

**MEMO# 24464**

August 4, 2010

## **ICI Draft Comment Letter on SEC Consolidated Audit Trail Proposal; Comments Due August 6**

[24464]

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TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 15-10  
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 23-10  
ETF ADVISORY COMMITTEE No. 34-10  
EQUITY MARKETS ADVISORY COMMITTEE No. 31-10  
SEC RULES COMMITTEE No. 32-10 RE: ICI DRAFT COMMENT LETTER ON SEC CONSOLIDATED AUDIT TRAIL PROPOSAL; COMMENTS DUE AUGUST 6

As we previously informed you, the Securities and Exchange Commission has proposed to require the Financial Industry Regulatory Authority and the national securities exchanges (collectively, "SROs") to develop, implement, and maintain a consolidated audit trail ("CAT"), and a central repository for the CAT data, for the trading of listed equities and options. [\[1\]](#) The CAT would be designed to aid the Commission and SROs in their efforts to detect and deter fraudulent and manipulative acts and practices in the marketplace, as well as efforts to investigate and prepare market reconstructions and understand causes of unusual market activity. The Institute has prepared a draft comment letter, which is attached and briefly summarized below.

Comments on the proposal are due to the SEC on Monday, August 9. If you have comments on the attached draft letter, please provide them to Heather Traeger via e-mail at [htraeger@ici.org](mailto:htraeger@ici.org) or by phone at 202/326-5920 by Friday, August 6.

### **CAT Proposal**

The draft letter supports the concept underlying the Commission's proposal to create a CAT and repository for CAT data. It raises significant concerns, however, about the confidential treatment of the CAT data, the requirement for real-time reporting, and the costs of the proposal.

## Confidentiality and Use of CAT Data

The draft letter notes that the proposal would provide each SRO and the Commission with unlimited access to the CAT data, including customer information, for purposes of performing their regulatory and oversight responsibilities pursuant to federal securities laws, rules, and regulations. The letter raises concerns regarding how this information will be protected; it explains that without confidential treatment, the disclosure or improper use of customer information could have a detrimental impact on a customer's financial condition, its trading activity, and the markets generally. The letter states that the need for confidential treatment of the information transmitted to the repository extends to staff at the Commission, the SROs, the SROs' members, and the repository. To address confidentiality concerns, the draft letter makes the following recommendations:

- The Commission should specifically set forth who will have access to the CAT information, when they may access it, and what they may do with it. For example, academics and economists may be permitted to access CAT data on a delayed basis (e.g., 30 days) for limited purposes, including academic research and assisting regulators in analyzing market activity. The data, however, should not contain an asset manager's name or location.
- The Commission should require that all of the data sent to the proposed repository be encrypted. In addition to encryption, the Commission should consider a requirement to mask certain data fields or delay reporting of CAT information to the end of the day.
- The Commission and each SRO should be required to adopt a comprehensive and robust information security program. As part of such a program, information barriers should be established within the Commission and SROs to ensure that the CAT data is used only for regulatory purposes. In addition, there should be an audit trail of the Commission's and SROs' staff access to, and use of, information in the repository to help monitor compliance with appropriate use of the data.
- The Commission, SROs, and repository should have an express legal duty to notify immediately each customer whose nonpublic information may have been accessed inappropriately. To assist the SROs and the proposed repository in quickly identifying instances of security breaches, the Commission should regularly examine the SROs and the repository, and consider enforcement actions, for failures to comply with their stated policies and procedures to ensure the security and confidentiality of all information submitted to, and maintained by, the repository.
- The Commission should explain how it intends to respond to requests under the Freedom of Information Act ("FOIA") for CAT data within its possession.

## Cost of CAT Proposal and Real Time Reporting

The draft letter questions whether there is a less costly means to achieve a CAT, noting that the costs of the proposal likely would be passed to customers. To reduce costs, as well as minimize concerns regarding the confidentiality of CAT data, the letter recommends that the Commission consider end-of-day reporting. The letter notes that real time reporting would be extremely expensive and difficult to implement because technology and routing systems have to be much more robust to capture and relay information as it happens. In addition, the letter highlights the fact that real time reporting is unnecessary because CAT data typically would not be used in real time. For example, reviewing patterns of trading activity would require all of the data for multiple days, and could be accomplished by analyzing data provided at the end of the day for each of those days. Finally, the letter

states that end-of-day reporting would better balance the costs and burdens of developing and implementing the CAT proposal but, to accommodate regulatory needs, the Commission could consider employing real time reporting in limited circumstances to report certain critical items that present a legitimate need for instant access.

## **Operational Difficulties Stemming From the Proposed Definition of “Customer”**

The draft letter explains that changing the definition of “customer” for purposes of reporting under the proposed CAT does not eliminate the operational difficulties associated with identifying the beneficial owner of the account originating the order and the person exercising investment discretion for the account originating the order, if different from the beneficial owner. It does, however, have the potential unintended consequence of limiting the use of omnibus accounts, routing orders through multiple accounts at multiple clearing firms, or using “average price accounts” to effect trades that are eventually settled in multiple customer accounts. (The letter provides an example of how funds perform final allocation to the account level at the end of the transaction period so that the funds may effectively determine the correct pro-rata allocation to each account to ensure fairness.) To avoid this outcome, the draft letter recommends that the Commission adopt end-of-day reporting.

## **Overlap with Large Trader Reporting Proposal**

The draft letter recommends that the Commission eliminate redundancies between the CAT proposal and the proposal to create a large trader reporting (“LTR”) system, [\[2\]](#) by adopting provisions that produce a single source for each data element necessary to produce a comprehensive CAT. [\[3\]](#) The letter explains that the costs and burdens of the LTR proposal would be magnified if the Commission also pursued its CAT proposal, and recommends that the Commission harmonize the regulatory reporting requirements where possible to eliminate unwarranted costs.

## **Market Structure Reform**

The draft letter supports the need for the Commission and SROs to develop the tools necessary to easily identify individual traders to evaluate their trading activity, and to have the ability to readily review and assess the trading practices and policies of markets and market participants. It commends the Commission for its efforts to develop a CAT and other recent efforts to address weaknesses and inefficiencies in our current market structure. The draft letter concludes by recommending that the Commission continue to pursue its review of the current market structure without delay and, in so doing, coordinate solutions across all types of markets both domestically and internationally.

Heather L. Traeger  
Associate Counsel

[Attachment](#)

## endnotes

[1] See SEC Release No. 62174 (May 26, 2010), 75 FR 32555 (June 8, 2010) (“Release”), available at <http://www.sec.gov/rules/proposed/2010/34-62174.pdf>.

[2] See SEC Release No. 61908 (April 14, 2010), 75 FR 21456 (April 23, 2010).

[3] The only data element from the LTR proposal that would not be readily available through a CAT would be the identity of a large trader. The Commission’s CAT proposal would capture this information by requiring that the large trader identifier be reported to the central repository as part of the identifying customer information. Id.

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