

## SEC Enhances Market Oversight With Adoption of Consolidated Audit Trail Rule

The U.S. Securities and Exchange Commission (SEC) on July 11, 2012 voted to adopt new rulemaking to implement a consolidated audit trail (CAT) to monitor and analyze trading activity. The rulemaking is the result of efforts to improve market-wide surveillance stemming from the so-called “flash crash” in 2010 and more recent market events.

Rule 613 of Regulation NMS (Rule) under the Securities Exchange Act of 1934 (Exchange Act)<sup>1</sup> will require self-regulatory organizations (SROs), including the national securities exchanges and the Financial Industry Regulatory Authority (FINRA), to jointly create a comprehensive CAT that will allow regulators to rapidly reconstruct trading activity in exchange-listed equity securities and listed equity options. The CAT will capture order and event information across all markets — from order inception through routing, cancellation, modification, and execution.

Principally, the new Rule requires the SROs jointly to submit a plan to the SEC to develop and implement a CAT (NMS plan). The Rule identifies the types of data that will be collected, when the data will be transmitted to regulators and the methods to prepare the data and information for use by regulators. While the Rule was anticipated to require some significant software development by industry members, these costs would be partially offset by the expense of responding to ad hoc surveillance requests. One of the most significant costs in the rule proposal, a requirement for “real time”

reporting of information,<sup>2</sup> was abandoned by the SEC in favor of “next day” reporting.

### Background

The Rule is part of an initiative by the SEC to modernize oversight of securities trading. The Rule was proposed by the SEC in response to the May 6, 2010 “flash crash” that temporarily caused the Dow Jones to plummet 600 points and erased over \$800 million of U.S. equity value. In the aftermath of the flash crash, the SEC and other regulators were criticized for the length of time it took to collect trade data and analyze market events.

While some SROs presently collect trade data for surveillance purposes, the ability of regulators to reconstruct market conditions has been hampered by a lack of uniformity, incomplete information, and difficulty attributing the source of trading activity across multiple venues. The Rule, in part, seeks to increase the ability of regulators to conduct cross-market analysis by eliminating multiple data sources with disparate data and introducing a uniform cross-market order and execution tracking system.

Other measures adopted in response to the flash crash include: market wide circuit breakers; provisions relating to clearly erroneous trades; and the large trader reporting rules,<sup>3</sup> which require large traders, as defined

<sup>1</sup> Consolidated Audit Trail, Exchange Act Release No. 674547 (July 18, 2012).

<sup>2</sup> Consolidated Audit Trail, Exchange Act Release No. 62174 (June 8, 2010).

<sup>3</sup> For further information regarding the large trader reporting rules, please refer to our September 2011 *DechertOnPoint* “[SEC Adopts Large Trader Reporting Requirements.](#)”

by rule, to be assigned unique customer identifiers that will be linked to individual trades and form part of the CAT system.

## Significant Requirements

The Rule is intended to supplement existing SEC and SRO mechanisms,<sup>4</sup> including OATS, designed for the surveillance of market activity in NMS securities. As adopted, the Rule requires the NMS plan to impose a next-day reporting standard for audit trail data. Under the NMS plan, national securities exchanges and FINRA, and their respective members, will be required to provide quotes and trade information to a central repository by 8 AM (Eastern Time) the following trading day. Trade information must be linked by brokers to unique customer identifiers that can be produced on request, so that regulators will then have the ability to attribute an order to its specific sources and trace the order through its entire life cycle.

When drafting the NMS plan, the SROs will determine the process that market participants will need to use to report trade information. Ultimately, the Rule contemplates that the trade data will be synchronized to SRO clocks and reported in a manner that will allow the central repository to provide information to regulators in a uniform electronic format. Importantly, the NMS

<sup>4</sup> The SEC currently uses the electronic blue sheet system to maintain and gather trade records from broker-dealers. See Exchange Act Rule 17f-25. Other SROs keep their own audit trail records of their members. For example, FINRA uses the Order Audit Trail System (OATS), the New York Stock Exchange uses the Order Tracking System (OTS), and Equity Cleared Reports are provided by the National Securities Clearing Corporation (NSCC).

plan must discuss: potential costs and alternatives, as well as address methods to eliminate obsolete reporting systems that are superseded by the new CAT; policies to ensure the privacy of customer information stored in the central repository; and anticipated error rates and the error correction process.

FINRA, among others, suggested using the existing OATS system as a foundation for the new CAT requirements. The central repository, to which data must be submitted, will be jointly owned by the SROs and FINRA. As a “facility” of the SROs and FINRA, any rules and fees for the central repository, as well as access limitation and penalty provisions, will be subject to the SEC approval process. The Rule requires the establishment of an Advisory Committee to advise the SROs on issues related to the central repository.

## Timeline for Effectiveness

The NMS plan is required to be submitted to the SEC within 270 days of the date of publication of the adopting release in the Federal Register. The SEC will publish the proposed NMS plan for notice and comment by the public. SROs will start reporting the required data to the central repository within one year after effectiveness of the NMS plan. Broker-dealers, with possible exceptions for members of the SROs that qualify as small broker-dealers, will be required to report the required data to the central repository within two years after effectiveness of the NMS plan.



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