Securities Industry Association

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October 6, 1997

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
Re: SR-NASD-97-56

Dear Mr. Katz:

The Securities Industry Association's ("SIA")[1] Order Audit Trail System ("OATS") *Ad Hoc* Committee ("Committee")[2] appreciates this opportunity to provide comments on the National Association of Securities Dealers, Inc.'s ("NASD") proposed rule change relating to an order audit trail system. The Committee supports the development of an audit trail and has worked diligently with the NASD over the last year to provide industry input into the design of that system. Nevertheless, despite the productive dialogue that we have had, we are concerned that the August 1998 implementation date for the first phase is too ambitious given the extensive systems modifications that will be required. Until the rule filing is approved and the systems requirements and technical specifications are final, the industry cannot begin the process of planning the systems modifications necessary to comply with the proposed requirements. Moreover, we believe that less costly, more efficient alternatives should be considered before the industry sets out to develop multiple, possibly incompatible, systems for the capture and reporting of data in connection with telephone and electronic orders.

I. Background

The proposed system was established to comply with a settlement agreement between the NASD and the Securities and Exchange Commission ("SEC" or "Commission")[3] and is designed to capture order information reported by members for integration with quote information from The Nasdaq Stock Market, Inc. ("Nasdaq") and trade information reported to the Automated Confirmation Transaction Service ("ACT") in order to provide the NASD with an accurate time-sequenced record of orders and transactions. Specifically, the proposed rules will require member firms to capture and report electronically 25 data elements related to the handling and execution of orders for all Nasdaq equity securities. The implementation schedule contemplates that the requirements would apply to electronic orders as of August 1998, to all orders received by other than electronic means at the trading desk of a market maker that are executed the same day they are received as of January 1, 1999, **4** and to all other orders as of January 31, 2000.

In order to implement OATS in the most efficient and cost-effective manner, the *Ad Hoc* Committee has been providing industry input on the development of the system to the NASD since the summer of 1996. At a meeting in March 1997, which SEC staff attended, the Committee determined that it would be possible to provide most of the proposed data elements by August of 1998 for those orders that are currently captured in an automated system, *i.e.*, those orders that are submitted, transmitted, and executed electronically, or those that are promptly entered into an automated system upon receipt. Telephone orders, or those that are handled manually, present significant operational issues, which the industry is still working to resolve. The determination with respect to electronic orders, however, presumed that the release of the technical specifications was imminent and the necessary systems work could begin. This would have provided over a year for systems modification and testing.

II. Implementation Schedule Should be Revised

A technological undertaking of this magnitude will require more time, both for members and the NASD, to properly program and test the systems required to comply with the proposal. In addition, service bureaus that report trade data for many firms will need to upgrade their systems as well. It is expected that many more firms, particularly those that are not highly automated, will have to resort to service bureaus to meet their OATS reporting obligations. The Committee is particularly concerned about the scarcity of qualified systems personnel in light of other demands on the industry such as the Year 2000 conversion, the continuing phase-in of the order handling rules, the change to finer increments of trading, and the conversion to a decimal-based pricing system.

The Committee strongly urges the Commission to delay the effective date of the first phase of the OATS rules until all reasonable alternatives have been carefully considered. If, indeed, the system as proposed is determined to be the most feasible approach, the SEC should nevertheless delay the effective date until at least February 1999 or 12 months after the rules have been approved and firms and vendors can begin the necessary systems redesign. At a minimum, the SEC should consider experimenting with a selected group of issues as it did with the introduction of the order handling rules, or should impose a moratorium on enforcement actions for violations of the reporting requirements for some reasonable period of time. The Committee also believes the SEC should postpone setting an effective date for the latter phases until the NASD has had the opportunity to observe the operation of the first phase and it is clear that NASD and industry systems can handle the volume of message traffic that will result.

III. Industry Alternatives Have Not Been Addressed

Although the NASD has done a commendable job of keeping the industry informed during the development process, a number of alternatives proposed by the industry have not been addressed. Specifically, the Committee suggested that the NASD consider enhancing the ACT system to accommodate some, if not all, of the data elements called for by the NASD, in effect modifying ACT to create an automated order entry facility. The Committee believes that this approach would address many of the issues raised in connection with telephone orders and would facilitate the integration of those orders into the audit trail at the appropriate time.

As proposed, OATS would require certain data elements to be passed from one firm to another. Because of the highly inter-dependent nature of the system, an effective audit trail can be produced only if an order entry firm can automatically transmit and an order receiving firm can automatically capture the data elements. The linking of these electronic systems is a monumental task, requiring revising and testing, as discussed in more detail below, possibly thousands of interfaces.

The Committee believes that rather than attempt to develop an entirely new system, the NASD should use an existing system such as ACT to capture OATS data. It is the consensus of the Committee that the audit trail could be implemented in the least amount of time at the least cost to the industry by using such an existing system. Although NASD staff expressed concern about modifying the ACT system because of the potential for degradation in trade reporting that could result, it is not clear that this proposal has been seriously evaluated.

In order to minimize the systems changes that firms would be required to make, it has been suggested that the unique order identification requirement be modified. As proposed, at the point that an order is received or originated, certain identifying information will be required to be recorded, including a unique order identifier assigned by the member firm, the member identification symbol assigned by the NASD to the member, and the date on which the order was received or originated. This information, together with the terms of the order, must be passed to another firm if the order is forwarded to another firm for handling or execution.

The difficulty with the above requirement is that the Common Message Switch standard order format used by the industry does not accommodate either the date field or an expanded 12-character order identification. It does accommodate a four alpha character branch identifier and a four numeric character sequence number. This "branch/sequence number" is how firms have traditionally identified an order when forwarding it to either another firm or to one of the exchanges. If OATS were to use the branch/sequence number identification supplemented by the order details to uniquely identify the order, it would obviate the need for interfaces between the firms to be changed and tested.**5** In addition, it would prevent two different interfaces from evolving within the industry-one for Nasdaq and one for listed securities. The NASD has not yet indicated whether this would be a viable alternative.

Finally, the Committee believes that a recap or an acknowledgment of the transmission is an important component. Firms must be able to periodically audit their own reporting programs to ensure synchronization of their own and the OATS database. Although the Committee raised this with the NASD, there is no indication in the proposal that any progress has been made on this point.

IV. OATS May Have an Anti-Competitive Impact

The NASD acknowledges in the filing that the reporting requirements of the proposed rule generally will require member firms to modify existing systems to permit efficient and timely transmission of information, or in some cases, to create new data capturing and reporting systems. Firms that do not have the order flow to justify the development of an automated system will be forced to rely on service bureaus or, more likely, their clearing firms. The Committee believes this raises a competitive issue in that clearing firms will have an advantage over other executing firms in their ability to provide "one stop shopping" for their correspondents. Correspondents will be unable to execute orders away from the clearing firm because the cost of building an automated system to record and transmit the data elements to the NASD will be prohibitive, particularly if the system is required to be in place and testing completed within a short period of time.

Moreover, OATS is premised on a model of order-handling and securities trading not applicable to all broker-dealers, which could impair innovation and deter market competition. For example, some electronic communications networks ("ECNs") allow direct customer negotiation within their systems. Other systems protect their participants' place in the time/price priority queue if the participant updates an order. As proposed, OATS would require the cancellation and re-booking of customer orders as negotiations or updates take place, reducing the practicality of offering customers direct control over their orders. Broker-dealer customers that route orders to ECNs (or to market makers) on an aggregate basis would be impeded from doing so under rules that require transmission of a unique identifier upon the transfer of each order. These examples highlight the fact that in defining order reporting parameters, a market model may be presupposed that does not contemplate non-traditional brokerage providers. This could frustrate current and future attempts at innovation and unintentionally steer market participants towards a single variation of customer service. Despite the benefits of a comprehensive audit trail, the creation of such a system should not come at the cost of reduced competition and stifled innovation.

The Committee believes that an NASD system that could be accessed via a Nasdaq workstation, or another workstation for non-Nasdaq subscribers, would address some of the competitive issues. A more level playing field would result if firms or customers had the ability to report on their own. The Committee strongly believes that this approach merits more serious consideration.

V. Impact of Current Initiatives Should be Assessed Before Implementation

The NASD, with the support and cooperation of the industry, has made substantial progress toward the development of the audit trail system contemplated in the settlement agreement. Nevertheless, recording and transmitting the required data elements will involve significant systems changes and a substantial commitment of resources for most firms at a time when those resources are taxed by the systems upgrades necessary to accommodate the order handling rules and the change to trading in sixteenths. In fact, systems personnel industry-wide continue to struggle with the systems development demands and capacity problems caused by both of those initiatives.**6** For example, as a result of the Securities Industry Automation Corporation's ("SIAC") inability to handle the increased message traffic resulting from the change to sixteenths, industry participants report that exchange trades are continuously being executed based on stale quotations. **7** This is a clear example of why the Commission must proceed carefully and should not minimize the impact of the changes required by the OATS proposal.

VI. Conclusion

The Committee urges the Commission to issue an order extending the effective date of OATS for at least an additional six months. In addition, given the volume of order data that NASD systems will be required to handle, the Committee also urges the Commission to postpone setting an effective date for incorporating non-electronic orders until NASDR has gained experience with, and its systems have proved capable of handling, electronic orders. Indeed, because the large majority of Nasdaq's order flow is electronic, the initial phase will provide NASDR with an extremely useful surveillance tool.

Thank you for the opportunity to comment. Given the significance and far-reaching impact of this proposal, we would be happy to meet with appropriate staff to discuss our views in more detail. If you have any questions, please contact the undersigned or Judith Poppalardo, Vice President and Associate General Counsel, at 202-296-9410.

Sincerely,

Bernard L. Madoff
Chair
OATS *Ad Hoc* Committee

CC:
The Honorable Arthur Levitt, Chairman
The Honorable Norman S. Johnson, Commissioner
The Honorable Isaac C. Hunt, Jr., Commissioner
Dr. Richard R. Lindsey, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Howard Kramer, Associate Director, Division of Market Regulation
David Oestreicher, Senior Counsel, Division of Market Regulation
Richard G. Ketchum, Executive Vice President and Chief Operating Officer, NASD
Mary L. Schapiro, President, NASD Regulation
James M. Cangiano, Senior Vice President, NASD Regulation

Footnotes:

1 The Securities Industry Association ("SIA") is the trade association representing the business interests of about 750 securities firms in North America. Its members include securities organizations of virtually all types - investment banks, brokers, dealers and mutual fund companies, as well as other firms functioning on the floors of the exchanges. SIA members are active in all exchange markets, in the over-the-counter markets, and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for 90% of securities firm revenue in the United States. This and other recent SIA comment letters can be found on SIA's Internet home page, http://www.sia.com.

2 The *Ad Hoc* Committee is comprised of representatives from the Self-Regulation and Supervisory Practices, Operations, Trading, and Technology Management Committees and was formed to provide industry input into the development of the audit trail system. The *Ad Hoc* Committee met regularly with NASD staff during the development process and formed subgroups, as necessary, to address issues in connection with the reporting obligations for various types of orders.

3 As a result of a 21(a) Report issued by the SEC, the NASD entered into a settlement agreement with the SEC in which it has undertaken to, among other things, design and implement by August 1998 an audit trail that provides a time-sequenced record of all events in the life of an order from receipt from a customer through execution of the transaction.

4 The information required to be reported with respect to this phase would be limited to items readily available at the trading desk.

5 In the case of a retail firm, only a few interfaces may need to be changed. In the case of a wholesale firm, as many as 100 interfaces may have to be changed. In the case of an Electronic Communications Network ("ECN"), a much higher number of customer interfaces would require modification. In addition, once the order entry firm and the order receiving firm have modified their interfaces, the interfaces will have to be tested. For firms that maintain disaster recovery facilities, those interfaces will have to be changed and tested separately.

6 The full impact of the order handling rules will not be realized until the end of the fourth quarter of 1997 when the roll-out is complete.

7 The New York Stock Exchange recently filed a proposed rule change with the Commission that would, among other things, exculpate the Exchange, market data vendors, market data sources, and others from members' claims of liability as the result of inaccurate or delayed information, or the omission of information. *See* Securities Exchange Act Rel. No. 34-38930 (August 12, 1997), 62 FR 161. It appears that the proposed rule change is designed to insulate vendors from liability in these circumstances.