

**MEMO# 24358**

June 11, 2010

## **SEC Proposes Consolidated Audit Trail**

[24358]

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TO: ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 13-10  
ETF ADVISORY COMMITTEE No. 21-10  
EQUITY MARKETS ADVISORY COMMITTEE No. 19-10 RE: SEC PROPOSES CONSOLIDATED  
AUDIT TRAIL

The Securities and Exchange Commission has proposed to require the Financial Industry Regulatory Authority and the national securities exchanges (collectively, “SROs”) to jointly file a national market system (“NMS”) plan (the “Plan”) to develop, implement, and maintain a consolidated audit trail (“CAT”) with respect to the trading of listed equities and options (“NMS securities”). [1] The SEC believes that a consolidated audit trail would significantly aid in its and SROs’ 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. Comments on the proposal are due to the SEC no later than August 9, 2010.

We will hold a conference call on Tuesday, June 15, at 3:00 p.m. Eastern time to discuss the Institute’s comments relating to the SEC’s proposal. During the call we also will discuss the comment letter for the SEC’s large trader reporting proposal. [2] If you plan to participate on the call, please contact Ruth Tadesse by email at [rtadesse@ici.org](mailto:rtadesse@ici.org) or by phone at 202-326-5836 to receive the dial-in information.

### **The Plan**

The proposal would require the SROs to jointly file a Plan that would (1) create, implement, and maintain a CAT that captures customer and order event information, in real time, for all orders in NMS securities, across all markets, from the time of order inception through routing, cancellation, modification, or execution and (2) create and maintain a central data repository. [3]

### **Covered Products and Transactions**

Initially, the Plan would apply only to secondary market transactions in NMS securities. In

the Release, however, the SEC indicated its intention to ultimately expand the products included in the CAT to include, among others, corporate and municipal bonds, asset-backed securities, credit default swaps, equity swaps, security-based swaps, and all other products under its jurisdiction. The SEC also stated its belief that it would be beneficial, at some point, to expand the CAT to include information on primary market transactions. Consequently, the proposal would require SROs to jointly provide to the SEC a plan 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.

## Central Repository

The proposal would require the creation of a central repository that would be owned and operated by the SROs. 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 every order (both customer and proprietary orders) in an NMS security originated or received by a member of the SROs, including any bid or offer. The SROs and their members also would be required to report any “reportable event” relating to an order, which would include the receipt, origination, modification, cancellation, routing and execution (in whole or part) of an order. Data would need to be electronically transmitted to the central repository in a uniform electronic format. Importantly, the proposal would require that SROs and members report the requisite order and reportable event information only with respect to an action taken by that particular exchange, association, or member.

SROs and their members would be required to provide information regarding the order to the repository on a real time basis, including: information sufficient to identify the customer, including a unique customer identifier; [\[4\]](#) 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; [\[5\]](#) the identity and nature of the department or desk to which an order is internally routed; the date and time, in milliseconds, [\[6\]](#) of the origination, receipt, routing, modification, cancellation or execution of the order; the material terms of the order; [\[7\]](#) and a unique order identifier that would remain with the order throughout its life. [\[8\]](#)

Other information regarding execution or cancellation of the order would have to be provided “promptly” by an 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. Such information would include: 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; a cancelled trade indicator for any cancelled trade; any special settlement terms; short sale borrow information and identifiers; and any commission paid by the customer and the unique identifier of the broker-dealer to whom the commission is paid.

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

need to have policies and procedures designed to help ensure the timeliness, accuracy, and completeness of the data provided to the central repository, including policies and procedures governing how and when the plan processor should reject data.

## **Surveillance, Compliance and Operation and Administration of the Plan**

The proposal would require 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 the consolidated information contained in the CAT. In addition, the SROs would be required to file with the SEC rule changes to require their members to comply with the Plan and to enforce their members' compliance with the Plan. [\[9\]](#) The proposal also would require the SROs to resolve 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 Securities Exchange Act of 1934.

## **Access to the Central Repository and CAT Information**

The proposal would provide for access by the SROs and the SEC to the central repository for purposes of performing their regulatory and oversight responsibilities pursuant to federal securities laws, rules, and regulations. The SEC seeks comment, however, on whether access to the information in the repository should be expanded and whether the SROs should be allowed to make the data available to third parties. It also seeks comment on concerns about privacy and information "leakage," and whether certain data elements are more sensitive and could provide certain market participants with undue information advantages. In recognition of the sensitivity of reporting customer information and information about "live" orders on a real time basis, the proposal would require the Plan to include policies and procedures to ensure the security and confidentiality of the information provided to, and maintained by, the central repository. It also would require the SROs to agree to use the data for surveillance regulatory purposes only.

## **Implementation Timeline**

The proposal would impose the following implementation schedule, if adopted.

- 90 days after effectiveness of the proposal, SROs file a Plan;
- 120 days after effectiveness of the proposal, 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.

**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 [Memorandum](#) to SEC Rules Members No. 47-10 and Closed-End Investment Company Members No. 25-10 [24313], dated May 21, 2010 and SEC Release No. 61908 (April 14, 2010), 75 FR 21456 (April 23, 2010), available at <http://www.sec.gov/rules/proposed/2010/34-61908.pdf>.

[3] The Plan would be published in the Federal Register and be subject to public notice and comment.

[4] Under the proposal, the customer generating an order would be the beneficial owner(s) of the account originating the order and the person exercising investment discretion for the account originating the order, if different from the beneficial owner. Identifying information would include the customer name and address and account information, such as account number, account type, customer type, the date the account was opened, and the large trader identification number. See *supra* note 2.

[5] With respect to modification or cancellation of an order, the SROs or member handling the order would have to report to the central repository the unique order identifier, the date and time that the modification or cancellation was originated or received, the identity of the person responsible for the instruction, the price and remaining size of the order, if modified, and other modifications to the material terms of the order.

[6] The SROs and their members would be required to synchronize their clocks that are used for the purposes of recording the date and time of any event that must be reported under the proposal to the time maintained by the National Institute of Standards and Technology, consistent with industry standards.

[7] The material terms of an order would include: NMS security symbol, security type, price, size (displayed and nondisplayed), side (buy/sell), order type, designation of a sell order as long, short or short exempt, locate 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.

[8] In the proposal, the SEC states its preliminary belief that, in a situation where a member merely broke up a larger customer order into smaller orders and sent those orders, on an agency basis, to multiple markets for execution, the unique order identifier of the original customer order should carry through in some manner to the individual smaller orders that result when the original order is broken up. Thus, it could be necessary to attach two unique order identifiers to an order – the original order identifier (i.e., the parent order) and the individual smaller order identifier (i.e., the child order).

[9] The proposal suggests that the SROs could determine to impose penalties and fines for failures to comply with any provisions of the Plan.

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