

Amendment No. 1 to the proposed rule change.⁴ The Commission received one comment letter.⁵ The Commission approves the proposed rule change, as amended, and publishes this notice to solicit comments on Amendment No. 1. The Commission also approves Amendment No. 1 on an accelerated basis.

II. Description of the Proposed Rule Change

NASD Regulation proposes to add NASD rule 3115 to establish record-keeping requirements for ATSs that trade security futures⁶ and to amend NASD rule 3340 to prohibit members and associated persons from publishing a quotation for a security future when there is a regulatory trade halt in effect for the underlying security.

Specifically, NASD Regulation proposes to establish audit trail requirements relating to ATSs for the trading of futures on single securities and narrow-based security indices consistent with the Commodity Futures Modernization Act of 2000 ("CFMA").⁷ Under section 6(h)(5) of the Act,⁸ as added by the CFMA, a person⁹ other than a national securities association or national securities exchange member may not maintain or provide a marketplace or facilities for bringing together purchasers and sellers of security future products unless it is a member of a national securities association or national securities exchange that has: (1) Procedures for coordinated surveillance, (2) rules to require an audit trail necessary or appropriate to facilitate coordinated

surveillance, and (3) rules to require such person to coordinate trading halts with markets trading the securities underlying the security futures products and other markets trading related securities. The NASD, as a national securities association, proposes to meet these CFMA requirements to prepare for the trading of security futures by ATSs.

a. Requirements for Alternative Trading Systems

With respect to audit trails necessary to facilitate coordinated surveillance, the proposed rule change would require ATSs to record and report audit trail information on a T+1 basis in such form as the NASD requires. The NASD has based the required elements of the audit trail rule on Regulation ATS rule 302, the Commission's recordkeeping rule for ATSs.¹⁰ The form of the reports will be designed to facilitate the NASD's sharing the reports with members of the Intermarket Surveillance Group, an organization whose purpose is to coordinate surveillance among financial markets. The proposed rule change would require that ATSs preserve such records in accordance with rule 17a-4(b) under the Act,¹¹ which requires preservation of records for at least three years, the first two years in an easily accessible place.

b. Trading Halts

With respect to coordinated trading halts, the proposed rule change would amend the NASD's existing rule prohibiting trading during a halt. Currently, NASD rule 3340 broadly prohibits broker-dealers and associated persons from effecting a "transaction * * * in any security as to which a trading halt is currently in effect." The NASD proposes to amend this rule by adding a provision that prohibits member firms, including ATSs, from effecting any transaction or publishing a priced bid and/or unpriced indication of interest for: (a) A future on a single stock when the underlying stock is subject to a regulatory trading halt; and (b) a future on a narrow based securities index when one or more underlying securities that constitute 50 percent or more of the market capitalization of the index are subject to a regulatory trading halt.¹² Further, by limiting application of new NASD rule 3340(b) to regulatory trading halts, the NASD intends to exclude halts resulting from events such as an order imbalance or a systems failure.

III. Comments

The Commission received one comment letter from Island. Island recommended that the Commission require the NASD to: (1) More narrowly tailor the proposed recordkeeping requirements to be consistent with security futures and the regulatory framework governing security futures; and (2) conditionally exempt ATSs from certain aspects of the trading halt rule. Specifically, Island disputed that NASD rule 3115 governing recordkeeping requirements should mirror the existing audit trail rule in Regulation ATS designed for equity and debt securities. Island also noted its belief that the proposed recordkeeping requirements in NASD rule 3115 require far greater audit trail information than is necessary to perform coordinated surveillance to detect manipulation and insider trading as contemplated by the CFMA. In addition, Island did not believe it was appropriate to amend NASD rule 3340 to include ATSs trading security futures because the effective date of the rule had been delayed to clarify the NASD's interpretation of the rule. Island proposed that the rule be interpreted to exempt ATSs that: (1) Do not accept new orders in such security during a trading halt; and (2) have procedures in place reasonably designed to prevent the execution of orders during a trading halt.

In Amendment No. 1, the NASD responded to Island's comment letter. Specifically, the NASD stated that it reviewed the items required by NASD rule 3115 and the information provided by other markets that are expected to trade security futures products with respect to coordinated surveillance by the Intermarket Surveillance Group, and concluded that the NASD rule 3115 requirements are not unnecessarily broad or burdensome. Regarding the amendments to NASD rule 3340, the NASD noted that the rule has been in effect since October 9, 2001, and thus the proposed amendments, which supplement the rule to account for security futures, should be approved.

IV. Discussion

The Commission has reviewed carefully the proposed rule change, the comment letter, NASD's response to the comment letter, and the entire record herein, and finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations applicable to the Association.¹³

⁴ See letter from Gary Goldsholle, Associate General Counsel, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated August 13, 2002 ("Amendment No. 1"). In Amendment No. 1, the NASD responded to a comment letter from Island, added proposed NASD rule 3115(a)(15) to indicate that the ATS audit trail for security futures trading would include "an account identifier that relates the order back to the account owner(s)," and amended NASD rule 3340(b)(2) to increase the percentage of the market capitalization of underlying securities that trigger a trading halt in a narrow-based security index from 30% to 50%.

⁵ See letter from Chris Concannon, Vice-President, Island, to Jonathan Katz, Secretary, Commission, dated August 20, 2001 ("Island Comment Letter").

⁶ Section 3(a)(55) of the Act defines a "security future" as a contract of sale for future delivery of a single security or of a narrow-based security index. Security futures are defined as "securities" under the Act, thus making the federal securities laws generally applicable to them.

⁷ The CFMA was signed into law on December 21, 2000. Pub. L. No. 106-554, 114 Stat. 2763 (2000).

⁸ See 15 U.S.C. 78f(h)(5).

⁹ The term "person" means a natural person, company, government, or political subdivision, agency or instrumentality of a government. See 15 U.S.C. 78c(a).

¹⁰ 17 CFR 242.302(c).

¹¹ 17 CFR 240.17a-4(b).

¹² See Amendment No. 1, *supra* note 4.

¹³ 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).