

securities exchange.²⁵ In particular, the Commission believes that the proposal is consistent with section 6(b)(5) of the Act,²⁶ which requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market, and to protect investors and the public interest.

The Commission also finds that the Exchange, through the proposed rule change, satisfies an undertaking set forth in the SEC Order. Specifically, the SEC Order directed the Exchange to “design and implement * * * an audit trail sufficient to enable the NYSE to reconstruct its market promptly, to effectively surveil the NYSE and to facilitate the effective enforcement of the federal securities laws and NYSE rules.” At a minimum, the SEC Order called for the NYSE to provide “an accurate, time-sequenced record of orders * * *” throughout an order’s life, from receipt through execution or cancellation and for synchronization of clocks used in connection with the audit trail of orders.

The proposed rule change will implement: (1) NYSE Rule 123(f) to require that order execution reports containing certain data elements be entered into FESC and that any member organization proprietary system used to record the details of an order must also be capable of transmitting a report of the order’s execution to FESC; (2) NYSE Rule 132C to require members, upon request, to transmit order tracking data to the Exchange; and (3) NYSE Rule 132B to prescribe requirements and procedures with respect to orders in any security listed on the Exchange received or originated by a member. The Commission believes that the implementation of this proposed rule change will establish a complete and comprehensive audit trail which will provide the NYSE with an effective means to track and surveil an order from receipt through execution (or cancellation).

The Commission finds that the proposed rule change was designed to comply with, and fulfills an undertaking contained in the SEC Order relating to the Exchange’s regulatory responsibilities to establish the Phase II Order Audit Trail. As specified in the SEC Order, this proposed rule change establishes an audit trail that will enable

the Exchange to fulfill its regulatory responsibilities to effectively surveil its market and facilitate the effective enforcement of the Exchange Act and NYSE rules.

As described above, the sole commenter to the proposed rule change expressed concerns regarding the proposal’s requirement that firms record information, including the time of receipt, for manual orders. The commenter also expressed dissatisfaction with the requirement that members must assign manual orders an order identification number. While the Commission appreciates these concerns, it notes that manual orders often are large or block-sized orders, therefore such orders have great potential to significantly impact the market and are particularly susceptible to manipulation. In the Commission’s view, it is therefore essential to the creation of a complete and effective systemic order audit trail that the life of manual orders is captured to guard against, and aid surveillance for, potential manipulation.

The commenter also argued the proposal’s requirement that members record an OCS Control Number is not reasonable because it would require members to build a feed to incorporate this information into the audit trail and the cost would be significant. Again, the Commission appreciates the concerns regarding potential costs associated with providing the Exchange with an OCS Control Number. However, in light of the vital regulatory purpose that will be achieved by the creation of an effective and complete systemic order audit trail, the Commission believes that the anticipated development costs are not undue or unwarranted. In the Commission’s view, the OCS Control Number, or its equivalent, is an important part of the audit trail. The OCS Control Number will permit the Exchange to establish a complete order audit trail from order receipt through execution, thus permitting the Exchange to comply with its obligations under the SEC Order. Specifically, the Commission notes that the OCS Control Number will allow the Exchange to link the entry of an order, the execution report, and any modification to such report, thus providing a complete, systemic trail for each order.

Finally, the commenter expressed concern that compliance with the NYSE’s requirement to include a “Bunched Order Route Indicator” may be impossible because a firm typically does not know at the time an order is received whether the order will ultimately be part of a bunched order. The Commission notes, however, that in

order to comply with this provision, a member can make use to the OCS Control Number to locate and link together any parts of an order to which a Bunched Order Route Indicator might need to be appended. Further, the Commission notes that while this process may be somewhat time consuming, it does not expect that orders will be bunched on a regular basis; thus the process will be utilized only on rare occasions.

In approving this proposed rule change, the Commission emphasizes that the Exchange has committed to the following:

The Exchange believes it should not have access to data generated by members and member organizations pursuant to these requirements for the purpose of gaining an unfair advantage over other market participants. In this vein, the Exchange commits that it will not use data received from its members and member organizations pursuant to these requirements to gain a competitive advantage over another self-regulatory organization or broker-dealer (market maker or electronic communications network).²⁷

The Commission would be concerned if the information gained pursuant to OTS were used for any purpose other than regulatory surveillance.

In sum, the Commission recognizes that OTS will require some degree of system changes by NYSE members that will vary depending upon the business mix of the particular firm. These changes will entail costs for all NYSE members. Nevertheless, the Commission believes any costs are far outweighed by the substantial benefit to NYSE surveillance and enforcement that will be derived from OTS. The Commission expects that during the process of implementing and reviewing OTS, the Commission, the NYSE and NYSE members may identify ways in which to improve OTS to make it more efficient and effective from a technological or cost perspective. The Commission encourages a cooperative effort between the NYSE and its members to develop proposals that could achieve such efficiency while satisfying the requirements of the Exchange Act and the SEC Order for the NYSE audit trail.²⁸

²⁷ See Letter from Darla C. Stuckey, Assistant Secretary, NYSE to Belinda Blaine, Associate Director, Division, Commission, dated January 17, 2002 (“Amendment No. 3”).

²⁸ The Exchange states it is committed to a cooperative effort between the NYSE and its members and member organizations in implementing OTS. See Letter from Mary Yeager, Assistant Secretary, NYSE, to Jonathan G. Katz, Secretary, Commission, dated August 15, 2002.

²⁵ In approving this proposal, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

²⁶ 15 U.S.C. 78f(b)(5).