

SEC Proposes Consolidated Audit Trail

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Introduction

On May 26, 2010, the Securities and Exchange Commission (the “**SEC**”) proposed to require the Financial Industry Regulatory Authority and the national securities exchanges (collectively, the “**SROs**”) to adopt a plan (the “**Plan**”) for the development, implementation and maintenance of a consolidated audit trail (“**CAT**”) for the listed equities and options markets.

The SEC’s proposal would set in motion a vast, multi-year project that would culminate in the creation of a comprehensive, real time data repository for all information concerning orders and executions. This repository would permit the SEC and the SROs the ability to query and analyze in real time all trading activity in covered securities. The CAT would ultimately revolutionize securities surveillance and enforcement by eliminating many of the delays and much of the imprecision resulting from the disparate, unlinked and in many cases manual processes that currently exist. However, the SEC’s proposal would place on the SROs a very significant cost and burden of developing and operating the industry utility that will be the core of the CAT, retooling current surveillance methodologies and enforcing compliance by member broker-dealers. Broker-dealers also would have to shoulder considerable costs of compliance.

Beyond the question of cost, and who will bear it, the vast breadth of the information to be collected by the CAT will raise significant issues of customer privacy, the potential for leakage of sensitive information regarding trading activity and concerns that such information could be used for commercial or other non-regulatory purposes.

In addition, the extensive collection of customer information may cause publicity-shy traders to shun U.S. markets or to devise indirect trading arrangements to avoid disclosing their identities.

The Need for a Consolidated Audit Trail

In its [release](#) announcing the Proposed Rule (the “**Release**”), the SEC cites the increasingly electronic and dispersed securities markets as necessitating a single, consolidated system for tracking all trading activity in “NMS securities,” *i.e.*, listed stocks and options. Currently, this activity is tracked through a number of uncoordinated systems, including FINRA’s Order Audit Trail System, the New York Stock Exchange’s Order Tracking System and the multi-SRO Consolidated Options Audit Trail System. This fragmented structure hampers the SEC’s and SROs’ market analysis and enforcement ability, as no single system tracks orders routed through multiple SROs or all activity in a particular NMS security across all SROs.

Material Terms of An Order

The “material terms” of an order required to be provided to the central repository include the:

- NMS security symbol;
- security type;
- price;
- size (displayed and non-displayed);
- side (buy/sell);
- order type;
- designation of a sell order as long, short or short exempt;
- locate indicator;
- open/close indicator;
- time in force;
- whether the order is solicited or unsolicited;
- whether the account has a prior position in the security;
- the option type, symbol and root symbol for listed options; and
- any special handling instructions.

As a result, the SEC and SROs are forced in conducting any broad-based market review or enforcement action to collect several sets of incompatible data and manually combine them, a time-intensive and expensive process. Further complicating enforcement efforts are data gaps, reporting time lags built into these systems, unsynchronized clocks and the difficulty of tracking the identity of the ultimate customer. A single CAT, with data housed in a central repository, would allow the SEC and SROs to better detect fraudulent and manipulative activity and reconstruct market events, such as the “flash crash” of May 6, in near-real time.

The Proposal

Central Repository and Data Collection Requirements

If adopted, the SEC’s proposed rule (the “**Proposed Rule**”) would require the SROs to jointly file, within 90 days, a Plan that would articulate the CAT and create and govern a central data repository. The central repository would be owned and operated by the SROs. The Plan would also specify the data required to be provided by the SROs and their members to such a repository, subject to minimum requirements in the Proposed Rule.

Under the Plan, the SROs and their members would be required to submit, and the repository would be required to collect and retain, a time-sequenced record of information related to all “orders,” including bids and offers. Both customer and proprietary orders must be reported. In addition, the SROs and their members would be required to report any “reportable event” relating to an order, which includes the receipt, origination, modification, cancellation, routing and execution of an order.

SROs and their members would be required to provide information to the repository on a real time basis regarding the origination, routing, receipt, modification, cancellation or execution of the order, including:

- the material terms of the order, as described in the accompanying sidebar;
- a unique order identifier that will remain with the order throughout its life;
- information sufficient to identify the customer, including a unique customer identifier and customer account information;
- the date and time, in milliseconds, of the origination, receipt, routing, modification, cancellation or execution of the order;
- the unique identifier of the broker-dealer or national securities exchange originating, receiving, routing, modifying, cancelling or executing the order;
- the unique identifier of the branch office and registered representative receiving or originating the order; and
- the identity and nature of the department or desk to which an order is internally routed.

Information Required To Be Provided “Promptly”

Information required to be provided “promptly” by the SRO or its members, but not later than midnight of the day that the reportable event occurs or the SRO or its member receives the information, includes:

- the account number for subaccounts to which an execution is, in whole or in part, allocated;
- the unique identifier of the clearing broker or prime broker, if any;
- the unique order identifier for any contra-side order;
- any special settlement terms;
- short sale borrow information and identifiers;
- any commission paid by the customer and the unique identifier of the broker-dealer to whom the commission is paid; and
- a cancelled trade indicator for any cancelled trade.

Other information regarding execution or cancellation of the order must be provided “promptly” by an SRO or its members, as described in the accompanying sidebar.

The central repository established through the Plan must be able to receive, consolidate and retain all data described above, as well as collect and integrate the national best bid and offer and public transaction reports for each NMS security. The central repository must retain this information for at least five years in a directly available, searchable and electronic form.

Covered Products

While the Plan would first extend only to secondary market transactions in NMS securities, the SEC indicates in the Proposal its desire to ultimately expand the products included in the CAT. The Proposed Rule would require SROs to jointly provide to the SEC, within two months of effectiveness of the Plan, a proposal to include in the CAT secondary market activities in equity securities that are not NMS securities and debt securities and primary market transactions in all equities and debt securities. The SEC intends for the CAT to eventually include data on asset-backed securities, credit default swaps, equity swaps, security-based swaps and all other products under its jurisdiction. Notably, this list does not include security-related futures (other than securities futures products regulated by the SEC), likely due to the fragmented jurisdictional divide between the SEC and the Commodity Futures Trading Commission over such products. Given the close relationship between SEC-regulated securities and CFTC-regulated securities-related futures and options on futures, this is a potentially significant weakness in the system as a surveillance and enforcement tool.

Surveillance, Compliance and Operation and Administration of the Plan

The Proposed Rule requires the SROs to incorporate the data in the CAT into their current surveillance systems or develop and implement new real-time surveillance systems capable of using such data. In addition, the SROs would be required to file with the SEC rule changes to require their members to comply with the Plan and the Proposed Rule and to enforce their members’ compliance with the Plan. In addition, the Proposed Rule requires the SROs to resolve difficult plan administrative issues, including governance of the Plan, admission and withdrawal of participants, selection of a plan processor and cost allocation. Any violation of the Plan by an SRO would be considered a violation of the Exchange Act.

Privacy Concerns

In the Release, the SEC recognizes that the breadth of the required information about “live” trades in the repository raises privacy and confidentiality considerations. It also acknowledges concerns regarding the ability of SROs to access information regarding trades on or through

Implementation Timeline

If adopted, the Proposed Rule would require that by:

- 90 days after effectiveness of Proposed Rule, SROs file a Plan;
- 120 days after effectiveness of Proposed Rule, SROs file proposed rule changes to ensure member compliance;
- 120 days after filing of Plan, SEC approves or disapproves of Plan;
- Two months after effectiveness of Plan, SROs select plan processor and provide SEC with proposal to incorporate additional products and transactions;
- Four months after effectiveness of Plan, SROs synchronize clocks and require their members to do so;
- One year after effectiveness of Plan, SROs start providing required data to the central repository;
- Fourteen months after effectiveness of Plan, SROs develop real-time surveillance systems, using data in the CAT; and
- Two years after effectiveness of Plan, SRO members start providing required data to the central repository.

their competitors. The Proposed Rule requires the Plan to include policies and procedures to ensure the security and confidentiality of the information provided to the central repository and requires the SROs to agree to limit their access to the data in the repository collected by other SROs to regulatory and oversight use only. Nonetheless, the release suggests the possibility of the SROs making some data available to third parties. It is unclear to what extent concerns about privacy and information “leakage” may encourage certain entities to trade offshore rather than with U.S. broker-dealers or on U.S. exchanges subject to the Plan.

The potential for leakage and misuse of data, and for the identification of the ultimate trader responsible for transactions, is likely to cause traders that value their privacy to develop ways to mask their trading. These methods may include trading in emerging non-U.S. markets, or trading as principal through unregistered broker-dealers who offset their trades in U.S. markets.

The Cost of the Proposed Rule

While the CAT envisioned in the Proposed Rule would modernize the otherwise outdated and manual systems currently used, it would do so at a large cost. In the Release, the SEC estimates that the CAT would cost the SROs and their members approximately \$4 billion in one-time implementation expenses, and involve ongoing annual costs of approximately \$2.1 billion. This enormous cost may well be significantly understated. The costs of the central repository would be borne initially by the SROs, who would face significant obstacles in shifting these costs to their members or other market participants. Raising transaction fees in NMS stocks would be difficult because these fees are capped by Regulation NMS, and the SEC has proposed to cap transaction fees in options. In addition, exchanges that impose fees directly on their members risk a cycle of declining membership and rising member fees.

Scope of CAT Data

The inclusion in the CAT of its broad range of data items is surprising given the inevitable costs and complexity of the CAT. A number of the required data items may not be essential for an audit trail designed to reconstruct trading and allow investigation of illegal market activity, and will substantially raise the difficulty of implementing the CAT. For example, the industry may question whether items such as commissions charged, identifier of the broker-dealer receiving the commission, registered representative receiving the order, short sale borrow information, locate identifier, and subaccount numbers, are essential for the express purposes of the CAT or whether they should be obtained from broker-dealer books and records through a follow-up inquiry.

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Comment on the Proposed Rule

The SEC requests comment on all aspects of the Proposed Rule, including its scope, the requirements of the central repository, the data required to be reported by the SROs and their members, the Plan implementation period and the costs and benefits of the CAT. Comments are due by August 9, 2010.

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