regulation and Supervisory
Practices Committee