



March 27, 2014

Via Electronic Mail

Peter D. Santori
Executive Vice President, Chief Compliance Officer, and Chief Regulatory Officer
Chicago Stock Exchange
440 S LaSalle St.
Chicago, IL 60605

Re: Consolidated Audit Trail: SIFMA Priorities for the Development Advisory Group

Dear Mr. Santori:

This letter is to follow up on the discussions of industry priorities with the Development Advisory Group (“DAG”) for the Consolidated Audit Trail (“CAT”).¹ The Securities Industry and Financial Markets Association (“SIFMA”)² has specific suggestions for priority areas that the DAG should address during 2014. We appreciate the time and effort that the DAG has dedicated to specific operational issues, and we encourage the DAG to continue to reach resolution on those issues because they ultimately will be critical in a successful implementation of the CAT.

However, with that being said, SIFMA believes that the DAG should refocus its efforts going forward to substantively address the major policy issues surrounding the development of the CAT. With the Self-Regulatory Organizations’ (“SROs”) selection process³ for the CAT processor having been approved⁴ by the Securities and Exchange Commission (“Commission”), and with the final processor selection expected to occur during 2014, the broader policy issues are now more timely than the detailed analysis of granular operational issues.

In this regard, SIFMA suggests that the DAG focus on four primary issues: (1) Elimination of Systems and Rules; (2) Equitable Cost and Funding; (3) Industry Integration in

¹ 17 CFR 242.613.

² The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.

³ See Securities Exchange Act Release No. 70892 (November 15, 2013), 78 FR 69910 (November 21, 2013).

⁴ See Securities Exchange Act Release No. 71596 (February 21, 2014), 79 FR 11152 (February 27, 2014).

Governance; and (4) Transparency in the Bidding and Selection Process. Our views on these topics are set forth in more detail below.

Elimination of Systems and Rules

The elimination of duplicative and redundant systems and rules is a critical aspect of the CAT development process. In adopting Rule 613, the Commission stated clearly and expressly that the NMS Plan for CAT must include a “Plan to eliminate existing rules and systems (or components thereof) that will be rendered duplicative by the consolidated audit trail, including identification of such rules and systems (or components thereof).”⁵ In addition, Rule 613 provides that, for those existing rules or systems that are not rendered duplicative by the consolidated audit trail, the SROs must conduct an analysis of whether the collection of such information remains appropriate, and:

[i]f no longer appropriate, how the collection of such information could be efficiently terminated; the steps the plan sponsors propose to take to seek Commission approval for the elimination of such rules and systems (or components thereof); and a timetable for such elimination, including a description of how the plan sponsors propose to phase in the consolidated audit trail and phase out such existing rules and systems (or components thereof).⁶

SIFMA has provided a comprehensive list of systems and rules that will be duplicative and should be eliminated upon the implementation of the CAT, including, among other things, FINRA’s Order Audit Trail System (“OATS”), the Electronic Blue Sheets (“EBS”) reporting system, and Large Trader reporting.⁷ In addition, we believe the SROs have the authority under Rule 613 to build a CAT that receives information in addition to the elements set forth in the rule, particularly if that additional information accelerates the elimination of duplicative systems. To maximize the efficiency of the CAT implementation process, the SROs should work with the industry now, so that a jointly-developed plan to eliminate key systems can be part of the NMS Plan that the SROs file with the Commission.

The elimination of systems in connection with CAT is particularly important, as the Commission noted in the adopting release, because the SROs have their own disparate audit trail rules.⁸ A member of multiple SROs therefore could be subject to the audit trail rules of, and be required to submit different information to, more than one exchange and FINRA.⁹ With these

⁵ Rule 613(a)(1)(ix).

⁶ Rule 613(a)(1)(ix)(C).

⁷ See SIFMA Industry Recommendations for the Creation of a Consolidated Audit Trail (Mar. 28, 2013) at 5 available at <http://www.sifma.org/issues/item.aspx?id=8589942773> (the “SIFMA RFP Concepts Comment Letter”).

⁸ See Securities Exchange Act Release No. 67457 (July 18, 2012), 77 FR 45722 (August 1, 2012) (“Adopting Release”).

⁹ *Id.* at 45797.

varying requirements in mind, the Commission recognized that the creation of a consolidated audit trail will result in efficiency gains for market participants in their regulatory data reporting requirements and for regulators with respect to their surveillance activities.¹⁰ In this regard, the Commission stated its belief that “the implementation of a plan to eliminate duplicative existing rules and systems will result in increased efficiency to market participants that need to comply with the disparate reporting requirements for orders and with repeated requests for data by regulators who cannot obtain the data they need from existing sources of information.”¹¹

While there are many systems and rules that eventually should be eliminated in favor of CAT, the sunseting of OATS should be a critical priority in CAT development. In particular, the SROs should focus now on developing and building the CAT so that OATS can be sunsetted promptly upon the implementation of broker-dealer reporting to the CAT. It is essential that, from the outset, the SROs design and build the CAT to include all of the information necessary to eliminate OATS, including Over the Counter (“OTC”) equity securities. SIFMA supports including OTC equities in the initial scope for the CAT, even if it requires reporting of information beyond the minimum elements set forth in Rule 613. There is simply no reason the SROs should continue to require broker-dealers to maintain a legacy audit trail system through the OATS reporting infrastructure for any substantial length of time after a brand new audit trail system – the CAT – is in place and serving the exact same purpose. Simply put, SIFMA will not support an NMS Plan for CAT that does not provide a clear and specific schedule for the prompt elimination of OATS as part of its overall plan for the elimination of systems and rules.

Equitable Cost and Funding

The CAT’s cost and funding mechanism is another critical part in its development and any funding mechanism must provide for equitable funding among all market participants, including the SROs. Given the importance of cost and funding, the SROs and the industry should be substantively discussing the issue, rather than waiting for the determination of a final dollar amount. We know now that the CAT will require a significant amount of money to build and operate, and there is enough information available now to begin creating an equitable funding model. In this context, the cost and funding for CAT should be based on two fundamental principles. First, the cost and funding of CAT should reflect the cost savings that the SROs will realize through increased efficiencies that the CAT will bring to their regulatory operations. Second, to the extent that funds are needed over and above the SROs’ existing resources, the cost and funding of the CAT must be allocated equitably among CAT users and reporters.

The Commission recognized the importance of the issues surrounding cost and funding in adopting Rule 613, and it directed the SROs to include in the NMS plan, a discussion of the costs and how they will be allocated.¹² In addition, the Commission recognized the SROs may seek to

¹⁰ *Id.*

¹¹ *Id.*

¹² *See* 77 FR at 45794.

recover some or all of the costs from their members.¹³ The Commission stated its belief that, if the plan sponsors seek to recover costs from their members, it is important to understand the SROs' plans to allocate costs between themselves *and* their members, because that information will help inform the Commission's decision regarding the possible economic or competitive impact of the NMS plan.¹⁴

In this regard, the funding mechanism for CAT should be based on the cost savings to the SROs that they will realize through the elimination of systems and increased efficiencies to their regulatory programs. With the proper approach, the funding for CAT should not simply be additive to the SROs' existing sources of regulatory funding (*e.g.*, membership fees, registered representative fees, TAF fees, options regulatory fees). Specifically, the SROs should analyze the cost savings they will achieve through the combination of retiring systems and the significant efficiencies to their current surveillance mechanisms and analysis of surveillance output that will result from the implementation of CAT. The SROs should publish that analysis as part of the NMS Plan they submit to the Commission.

As an example, current SRO surveillance systems for specific violative market activity rely on source data that does not identify a beneficial owner. Where surveillance identifies potentially violative conduct, it may take multiple additional requests to determine if the activity is attributable to a specific beneficial owner, and not a 'false-positive.' The CAT's ready availability of beneficial owner information as (a) source data for surveillance and (b) an investigative tool will reap significant efficiencies for SROs in fulfilling their regulatory obligations. In this way, the cost of building and operating the CAT should be offset by current sources of funding (*e.g.*, regulatory and transaction fees), which can be reallocated by the SROs.

Just as important, if additional funds must be raised, any funding model must take into account both the users of CAT (the SROs and the Commission) and the reporters to CAT (the SROs and broker-dealers). It goes without saying that there would be no justification to allow the SROs to impose the entire cost and funding burden of the CAT onto the member firm community. The SROs should bear their equitable share of the CAT funding as a cost of doing business as a regulatory entity, just as broker-dealers face significant costs of their own through their obligations as regulated entities. However, unlike the SROs, broker-dealers do not have a statutory mechanism to offset those costs by imposing Commission-sanctioned fees on their customers. On the other hand, broker-dealers could become subject to an SRO fee structure as a matter of law, with virtually no recourse.

SIFMA has established a member working group to develop principles for a CAT funding model, taking these factors into account. This working group is made up of member representatives with appropriate financial expertise. Ultimately, we hope that the efforts of SIFMA's cost and funding working group can be integrated with the SROs' efforts on this issue, in particular by directly coordinating the financial expertise of SIFMA's members with their counterparts at the SROs.

¹³ *Id.* at 45795.

¹⁴ *Id.*

Industry Integration in CAT Governance

The CAT will be a uniquely complex facility, unlike any of the other facilities currently governed under NMS Plans, and industry participation in the governance of CAT will be critical. Although SIFMA has repeatedly expressed its views on CAT governance,¹⁵ the SROs have not engaged in any meaningful discussion with the industry on the issue. In addition, the SROs declined to respond to SIFMA's comments on the governance issue in responding to the comment letters on the proposed selection plan.

To reiterate, in furtherance of the Commission's goals of integrating industry participants and the SROs, SIFMA believes that the governance of CAT should include public representation, including industry representation, and we have stated repeatedly that the CAT governing body should include representation outside the SROs. SIFMA understands that its members should not have access to the surveillance patterns and other means by which the SROs will use the data collected by the CAT, but CAT will be a technical utility and the SROs' regulatory decisions will be made outside of the governance and operation of the CAT itself. Accordingly, there is no policy, regulatory, or other reason that the governance of CAT should not include representation outside the SROs themselves.

We note separately that Rule 613(b)(7) requires the NMS plan submitted to the Commission to provide for the creation of an Advisory Committee in order to advise the plan sponsors on the implementation, operation and administration of the CAT. The Commission envisioned the Advisory Committee as a means for the SROs to draw on the knowledge and expertise of their members, to foster industry consensus on how to approach and resolve possible issues, and to provide transparency regarding the governance process of the CAT. However, the current use of advisory committees to provide industry representation in NMS Plan governance has proven ineffective. In other contexts, advisory committees that were originally intended to have an integrated role have instead been relegated to passivity and effectively excluded from the deliberation process, in significant part, by the SROs' excessive use of executive sessions that precluded the participation of the advisory committee members. With these concerns in mind, SIFMA believes that the creation of an Advisory Committee should not in itself preclude a governance structure for CAT that also includes industry representation.

Transparency in the Bidding and Selection Process

As we have noted previously, it is critical for the selection process for the plan processor to be transparent.¹⁶ The CAT will be a significant industry utility and will result in extensive costs and compliance obligations for the entire industry.

¹⁵ See, e.g., Letter from Theodore R. Lazo, Managing Director and Associate General Counsel, SIFMA to Elizabeth M. Murphy, Secretary, Commission dated December, 23, 2013 ("SIFMA Selection Process Comment Letter").

¹⁶ See SIFMA Selection Process Comment Letter.

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The non-proprietary aspects of the responses to the Requests for Proposal (“RFP”) should be available to the public to inform the discussion regarding the costs and benefits of various CAT features and the technological feasibility of different solutions. Certain details, such as the cost associated with each of the bids and the overall approach to system design, will be beneficial information for public evaluation of the CAT bidders. The public has an interest in seeing these basic terms of the bids so it can better understand the SROs’ ultimate choice.

Industry members should be involved in the evaluation of bidders and the selection of the plan processor. The unique expertise and insight of the broker-dealer community complements that of the SROs and would bring the perspective of the entities that will be providing the lion’s share of the reported data to the CAT. For industry members participating in the review and selection process, the use of non-disclosure agreements may be appropriate specifically in connection with the review of confidential and proprietary information.

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SIFMA greatly appreciates your consideration of the issues raised above in connection with the CAT and the associated DAG. If you have any questions, please contact either me (at 202-962-7383 or tlazo@sifma.org) or Thomas Price (at 212-313-1260 or tprice@sifma.org).

Sincerely,



Thomas F. Price
Managing Director
Operations, Technology & BCP



Theodore R. Lazo
Managing Director and
Associate General Counsel

cc: CAT Development Advisory Group

Mary Jo White, Chair
Luis A. Aguilar, Commissioner
Daniel M. Gallagher, Commissioner
Michael S. Piwowar, Commissioner
Kara M. Stein, Commissioner

Stephen Luparello, Director, Division of Trading and Markets
James R. Burns, Deputy Director, Division of Trading and Markets
David S. Shillman, Associate Director, Division of Trading and Markets
Gregg Berman, Associate Director of the Office of Analytics and Research