

SEC Adopts Rule Requiring Consolidated Audit Trail

July 19, 2012

Introduction and Overview

On July 11, 2012, the SEC adopted a rule requiring the national securities exchanges and FINRA to jointly propose and implement a plan that would require these organizations and their members to report, into one consolidated audit trail (the “**CAT**”), comprehensive information about every material event in the lifecycle of every quote, order, and execution in all exchange-listed stocks and options.¹

When implemented, the CAT will revolutionize the way the SEC and the self-regulatory organizations oversee the securities markets by providing a searchable database of detailed time-sequenced (to the millisecond) information—including customer identity—with respect to every secondary market order and quote. This improved market oversight, however, comes at the cost of extensive new reporting obligations on market participants, untold costs for marketwide systems and technological upgrades, and the risk of leakage or misuse of highly confidential personal and business information.

The exact nature of the CAT will not be known until the exchanges and FINRA propose, and the SEC approves, the plan for the CAT. By providing the exchanges and FINRA with flexibility in structuring the CAT, the rule also leaves many details about the CAT open, in some cases deferring difficult questions—such as cost-benefit analysis and the scope of protection of information collected—to the exchanges and FINRA to consider in developing the plan.

With many procedural, rulemaking and implementation stages left, it will be over four years, at the earliest, before the CAT is fully implemented, with larger broker-dealers likely not required to begin reporting for at least three years.

The rule was adopted on a three-to-two vote, with Commissioners Aguilar and Walter dissenting based on their view that the rule lacks sufficient “prescriptive” requirements, leaving too much discretion in designing the CAT to the exchanges and FINRA.

Need for the CAT

In conducting market oversight, investigations, enforcement and market analysis, the SEC, FINRA and the exchanges currently rely on several disparate sources of information, such as exchange audit trails and transaction reports and ad hoc requests to broker-dealers for trading records through the electronic blue sheet system. According to the SEC, among other drawbacks, the disparate nature of these systems, differences in data elements recorded, difficulties tracing orders as they move across trading venues, and the significant delay in “cobbling” together the various data, cause inefficiencies and raise challenges for the regulators in overseeing the securities markets. As an example, the SEC cites the difficulties and delays it experienced in attempting to use existing audit trails to comprehensively reconstruct the events of the May 6, 2010 “flash crash.” The CAT would provide regulators with a single system containing comprehensive trading information, allowing the regulators to quickly identify potential unlawful trading, such as attempted market manipulation or insider trading, or conduct market reconstructions.

¹ The Adopting Release, issued in draft form, is available [here](#).

Differences from Proposed Rule

New Rule 613 of Regulation NMS (the “**Final Rule**”) adopts many of the requirements set forth in the SEC’s original 2010 proposal, but is different in a number of important respects.² The most significant change is the relaxation of the time by which the earliest reporting will be required—by 8:00 a.m. on the trading day after the trade date (*i.e.*, T+1), rather than in “real time.” In general, the Final Rule provides the exchanges and FINRA with more flexibility in choosing how to develop and structure the CAT, so long as the final CAT meets prescribed requirements. For example, rather than requiring that all information be reported to the CAT in a uniform format as originally proposed, the Final Rule allows the exchanges and FINRA, if they choose, to allow reporting in various formats—so long as the CAT is able to make all information available to regulators in a uniform format. Additionally, the Final Rule eliminated some of the more tangential data elements that the proposed rule would have required to be regularly reported to the CAT.³

Significant new elements in the Final Rule include a requirement for policies and procedures to ensure the confidentiality and privacy of information reported to the CAT and the establishment of an advisory committee including representation of member firms. Further, the Final Rule also greatly expands the level of detailed analysis that the exchanges and FINRA must include to explain the choices made in developing the CAT plan.

Summary of Final Rule

The Final Rule requires the exchanges and FINRA to jointly file a national market system plan that will govern the creation, implementation, and maintenance of the CAT. The CAT plan must include extensive discussion and analysis of the way the exchanges and FINRA propose the CAT to function, as well as the basis for their decision-making, alternative approaches that were considered, the costs and benefits of the CAT as proposed in the CAT plan, the proposed funding mechanism, and the CAT’s impact on competition, efficiency and capital formation.

The CAT must be required to collect and retain a millisecond time-sequenced record of information related to all orders and bid and offer quotations, and each “reportable event” relating to an order, including the receipt, origination, modification, cancellation, routing and execution (in whole or part) of an order. This information must be reported to the CAT by the exchanges, FINRA, and each broker-dealer. To facilitate this data collection, the exchanges, FINRA and each broker-dealer will be assigned a unique “**CAT Reporter ID**,” each customer will be assigned a unique “**CAT Customer ID**,”⁴ and each order, or leg of an order,⁵ will be assigned a unique “**CAT Order ID**.” The exchanges, FINRA and each broker-dealer will also be required to synchronize their system clocks used for purposes of reporting CAT data, to the time maintained by the National Institute of Standards and Technology.

² Exchange Act Release 62174 (May 26, 2010), containing the SEC’s May 2010 CAT proposal, is available [here](#).

³ The following data elements proposed to be required were eliminated from the Final Rule: the branch and registered representative originating or receiving the order, solicited versus unsolicited, whether the account had a prior position in the security, a locate identifier for short sales, short sale borrow information, amount of commission charged, if any, identification of the broker to whom a commission was paid, and any special settlement terms.

⁴ For purposes of the CAT, the “customer” is the accountholder of record at the broker-dealer originating the order and any person (if different) from whom the broker-dealer is authorized to accept trading instructions for the account. Notably, the proposed rule would have defined “customer” as the “beneficial owner” of the account, which may have been a more difficult item of information for a broker-dealer to know with certainty.

⁵ The Final Rule allows the CAT plan to either require that the full lifecycle of an order be either assigned one single CAT Order ID, or several CAT Order IDs for each separate leg of the order, so long as the several CAT Order IDs can be linked for purposes of reviewing the order’s full lifecycle.

The exchanges, FINRA and broker-dealers will be required to report certain required information about each order and reportable event to the CAT's central repository by no later than 8:00 a.m. on T+1 (the "**T+1 Data**"), and certain other supplemental information regarding the trading by 8:00 a.m. on the trading day following the day on which the information is received (the "**Delayed Data**"). While reporting of T+1 Data may not be required until 8:00 a.m. on T+1, the data elements must be *recorded* by each exchange, FINRA, and broker-dealer contemporaneously with the reportable event. Because such data is often not immediately available, the Delayed Data need not be recorded contemporaneously.

The T+1 Data generally includes (as applicable):

- The CAT Customer ID for the order;
- The "material terms of the order" (as defined below);
- The CAT Order ID for the order or the relevant leg of the order;
- The CAT Reporter ID of the exchange, FINRA or broker-dealer, as applicable, receiving, originating, routing, modifying, cancelling or executing the order;
- For internal routing within a broker-dealer, the identity and nature of the department or desk to which the order was routed;⁶
- The date and time of the order receipt, origination, routing, modification, cancellation or execution;
- For orders modified, the relevant changes, and the price and remaining size of the order; and
- For orders executed,
 - the execution capacity (e.g., principal, agency, or riskless principal);
 - price and size; and
 - whether the execution was reported pursuant to the applicable transaction reporting plan.

The "**material terms of the order**" are the symbol; security type; price (if applicable); size (displayed and non-displayed); side (buy/sell); order type; if a sell order, whether the order is long, short, short exempt; open/close indicator; time in force (if applicable); if the order is for a listed option, option type (put/call), option symbol or root symbol, underlying symbol, strike price, expiration date, and open/close; and any special handling instructions.

The Delayed Data generally includes:

- For orders executed in whole or part,
 - the account number for any subaccounts to which the execution is allocated, in whole or part;
 - the CAT Reporter ID of the clearing broker or prime broker, if applicable; and
 - the CAT Order ID of any contra-side order(s);
- For orders cancelled, a cancelled order indicator; and
- For the original receipt or origination of an order, information sufficient to identify the customer and customer account information.⁷

⁶ For example, where an order was initially received by a customer-facing sales desk and is then routed to a separate trading or market-making desk.

The CAT plan also requires that a chief compliance officer be appointed to regularly review the operation of the CAT's central repository and make recommendations for enhancements. Each exchange and FINRA must also develop and implement a surveillance system, or enhance existing systems, to make use of the CAT data.

Process and Timing

The creation and implementation of the CAT will be a multi-stage process that will span several years. Although the exact timing of each stage is not yet certain, the Final Rule makes clear that the following steps with the applicable deadlines, are required before the CAT is fully implemented:

1. Once the Final Rule becomes effective at least 60 days from now,⁸ the exchanges and FINRA must develop and file the CAT plan within 270 days, but after solicitation and consideration of member views.
2. Upon the filing of the CAT plan, the SEC must publish notice of the filing of the plan for public comment.
3. The SEC must determine whether to approve the CAT plan within 120 days of publishing the notice of filing—or up to 180 days if the SEC deems such longer period appropriate or if the exchanges and FINRA consent to the extension.
4. Within 60 days of approval of the CAT plan, each exchange and FINRA must file a proposed rule change to require its members to comply with Rule 613 and the CAT plan.
5. Within two years of the effectiveness of the CAT plan, each broker-dealer, other than certain broker-dealers with less than \$500,000 in total capital, must begin reporting data to the CAT.
6. Within three years of the effectiveness of the CAT plan, all remaining broker-dealers must begin reporting data to the CAT.

Future Expansion of the CAT

The CAT will initially cover only secondary market transactions in U.S. listed stocks and options (referred to as “NMS securities”). However, the Final Rule also contemplates the CAT being expanded to a wide range of other securities over time. The Final Rule requires that the CAT plan include a discussion by the exchanges and FINRA of the feasibility, benefits and costs of reporting information about primary market transactions.⁹ Further, within six months after the effectiveness of the CAT plan, the exchanges and

(cont.)

⁷ “Customer account information” includes the account number, account type, customer type, date account opened, and large trader identifier (if applicable).

⁸ The Adopting Release contemplates the Final Rule becoming effective 60 days after publication in the Federal Register. However, the Adopting Release has been made available only in draft form, pending a “Major Rule Analysis” review by the Office of Management and Budget under the Small Business Regulatory Enforcement and Fairness Act. Under that Act, if the rule is determined to have an annual effect on the economy of \$100 million or more, it cannot become effective until at least 60 days after the SEC submits it for Congressional review.

⁹ Including such information in the CAT would significantly expand regulators’ market oversight abilities. In addition to surveilling the primary market transactions for potential legal or regulatory violations (e.g., taking excessive markups), the combination of primary and secondary market transaction information into one system would allow for the consolidated monitoring of potentially related transactions occurring in each market. For example, with the CAT receiving information about both secondary and primary market transactions, the SEC will be able to quickly (if not automatically) identify persons that entered into a short sale of securities shortly before purchasing the securities in a primary offering, in potential violation of Rule 105 of Regulation M. See, e.g., Adopting Release at 89.

FINRA will be required to provide the SEC with a document outlining how the CAT could incorporate information about transactions in OTC equities and debt securities.

Open Questions

The Final Rule leaves several important questions unanswered, in part because many aspects of how the CAT will ultimately be structured have been deferred to the exchanges and FINRA.

- **Costs and Benefits.** Will the benefits of the CAT outweigh the costs?

One of the most striking elements of the Adopting Release is that, in many cases, it analyzes the cost to the exchanges and FINRA of proposing the CAT plan compared to the benefits of the CAT plan being proposed, rather than the overall, market-wide costs and benefits of the CAT itself. The SEC explained that, because many decisions regarding the way the CAT will be developed and implemented have been left to the exchanges and FINRA to propose in the CAT plan, the SEC cannot conduct its cost-benefit analysis until it considers the proposed CAT plan.

- **New System or Expansion of Existing Systems.** Will the CAT be an entirely new system, or an expansion of FINRA's current Order Audit Trail System and the options exchanges' current Consolidated Options Audit Trail System, and what impact will this decision have on the speed and cost of implementation?

The SEC's original proposal would have required the exchanges and FINRA to create an entirely new system, while the Final Rule allows them to also consider building the CAT from existing audit trail technology. As the exchanges and FINRA are required to jointly file a single plan, it is notable that they have thus far not spoken with one voice. FINRA has advocated for a CAT built on existing systems, while NASDAQ has supported the development of an entirely new system.

- **Information Security and Confidentiality.** How will the exchanges and FINRA ensure that the information reported to the CAT is maintained securely and confidentially and used only for appropriate regulatory purposes?

The CAT will receive an enormous amount of highly confidential and sensitive personal and proprietary trading information. The existence of a repository of information of this nature could invite all manner of potential misuse—from criminals attempting to gain personal information for identity theft, to traders interested in reverse engineering others' trading strategies, to exchanges themselves seeking competitive information about other exchanges. The Final Rule requires the CAT plan to include policies and procedures to ensure the confidentiality of information reported to the CAT, including, for example, a mechanism to track persons accessing CAT data and information barriers between exchange and FINRA regulatory staff and non-regulatory staff with respect to CAT data. Market participants are sure to have a keen interest in the security measures the CAT plan proposes and ensuring that their data cannot be inappropriately accessed.

- **Susceptibility to Subpoena.** To what extent will CAT data be accessible by private parties in civil litigation?

In the Adopting Release, the SEC said that it "intends to assert all appropriate exemptions," of which it believes there are several, in response to any requests for CAT data under the Freedom of Information Act. However, the extent to which the data may nonetheless be susceptible to disclosure under a subpoena issued in a civil litigation to the CAT processor, an exchange or FINRA remains unclear. Further, if produced in response to a subpoena, can data released be effectively protected from further use or disclosure?

- **Customer Behavior.** Will the regulator's new insight into the market impact customer behavior or cause some investors to avoid U.S. markets or trade through foreign intermediaries to obscure their activities?

As noted above, the CAT will require that each customer be assigned a unique CAT Customer ID, which will be reported with every order. Notably, in the case of a non-U.S. customer trading through a foreign broker-dealer, the Adopting Release states that the U.S. broker-dealer's "customer" for purposes of the CAT would be the foreign broker-dealer—rather than the ultimate customer. This exception could give some traders interested in masking their identity an incentive to trade through foreign broker-dealers, allowing them to escape some level of systematic individual customer-level surveillance.

- **Industry Input.** How much input will the regulated industry have into the development of the CAT?

The Final Rule requires that the CAT plan include a discussion of the exchanges' and FINRA's solicitation of views of members and how such views were taken into account in preparing the CAT plan. It is not clear from the rule, however, that the exchange and FINRA are required to formally propose the CAT plan to members for comment before filing with the SEC, or if some level of informal solicitation of views is acceptable. Further, the Final Rule requires that the plan provide for an "advisory committee," including representatives of exchange and FINRA member firms, to advise on the implementation, operation and administration of the CAT. The advisory committee may technically attend any of the exchange and FINRA meetings about the CAT—but can be excluded from meetings held in "executive session" based on a simple majority vote of the exchanges and FINRA.

- **Duplication of Existing Rules.** To what extent will other rules made duplicative by the CAT, such as large trader reporting, be eliminated?

The CAT may make existing trade reporting and audit trail rules duplicative. The plan must include a discussion and analysis of any existing exchange or FINRA rules and systems, or components thereof, made duplicative by the CAT, and whether they can and should be eliminated.

One such potential duplication is the SEC's recently adopted Exchange Act Rule 13h-1, which requires "large traders," as defined, to identify themselves to the SEC, obtain a unique identification number, and make certain disclosures on Form 13H, while broker-dealers are required to capture and report certain information regarding large traders' and unidentified large traders' trading activities. When the CAT is implemented, large traders (like all customers) will be issued a unique ID, and the SEC may be able to use the CAT to identify and monitor large traders without the need for Rule 13h-1. In the Adopting Release, the SEC notes that certain of the broker-dealer reporting obligations may become unnecessary once the CAT is implemented, but otherwise indicates that both rules will remain.

The Final Rule's adoption is the beginning of a process to create, structure and implement the CAT. The industry should seek to actively participate in the process to assure that the CAT is developed in the most effective, efficient and secure manner, while minimizing the costs and burdens of implementation.

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