January 1, 2006 or on the date all of the proposed enhancements to the MFQS system have been implemented. The Commission believes that this change to the proposal sufficiently addresses the concerns expressed by the commenter.

The Commissioner finds good cause for approving proposed Amendment No. 2 before the 30th day after the date of publication of notice of filing thereof in the **Federal Register.** Nasdaq filed Amendment No. 2 in response to comments it received after publication of the notice of filing of the proposed rule change, to address the commenter's concerns. Because Amendment No. 2 is responsive to the commenter's concerns, the Commission finds good cause for accelerating approval of Amendment No. 2.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether Amendment No. 2 is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*); or
- Send an e-mail to *rule-comments@sec.gov.* Please include File Number SR–NASD–2005–059 on the subject line.

Paper Comments

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

All submissions should refer to File Number SR–NASD–2005–059. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the NASD. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–NASD–2005–059 and should be submitted on or before October 25, 2005.

VI. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[15] that the proposed rule change (File No. SR–NASD 2005–059), as modified by Amendment No. 1, thereto, be, and it hereby is, approved and that Amendment No. 2 be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[16]

Jonathan G. Katz,

Secretary.

[FR Doc. 05–19808 Filed 10–3–05; 8:45 am]

BILLING CODE 8010–01–M

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

[16] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–52521; File No. SR–NASD–00–23]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Amendment No. 2 to Proposed Rule Change by Relating to Amendments To Order Audit Trail System Rules and Notice of and Order Granting Accelerated Approval to Amendment No. 3

September 28, 2005.

I. Introduction

On April 19, 2000, the National Association of Securities Dealers, Inc. (''NASD'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission''), 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 amend its rules relating to its Order Audit Trail System (''OATS''). On September 5, 2000, NASD filed Amendment No. 1 to the proposed rule change. The proposed rule change, as amended by Amendment No. 1, was published for comment in the **Federal Register** on October 3, 2000.[3] The Commission received 13 comment letters from 12 commenters in response to the publication.[4]

In response to those comments, on June 10, 2005, NASD filed Amendment No. 2 to the proposed rule change. Amendment No. 2 was published for comment in the **Federal Register** on June 27, 2005.[5] The Commission received six comment letters in response to the publication.[6] On September 14, 2005, NASD filed Amendment No. 3 to the proposed rule change to address the concerns raised in those comment letters, and to make a technical change to the rule text. This order approves Amendment No. 2 to the proposed rule change. In addition, the Commission is publishing this notice to solicit comments on Amendment No. 3 to the proposed rule change and is

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

[2] 17 CFR 240.19b–4.

[3] *See* Securities Exchange Act Release No. 43344 (September 26, 2000), 65 FR 59038.

[4] *See* letters to Jonathan G. Katz, Secretary, Commission, from Harold M. Golz, Krys Boyle Freedman & Sawyer, P.C. on behalf of Rocky Mountain Securities & Investments, Inc., dated October 20, 2000 (''Rocky Mountain Letter''); Mitchell M. Almy, President, Mitchell Securities Corporation of Oregon, dated October 20, 2000 (''Mitchell Securities Letter''); Joanne Ferrari, Compliance Manager, Weeden & Co., dated October 23, 2000 (''Weeden Letter''); Bonnie K. Wachtel, CEO and Wendie L. Wachtel, COO, Wachtel & Co., Inc. dated October 24, 2000 and March 26, 2001 (''Watchel Letters—1''); Laurence Storch, Storch & Brenner, LLP, dated October 24, 2000 (''Stroch & Brenner Letter''); Allen Thomas, Vice President, A.G. Edwards & Sons, Inc., dated October 24, 2000 (''A.G. Edwards Letter''); Stuart J. Kaswell, Senior Vice President and General Counsel, Securities Industry Association, Ad Hoc Committee, dated October 24, 2000 (''SIA Letter-1''); W. Leo McBlain, Chairman and Thomas J. Jordan, Executive Director, Financial Information Forum, dated October 24, 2000 (''FIF Letter-1''); Thomas F. Guinan, Senior Vice President, Pershing Division of Donaldson, Lufkin & Jenrette Securities Corporation, dated October, 24, 2000 (''Pershing Letter''); Paul A Merolla, Senior Vice President and General Counsel, Instinet Corporation, dated October 25, 2000 (''Instinet Letter''); Richard E. Schell, Vice President and Assistant General Counsel, First Options of Chicago, dated October 25, 2000 (''First Options Letter''); Jill W. Ostergaard, Vice President, Morgan Stanley Dean Witter, dated October 27, 2000 (''MSDW Letter'').

[5] *See* Securities Exchange Act Release No. 51890 (June 21, 2005), 70 FR 36985.

[6] *See* letters to Jonathan G. Katz, Secretary, Commission, from Chris Charles, President, Wulff, Hansen & Co., dated July 12, 2005 (''Wulff Letter''); Bonnie K. Wachtel, CEO and Wendie L. Wachtel, COO, Wachtel & Co., Inc. dated July 18, 2005 (''Wachtel Letter-2''); Ronald C. Long, Senior Vice President, Wachovia Securities, LLC, dated July 18, 2005 (''Wachovia Letter''); Howard Meyerson, General Counsel, Liquidnet, Inc., dated July 19, 2005 (''Liquidnet Letter''); Bob Linville, ADP/SIS Service Bureau Committee Co-Chair, Deborah Mittelman, Sunguard Service Bureau Committee Co-Chair, W. Leo McBain, Chairman, Manisha Kulkarni, Executive Director, Financial Information Forum, dated July 22, 2005 (''FIF Letter-2''); Ira Hammerman, Senior Vice President and general Counsel, Securities Industry Association, dated July 26, 2005 (''SIA Letter-2'').

simultaneously approving the amendment on an accelerated basis.

II. Background

On March 6, 1998, the Commission approved NASD Rules 6950 through 6957 (''OATS Rules'').[7] OATS provides information regarding orders and transactions that allows NASD to conduct surveillance and investigations of member firms for potential violations of NASD rules and the federal securities laws. OATS is designed,[8] at a minimum, to: (1) 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 (2) provide for market-wide synchronization of clocks used in connection with the recording of market events.

The OATS Rules generally impose obligations on member firms to record in electronic form and report to NASD on a daily basis certain information with respect to orders originated or received by NASD members relating to securities listed on Nasdaq. OATS captures this order information reported by NASD members and integrates it with quote and transaction information to create a time-sequenced record of orders and transactions. This information is used by NASD staff in conducting surveillance and investigations of member firms for violations of federal securities laws and NASD rules.

The OATS requirements were implemented in three phases. All members were required 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. In addition, electronic orders received at the trading department of a market maker and those received by ECNs were required to be reported to OATS as of March 1, 1999 (''Phase One''). Additional information relating to market maker and ECN electronic orders and all other electronic orders were required to be reported to OATS by August 1, 1999 (''Phase Two''). Finally, pursuant to Rule 6957(c), the OATS Rules were to apply to all manual orders effective 120 days after Commission approval of the instant filing, SR–NASD–00–23, (''Phase Three'').[9]

During the implementation of OATS, NASD has identified several changes to OATS that it believes would enhance NASD's automated surveillance for compliance with trading and market making rules such as Interpretive Material (IM) 2110–2, (commonly referred to as the ''NASD's Limit Order Protection Interpretation''), the SEC's Order Handling Rules [10] and a member firm's best execution obligations. In addition to implementing Phase Three of OATS, NASD proposed these changes in SR–NASD–00–23 and Amendment No. 1 thereto. Provided below is a description of the original proposal, as modified by Amendment No. 1, a summary of the comments received in response to the proposed changes, and a description of NASD's response (''Amendment No. 2'').

III. Description of Initial Proposal and Amendment No. 1, Comments Received and NASD's Response Thereto (Amendment No. 2)

A. Proposed Definition of Time of Receipt

1. Description

NASD Rule 6954 requires certain identifying information be recorded at various critical points during the life of an order, thereby assisting NASD in carrying out its regulatory responsibilities. In particular, NASD Rule 6954(b)(16) requires that members record and report the date and time the order is originated or received by a Reporting Member (''time of receipt''). The OATS Rules, which currently only apply to electronic orders, require that the time of receipt for an electronic order be the time an order is received by a firm's electronic order handling system. Upon approval of the instant proposed rule change, members will be required to record and report OATS information for manual orders as well.

The time of receipt for manual orders is the time the order is received by the member from the customer, whether that is at a trading desk or at another location. In the original filing, NASD proposed that the time of receipt for manual orders be the time the order is received by the member firm's trading desk or trading department for execution or further routing purposes. NASD also proposed to codify the staff's position that the time of receipt for electronic orders is the time the order is captured by a member's electronic order-routing or execution system.

In Amendment No. 1, NASD amended its original filing and proposed that the time of receipt for manual orders of less than 10,000 shares be the time the order is received by the member's trading desk or trading department for execution or routing purposes. For manual orders that are 10,000 shares or greater, the time of receipt would continue to be the time the order is received by the member from the customer.[11]

2. Comments and NASD's Response

One commenter supported the proposed definitions,[12] while several commenters opposed having two definitions of time of receipt for manual orders.[13] Specifically, commenters opposed the requirement that the time of receipt for a manual order of 10,000 shares or greater be the time the order is received by the member from the customer, rather than the time the order is received at the member's trading desk or trading department for execution or routing purposes. Commenters asserted that eliminating the time a 10,000 share or greater order is received by the trading desk for OATS purposes would impede NASD surveillance capabilities while, conversely, the inclusion of the customer order receipt time for these orders would not improve significantly NASD's ability to oversee and enforce sales practice violations.[14] Further, commenters noted that NASD, where necessary, could obtain from members the customer order receipt time from members, which is required to be maintained under Rule 17a–3(a)(6) of the Act.[15] In addition, commenters indicated that the two differing definitions of receipt time would create unnecessary costs and burdens for members in establishing automated systems to capture OATS data at branch locations, as well as confusion for salespersons in the branches and trading

[7] *See* Securities Exchange Act Release No. 39729, 63 FR 12559 (March 13, 1998).

[8] OATS is intended to fulfill one of the undertakings contained in the order issued by the Commission relating to the settlement of an enforcement action against the NASD for failure to adequately enforce its rules. *See* In the Matter of National Association of Securities Dealers, Inc., Securities Exchange Act Release No. 37538, August 8, 1996; Administrative Proceeding File No. 3–9056.

[9] The original effective date for Phase Three was July 31, 2000. NASD filed a proposed amendment with the SEC for immediate effectiveness to extend the implementation date of Phase Three to 120 days after SEC approval of SR–NASD–00–23. *See* Securities Exchange Act Release No. 43654 (December 1, 2000), 65 FR 77405 (December 11, 2000).

[10] *See* Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996).

[11] Because certain order handling rules may apply differently to block orders of 10,000 shares or greater, NASD proposed, in Amendment No. 1, to define the time of receipt differently depending on the size of the order.

[12] *See* Mitchell Securities Letter.

[13] *See* SIA Letter-1; MSDW Letter; Pershing Letter; A.G. Edwards Letter; and Rocky Mountain Letter.

[14] *See* SIA Letter-1 and A.G. Edwards Letter.

[15] 17 CFR 240.17a–3(a)(6); *See* SIA–1 Letter; MSDW Letter; A.G. Edwards Letter; and Pershing Letter.

desk personnel of firms, and would lead to inadvertent mistakes and delays in executions.[16]

NASD agreed with commenters that having two differing definitions of time of receipt based solely on the size of the order would create burdens for members. However, because NASD believes that it is critical that OATS capture the time that an order is received by the trading desk, and have an electronic record of when orders, especially larger orders, are received at a firm to enable the staff to perform surveillance to detect violations such as frontrunning, as reflected in Amendment No. 2, NASD determined that OATS should capture both the time the order is received by the member from the customer and the time the order is received by the member's trading desk or trading department, if those times are different.

Given that orders may be routed to multiple locations within a firm prior to reaching the trading desk (or even routed outside the firm directly from a desk other than the trading desk), in Amendment No. 2, NASD proposes to capture the various receipt times (customer receipt time, trading desk receipt time, etc.) by expanding the OATS order transmittal requirements that apply to intra-firm routes to include orders routed to the trading department.[17] Specifically, if an order were not received immediately at the trading department, members would be required to capture information relating to the transfer of that order to the trading department under the order transmittal requirements of NASD Rule 6954(c). To the extent that the time of receipt of the order from the customer and receipt of the order by the trading department are the same, no Desk Report would be required, given that the New Order Report would accurately capture the time of receipt at the trading department.

The proposed rule change, as reflected in Amendment No. 2, would apply equally to both electronic and manual orders. In other words, the time of receipt for purposes of order origination would always be the time the order is received from the customer. Amendment No. 2 also would require that members provide information on the nature of the department to which an order was transmitted, the number of shares to which the transmission applies, and any special handling requests. As with other technical requirements relating to OATS, NASD represented that it will specify in the *OATS Reporting Technical Specifications* how firms should report this information.

B. Proposed Exclusion From the Definition of ''Reporting Member''

1. Description

Certain NASD members engage in non-discretionary order routing processes whereby, immediately after receipt of a customer order, the member routes the order, by electronic or other means, to another member (''receiving Reporting Member'') for further routing or execution at the receiving Reporting Member's discretion. Currently, the OATS Rules require both the member with which the order originated and the receiving Reporting Member to create and report New Order Reports and possibly Route Reports. This results in the receipt of duplicative information by OATS. Therefore, NASD proposed in the original filing that the OATS Rules be amended to require, in such instances, that only the receiving Reporting Member report OATS data. NASD proposed that a member would not be required to report OATS data regarding an order, if the following conditions are met:

(1) the member engages in a non-discretionary order routing process, pursuant to which it immediately routes, by electronic or other means, all of its orders to a single receiving Reporting Member;[18]

(2) the member does not direct or maintain control over subsequent routing or execution by the receiving Reporting Member;

(3) the receiving Reporting Member records and reports all information required under NASD Rules 6954 and 6955 with respect to the order; and

(4) the member has a written agreement with the receiving Reporting Member specifying the respective functions and responsibilities of each party to effect full compliance with the requirements of NASD Rules 6954 and 6955.

2. Comments and NASD's Response

One commenter suggested that the exclusion from the definition of ''Reporting Member'' for members that use a non-discretionary order routing process as described in the proposed rule change be expanded to allow for an additional exclusion for members that regularly route all of a particular type of order or class of securities to a single receiving Reporting Member pursuant to a contractual arrangement.[19] For example, if a firm regularly routes to a receiving Reporting Member all transactions in margin accounts and the receiving Reporting Member otherwise has total execution discretion and meets the other requirements set forth in the proposed rule change, the firm should be excluded from reporting these orders under the OATS Rules. The commenter noted that such an exclusion could be limited to no more that two or three such relationships.[20] One commenter also suggested an order-by-order exclusion.[21] Another commenter suggested allowing firms to handle an occasional order in a discretionary manner, but still be eligible for the exclusion.[22]

Another commenter stated that it is inequitable to provide an exclusion to correspondent firms that send all their order flow to their clearing firm, but not other kinds of order entry firms.[23] The commenter generally argued that this proposed exclusion is unfair to other firms with different business models and is likely to hasten the decision by some firms to entrust all of their order flow with one executing party.[24] This commenter suggested that the exemption be extended to all reporting firms based on the number of manual orders they handle as a percentage of total volume.[25]

In response, NASD states that the proposed exclusion from the definition

[16] *See* SIA–1 Letter; MSDW Letter; and A.G. Edwards Letter.

[17] NASD Rule 6954(c) currently requires that certain information be recorded when an order is transmitted to a department within a firm, other than the trading department. In furtherance of this provision, the *OATS Reporting Technical Specifications* requires that this information be reported to OATS via a ''Desk Report.'' When the OATS Rules originally were adopted in 1998, the OATS reporting framework was based on NASD staff's understanding that most electronic orders received by members were transferred to the trading department for execution and that such transfer was instantaneous with receipt of the order. Members had indicated that the ''routine'' order flow from point of receipt to the trading department would generate a significant number of OATS Desk Reports, and that reporting that information to OATS would be very burdensome and provide little additional information, since the transfer was instantaneous. As a result, Desk Reports were required only in those instances where orders were transmitted to departments other than the trading department (*e.g.*, block desk, arbitrage desk). Since that time, member order routing and handling systems have changed and a larger percentage of orders are not routed immediately to the trading desk. Therefore, NASD staff believes the exclusion for orders routed to the trading department no longer makes sense and may result in gaps in the audit trail.

[18] If any delay results in the routing of an order due to systems problems or other reasons, the member with which the order originated would be required to report OATS data.

[19] *See* Rocky Mountain Letter.

[20] *See* Rocky Mountain Letter.

[21] *See* Pershing Letter.

[22] *See* FIF Letter-1.

[23] *See* SIA Letter-1.

[24] *See* SIA Letter-1.

[25] *See* SIA Letter-1.

of Reporting Member is directed at those members that use a non-discretionary order routing process whereby, immediately after receipt of its customer orders, the member routes all its orders, by electronic or other means, to a single receiving Reporting Member for further routing or execution at the receiving Reporting Member's discretion. NASD states that the proposed exclusion is not limited to correspondent/clearing relationships, but applies to any relationship that meets the proposed conditions.

NASD explained that the goal of the proposed rule is to eliminate the reporting of duplicative information to OATS where *all* of the OATS data of one member would be captured by the receiving Reporting Member. NASD noted that if the proposed rule were to permit deviations from this as commenters suggest, the exclusion would, in effect, permit an exclusion for almost any category of orders that are routed to another firm. Without the condition that all orders be routed to one firm, NASD would not have the ability to easily identify which receiving Reporting Member is providing the OATS order information that corresponds to the orders initially received by the member. Therefore, NASD declined to make any further changes to this proposed rule as described by commenters. However, in Amendment No. 2, NASD proposes to modify the rule text to clarify that, to qualify for the proposed exclusion to the definition of ''Reporting Member,'' the member must route all of its orders to a single receiving Reporting Member.

C. Recording and Reporting a Routed Order Identifier

1. Description

OATS has the capability of tracking the history of an order by linking such orders across firms through the use of a routed order identifier. If the order does not contain a routed order identifier, the order cannot be linked systematically to subsequent actions, such as further routing or execution by other firms or Nasdaq systems. In this regard, the complete history of a significant percentage of orders may not be tracked because the OATS rules do not require a receiving Reporting Member to capture and report a routed order identifier if the order is routed to it manually.

2. Comments and NASD's Response

Several commenters opposed the proposed requirement that members be required to capture and report a transmitting member's unique identifier for all manually routed orders.[26] Commenters stated that members should not be responsible for capturing accurately on a manual basis the routed order identifier from other firms noting that errors will be frequent and carried on to the next firm to which the order is routed.[27]

Commenters further noted that the proposed requirement would lead to delays in order communication and executions and ultimately harm public investors.[28] Because orders that are transmitted manually may not be entered into a firm's system and no systematic order identifier generated, commenters indicated that the proposed requirement would pose serious operational and logistical problems.[29] Commenters also argued that NASD could effectively link or match together routed orders with new orders of the firm they are routed to without the routed order identifier information.[30]

In response to these comments, NASD reiterated that the use of a routed order identifier reported through OATS permits NASD to track the history of orders routed between firms on an automated basis and that if the order does not contain a routed order identifier, the order cannot be linked systematically on an automated basis to subsequent actions, such as further routing or execution by other firms. In the case of manually routed orders, however, NASD stated that it does not believe that the benefits provided by such an identifier clearly outweigh the related costs to members. In support of this, NASD noted in particular the commenters' concerns that requiring routed order identifiers for manually-routed orders creates potential delays in the handling and execution of customer orders and creates the likelihood of high levels of data errors. Further, NASD recognized that while it would not be able to track the history of manual orders between firms on an automated basis without a routed order identifier, the staff could create, on an order by order basis, a process that links manual orders to subsequent events with an acceptable level of accuracy. Therefore, NASD concluded that the costs imposed by this proposed requirement relating to manually routed orders as described by commenters are not outweighed by the incremental benefits to NASD regulatory data and surveillance systems and in Amendment No. 2, deleted this proposed requirement.

D. Proposed Exemptive Relief

1. Description

Finally, NASD proposed in Amendment No. 1 new paragraph (d) of NASD Rule 6955 and an amendment to NASD Rule 9610(a) to permit NASD to grant exemptive relief to certain members from the reporting requirements of the OATS Rules under the procedures set forth in the NASD Rule 9600 series. Specifically, members that meet the following criteria would be eligible to request an exemption to the OATS reporting requirements for manual orders:

(1) the member and current control affiliates and associated persons of the member have not been subject within the last five years to any disciplinary action, and within the last ten years to any disciplinary action involving fraud;

(2) the member has annual revenues of less than $2 million;

(3) the member does not conduct any market making activities in Nasdaq Stock Market equity securities;

(4) the member does not execute principal transactions with its customers (with limited exceptions for error corrections); and

(5) the member does not conduct clearing or carrying activities for other firms.

Under the proposed rule change, any exemptive relief granted would expire no later than two years from the date the member receives the exemptive relief. At or prior to the expiration of a grant of exemptive relief, members meeting the specified criteria may request a subsequent exemption. In addition, under the proposed rule change, NASD's exemptive authority would be in effect for five years from the effective date of the proposed rule change.

The proposed exemptive authority would provide NASD the ability to grant relief to members meeting the specified criteria in situations where, for example, reporting of such information would be unduly burdensome for the member or where temporary relief from the rules (in the form of additional time to achieve compliance) would permit the member to avoid unnecessary expense or hardship.

2. Comments and NASD's Response

Commenters generally supported the proposed rule change that would provide NASD with the authority to exempt certain members from OATS reporting for manual orders, but opposed many of the conditions placed

[26] *See* SIA Letter-1; FIF Letter-1; MSDW Letter; Wachtel Letters-1; Pershing Letter; and Mitchell Securities Letter.

[27] *See* SIA Letter-1; FIF Letter-1; Pershing Letter; and Mitchell Securities Letter.

[28] *See* SIA Letter-1; A.G. Edwards Letter; MSDW Letter; Pershing Letter; and Wachtel Letters-1.

[29] *See* SIA Letter-1.

[30] *See* SIA Letter-1 and A.G. Edwards Letter.

on members in order for them to request exemptive relief.[31] For example, several commenters suggested changes to the proposed condition that requires that members requesting exemptive relief not have been subject within the last five years to any disciplinary action, and within the last ten years to any disciplinary action involving fraud.[32] One commenter indicated that the five and ten year disciplinary action test should commence from the date the disciplinary action is initiated, rather than when the disciplinary action is finalized.[33] The commenter indicated that the date of initiation of the disciplinary action is the date most closely linked to the conduct that is triggering the sanction and that members should not be discouraged from seeking a hearing or other recourse due to the proposed condition on obtaining exemptive relief for OATS purposes.[34] One commenter suggested a *de minimis* exception for single disciplinary action incurring a fine of not more than $10,000,[35] while another commenter suggested that NASD be provided discretion to consider a firm's overall disciplinary history in determining whether to grant an exemption.[36]

One commenter suggested that exemptive relief be available for market makers that conduct principal trades.[37] Another commenter recommended eliminating the condition restricting firms that clear for others from obtaining exemptive relief where the introducing firm is not a reporting member under NASD Rule 6951 (except the exclusion that another member report its trades) and/or the introducing firm obtains an exemption under NASD Rule 6955.[38] This commenter also suggested that the provision stating that a firm seeking an exemption cannot clear for other firm might disrupt a longstanding relationship that is integral to the introducing firm's business.[39]

One commenter noted that the five-year ''sunset'' provision on NASD's ability to grant exemptions should be extended indefinitely, noting that there currently is no reason to believe the rationale for providing NASD exemptive authority will be any different in five years. Moreover, the procedural impediments necessary for NASD to request that its exemptive authority be extended would be very burdensome.[40]

Another commenter stated that exemptive relief should be provided from all OATS reporting requirements for any NASD member that: (1) Carries no accounts for customers; (2) provides execution services in Nasdaq equity securities only to other dealers who are acting as market makers or proprietary traders and not on behalf of a customer; and (3) does not itself (other than in an error account) engage in market making or proprietary trading.[41]

NASD did not propose any changes to this exemptive provision in Amendment No. 2. However, NASD staff committed to review and analyze closely the application of such conditions to exemptive authority and determine whether it would be appropriate to seek changes to these conditions, including the types of changes suggested by commenters.

In Amendment No. 2, however, NASD proposes to amend NASD Rule 6955(d)(1)(A) to clarify that the condition on members that may request exemptive relief under the proposed rule applies only to *final* disciplinary actions within the last five years and does not include minor rule violations pursuant to Rule 19d-1(c)(2) of the Act.[42]

E. Comments on Implementation Schedule

Several commenters requested additional time to comply with the proposed Phase Three requirements.[43] In recognition of the technological burdens that may be imposed on members as a result of the changes proposed, in Amendment No. 2, NASD proposes to provide an implementation date 120 days from Commission approval of the proposed rule change.

Amendment No. 2 was published for comment in the **Federal Register** on June 27, 2005.[44] The Commission received six comment letters in response to the publication.[45]

IV. Summary of Comments on Amendment No. 2 and NASD's Response Thereto (Amendment No. 3)

A. Definition of Time of Receipt

One commenter indicated that requiring members to capture the time the order is received by the member from the customer would create unnecessary costs and burdens for members in establishing automated systems to capture OATS data.[46] In response, NASD stated that it recognizes that this requirement may impose additional costs on member firms, however NASD believes that it is critical to NASD's surveillance systems and regulatory program that OATS capture the full lifecycle of an order within a firm and, in particular, the time that an order is received from the customer. However, in recognition of these burdens, NASD proposed to extend the implementation period of the proposed rule change.[47]

B. Exemptive Authority

Commenters generally supported the proposed rule change that would provide NASD with the authority to exempt certain members from OATS reporting for manual orders, but opposed the limited nature of NASD's exemptive authority.[48] For example, one commenter suggested that an exemption be provided to any member that handles a small percentage of manual orders as compared to its overall volume, [49] while another opposed the expiration of NASD's exemptive authority in five years.[50]

One commenter suggested revising the condition that only members with annual revenues of less than $2 million may request exemptive relief. Specifically, the commenter suggested that annual revenues for this purpose be based only on revenues from transactions in Nasdaq securities.[51]

In response to these comments, NASD committed to review and analyze closely its exemptive authority and determine whether it would be appropriate to seek any changes, including the types of changes suggested by commenters to the proposed rule change, but declined to make the changes suggested by commenters in Amendment No. 3.

C. Application to Preferred and Convertible Securities

One commenter suggested that NASD grant a carve-out or phased implementation for preferred securities and convertible securities, given the manual nature of the trading in these securities.[52] In response to this

[31] *See* Mitchell Securities Letter; Wachtel Letters-1; Storch & Brenner Letter; and First Options Letter.

[32] *See* Watchel Letters-1.

[33] *See* Watchel Letters-1.

[34] *See* Watchel Letters-1.

[35] *See* Watchel Letters-1.

[36] *See* Storch & Brenner Letter.

[37] *See* Mitchell Securities Letter.

[38] *See* Wachtel Letters-1.

[39] *See* Watchel Letters-1.

[40] *See* Watchel Letters-1.

[41] *See* First Options Letter.

[42] 17 CFR 240.19d-1(c)(2).

[43] *See* SIA Letter-1; FIF Letter-1; MSDW Letter; A.G. Edwards Letter; Weeden Letter; and Pershing Letter.

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

[45] *See* note 6, *supra.*

[46] *See* Wachovia Letter.

[47] *See* Section IV.E., *infra.*

[48] *See* Wachovia Letter; SIA Letter-2; Wachtel Letter-2.

[49] *See* SIA Letter-2.

[50] *See* Wachtel Letter-2.

[51] *See* Wulff Letter.

[52] *See* SIA Letter-2.

comment, NASD stated that it does not believe it poses any additional burdens than those associated with manual orders of other securities. NASD noted that it proposed to extend the implementation time for the proposed rule change, which it believes will provide members adequate time for any technological or system changes required to address OATS reporting of manual orders in convertible and preferred securities.[53]

D. Comments Requesting Clarification

One commenter requested clarification on how the term ''trading desk'' or ''trading department'' would apply, particularly for firms that do not have a trading desk.[54] In response, NASD noted that it had previously issued guidance relating to the term ''trading department'' and that this same guidance will continue to apply with respect to the proposed rule change.[55]

One commenter requested clarification as to the time parameter associated with the term ''immediately'' in the context of order receipt time under the proposed rule change.[56] In response NASD explained that if an order were not received immediately at the trading department, members would be required to capture information relating to the transfer of that order to the trading department under the order transmittal requirements of Rule 6954(c). In Amendment No. 3, NASD stated that it believes that where a member receives and handles an order within the same second, the member would not be required to report a Desk Report relating to that order.

One commenter requested clarification on order receipt time in the context of third party Internet service providers. The commenter indicated that a third party Internet service provider may capture orders on behalf of a member after trading hours and submit these orders in batch the next trading day. The commenter indicated that order receipt data is not transmitted by the third party Internet service provider as part of the order data.[57] In response, NASD explained that, as with any requirement under the OATS Rules, the decision by a member to use a third party provider does not change the member's obligation under the rules. As such, NASD stated that the member is required to capture order receipt time on all orders. The batching or other transmittal practices of a third party vendor would not change this requirement.

Another commenter supported the proposed exclusion from the definition of ''Reporting Member'' under the OATS Rules, but suggested that NASD provide additional guidance in the future regarding the condition that the member does not direct or maintain control over subsequent routing or execution by the receiving Reporting Member.[58] NASD responded that if the proposed rule change is approved, it would issue a *Notice to Members* announcing approval of the proposed rule change and, as part of that *Notice,* it would provide additional guidance on a number of issues, including the exclusion from the definition of ''Reporting Member.''

E. Implementation Issues Relating to the Proposed Rule Change

Several commenters suggested that the proposed implementation period of the proposed rule change should be extended, noting the significant technological changes needed to implement OATS reporting requirements for manual orders.[59] Commenters also requested that NASD promptly publish the *OATS Reporting Technical Specifications* relating to the proposed rule change and that the implementation date be linked to its publication, and that NASD provide adequate time for testing.[60]

In response to commenters and in recognition of the technological burdens that may be imposed on members as a result of this proposal, in Amendment No. 3, NASD proposes to amend the text of NASD Rule 6957(c) to provide an implementation date that is six months after publication of the *OATS Reporting Technical Specifications* relating to SR–NASD–00–23, rather than 120 days from Commission approval of the proposed rule change. In Amendment No. 3, NASD also committed to publish the *OATS Reporting Technical Specifications* within 45 days of Commission approval. In addition, NASD states that it would ensure that adequate time for testing is incorporated into the implementation schedule and will make the testing environment available at least six weeks prior to the implementation date of the proposed rule change.

F. Technical Amendments

In Amendment No. 3, NASD also proposes to make technical amendments to NASD Rule 6957(c) to clarify the OATS order information required under NASD Rule 6954(b)(4)[61] and (5)[62] and the OATS order transmittal requirements under NASD Rule 6954(c)(1) apply to manual orders.[63] NASD explained that, as stated in Amendment No. 2, the proposed rule change applies to both electronic and manual orders. As such, NASD clearly intended to have the inter-departmental order transmittal requirements apply to manual orders. Similarly, department identification information concerning where a manual order was originated also was intended to be included. Therefore, NASD proposes to eliminate the prior exclusion of this information from the OATS requirements for manual orders.

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.[64] Specifically, the Commission believes the proposal is consistent with the requirements of Section 15A(b)(6) of the Act.[65] 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

[53] The Commission notes that when the OATS Rules where originally proposed, a commenter argued that order information on preferred stocks should not be required to be included in OATS. The NASD disagreed, as did the Commission, which stated in the original approval order, ''The Commission believes that NASDR's decision not to provide a specific exemption from 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.'' *See* note 7, *supra* at 12568. The Commission believes this rationale continues to apply.

[54] *See* FIF Letter-2.

[55] *See* Letter from NASD Regulation to Charles R. Hood, dated July 30, 1998. Specifically, NASD stated that the term ''trading department'' is intended to refer to the function within the firm that is responsible for executing orders in Nasdaq equity securities. For an ECN, for example, this may be interpreted as either the trading system (where orders are executed automatically without trader intervention) or the trading department (where orders are executed with the assistance of traders).

[56] *See* FIF Letter-2.

[57] *See* id.

[58] *See* Wachovia Letter.

[59] *See* Wachovia Letter; Liquidnet Letter; FIF Letter-2; and SIA Letter-2.

[60] *See id.*

[61] NASD Rule 6954(b)(4) requires members to record the identification of any department or the number of any terminal where an order is received directly from a customer when an order is received.

[62] NASD Rule 6954(b)(5) requires members to record, where the order is originated by a Reporting Member, the identification of the member that originates the order when an order is received.

[63] As proposed in Amendment No. 2, NASD Rule 6954(c)(1) would require members to record certain order information when a member transmits an order to another department within the member.

[64] 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).

[65] 15 U.S.C. 78o-3(b)(6).

regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, and in general, to protect investors and the public interest.

A. Definition of Time of Receipt

Currently, members are required to capture the time of receipt of an order pursuant to NASD Rule 6954(b)(16). In Amendment No. 2, NASD proposed to define the order origination or receipt time for an order as the time the order is received from the customer. The Commission believes that this change, along with a new requirement that members must record the date and time they transmit orders to their trading departments, should ensure that OATS captures both the time the order is received by the member from the customer and the time the order is received by the member's trading desk or trading department. Importantly, these changes will apply to both electronic and manual orders so that the time of receipt for purposes of order origination should always be the time the order is received from the customer.

The Commission believes that it is important to NASD's automated surveillance systems that OATS capture the time that an order is received by the trading desk, and have an electronic record of when orders, especially larger orders, are received at a firm to enable NASD to perform surveillance to detect certain violations, such as frontrunning. Therefore, the Commission believes that it is appropriate for OATS to capture both the time the order is received by the member from the customer and the time the order is received by the member's trading desk or trading department, if those times are different.

By proposing these changes, NASD would capture the complete lifecycle of an order within a firm, even in those situations where an order is held at the sales trading or other desk within a member firm, and then later routed to the trading desk. Although the Commission recognizes that this requirement may impose additional costs on member firms, the Commission agrees with NASD it is important to NASD's surveillance systems and regulatory program that OATS capture the full lifecycle of an order within a firm and, in particular, both the time that an order is received from the customer and the time the order is received by the trading desk.

B. Definition of Reporting Member

The proposed exclusion from the definition of Reporting Member is directed at those members that use a non-discretionary order routing process whereby, immediately after receipt of its customer orders, the member routes all its orders, by electronic or other means, to a single receiving Reporting Member for further routing or execution at the receiving Reporting Member's discretion. The NASD has explained that the proposed exclusion is not limited to correspondent/clearing relationships, but applies to any relationship that meets the proposed conditions.

The Commission believes that this proposed rule should eliminate the reporting of duplicative information to OATS where all of the OATS data of one member would be captured by the receiving Reporting Member. The Commission also agrees with NASD's proposal to impose a condition on the exclusion that all of a member's orders must be routed to a single firm. The Commission believes that without this requirement, NASD would lack the ability to easily identify which receiving Reporting Member is providing the OATS order information that corresponds to the orders initially received by the member, thus decreasing NASD's ability to efficiently surveil its members.

In addition to eliminating the reporting of duplicative information to OATS, the Commission believes that proposed rule change should reduce the regulatory burdens on members, particularly smaller members, that route all their orders to another receiving Reporting Member by means of a non-discretionary order routing process, for execution or further routing purposes.[66]

C. Routed Order Identifier

After considering comments regarding the pitfalls associated with requiring members to capture and report a transmitting member's unique identifier for all manually routed orders, in Amendment No. 2, NASD concluded that the benefits provided by requiring the capture and reporting of such an identifier do not outweigh the related costs to members. In reaching this decision, NASD recognized the concern that requiring routed order identifiers for manually routed orders could create delays in the handling and execution of customer orders and could result in a high level of data errors. NASD explained that although it would not be able to track the history of manual orders between firms on an automated basis without a routed order identifier, the staff could create, on an order by order basis, a process that links manual orders to subsequent events with an acceptable level of accuracy.

While the Commission believes that requiring the capture and reporting of a routed order identifier for all manually routed orders would enhance NASD's ability to track the history of orders routed between firms on an automated basis, the Commission understands NASD's reluctance to impose such a burdensome requirement on members given that a history of manual orders can be created, albeit in a less efficient fashion, and believes that it is acceptable to relieve members of the burden of capturing a routed order identifier for manual orders at this time.

D. Exemptive Relief

The Commission believes that the exemptive authority proposed by the NASD is appropriate in that it is narrowly tailored to provide NASD the ability to grant relief to members meeting the specified criteria in situations where, for example, reporting of such information would be unduly burdensome for the member or where temporary relief from the rules (in the form of additional time to achieve compliance) would permit the member to avoid unnecessary expense or hardship.

VI. Amendment No. 3

The Commission finds good cause for approving proposed Amendment No. 3 prior to the thirtieth day after the date of publication of the notice of filing thereof in the **Federal Register**. In Amendment No. 3, NASD proposes changes to the implementation schedule for the proposed new OATS Rules and proposes a technical change relating to data required to be reported for manual orders. Accordingly, the Commission believes that Amendment No. 3 raises no issues of regulatory concern.

In Amendment No. 2, NASD proposes an implementation date for the proposed OATS Rules of 120 days from Commission approval of the proposed rule change. A number of commenters, however, argued that the proposed implementation schedule should be extended to allow member firms additional time to prepare to comply with the new OATS Rules. In response to these comments, NASD proposed to amend the text of NASD Rule 6957(c) to provide an implementation date that is six months after publication of the *OATS Reporting Technical Specifications* relating to SR–NASD–00–23, rather than 120 days from Commission approval of the proposed rule change. In Amendment No. 3, NASD also committed to publish the

[66] This exclusion would not change a member's requirement to capture and retain the time an order was received from a customer under SEC Rule 17a–3(a)(6).

OATS Reporting Technical Specifications within 45 days of Commission approval. In addition, NASD stated that it would ensure that adequate time for testing is incorporated into the implementation schedule and will make the testing environment available at least six weeks prior to the implementation date of the proposed rule change.

The Commission believes that the proposed changes to the implementation schedule for the proposed OATS Rules 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.

In Amendment No. 3, NASD also proposes to make technical amendments to NASD Rule 6957(c) to clarify that the OATS order information required under NASD Rule 6954(b)(4) and (5) and the OATS order transmittal requirements under NASD Rule 6954(c)(1) apply to manual orders. Currently, NASD Rule 6957 provides that for manual orders, firms shall not be required to record this information. However, the Commission notes that in Amendment No. 2, NASD stated that the proposed rule change was to apply to both electronic and manual orders. As such, the Commission believes that NASD clearly intended to have the inter-departmental order transmittal requirements apply to manual orders. Similarly, the Commission believes that it was clear that NASD intended that department identification information concerning where a manual order was originated also was intended to be included. Therefore, the Commission finds that it is consistent with the Act in general, and with Section 15A(b)(6) of the Act in particular,[67] to approve Amendment No. 3 to the proposed rule change, as reflected in Amendment No.2, on an accelerated basis.

VII. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 3, including whether the amendment is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*); or
- Send an e-mail to *rule-comments@sec.gov.* Please include File Number SR–NASD–00–23 on the subject line.

Paper Comments

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

All submissions should refer to File Number SR–NASD–00–23. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of NASD.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to the File Number SR–NASD–00–23 and should be submitted on or before October 25, 2005.

VIII. Conclusion

The Commission believes that the proposed rule change, as reflected in Amendments No. 2 and 3, 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[68] and the rules and regulations thereunder.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[69] that Amendment No. 2 to the proposed rule change (SR–NASD–00–23) is hereby approved, and Amendment No. 3 is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[70]

Jonathan G. Katz,

Secretary.

[FR Doc. 05–19809 Filed 10–3–05; 8:45 am]

BILLING CODE 8010–01–P

[67] 15 U.S.C. 78o–3(b)(6).

[68] 15 U.S.C. 78o–3(b)(6).

[69] 15 U.S.C. 78s(b)(2).

[70] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–52513; File No. SR–PCX–2005–106]

Self-Regulatory Organizations; Pacific Exchange, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Rescinding Pilot Rules Relating to the Waiver of the California Ethics Standards for Neutral Arbitrators in Contractual Arbitration and Section 1281.92 of the California Code of Civil Procedure

September 27, 2005.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on September 20, 2005, the Pacific Exchange, Inc. (''PCX'' or ''Exchange'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I and II below, which Items have been prepared by PCX. PCX has designated this proposal as ''non-controversial'' pursuant to Section 19(b)(3)(A)(iii) of the Act,[3] and Rule 19b–4(f)(6) thereunder,[4] which renders the proposed rule change effective immediately upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

PCX is proposing to amend the PCX Options and PCX Equities, Inc. (''PCXE'') arbitration rules to rescind the pilot rules (the ''Pilot Rules'') relating to the waiver of the California Ethics Standards for Neutral Arbitrators in Contractual Arbitration (the ''California Standards'') and the waiver of California Code of Civil Procedure Section 1281.92 (''CCCP Claims''). The text of the proposed rule change is available on the PCX's Web site (*http://www.pacificex.com*), at the PCX's Office

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

[2] 17 CFR 240.19b–4.

[3] 15 U.S.C. 78s(b)(3)(A)(iii).

[4] 17 CFR 240.19b–4(f)(6).