

SEC Approves Consolidated Audit Trail Plan

December 20, 2016

On November 15, 2016, the SEC **approved a plan** (the “**Plan**”) to create a consolidated audit trail (the “**CAT**”) that will contain a record of order events for most equity and listed options transactions in the United States. When implemented, the CAT will dramatically enhance the ability of the SEC and the securities exchanges and FINRA (the “**SROs**”) to investigate and analyze market anomalies and potential misconduct.

These improvements, however, will require significant financial and technological investment—especially by broker-dealers—both in terms of fees to fund the SROs’ development and operation of the CAT and to develop their own supporting technology, processes and controls to facilitate reporting.

What Is the CAT and Who Will Operate It?

The CAT will receive specified data from broker-dealers and SROs concerning order lifecycle events for covered securities transactions. Although the SROs already maintain their own audit trail systems, these vary in scope, required data elements and format. In addition, the disparate nature of these systems makes it difficult for regulators to trace orders as they are routed, aggregated, rerouted and disaggregated across multiple markets. The CAT, on the other hand, will capture customer and order event information in covered securities across all markets in a single, consolidated data repository (the “**Central Repository**”). As a result, the CAT should substantially enhance the ability of regulators to oversee the securities markets.

The Plan, which provides the general framework for the CAT, has been several years in the making. The SEC originally adopted Rule 613 of Regulation NMS, requiring the SROs to develop the Plan, in 2012.¹ The Plan approved by the SEC is generally consistent with the requirements of Rule 613, but with several modifications, which were made based on input from market participants.² Key components of the CAT and the Plan include:

- **The CAT LLC and Its Management.** The SROs will conduct the activities related to the CAT through a not-for-profit Delaware limited liability company (the “**CAT LLC**”) jointly owned by the SROs. The SROs will form an operating committee consisting of representatives from each of the SROs (the “**Operating Committee**”) to manage the CAT LLC. The Plan also requires the Operating Committee to establish and select the members of an advisory committee (the “**Advisory Committee**”) consisting of various types of market participants that will advise the SROs and the Operating Committee, including with regard to possible expansion of the Central Repository to other securities and other types of transactions. Although the Advisory Committee has the right to attend Operating Committee meetings and receive information concerning the operation of the Central Repository, the Advisory Committee is not entitled to vote and may be excluded from Operating Committee meetings held in executive session.

¹ See Davis Polk Memorandum, SEC Adopts Rule Requiring Consolidated Audit Trail, available [here](#).

² These modifications relate to the manner of reporting of options market maker quotations, the reporting of identifiers for customers and CAT Reporters, the linking of executions to specific subaccount allocations and the time stamp granularity for certain manual order events.

- **Central Repository.** The Plan requires the SROs and, pursuant to rules required to be promulgated by the SROs, SRO member broker-dealers (“**Industry Members**” and, collectively with the SROs, “**CAT Reporters**”) to report order and transaction information to the Central Repository, which will consolidate and retain submitted data. The SEC and the SROs will have access to the Central Repository to conduct advanced search queries, including reconstruction of market events and the status of order books at various time intervals.
- **Plan Processor.** The SROs will form a selection committee, comprised of one senior officer from each SRO, to hire a firm to act as the “**Plan Processor**,” responsible for building, maintaining and operating the Central Repository. The Plan Processor must designate a Chief Information Security Officer (“**CISO**”) and a Chief Compliance Officer (“**CCO**”). In addition, although the Plan provides the general framework for the CAT, the Plan Processor must publish detailed instructions regarding the submission of data by CAT Reporters to the Central Repository (the “**Technical Specifications**”). In November 2015, the SROs narrowed the list of potential Plan Processors to three: FINRA, SunGard and Thesys. Each of these bidders has also partnered with a technology firm to assist in the development of the CAT.

What Data Will Need to Be Reported?

CAT Reporters will be required to report specified data elements (“**CAT Data**”) to the Central Repository following certain events in the lifecycle of a secondary market order, such as the original receipt or origination, modification, cancellation, routing or execution (in whole or in part) of an order (“**Reportable Events**”), including:

- identifying information for the customer submitting the order³ and the broker-dealer handling the order;
- the date and time of the Reportable Event; and
- the security symbol, order type, price, size, time in force and other material terms of the order.

CAT Reporters must generally report this information to the Central Repository by 8:00 a.m. ET on the trading day following the Reportable Event. CAT Data (other than manual order events) must generally be reported in milliseconds; however, if the CAT Reporter’s order handling and execution systems use time-stamp increments finer than a millisecond, such finer increment must be used. To ensure that regulators are able to properly sequence Reportable Events, SROs and Industry Members must synchronize their business clocks to within 100 microseconds and 50 milliseconds, respectively, of the time maintained by the National Institute of Standards and Technology (the “**NIST**”). However, business clocks used by SROs and Industry Members solely for manual order events may be synchronized to within one second of the time maintained by the NIST.

What Securities and Transactions are Covered?

The Plan will initially require the reporting of CAT Data for NMS Securities, which generally includes U.S. exchange-listed stocks (other than primary market transactions) and equity and equity index options, as well as unlisted stocks that are not restricted securities (e.g., stocks trading on OTC markets). In addition, the SROs are required to submit a document to the SEC by May 15, 2017 outlining how the CAT can be

³ Industry Members must submit an initial set of identifying information for each active account, including the customer’s name and address, and must assign the customer a unique identifier (e.g., an account number) for purposes of identifying the customer on an ongoing basis. The Plan Processor will use this information to assign each customer an identifier that is consistent across all Industry Members.

expanded to include information with respect to debt securities and primary market transactions in equity securities. The SROs have also stated that they intend to assess whether to expand the scope of the CAT to include certain futures, such as equity index futures, at a later date.

What Is the Timeline for Implementing the CAT?

The next step in the implementation of CAT is that each SRO must submit a rule proposal to the SEC by January 13, 2017 that would require its member broker-dealers to comply with Rule 613 of Regulation NMS and the Plan. SROs begin reporting on November 15, 2017 and Industry Members, other than certain small broker-dealers (“**Small Industry Members**”), on November 15, 2018. These and other key dates in the implementation of CAT are listed in the table below.

Milestone	Deadline
<ul style="list-style-type: none"> SROs must file a proposal with the SEC to require its members to comply with the requirements of Rule 613 of Regulation NMS and the Plan 	January 14, 2017
<ul style="list-style-type: none"> SROs must select the Plan Processor 	January 15, 2017
<ul style="list-style-type: none"> SROs and industry members must synchronize their business clocks 	March 15, 2017
<ul style="list-style-type: none"> SROs must file proposals with the SEC to eliminate or modify duplicative SRO rules SROs must file a proposal with the SEC to incorporate into CAT debt securities and equity securities that are currently not covered by the Plan Plan Processor must publish Technical Specifications for SRO submission of order and market maker quote data 	May 15, 2017
<ul style="list-style-type: none"> SROs must begin reporting CAT Data Plan Processor must publish Technical Specifications for Industry Member submission of order data 	November 15, 2017
<ul style="list-style-type: none"> SROs must implement enhanced surveillance using CAT Data 	January 15, 2018
<ul style="list-style-type: none"> Plan Processor must publish the procedures, connectivity requirements and Technical Specifications for Industry Members with respect to certain customer information 	May 15, 2018
<ul style="list-style-type: none"> Industry Members (other than Small Industry Members) must begin reporting customer / institutional / firm account information 	October 15, 2018
<ul style="list-style-type: none"> Industry Members (other than Small Industry Members) must begin reporting CAT Data 	November 15, 2018
<ul style="list-style-type: none"> Small Industry Members must begin reporting customer / institutional / firm account information 	October 15, 2019
<ul style="list-style-type: none"> Small Industry Members must begin reporting CAT Data 	November 15, 2019

Who Will Have Access to CAT Data and For What Purposes?

At least initially, only the SEC and the SROs will be permitted to access and use the Central Repository and CAT Data (other than access provided to an Industry Member for the purpose of correcting CAT Data previously reported).

The SEC and the SROs may only access CAT Data for the purpose of performing their respective regulatory and oversight responsibilities pursuant to the federal securities laws, rules and regulations or any contractual obligations; however, each SRO may use raw data that it reports to the Central Repository for commercial or other purposes, as permitted by applicable law.

How Will the Plan Processor Ensure That CAT Data Is Secure?

The Plan requires the Plan Processor to develop and maintain a comprehensive information security program for the Central Repository, which must:

- cover all components of the CAT system, including physical assets and personnel, and the training of all persons who have access to the Central Repository;
- ensure that all CAT Data is encrypted at rest and in flight;
- include a formal cyber incident response plan;
- require periodic penetration testing and application security code audits by a third party; and
- be consistent with the NIST's Cyber Security Framework.

What Will Happen to Existing Trade and Order Data Reporting Systems?

The Plan requires the SROs to file proposals with the SEC to modify or eliminate key SRO rules and systems that will be rendered duplicative by the CAT, including FINRA's Order Audit Trail System and the Consolidated Options Audit Trail System. In addition, the SEC expects to develop a proposal to amend any aspects of the SEC's electronic blue sheets rules that are made redundant by the CAT and to eliminate the broker-dealer reporting requirements in the SEC's large trader rules.

How Will the CAT Be Funded?

The Plan contemplates that costs associated with building and operating the Central Repository will be borne by: (1) the SROs and alternative trading systems ("**ATs**") through tiered fixed fees based on market share; and (2) Industry Members (other than ATs) through tiered fixed fees based on message traffic. The Plan does not set forth the specific fees to be charged. Instead, the SROs must separately file fee proposals with the SEC, which will be published for public comment, but potentially effective upon filing. These fees must be consistent with applicable Exchange Act standards, including being reasonable and equitably allocated and not unfairly discriminatory.

Next Steps

Although broker-dealers are not required to report CAT Data until 2018 at the earliest, they should undertake steps now to prepare for their future reporting obligations. For example, firms should review their current capabilities and infrastructure to ensure that they are able to retrieve and report CAT Data. Once the Plan Processor publishes the Technical Specifications, firms should establish sound policies and procedures and institute relevant training to ensure compliance.

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