

June 10, 2010

SEC Proposes Major Initiative to Build a Consolidated Audit Trail for Equities and Options

On May 26, the Securities and Exchange Commission (SEC) proposed new Rule 613, which would require the national securities exchanges and national securities associations (collectively, "SROs") to develop a consolidated audit trail. Under the proposal, the SROs are to work together to implement a consolidated order tracking system with respect to the trading of all national market system securities ("NMS stocks") and listed equity options. The proposal would put in place a centralized and standardized system to track and give regulators access to information related to trading orders received and executed across the securities markets, where possible on a real-time basis. According to SEC Chairman Mary Schapiro, such a system "would allow [regulators] to rapidly reconstruct trading activity and quickly analyze both suspicious trading behavior and unusual market events."¹

Developing a consolidated audit trail has been under consideration for some time, but in the wake of the May 6 "Flash Crash" it is seen as even more imperative. Piecing together what happened on May 6 has proven time consuming and complicated for regulators, given the multiple sources of order and execution data for the various equity, option and futures exchanges. The proposed consolidated audit trail would capture equities and options data—although not data from futures exchanges—and would presumably go a long way toward offering regulators a comprehensive and standardized database of all orders and executions across securities markets.

The SEC estimates the cost for the initial implementation of the consolidated audit trail at approximately \$4 billion, which includes the estimated costs to be incurred by the SROs and member firms.² For member firms with their own internal order management systems, the SEC estimates that the average one-time initial cost per member would be approximately \$1.5 million. The SEC further estimates the costs for maintaining the consolidated audit trail system at \$2 billion annually for the SROs and member firms. The details as to how costs will be allocated across the industry are yet to be determined.

¹ Press Release, Securities and Exchange Commission, *SEC Proposes Consolidated Audit Trail System to Better Track Market Trades* (May 26, 2010), available at <http://www.sec.gov/news/press/2010/2010-86.htm> (the "SEC Press Release").

² Consolidated Audit Trail, Exchange Act Release No. 34-62174 (May 26, 2010), available at <http://www.sec.gov/rules/proposed/2010/34-62174.pdf> (the "Proposing Release") at 171.

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SROs Must Work Together to Plan Audit Trail

The SEC proposal would require the SROs to file jointly with the SEC a plan to govern the creation, implementation and maintenance of a consolidated audit trail information system. Historically, the SEC has asked the SROs to work together to implement other major regulatory initiatives, such as the real-time collection and dissemination of last sale and quotation data.

The plan from the SROs must provide for the establishment of a central repository, which would be jointly owned by the SROs, and which would receive and archive the extensive trade information provided by the SROs and their members regarding all trading of NMS stocks and options. The data maintained by the central repository would be available to the SEC and the SROs for the purpose of performing their regulatory and oversight responsibilities.

Furthermore, to take full advantage of the information collected and stored by the central repository, SROs would be required to develop and implement surveillance systems or enhance existing surveillance systems to fully utilize such consolidated information. However, the SEC is not proposing coordinated surveillance across the SROs. Rather, the SEC intends that each SRO be responsible for surveillance of its own market and its own members using the consolidated audit trail information.

Real-Time Submission to the Central Repository

The proposal requires the SROs and their members to establish systems to provide the centralized repository, on a real-time basis and for each order being originated, routed, modified or executed in relation to an NMS stock or listed equity option, the following data elements:³ (1) a unique identifier for each order; (2) the identity of the customer; (3) the identity of the broker-dealer or national securities exchange receiving, originating or routing the order; (4) the date and time, in milliseconds, of the receipt, routing, modification or execution of the order; and (5) the material terms of the order or any changes thereto.

Additionally, SROs and their members would be required to provide, promptly upon obtaining such information, but in no event later than midnight of the day such event occurs or such information is obtained: (1) the account number for any subaccounts to which an executed order is allocated; (2) the identity of the clearing broker or prime broker for any executed order; (3) the identity of any contra-side orders to any executed order; (4) any special settlement terms of an executed order, and short sale borrow information regarding any executed order; (5) the amount of any commission paid by the customer of any executed order; and (6) the canceled trade indicator of any canceled order.

For the purposes of this rule, “real time” means “immediately and with no built in delay from when the reportable event occurs.”⁴ Other information would be permitted to be captured and transmitted to the central repository promptly after the SROs or members receive the information, but in no instance after the later of midnight of the day that the reportable event occurs or the time that the SROs or members receive such information. Furthermore, the data collected by the SROs and their members would be required to be transmitted electronically to the central repository in a uniform, electronic format.

Reporting Customer Information

The SEC’s proposal would require broker-dealers to include information identifying 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. In contrast, current SEC Rule 17a-25 requires broker-dealers to submit customer trading data to the SEC and the SROs only upon request. The SEC believes that this results in delays in receiving such information from broker-dealers and requiring the data in the initial reports to the central audit trail would enhance and increase the speed with which enforcement activities and cross-market surveillance of trading activity can be performed.

³ This list is a summary of the relevant provision and does not include all the details of the information required to be provided. For a complete list of the relevant information, please see the Proposing Release, pp. 62-88.

⁴ *Id.* at 61.

Synchronized Clocks and Milliseconds

To facilitate the provision of standardized information among many different trading platforms, SROs and their members must synchronize their business clocks for the purpose of recording the date and time of any event to the time maintained by the National Institute of Standards and Technology. Importantly, the proposal would require that all data elements for the audit trail be maintained with timestamps indicating milliseconds. This will require many firms to develop significant enhancements to their existing order management and reporting systems.

Possible Expansion to OTCBB Stocks, Debt and Swaps

Initially, the proposed rule would apply only to NMS stocks and listed equity options. The SEC indicated that it intends for the consolidated audit trail to cover secondary market transactions in other securities, including equity securities that are not NMS stocks, corporate bonds, municipal bonds and asset-backed securities and other debt instruments; credit default swaps, equity swaps and other security-based swaps; and any other products that may come under the SEC's jurisdiction in the future.⁵ In this regard, the SEC intends to require SROs to jointly submit a report within two months following the final approval of the proposed rule outlining how the SROs would propose to incorporate equity securities that are not NMS stocks, debt securities and primary market transactions in equity and debt securities into the consolidated audit trail system.

Implementation Schedule

The SEC stated that it would be prudent to implement the proposed audit trail at a measured pace to ensure that all market participants are fully able to meet its requirements. Specifically, the proposed rule provides that the national securities exchanges and national securities associations would be required to comply with the proposed data collection and submission requirements within one year after these requirements become effective. Members of the SROs would be required to comply with these requirements within two years after they become effective.

The SEC believes that this phased approach will allow members additional time to implement systems changes necessary to begin providing the information to the central repository and to develop procedures designed to capture customer and order information that they may not have previously been required to collect to comply with other SEC and SRO rules.

Request for Comment

In the Proposing Release, the SEC requests comment on a number of issues, including: whether the proposed time frames are reasonable with respect to the information that would be required to be reported; whether the proposed rule should only require that information be reported promptly after receipt; how "promptly" should be measured for the purposes of the proposed rule; and whether it would be more cost efficient to establish a coordinated surveillance system across exchanges and FINRA, rather than having each SRO remain responsible for surveillance on its own market using the consolidated data.

⁵ *Id.* at 50-52.

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