A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for the Proposed Rule Change

1. Purpose

The proposed rule change postpones the effective date of the amendments set forth in SR–NASD–97–78 that was approved on January 20, 1998.[4] In that Release, the Commission approved amendments to NASDR's Public Disclosure Program (''PDP''), as set forth in Interpretive Material 8310–2, and amendments to the Forms U–4 and U–5. These amendments were to become effective on February 17, 1998.[5] Between January 20 and February 17, 1998, member firms expressed concern that they did not have sufficient time to change their operations for filing the Forms and for educating their employees as to changes in the Forms, and therefore requested that the implementation of the Forms be delayed for one month.[6] Because the Forms are designed to provide NASDR with information that will be used as the basis for the modification to the PDR, NASDR has determined that it is appropriate to delay the effective date for the amendments to Interpretive Material 8310–2 as well

2. Statutory Basis

NASDR believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6)[7] of the Act. NASDR believes that delaying the effective date of the new rules to ensure that members are provided with a sufficient amount of time to change their operations so that Forms U–4 and U–5 are properly submitted will not be inconsistent with these requirements.

[4] *See* Securities Exchange Act Rel. No. 39562 (January 20, 1998), 63 FR 3942 (January 27, 1998). *See also* Securities Exchange Act Rel. No. 39442 (December 11, 1997) 62 FR 66706 (December 19, 1997), (partially approving, on an accelerated basis, that portion of the proposed rule change giving the NASD the option of responding to electronic inquiries requesting employment and disciplinary history of its members and their associated persons).

[5] *Id.* at p. 3943.

[6] On February 17, 1998, the NASDR submitted a letter informing the Division that it was changing the implementation date of the Interim Forms U–4 and U–5 from February 17, 1998 to March 16, 1998. *See* letter from Alden S. Adkins, General Counsel, NASD Regulation, Inc., to Katherine A. England, Assistant Director, Division of Market Regulation, SEC, dated February 13, 1998.

[7] Section 15A(b)(6) requires that the rules of the Association be designed to prevent fraudulent and manipulative acts and practices, to remove impediments to and perfect the mechanism of a free and open market, and in general, to protect investors and the public interest.

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

NASDR 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.

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

Written comments were neither solicited nor received.

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

The foregoing rule change has become effective pursuant to Section 19(b)(3)(A)(i) of the Act and subparagraph (e) of Rule 19b–4 thereunder[8] in that it constitutes a stated policy, practice, or interpretation with respect to the meaning of an existing rule.

At any time within 60 days of the filing of a rule change, the Commission may summarily abrogate the rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, D.C. 20549. 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 such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by April 3, 1998.

[8] 17 CFR 240.19b–4(e)(1).

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[9]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 98–6525 Filed 3–12–98; 8:45 am]

BILLING CODE 8010–01–M

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–39729; File No. SR–NASD–97–56]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 2, 3, 4, 5, and 6 to Proposed Rule Change by the National Association of Securities Dealers, Inc., To Amend Rule 3110 and to Adopt New Rules 6950 Through 6957 Relating to the Creation of an Order Audit Rail System

March 6, 1998.

I. Introduction

On July 29, 1997, NASD Regulation, Inc. (''NASDR''), a wholly-owned subsidiary of the National Association of Securities Dealers, Inc. (''NASD'' or ''Association''), submitted to the Securities and Exchange Commission (''SEC'' or ''Commission'') on behalf of the NASD, pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b-4 thereunder,[2] a proposed rule change to adopt new rules relating to the creation of an order audit trail system (''Order Audit Trail System'' or ''OATS''). On August 25, 1997, the NASDR submitted Amendment No. 1 to the proposed rule change.[3]

The proposed rule change was published for comment in the **Federal**

[9] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b-4.

[3] *See* Letter from Joan C. Conley, Corporate Secretary, NASDR, to Katherine A. England, Assistant Director, Division of Market Regulation (''Division''), Commission, dated August 25, 1997 (''Amendment No. 1''). In addition to proposing technical corrections, Amendment No. 1: (1) expands the proposal's definition of ''order,'' (2) clarified that the proposed requirements of Rule 3110(c) (regarding required books and records) would be temporary and only in effect from January 1, 1999, to January 31, 2000; (3) conforms the discussion section to the language of the proposed rule regarding effective dates for orders other than electronic orders; and (4) notices that the NASDR consulted generally with industry representatives and received a number of comment letters. The changes proposed in Amendment NO. 1 were incorporated into the Commission's notice of filing of the proposal prior to its publication in the **Federal Register.**

Register on September 5, 1997.[4] The Commission received eighteen comments on the proposal.[5] On October 9, 1997, the NASDR filed Amendment No. 2 to the proposed rule change.[6] The NASDR filed Amendment No. 3 to the proposed rule change on October 29, 1997.[7] On February 3, 1998, the NASDR filed Amendment No. 4 to the proposed rule change.[8] The NASDR filed Amendment No. 5 to the proposed rule change on February 11, 1998.[9] On March 5, 1998, the NASDR filed Amendment No. 6 to the proposed rule change.[10] This order approves the proposed rule change and Amendment No. 1. In addition, the Commission is publishing this notice to solicit comments on Amendment Nos. 2, 3, 4, 5, and 6 to the proposed rule change and is simultaneously approving those amendments on an accelerated basis.

II. Background

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.[11] Pursuant to the SEC Order, the Association agreed to design and implement by August 8, 1998 (or as specified by further order of the Commission) an order audit trail sufficient to enable the Association to reconstruct markets promptly, conduct efficient surveillance and enforce its rules.[12] OATS is required, subject to the Commission's approval, at a minimum, to (a) provide an accurate time-sequenced record of orders and transactions, 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 (b) provide for market-wide synchronization of clocks used in connection with the audit trail.[13]

The SEC Order was issued in response to the filings of the Commission's 21(a) Report.[14] In the Appendix to its 21(a) Report, the Commission stated that,

> In the course of the investigation [of the NASD], the Commission staff encountered significant difficulties reconstructing activity in the Nasdaq market. Broker-dealer order tickets, among the most fundamental of records, were too often unavailable or inconvenient to retrieve. Timestamping was often unreliable for the purposes of determining compliance with applicable rules, such as the firm quote rule and limit order protection rules.
>
> A further difficulty was the inadequate documentation of telephone orders received at [over-the-counter] trading desks. As noted above, order tickets if they were available at all, were not always reliably timestamped. Having reliable and accurate records of telephone orders is crucial to evaluating a market maker's compliance with the firm quote rule and trade reporting rule. Because telephone orders and transactions are a significant part of the activity in the Nasdaq market, the documentation of these orders and transactions is essential to adequate surveillance and compliance in the market.
>
> The NASD has automated surveillance capabilities with respect to its current audit trail, although it has not consistently maintained adequate routine automated surveillance capabilities over the audit trail. Its surveillance and enforcement responsibilities with respect to market conduct has increased substantially in recent years. The adoption of limit order protection rules in 1994 and 1995 and the frequency of backing away from quotations and late trade reporting revealed by this investigation, all indicate the need for an improved surveillance capability. In light of the high volume of trading on today's Nasdaq market and the dispersed nature of that market, these rules cannot be efficiently enforced through current NASD inspections and analysis of hard copies of order tickets and other records. Automated surveillance is essential if there rules are to be effectively enforced. This surveillance capability can only be implemented with an improved audit trail.

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[4] *See* Securities Exchange Act Release No. 38990 (August 28, 1997) 62 FR 47096.

[5] *See* Letters to Jonathan G. Katz, Secretary, Commission from: Edward J. Johnsen, Vice President and Assistant General Counsel and Christopher R. Franke, Vice President and Compliance Manager, J.P, Morgan Securities, Inc. (''J.P. Morgan''), dated September 25, 1997; John B. Morgan, Director of Legal and Compliance, Mabon Securities Corp. (''Mabon''), dated September 24, 1997; John A. Goc, Senior Vice President, Equity Trading, Boston Institutional Services (''BIS''), dated September 19, 1997; Steven Alan Bennett, Senior Vice President and General Counsel, Banc One Corporation (''Banc One''), dated September 26, 1997; H. Michael Reese, Chief Financial Officer, HBK Finance L.P. (''HBK Finance''), dated September 23, 1997; Allen J. Thomas, Vice President, A.G. Edwards & Sons, Inc. (''A.G. Edwards''), dated September 26, 1997; Charles R. Hood, Senior Vice President and General Counsel, Instinet Corporation (''Instinet''), dated September 26, 1997; Brooke Berstein, Vice President and Counsel, Morgan Stanley & Co. Inc. (''Morgan Stanley''), dated September 29, 1997; James M. Davis, Managing Director of Compliance, The Franklin Templeton Group (''Franklin Templeton''), dated September 26, 1997; Richard O. Scribner, Director for Regulation, Salomon Brothers, Inc. (''Salomon Bros.''), dated September 30, 1997; Timothy F. McCarthy, Charles Schwab & Co., Inc. (''Schwab''), dated September 30, 1997; Bernard L. Madoff, Chair, OATS Ad Hoc Committee, Securities Industry Association (''SIA''), dated October 6, 1997; James R. Orvis, Senior Vice President and Director of Operations, Advest, Inc. (''Advest''), dated October 7m 1997; John M. Ivan, Managing Director Compliance, Wheat First Butcher Singer (''Wheat First''), dated October 10, 1997; Robert B. Sloan, Partner, Director/Information Services, J.C. Bradford & Co. (''J.C. Bradford''), dated October 8, 1997; John J. Sanders, Jr., Principal, BancAmerica Robertson Stephens (''BancAmerica''), dated October 6, 1997; Kathryn G. Casparian, Director of Regulatory Affairs, Oppenheimer & Co., Inc. (''Oppenheimer''), dated October 15, 1997; and Robert E. Maina, First Vice President, Merrill Lynch (''Merrill Lynch''), dated October 17, 1997. Two additional letters were forwarded to the Commission subsequent to the close of the comment period. These consist of a letter from Bernard L. Madoff, Chair, OATS Ad Hoc Committee, SIA, to Richard G. Ketchum, Executive Vice President and Chief Operating Officer, NASD, dated December 3, 1997 and a letter to James M. Cangiano, Senior Vice President, Market Regulation, NASDR, from Charles R. Hood, Senior Vice President and General Counsel, Instine, date November 25, 1997.

[6] *See* Letter from John M. Ramsay, Deputy General Counsel, NASDR, to Katherine A. England, Assistant Director, Division Commission, dated October 7, 1997 (''Amendment No. 2''). In Amendment No. 2, the NASDR consent to an extension of the time periods specified in Section 19(b)(2) of the Act.

[7] *See* Letter from Joan C. Conley, Corporate Secretary, NASDR, to Katherine A. England, Division, Commission, dated October 28, 1997 (''Amendment No. 3''). In Amendment No. 3, the NASDR proposes to modify the numbering of the text of the proposed rules from 6900 through 6970 to 6950 through 6957.

[8] *See* Letter from Mary N. Revell, Associate General Counsel, NASDR, to Howard Kramer, Associate Director, Division, Commission, dated February 3, 1998 (''Amendment No. 4''). In Amendment No. 4, the NASDR proposes to amend the proposal to, among other things: (1) modify the specifications for electron orders to conform to the industry standard of an eight character order identifier and to delete the requirement to pass the order origination date; (2) extend the phase-in of the OATS implementation schedule, as discussed in section III.E. below; (3) revise the definition of the term ''electronic order,'' (4) define the terms ''Electronic Communication Network'' and ''manual order,'' (5) clarify the treatment of bunched orders; (6) revise the test of proposed Rule 6954 to separately address four different order transmittal scenarios; (7) limit the reporting requirements of ECNs; and (8) make technical corrections.

[9] *See* Letter from Mary N. Revell, Associate General Counsel, NASDR, to Howard Kramer, Associate Director, Division, Commission, dated February 11, 1998 (''Amendment No. 5''). In Amendment No. 5, the NASDR proposes to amend the text of proposed Rule 6954(c) and Amendment No. 4 to delete provisions stating that the information to be recorded by a Reporting Member operating an ECN is that information provided to the ECN by the transmitting Reporting Member.

[10] *See* Letter from Mary N. Revell, Associate General Counsel, NASDR, to Howard Kramer, Associate Director, Division, Commission, dated March 5, 1998 (''Amendment No. 6''). In addition to several clarifying technical amendments, the NASDR proposes in Amendment No. 6 to: (1) reinstate and amend the books and records provisions of Rule 3110, previously deleted in Amendment No. 4, to require members to record certain information; (2) revise proposed Rule 6954(c)(1) to exempt from reporting to OATS orders routed from one department within a member to the member's trading desk; (3) revise the implementation date for electronic orders transmitted to a market maker or an ECN to March 1, 1999; and (4) clarify the proposed treatment of bunched orders.

[11] *See In the Matter of National Association of Securities Dealers, Inc.; SEC Release No. 34–37538, August 8, 1996; Administrative Proceeding File No. 3–9056 (''SEC Order'').*

[12] *Id.*

[13] *Id.*

[14] *See* Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market, Release No. 34–37543, Commission, August 8, 1996.

Hundreds of millions of share trade very day on Nasdaq, and effective regulation of this market requires a comprehensive centralized and computerized recordkeeping system. Surveillance methods employed in this market must keep pace with the rapidly of trading done with computer technology. 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. Such an audit trail would feature the computerized recordation of the time and terms of an order, and of the sequence of steps to execute the order. By providing the details, the enhanced audit trail would allow for prompt surveillance on a scale that cannot be attained with traditional methods of examination.[15]

III. Description of the Proposal

In response to the findings in the 21(a) Report and the corresponding undertakings, the NASD proposed OATS. The proposed OATS would capture order information reported by NASD members. This information would be integrated with quote information and transaction information reported to the Automated Confirmation Transaction Service (''ACT'') [16] to provide the Association with an accurate, time-sequenced record of orders and other transactions. In general, the OATS would impose obligations on member firms to record in electronic form and to report to the NASDR certain information with respect to orders originated, received, transmitted, modified, canceled, or executed (''reportable events'') by NASD members relating to equity securities traded on The Nasdaq Stock Market, Inc. (''Nasdaq'').[17] In addition, the proposal would require member firms to synchronize their business clocks and continually to keep them synchronized with a specific time designated by the Association.

The proposed OATS would be operated by the NASDR, the operating subsidiary of the Association that is responsible for regulating member firms and conducting surveillance of Nasdaq. The NASDR would obtain ACT transaction data from Nasdaq on a daily basis for purposes of constructing an integrated audit trail of transactions and order data, and NASD members would be required to transmit ACT identifying information to the OATS.

The OATS requirements are set forth in proposed new Rules 6950 through 6957 [18] of the NASD's Conduct Rules relating to an audit trail system owned and operated by the NASD. The proposed rules are summarized in subsection A below and are discussed in detail in subsection B–F.

In addition to adopting the new OATS rules, the proposal would amend NASD Rule 3110 to impose recordkeeping requirements on NASD members that are obligated to record and report information to the NASD under the OATS rules. Such members would be required to record, with respect to an order that is received or [19] executed at the members' trading department, the identification of each registered person who receives an order directly from a customer and the identification of each person who executes an order at a market maker's trading desk.[20] In addition, the revised Rule 3110 would require members to record the identification of the department of the member that originated an order that is transmitted manually to another department within a member.

a. Summary of Proposed New Rules

(1) NASD Rule 6951—Definitions

Proposed NASD Rule 6951 sets forth the definitions that apply to the new OATS rules. For example, the term ''order'' is defined as ''any oral, written, or electronic instruction to effect a transaction in a [Nasdaq] 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.'' Proposed Rule 6951 specifies that the term ''order'' does not include a market maker's proprietary transactions originated by a trading desk in the ordinary course of an NASD member's market making activities. Proposed new Rule 6951, as amended, distinguishes between the terms ''electronic order'' and ''manual order.'' An electronic order under the rule is an order ''captured by a member in an electronic order-routing or execution system.'' [21] The term *manual order* is added to the amended proposal and is defined as ''an order that is captured by a member other than in an electronic order-routing or execution system.'' The amended definition of the term *electronic order* makes clear that orders that are received manually and subsequently entered into an automated system will be considered electronic orders under the proposed OATS rules. The proposed rule defines the term *Reporting Member* as an NASD member that receives or originates an order and has an obligation to record and report information about that order to the NASDR under the applicable provisions of the OATS rules. Finally, the term ''Reporting Agent'' is defined in the proposal as ''a third party member that enters into an agreement with another member pursuant to which the Reporting Agent agrees to fulfill such member's obligations under Rule 6955.''

(2) NASD Rule 6952—Applicability

Proposed Rule 6952 establishes the scope of the proposed OATS rules. Specifically, proposed Rule 6952 clarifies that the proposed rules would apply to all NASD member brokers and dealers and to their associated persons and to all executed and unexecuted orders for equity securities traded on Nasdaq. In addition, proposed Rule 6952 makes clear that, notwithstanding their obligations under the proposed OATS rules, NASD members would be required to continue to comply with the other requirements contained in the Association's rules and By-Laws.

(3) NASD Rule 6953—Synchronization of Member Business Clocks

Proposed Rule 6953 would require each NASD member to synchronize its business clocks used for purposes of recording the date and time of any event that must be recorded pursuant to the By-Laws or other rules of the Association, with reference to a time source designated by the Association for this purpose, and to maintain the synchronization of business clocks in

[15] *See* Appendix to Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market, Commission, August 8, 1996, at 100–101.

[16] ACT is an automated system owned and operated by Nasdaq that captures transaction information in real-time. *See* Amendment No. 4, *Supra* note 8.

[17] The proposed rules do not apply to orders for stocks traded on the Bulletin Board, debt, and securities listed on national securities exchanges. *See* NASD proposed Rules 6951(j) and 6952(c).

[18] The original filing proposed numbering the text of the proposed rule 6900 through 6970. Subsequently, the numbering of the proposed rule was changed to 6950 through 6957. *See* Amendment No. 3, *supra* note 7.

[19] As originally proposed, Rule 3110 would have required an NASD member to record information pertaining to orders received *and* executed at its trading department. [emphasis added]. This language has been modified to require an NASD member to record information relating to orders received or executed at its trading department. Per phone conversation between Mary Revell, Associate General Counsel, NASDR, and Deborah Flynn, Division, Commission, on March 6, 1998.

[20] In Amendment No. 4, the NASDR deleted a proposed revision to NASD Rule 3110, that was proposed in the original proposed rule change and published for comment. The proposed provision required members to record the identification of each registered person who executes an order. *See* Amendment No. 4, *supra* note 8. In Amendment No. 6, the NASDR proposes to reinstate that provision. *See* Amendment No. 6, *supra* note 10.

[21] *See* Amendment No. 4, *supra* note 8. In the original proposal, the term *electronic order* was defined as an order ''captured by members in electronic form upon or promptly after receipt.''

conformity with procedures that the Association may prescribe.

(4) NASD Rule 6954—Recording of Order Information

Proposed Rule 6954 delineates the specific information that must be recorded, in terms of hours, minutes, and seconds, by NASD members in connection with the origination, receipt, transmission, modification, cancellation, or execution of an order for a Nasdaq equity security. The proposed rule would establish varying requirements, which are discussed in detail in section III.B. below, depending on, for instance, how the order is transmitted to the Reporting Member (*i.e.*, electronically or manually) and the intended recipient of the transmission (*i.e.*, another department within the same member, an ECN, or another member).

(5) NASD Rule 6955—Order Data Transmission Requirements

Proposed rule 6955 would mandate that the data required to be recorded under proposed Rule 6954 be transmitted by each Reporting Member or its designated Reporting Agent to the OATS in electronic form. The proposed rule would require the requisite information to be transmitted on the day the reportable event occurred, or the day that such information first becomes available. In addition, proposed Rule 6955 would specifically allow members to enter into written agreements with Reporting Agents under which such agents agree to fulfill the Reporting Member's reporting obligations arising under the proposed rule. Such agreements would not, however, relieve the member that originally receives or originates the order from its regulatory responsibilities under OATS.

(6) NASD Rule 6956—Violation of Order Audit Trail System Rules

Penalties for noncompliance with the OATS requirements are set forth in proposed Rule 6956. This provision makes clear that members' or associated persons' failure to comply with the proposed OATS rules would be considered conduct in violation of NASD Rule 2110. As a result, penalties that result from violations of NASD Rule 2110 also could apply to violations of the OATS rules.

(7) NASD Rule 6957—Effective Date

Finally, proposed Rule 6957 would establish the implementation schedule for the proposed new OATS rules.

B. Information That Must Be Recorded

Proposed Rule 6954 would require certain identifying information to be recorded at various important points during the life of an order. In addition to uniquely identifying the order, this information would assist the NASDR in carrying out its regulatory responsibilities with respect to that order. The required information items relate to: (1) the origin of an order (*i.e.*, in-house, customer, or another member); (2) whether the member relies upon a Reporting Agent to fulfill its reporting obligations; (3) how the order was received (*i.e.*, manually or electronically); (4) the terms of the order; (5) whether the order was transmitted for execution to another department within the member (other than to the trading department),[22] to another member, or to an electronic communications network (''ECN'') and how it was transmitted (*i.e.*, manually or electronically); and (6) whether the order was modified, canceled or executed.

(1) Origin of the Order

At the point that an order is received or originated, the Reporting Member must record certain information items to identify where the order came from and when it was received or originated, including: an order identifier assigned by the Reporting Member for the date the order was received;[23] the market participant symbol assigned by the Association to the Reporting Member;[24] the date and time the order was originated or received;[25] an identification of any department or the identification number of any terminal where an order is received directly from a customer;[26] and where an order is originated by a Reporting Member, an identification of the department of the member where the order originated.[27]

(2) Reliance Upon a Reporting Agent

Under the terms of the proposal, a member would be required to record, at the time of origination or receipt of an order, the identification of the Reporting Agent if the member relies upon a Reporting Agent to fulfill its reporting obligations arising under the OATS rules.[28]

(3) How an Order is Received

The proposed rules would not require specific information items to be recorded to identify how the original Reporting Member received the order (*i.e.*, electronically or manually). Nonetheless, as discussed in section III.A.(1) above, proposed Rule 6951 distinguishes between electronic and manual orders. For purposes of the OATS rules, the distinction between electronic and manual orders is particularly significant as it relates to the implementation schedule set forth in proposed Rule 6957, details of which are provided in section III.E. below.

(4) Terms of the Order

Proposed Rule 6954 also would require certain information items directly related to the terms of the order itself to be recorded at the time of origination or receipt of an order. These information items include: the identification symbol assigned by the Association to the security;[29] the number of shares to which the order applies;[30] the designation as a buy or sell order;[31] the designation as a short sale order;[32] the designation as a market order, limit order, stop order or stop limit order;[33] any limit or stop price prescribed in the order;[34] the time limit during which the order is in force;[35] any special handling requests[36] contained in the order;[37] any request by a customer that an order not be displayed, or that a block size order be displayed pursuant to Rule 11Ac1–4(c);[38] the date on which the order expires, and if less than one day, the time when the order expires;[39] the type of account for which the order is placed;[40] and whether the order is related to a Program Trade or an Index Arbitrage Trade.[41]

[22] The NASDR proposes to revise proposed Rule 6954(c)(1) to require members to report to OATS only orders transmitted to departments within the firm other than to the trading department. *See* Amendment No. 6, *supra* note 10. OATS will assume that transmissions for which there is no routing report have been transmitted to the member's trading desk.

[23] *See* proposed Rule 6954(b)(1).

[24] *See* proposed Rule 6954(b)(3).

[25] *See* proposed Rule 6954(b)(16).

[26] *See* proposed Rule 6954(b)(4).

[27] *See* proposed Rule 6954(b)(5).

[28] *See* proposed Rule 6954(b)(6).

[29] *See* proposed Rule 6954(b)(2).

[30] *See* proposed Rule 6954(b)(7).

[31] *See* proposed Rule 6954(b)(8).

[32] *See* proposed Rule 6954(b)(9).

[33] *See* proposed Rule 6954(b)(10).

[34] *See* proposed Rule 6954(b)(11).

[35] *See* proposed Rule 6954(b)(13).

[36] According to the NASDR, examples of special handling requests include the following types of requests: Kill or Fill, All or None, Not Held, Immediate or Cancel, Market at Open, Market at Close, Over the Day, Scale, Work, Minimum Quantity, and Peg. *See* Amendment No. 4, *supra* note 8.

[37] *See* proposed Rule 6954(b)(15).

[38] *See* proposed Rule 6954(b)(14).

[39] *See* proposed Rule 6954(b)(12).

[40] *See* proposed Rule 6954(b)(18).

[41] *See* proposed Rule 6954(b)(17). Transaction data for trades that are part of a program trade or index arbitrage strategy is required by the New York

(5) Transmission of an Order

Proposed Rule 6954 also requires information to be recorded regarding how and to whom an order is transmitted.

Transmitted to Another Department Within the Member-Firm—Pursuant to proposed Rule 6954(c)(1), when a Reporting Member transmits an order to another department within the member other than to the trading department,[42] the member would be required to record the following information: the order identifier assigned to the order by the member; the market participant symbol assigned by the Association to the member; the date the order was first received or originated by the member; an identification of the department to which the order was transmitted; and the date and time the order was received by that department.

Electronically Transmitted to Another Member—When an order is electronically transmitted to another member, other than for execution on an ECN, proposed Rule 6954(c)(2) would require certain information to be recorded by the transmitting and receiving members. The *transmitting* Reporting Member must record the following information: the order identifier assigned to the order by that firm; the respective market participant symbols assigned by the Association to the transmitting member and to the member to which the order is transmitted; the date the order was originally received or originated by the Reporting Member; the date and time the order is transmitted; and the number of shares to which the transmission applies.

The *receiving* member would be required to capture all of the elements prescribed in proposed Rule 6954(b) that apply with respect to the order. In addition, the receiving member would be required to record: the order identifier assigned to the order by the transmitting member; and the transmitting member's market participant symbol assigned by the Association.

Electronically Transmitted to an ECN—Pursuant to proposed Rule 6954(c)(3), when a member electronically transmits an order for execution on an ECN, the *transmitting* member would be required to record: the fact that the order was transmitted to an ECN; the order identifier assigned to the order by the transmitting member; the respective market participant symbols assigned by the Association to the transmitting member and to the ECN; the date the order was first originated or received by the transmitting Reporting Member; the date and time the order is transmitted; and the number of shares to which the transmission applies.

The *receiving Reporting Member operating the ECN* would be required to record, in addition to the applicable information items specified in proposed Rule 6954(c)(3)(B)(iii), the fact that the order was received by an ECN and the market participant symbol assigned by the Association to the member transmitting the order to the ECN.

Manually Transmitted to Another Member Other Than and ECN—Proposed Rule 6954(c)(4) sets forth the recording obligations for manual transmissions of orders between members other than ECNs. Pursuant to the proposal, *transmitting* members would be required to record: the fact that the order was transmitted manually; the order identifier assigned to the order by the transmitting member; the respective market participant symbols assigned by the Association to the transmitting and receiving members; the date the order was first originated or received; the date and time the order is transmitted; the number of shares to which the transmission applies; and for each order to be included in a bunched order, the bunched order route indicator.[43]

The member *receiving* a manual transmission would be required to record, in addition to all other applicable information items set forth in proposed Rule 6954(b), the fact that the order was received manually and the market participant symbol assigned by the Association to the transmitting member.

Manually Transmitted to an ECN—Proposed Rule 6954(c)(5) specifies the obligations that would arise under the rules when a member manually transmits an order to an ECN. The *transmitting* member would be required to record: the fact that the order was transmitted manually; the order identifier assigned to the order by the transmitting member; the respective market participant symbols of the transmitting member and the ECN; the date the order was first originated or received; the date and time the order is transmitted; the number of shares to which the transmission applies; and for each order to be included in a bunched order, the bunched order route indicator.[44]

The *receiving* ECN would be required to report: the fact that the order was received manually; the market participant symbol assigned by the Association to the transmitting member; and all other applicable information with respect to the order as set forth in proposed Rule 6954(c)(5)(B)(iii).

(6) Modifications, Cancellations, and Executions

Proposed Rule 6954 also requires NASD members to record certain information to identify the disposition of the order (*i.e.*, whether it was modified, canceled, or executed).

Modifications—Pursuant to proposed Rule 6954(d), whenever an NASD member modifies the terms of an order that it has originated, or receives a modification to the terms, the OATS would treat the modification effectively as a cancellation of the original order and a replacement by the modified order. Accordingly, all information prescribed by the rule would need to be recorded pursuant to proposed Rule 6954(b) as if the order was originated or received at the time of the modification. In addition, to permit the linkage by the OATS of the modified order to the original one, the proposal would require the member to record the following information: the order identifier that was assigned to the order by the member prior to the modification; the date and time the modification was originated or received; and the date the original order was first originated or received by the member.

Cancellations—In the event of a cancellation of an existing order, whether it is a total or partial cancellation, the following elements would be required to be recorded pursuant to proposed Rule 6954(d)(2): the order identifier assigned by the member; the market participant symbol assigned to the Reporting Member by the Association; the date the order was first originated or received by the member; the date and time the cancellation was originated or received; if the open balance of an order is canceled after a partial execution, the number of shares canceled; and whether or not the order was canceled at the instruction of the member, or a customer.

Executions—For executed orders, members would be required, under proposed Rule 6954(d)(3), to record: the order identifier assigned by the member; the market participant symbol assigned

Stock Exchange to be transmitted to ACT with respect to securities listed on that exchange.

[42] *See* note 22, *supra*.

[43] *See* Amendment No. 6, *supra* note 10. In Amendment No. 6, the NASDR proposes to clarify the rule language with respect to bunched orders. Amendment No. 6 revises the rule language to make clear that a bunched order route indicator must be reported for *each* manual order included in a bunch.

[44] *Id*.

by the Association to the member; the date the order was first originated or received by the member; the member's number assigned for purposes of identifying transaction data in ACT; the designation of the order as fully or partially executed; the number of shares to which a partial execution applies and the number of unexecuted shares remaining; the identification number of the terminal where the order was executed; and the date and time of execution.

C. Information That Must Be Reported to the OATS

Proposed Rule 6955 requires that all applicable order information that must be recorded under proposed rule 6954 be reported to the OATS by either the member or by a Reporting Agent under a written agreement, as described in paragraph (c) of proposed Rule 6955.[45] The proposal would require order information to be submitted to the OATS in either single or multiple electronic file transmissions on the same day that the order was received, originated, canceled, modified, transmitted to another department within the member or to another member, or executed. Where information concerning a particular order is not complete or changes, proposed Rule 6955 would require the additional information to be reported to the OATS on the day that the information first becomes available.

D. Synchronization of Clocks

In addition to the recordkeeping and reporting requirements discussed above, proposed Rule 6953 would require that the business clocks of all member firms that are used for purposes of recording the date and time of any event that must be recorded pursuant to the By-Laws or other rules of the NASD be appropriately synchronized to one time source designated by the NASD. Market-wide synchronization of business clocks was included as a element of one of the undertakings contained in the SEC Order.[46] Proposed Rule 6953 would require members to initially synchronize their clocks and to follow procedures prescribed by the NASD to continuously maintain synchronization.

E. Effective Dates

The proposed effective dates for the requirements of the proposal are set forth in proposed Rule 6957. As amended, the proposal would require all members to synchronize their computer system clocks and all mechanical clocks that record times for regulatory purposes by August 7, 1998, and July 1, 1999, respectively.[47] In addition, the implementation schedule, as amended,[48] would require that electronic orders received at the trading department of a member that is a market maker in the subject securities and those received by ECNs be entered into the OATS[49] as of March 1, 1999 (''Phase One'').[50] Information items relating to all electronic orders would be required to be reported to the OATS by August 1, 1999 (''Phase Two'').[51] Further, the proposed OATS rules would apply to all manual orders as of July 31, 2000 (''Phase Three'').[52] With respect to manual orders and all orders received by ECNs, however, the data required to be electronically recorded and transmitted to the OATS is limited to information that is expected to be readily available at the trading desk.[53]

The proposed books and records requirements, set forth in Rule 3110(c)(1) and (2), pertaining to the identification of the registered representative who receives an order directly from a customer and the identification of each registered person who executes the order, would be effective on March 1, 1999.[54] The proposed recordkeeping requirements, set forth in Rule 3110(c)(3), applicable to orders originated by a member and manually transmitted to another department within the member firm, would be effective on July 31, 2000.[55]

F. Penalties for Noncompliance

Finally, pursuant to proposed Rule 6956, a member's failure to comply with any of the requirements set forth in the proposed rules may be considered conduct that is inconsistent with high standards of commercial honor and just and equitable principles of trade, in violation of NASD Rule 2110.

IV. Summary of Comments

The Commission received 18 comment letters on the proposed rule change, 16 of which were submitted by broker-dealers.[56] One comment letter was submitted by a trade association representing securities firms, and one was submitted by an ECN.[57] The commenters generally supported the proposal, recognizing the importance to the NASD's surveillance efforts of a

[45] As discussed above, proposed Rule 6955(c) contains a special provision that allows a member to enter into a written agreement with a Reporting Agent pursuant to which such agent agrees to report order information to OATS on its behalf. However, the member that actually receives or originates the order would remain primarily responsible for fulfilling each of its obligations under the proposal.

[46] *SEe* note 11, *supra.*

[47] As originally filed, the proposal required NASD members to synchronize their business clocks by February 2, 1998. In Amendment Nos. 4 and 6, the NASDR proposed to delay the effective date of the implementation of this requirement. *See* Amendment Nos. 4 and 6, *supra* notes 8 and 10.

[48] In response to concerns raised by commenters that the proposed implementation dates did not provide sufficient time for necessary systems changes, the NASDR proposes to amend the implementation schedule to allow NASD member firms additional time to develop and test their systems' capabilities to record and transmit orders to the OATS. *See* Amendment No. 4, *supra* note 8.

[49] Not all information relating to electronic orders received by market makers will be required to be reported to the OATS as of this date. Specifically, the NASDR proposes that market makers be required to report information item (18) (type of account for which the order is submitted) of Rule 6954(b) only to the extent that such information item is available. Market makers would not be required to report information items (5) (identification of the department of the member originating an order) and (18) (type of account for which the order is submitted) of proposed Rule 6954(b) and information items (2)(A) (recordkeeping requirements of the transmitting member for an order electronically transmitted to another member), (2)(B)(i) (order identifier assigned to the order by the transmitting member), (3)(A) (recordkeeping requirements of the transmitting member for an order electronically transmitted to an ECN), (4)(A) (recordkeeping requirements of the transmitting member for an order manually transmitted to another member) and (5)(A) (recordkeeping requirements of the transmitting member for an order manually transmitted to an ECN) of Rule 6954(c) until August 1, 1999. *See* Amendment No. 4, *supra* note 8.s, 4 and 6, *supra* notes 8 and 10.

[50] In Amendment No. 6, the NASDR proposes to implement Phase One by March 1, 1999, rather than February 1, 1999, as proposed in Amendment No. 4, *See* Amendment Nos. 4 and 6, *supra* notes 8 and 10.

[51] *See* Amendment No. 5, *supra* note 8.

[52] *Id.*

[53] Specifically, with respect to manual orders, information item (18) (type of account for which the order is submitted) of Rule 6954(b) would be required to be reported only to the extent that such information item is available. Information items (4) (identification of any department or the identification number of any terminal where an order is received) and (5) (identification of the department of the member originating an order) of proposed Rule 6954(b) and (1) (recordkeeping requirements for orders transmitted to another department within the member) specified in proposed Rule 6954(c) would not be required to be recorded and reported with respect to manual orders. In addition, information items (4) (identification of any department or identification number of any terminal where an order is received), (5) (the identification of the department of the member that originates the order), (9) (the designation of the order as a short sale), (14) (any request by a customer that an order not be displayed or that a block size order be displayed, pursuant to Rule 11Ac1–4(c)), (17) (the identification of the order as related to a Program Trade or an Index Arbitrage Trade), and (18) (the type of account for which the order is submitted) specified in proposed Rule 6954(b) would not be required to be recorded and reported by ECNs receiving orders either electronically or manually. *See* Amendment Nos. 4 and 6, *supra* notes 8 and 10.

[54] *See* Amendment No. 6, *supra* note 10.

[55] *Id.*

[56] *See* note 5, *supra.*

[57] *Id.*

reliable mechanism for reconstructing orders from the time of receipt through execution. As discussed below, however, the commenters expressed a number of concerns regarding the feasibility of the proposal, as originally submitted.

A. Implementation Schedule

Twelve commenters stated that the proposed implementation schedule was unrealistic and overly ambitious and should be delayed.[58] Thirteen commenters believed the industry would be unable to meet the proposed deadlines due to the existing burdens on the industry's technical resources caused by the Year 2000 conversion, the implementation of the Commission's Order Handling Rules, the move to trading in sixteenths and efforts to prepare for the move to decimal-based pricing.[59] Four commenters noted that the Association's failure to provide timely technical specifications made the proposed implementation dates unworkable.[60] Two commenters recommended that, similar to the implementation of the Order Handling Rules, the implementation of the new OATS rules should be phased-in incrementally, beginning with a small group of issues.[61] A moratorium on enforcement for some specified period of time also was suggested by one commenter.[62]

In response to the commenters, the NASDR has proposed to delay the implementation schedule for the proposed rules, as discussed above in section III.E.[63] However, the NASDR has neither proposed to modify the implementation schedule to phase-in a certain number of stocks incrementally nor proposed a moratorium on enforcement.

B. Costs of Proposal

As noted above, thirteen commenters noted the significance of the existing burdens on the industry's technical and financial resources associated with the Year 2000 conversion, the implementation of the Commission's Order Handling Rules, the move to trading in sixteenths and efforts to prepare for the move to decimal-based pricing.[64] Similarly, six commenters expressed concerns regarding the substantial initial costs to be incurred as a result of the implementation of the proposal.[65] The commenters complained that such costs were not justified by the NASD in its proposal. Several commenters also expressed concerns that OATS would reduce market liquidity, increase costs to investors and place smaller firms at a competitive disadvantage.[66] In addition, two commenters complained that the proposed OATS would slow customer executions.[67]

In response to cost concerns, the NASDR notes that while it has considered the costs to firms of implementing the system, the proposed OATS is directly responsive to a mandate issued by the Commission.[68] In addition, the NASDR notes that the proposed modifications to the recordkeeping and reporting requirements, coupled with the proposed delay in the implementation schedule and the OATS' reliance on historical, rather than real-time data, should help to reduce the cost of the proposal.[69]

C. Technological Interface Concerns

Three commenters cited potential problems created by the incompatibility of different order routing and execution systems used both within firms and between firms.[70] One of those commenters further noted potential issues arising from the fact that within certain firms, orders received electronically (which would have fit within the definition of ''electronic order'' as originally proposed) may be dealt with manually at some point and therefore, should not be considered electronic for purposes of the proposal.[71] In response to concerns regarding the distinctions between electronic and manual orders, the NASDR amended proposed Rule 6951 to revise the definition of the term ''electronic order'' and add a definition of the term ''manual order.''[72] In addition, the NASDR proposes to amend proposed Rules 6954 and 6957 to modify the recordkeeping requirements and the implementation dates, respectively, applicable to manual orders.[73]

D. Bunched Orders

Three commenters expressed concerns that the proposed prohibition on bunching of orders or aggregation of order flow would result in decreased market efficiency and increased transaction costs.[74] In response, the NASDR proposes to amend its proposal to explicitly allow for bunched orders, aggregated prior to execution.[75] As discussed above, the NASDR proposes to amend Rule 6954 to require members transmitting manual orders in a bunch to record and report for each order to be included in a bunched order, the bunched order route indicator assigned by the transmitting member.[76]

E. Preferred Stock

One commenter noted that because of its similarity to debt instruments, many member firms trade preferred stock in their fixed income departments.[77] The commenter recommended that, as a result, preferred stock should be excluded from the proposed OATS requirements.[78] The NASDR has not amended its proposal to provide a specific exemption from the requirements of the OATS rules for preferred stock.[79]

F. Unique Order Identifier and Other Order Transmission Issues

With respect to technical concerns raised by the proposal, three commenters recommended that the proposal be amended to allow the unique order identifier to consist of the eight characters currently recognized by the industry as the Common Message Switch's standard order format.[80] One commenter stated that the mandated disclosure of a unique order identifier, which may contain proprietary information relating to a trader's strategies, would compromise the trader's ability to work the market to receive the best execution for the

[58] *See* Letters from J.P. Morgan, Mabon, Banc One, A.G. Edwards, Instinet, Morgan Stanley, Salomon Bros., Schwab, SIA, Advest, BancAmerica, and Oppenheimer, *supra* note 5.

[59] *See* Letters from J.P. Morgan, Mabon, A.G. Edwards, Instinet, Morgan Stanley, Salomon Bros., Schwab, SIA, Advest, Wheat First, J.C. Bradford, BancAmerica, and Oppenheimer, *supra* note 5.

[60] *See* Letters from J.P. Morgan, HBK Finance, SIA, and J.C. Bradford, *supra* note 5.

[61] *See* Letters from SIA and Merrill Lynch, *supra* note 5.

[62] *See* SIA Letter, *supra* note 5.

[63] *See* Amendment Nos. 4 and 6, *supra* notes 8 and 10.

[64] *See* note 59, *supra.*

[65] *See* Letters from Mabon, Banc One, HBK Finance, Instinet, Morgan Stanley, and Franklin Templeton, *supra* note 5.

[66] *See* Letters from Mabon, BIS, Banc One, and Schwab, *supra* note 5.

[67] *See* Letters from Instinet and Morgan Stanley, *supra* note 5.

[68] *See* note 11, *supra.*

[69] *See* Amendment No. 4, *supra* note 8.

[70] *See* Letters from Morgan Stanley, Schwab, and BancAmerica, *supra* note 5.

[71] *See* Morgan Stanley Letter, *supra* note 5.

[72] *See* Amendment No. 4, *supra* note 8. These definitions are discussed above in section III.A.

[73] *See* Amendment Nos. 4 and 6, *supra* notes 8 and 10.

[74] *See* Letters from A.G. Edwards, Instinet, and J.C. Bradford, *supra* note 5.

[75] *See* Amendment Nos. 4 and 6, *supra* notes 8 and 10.

[76] *See* Amendment No. 6, *supra* note 10.

[77] *See* Salomon Bros. Letter, *supra* note 5.

[78] *Id.*

[79] *See* Amendment No. 4, *supra* note 8.

[80] *See* Letters from J.P. Morgan, SIA, and Merrill Lynch, *supra* note 5.

customer.[81] Two commenters suggested that the OATS include a mechanism to provide a recap or acknowledgment of the transmission to be sent to the member firm.[82] Another commenter noted that transmission of data to the OATS must occur after-hours to allow member firms adequate time to process all business transactions.[83]

In response to the expressed concerns, the NASDR proposes to provide technical specifications that permit the order identifier for orders transmitted electronically other than to ECNs to contain the industry standard of only 8 characters, rather than the 12 characters initially proposed.[84] With respect to orders transmitted manually, the NASDR proposes to amend proposed Rule 6954 to eliminate the requirement that the order identifier and the order origination date be passed when the order is transmitted.[85]

G. Synchronization of Business Clocks

Several comments were addressed to the proposed synchronization of business clocks. One commenter stated that it would be impossible for member firms both to initially synchronize their manual business clocks and to maintain synchronization of all business clocks.[86] The same commenter also cited the difficulties inherent in requiring each registered representative to time-stamp and date every order, particularly those orders received when the representative is not in the office.[87] Another commenter recommended that synchronization of business clocks should be industry-wide and should include the automatic order entry and execution systems operated by the various exchanges.[88]

Other than to delay the implementation date of mandatory synchronization to August 7, 1998, for computer system clocks and July 1, 1999, for mechanical clocks, the NASDR has not modified its proposal in response to these comments.[89]

H. ECNs

One commenter noted the special problems the proposal would create for ECNs.[90] Specifically, this commenter observed that the proposal would require ECNs to distinguish between market maker proprietary orders and other orders, which existing technology does not currently permit.[91] In addition, this commenter noted that the proposed treatment of order modifications as canceled or replaced is contrary to ECN users' practice of negotiating and trading directly with each other.[92]

In recognition of the unique characteristics of ECNs and in response to the concerns expressed in the comment letter from Instinet, an ECN, the NASDR proposes to limit ECN reporting to the OATS to the events that occur within the ECN. ECNs would be required to record and report only those information items that the member transmitting the order to the ECN has provided. The NASDR proposes that all orders transmitted to ECNs, regardless of how such orders were transmitted to the ECN, be treated like manual orders.[93]

I. Modifications to ACT and Other Alternatives to the OATS

Several alternatives to OATS were recommended by the commenters. For example, eight commenters recommended that rather than creating OATS, the Association should focus its efforts on improving the existing ACT system to incorporate the additional required information.[94] One commenter proposed that rather than requiring further development, the NASD should recognize existing electronic audit trails relied upon by member firms as appropriate vehicles for surveillance.[95] In addition, one commenter recommended that the NASD develop a uniformly available technology platform to be used by all industry participants for non-electronic orders.[96]

The NASDR has not modified the proposal in response to these comments. The NASDR stated that modifying ACT would be detrimental to the current function or capacity of the ACT system and might degrade the performance or trade reporting function of ACT.[97]

V. Discussion

After careful review, 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.[98] Specifically, the Commission believes the proposal is consistent with the requirements of Section 15A(b)(6) of the Act.[99] That section requires that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, and in general, to protect investors and the public interest.

As discussed in section II above, pursuant to the SEC Order, the NASD agreed to design and implement by August 8, 1998 or such later time as the Commission may order,[100] an order audit trail system that would enable the NASD to reconstruct markets promptly, conduct efficient surveillance and enforce its rules. At a minimum, the audit trail is required to: (a) provide an accurate, time-sequence record of orders and transactions which documents the receipt and life of the order and (b) market-wide synchronization of member firms' business clocks. In the Appendix to its 21(a) Report, the Commission stated 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.'' [101] The Commission further noted that the implementation of an enhanced audit trail would ''allow for prompt surveillance on a scale that cannot be attained with traditional methods of examination'' and ''would greatly facilitate the ability of the NASD and the Commission to protect the interests of investors.'' [102] The Commission believes that, as proposed, the OATS will satisfy both conditions of the SEC Order and is consistent with the requirements of Section 15A(b)(6) of the

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[81] *See* A.G. Edwards Letter, *supra* note 5.

[82] *See* J.P. Morgan and SIA Letters, *supra* note 5.

[83] *See* A.G. Edwards Letter, *supra* note 5.

[84] *See* Amendment No. 4, *supra* note 8. According to the NASDR, where two or more orders share the same order identifier, additional order details including information items in proposed Rule 6954(b) can be used to uniquely identify a particular order.

[85] *See* Amendment No. 4, *supra* note 8.

[86] *See* A.G. Edwards Letter, *supra* note 5.

[87] *Id.*

[88] *See* Merrill Lynch Letter, *supra* note 5.

[89] *See* Amendment No. 4, *supra* note 8.

[90] *See* Instinet Letter, *supra* note 5.

[91] *Id.*

[92] *Id.*

[93] See Amendment No. 4, *supra* note 8.

[94] *See* Letters from J.P. Morgan, BIS, HBK Finance, Morgan Stanley, SIA, BancAmerica, Oppenheimer, and Merrill Lynch, *supra* note 5.

[95] *See* Instinet Letter, *supra* note 5.

[96] *See* J.P. Morgan Letter, *supra* note 5.

[97] *See* Amendment No. 4, *supra* note 8.

[98] In approving this rule, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[99] 15 U.S.C. 78o–3(b)(6).

[100] The Commission notes that the NASDR is prepared to meet the established August 1998 deadline. The implementation schedule was delayed not to accommodate the NASDR, but rather, at the request of the industry. The Commission finds the delayed implementation to be reasonable to enable the industry to effect the necessary systems conversions in an efficient and smooth manner.

[101] *See* note 14, *supra.*

[102] *Id.*

Act [103] in that it will greatly assist both the NASD's and the Commission's efforts to more rapidly detect and punish fraudulent and manipulative acts and practices involving Nasdaq equity securities. OATS is designed to capture the type of information that the NASDR can use to prevent the trading abuses that threatened to undermine the integrity of its market and which harmed investors. In short, OATS is an integral part of the NASD's efforts, as mandated by its settlement with the Commission, to uphold its self-regulatory responsibilities to enforce its rules.

To the extent that commenters' suggestions could lessen the costs of OATS without diminishing its effectiveness, they have been adopted by the NASD in amendments to its proposal, as described below. As discussed in section IV above, a number of commenters stated that the proposed implementation schedule was unrealistic and should be delayed to allow member firms to prepare to comply with the OATS rules. The Commission notes that the NASDR responded to such comments by delaying the effective dates of the proposal and by phasing in the requirements more gradually. For example the Commission notes that under the original proposal, all electronic orders were subject to the OATS rules as of August 8, 1998. The amendment implementation schedule would apply the OATS rules as of March 1, 1999 only to electronic orders received by ECNs and the trading departments of members that are market makers in the securities that are the subject of the orders. All electronic orders will not be subject to the OATS rules until August 1, 1999, pursuant to Amendment No. 4.

The Commission believes that the proposed changes to the implementation schedule for the Order Audit Trail System are reasonable as the additional time provided should allow member firms ample opportunity to develop and test their systems to ensure compliance with the requirements of the proposed rules. The Commission notes that delaying the final effective date of the initial phase-in of the system by six months should provide the NASDR, market-makers, and ECNs adequate time for testing of the Order Audit Trail System prior to March 1, 1999. Member firms not subject to the March 1999 deadline may be expected to benefit from observing the implementation process and thereby, to better focus their own efforts to successfully prepare prior to their scheduled implementation dates.

Further, the Commission believes that, given the critical role that market makers play in the market for Nasdaq equity securities, it is appropriate that the requirements of OATS would be effective first for the electronic orders received by market makers in those securities. In addition, the Commission notes that, although the March 1, 1999 effective date also applies to electronic orders received by ECNs, neither ECNs nor market makers will have to report any information to the OATS that is not readily available at trading desks by March 1, 1999. Therefore, the Commission believes that both the NASDR and Nasdaq market participants should have a sufficient opportunity to obtain important insight into the OATS process and to make any necessary systems changes prior to the August 1, 1999 effective date for all electronic orders.

As discussed in the Summary of Comments section above, member firms were particularly concerned about their ability to capture the required information regarding orders that are received manually. The Commission believes the proposed delay in implementing the requirements for manual orders until July 31, 2000 should provide adequate time for all member firms to either develop the necessary systems in-house or make arrangements to have their reporting obligations arising under the OATS rules fulfilled on their behalf by a Reporting Agent.

Several comment letters addressed the proposed synchronization of business clocks. The Commission notes that the requirement for synchronization of members' business clocks is a specified element of the undertakings contained in the SEC Order.[104] The Commission believes the reliability and usefulness of the OATS is contingent upon the synchronization of all applicable business clocks of all member firms. Determining whether members have complied with the OATS rules depends critically on establishing with confidence the time at which order information is received as measured by a source that is standard throughout the industry.[105] As discussed in section IV.G. above, the Commission notes that one commenter recommended that the proposed synchronization of business clocks should be truly industry-wide and should include the automatic order entry and execution systems operated by the various exchanges.[106] The Commission supports a move toward industry-wide synchronization of clocks and believes the synchronization requirement in OATS is an important first step.

The Commission notes that NASD's members' obligation to maintain the synchronization of business clocks will be ongoing. The technical specifications proposed by the NASDR will require that the accuracy of clocks be resynchronized every day before the market opens. The proposed technical specifications further contemplate that business clocks would be checked against the standard clock periodically throughout the day at pre-determined intervals and re-synchronized, if necessary. The Commission further notes that compliance examinations, conducted by both the NASDR and the Commission, will include a review of member firms' compliance with these requirements, including the adequacy of procedures and the degree of accuracy of all business clocks. The Commission believes the proposed procedures should ensure the accuracy and reliability of business clocks that are used for trading and reporting purposes. Accordingly, the Commission believes that the proposed requirements relating to the synchronization of member business clocks is consistent with the requirements of Section 15A(b)(6) of the Act [107] insofar as a reliable record of the timing of reportable events should greatly assist the NASDR's efforts to detect and to punish fraudulent and manipulative activity more quickly.

The Commission also notes that a number of commenters expressed concerns regarding the original proposal to use a non-industry standard 12 character order identifier and problems with passing the order origination date. The proposed rules, as amended, would conform the requirements of the unique order identifier to comply with the industry standard, eight-character alphanumeric field and eliminate the requirement to pass the order origination date. According to the NASDR, the eight alphanumeric character order identifier will suffice to gather the needed information required by OATS. In situations where the unique order identifier is not transmitted, other order data required to be reported should allow orders to be uniquely identified. The Commission believes the proposed modifications to

[103] 15 U.S.C. 78o–3(b)(6).

[104] *See* note 11, *supra.*

[105] Synchronization of all business clocks also is important in evaluating compliance with other rules to which member firms are subject, including, among others, best execution obligations, firm quote rules, and prohibitions on frontrunning customer orders.

[106] *See* note 88, *supra.*

[107] 15 U.S.C. 78o–3(b)(6).

the requirements relating to the unique order identifier should reduce the requisite number of program changes and the amount of testing required of member firms without jeopardizing the usefulness of the data to be received by the NASDR. In turn, this amendment should lower the cost of the proposal and thereby, address, to some extent, the concerns expressed by several commenters relating to the costs associated with implementation of the proposal.[108]

Moreover, the Commission notes that for orders transmitted manually and all orders transmitted to ECNs, neither an order identifier nor an order origination date will be passed when the order is routed. In addition, in response to concerns expressed by several commenters,[109] only certain information items would be required to be recorded and reported to OATS. As these information items generally correspond to data that is expected to be readily available at trading desks at the time that the orders are received, the Commission believes that the proposal acknowledges the unique challenges OATS presents to member firms that handle manual orders and to ECNs. The Commission believes that the proposal, as amended, appropriately addresses these concerns as delineated above, while continuing to allow NASDR to track these orders through the OATS. The Commission further believes that, so long as manual orders and orders transmitted to ECNs can be manually matched by the NASDR, the proposed elimination of these requirements is appropriate.

In addition, the Commission believes the provisions of proposed Rule 6954(c) permitting a Reporting Agent to fulfill a member's reporting obligations should provide member firms with needed flexibility. These provisions, which require a written agreement and make clear that the member firm retains primary compliance responsibility for recording and reporting order information, should benefit smaller member firms by providing them with the option to rely on third parties to comply with the reporting obligations arising under the proposed rules. The Commission believes that the provisions contained in proposed Rule 6955(c) should alleviate some of the concerns expressed by commenters that OATS would place smaller firms at a competitive disadvantage.[110]

The Commission notes that in response to concerns express by several commenters, the NASDR clarified that reporting of bunched orders would be permitted and required additional information to be recorded and reported with respect to such orders. The Commission believes the NASDR's proposed treatment is appropriate as it will allow those members that are accustomed to bunching their orders to continue to do so while permitting those manual orders that are bunched to be easily identified by the OATS.

The Commission notes that one commenter recommended that preferred stock be excluded from the proposed requirements.[111] The Commission believes that the NASDR's decision to not provide a specific exemption from the OATS, requirements for preferred stock is appropriate because the preferred stock is an equity security that poses many of the same surveillance concerns as common stock.

The Commission 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 the Commission in carrying out their regulatory responsibilities. Nonetheless, the Commission believes that the NASDR's proposal represents a significant and appropriate effort to satisfy the Commission mandate to develop and implement OATS, while attempting to minimize the costs imposed on the industry by such an undertaking. The Commission expects that during the process of implementing and reviewing OATS, the Commission and the NASDR will identify ways in which to improve OATS. The Commission fully expects the NASDR to submit proposals to modify the requirements of OATS, as needed, to enhance the effectiveness of OATS as a regulatory tool.

The Commission notes that the proposed revisions to NASD Rule 3110 would impose recordkeeping requirements on Reporting Members in addition to the recordkeeping and reporting requirements set forth in the OATS rules. Proposed Rule 3110(c) would require members to record the identification of the registered representative who receives an order directly from a customer, the identification of each registered person who executes the order, and the identification of the department that originates an order that is manually transmitted to another department within the member firm. The Commission notes that the proposal, as originally submitted, required the identification of the individual receiving and the department originating an order to be recorded and reported to OATS. Although this information may be critical to the Commission and the NASDR for surveillance and enforcement purposes, the Commission believes, as noted above, that it is reasonable to require this information to be recorded, but not reported to OATS, to allow the implementation of OATS to proceed as quickly as possible. Again, after the Commission and the NASDR have gained experience with OATS, further modification to these requirements may be deemed necessary.

The Commission finds good cause for approving proposed Amendment Nos. 2, 3, 4, 5, and 6 prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The Commission notes that Amendment Nos. 2 and 3 involve technical and procedural matters relating to the extension of the Commission's statutory review process and the numbering of the proposed rules. Accordingly, the Commission believes that Amendments Nos. 2 and 3 raise no issues of regulatory concern.

With respect to Amendment No. 4, the Commission notes that the Amendment, among other things, clarifies the proposal and extends the implementation schedule for the proposed changes. In Amendment No. 4, the NASDR clarifies its original proposal by redefining certain terms, such as "electronic order," and adding defined terms, such as "manual order," to more accurately reflect current industry understanding of those terms. Amendment No. 4 also revises proposed Rule 6954 to separately address four different order transmittal scenarios. The Commission supports these clarifications and believes they should assist member firms in their efforts to comply with the new requirements. The NASDR also proposes to delay the phase-in of the OATS implementation schedule to provide member firms with additional time to develop and test their systems prior to the mandatory implementation date. The Commission notes that the proposed extension of the effective dates is directly responsive to the comment letters submitted on the proposed rule.

[108] *See* discussion in section IV.B. above. The Commission recognizes that OATS will require some degree of systems changes by NASD members that will vary depending upon the business mix of the particular firm. These changes will entail costs for all NASD firms. Nevertheless, the Commission believes any costs are far outweighed by the substantial benefit to NASDR surveillance and enforcement that will arise from OATS. Without the implementation of OATS, it would be harder to detect and deter the types of trading abuses described in the Commission's 21(a) Report.

[109] *See* discussion in section IV.H. above.

[110] *See* note 66, *supra.*

[111] *See* note 78, *supra.*

In addition, Amendment No. 4 contains several proposed modifications to the proposed rule change, the majority of which will facilitate member compliance, often at a lower cost. For example, in response to a number of commenters' concerns, Amendment No. 4 proposes to modify the specifications for electronic orders to conform the unique order identifier requirement to the industry standard of eight characters and to delete the requirement to pass the order origination date. The Commission believes that the proposed modifications relating to the technical specifications for electronic orders should substantially ease the compliance burden imposed on NASD members by the proposed rule without undermining the purpose of the OATS. Further proposed modifications contained in Amendment No. 4 would facilitate the reporting requirements relating to bunched orders. Amendment No. 4 also proposes to modify the proposal by limiting the reporting requirements applicable to ECN's to conform to those requirements applicable to manually transmitted orders.

Moreoever, Amendment No. 5 proposes to delete the provisions in the proposed rule text stating that the information required to be recorded by the Reporting Member operating an ECN is that information provided to the ECN by the transmitting Reporting Member. The Commission notes that Amendment No. 5 proposes to conform the language of the text to the technical specifications for OATS developed by the NASDR. Consequently, the receiving ECN will be required to record the applicable information items specified in Rule 6954(c) at the time the order is received from the transmitting member. As discussed above, the Commission notes that the proposed modifications to the proposed rule change contained in Amendment Nos. 4 and 5 are directly responsive to the concerns expressed in comment letters submitted to the Commission.

Finally, Amendment No. 6 provides a number of clarifying and technical amendments which raise no issues of regulatory concern. Amendment No. 6 clarifies the treatment of bunched orders, and modifies the language of the proposed rule both to eliminate inapplicable references and to make the rule text easier to understand. Amendment No. 6 also revises the implementation date of Phase One of OATS to allow market participants additional time to implement the required systems changes and to conduct necessary testing.

Further, Amendment No. 6 eliminates the requirement under proposed Rule 6954(c)(1) that an order that is transmitted from one department to the trading desk of the same firm must be reported to OATS. As OATS will assume that transmissions for which there is no routing report have been transmitted to the member's trading desk, the Commission believes that this amendment will allow OATS to obtain sufficient information while reducing unnecessary recordkeeping and reporting burdens imposed on member firms.

In addition, Amendment No. 6, by amending NASD Rule 3110, reinstates the recordkeeping requirements initially proposed by the NASDR and published for comment by the Commission. In particular, Amendment No. 6 amends Rule 3110 to require information items pertaining to the identification of persons and departments receiving or originating orders to be recorded by Reporting Members. The Commission notes that such items were initially proposed to be recorded and reported to OATS and thus, Amendment No. 6 minimizes the reporting obligations of member firms while ensuring that vital identifying information continues to be available for regulatory purposes. Accordingly, the Commission believes that it is consistent with the Act in general and with Section 15A(b)(6) of the Act [112] in particular to approve Amendment Nos. 2, 3, 4, 5, and 6 to the proposed rule change on an accelerated basis.

VI. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendments Nos. 2, 3, 4, 5, and 6, including whether the proposed Amendments are consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. 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, N.W., Washington, D.C. 20549. Copies of all such filings will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR–NASD–97–56 and should be submitted by April 3, 1998.

VII. Conclusion

The Commission believes that the proposal, as amended, should significantly assist the NASDR's efforts in fulfilling its regulatory responsibilities. The Commission further believes the proposed rules meet the minimum requirements for an order audit trail system imposed by the Commission in the SEC Order, which required a time-sequenced record of orders and market-wide synchronization of all member firms' business clocks. In addition, the OATS should provide a useful surveillance tool that will allow earlier detection of fraudulent activity for the benefit of investors and the public. Therefore, the Commission believes the approval of the proposed Order Audit Trail System, as amended, is appropriate and consistent with the requirements of the Act applicable to a national securities association, and in particular, with the requirements of Section 15A(b)(6) of the Act [113] and the rules and regulations thereunder.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[114] that the proposed rule change (SR–NASD–97–56), including Amendment Nos. 1, 2, 3, 4, 5, and 6, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[115]

Jonathan G. Katz,

Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–39722; File No. SR–PHLX–97–46]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to Proposed By-Law Amendments to Article IV, Section 4–8, Article V, Section 5–5, and Article XXII, Section 22–1

March 4, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934

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[112] 15 U.S.C. 78o–3(b)(6).

[113] 15 U.S.C. 78o–3.

[114] 15 U.S.C. 78s(b)(2).

[115] 17 CFR 200.30–3(a)(12).