

**SEC PROPOSES CONSOLIDATED AUDIT TRAIL FOR
TRADING OF CERTAIN EQUITY SECURITIES**

Continuing its recent efforts in the area of market structure,¹ the U.S. Securities and Exchange Commission (the “SEC”) has proposed to adopt Rule 613 of Regulation NMS under the Securities Exchange Act of 1934 (the “Exchange Act”).² Rule 613 (the “Proposed Rule”) would require self-regulatory organizations (“SROs”) to create jointly a national market system (“NMS”) plan to develop, implement, and maintain a consolidated audit trail for trading in “NMS securities,” meaning NMS stocks and listed options.³ Proposed Rule 613 would require specified information about each order in NMS securities, from its origination until its execution, to be reported to, and maintained by, a central repository. The Proposed Rule is intended to give the SEC and SROs access to real-time information about orders in NMS securities on a cross-market basis to assist those regulators in investigations of potential violations of securities law and in performing market reconstruction or other analyses necessary to understand trading activity. The comment period for the Proposed Rule closes on August 9, 2010.

Existing Audit Trail Requirements

The Proposed Rule would supplement, and in some respects replace, existing SEC and SRO systems for obtaining information about trading in NMS securities. The SEC relies on the electronic blue sheet system (“EBS”), as supplemented by Rule 17a-25 under the Exchange Act, to obtain trading records from broker-dealers for regulatory purposes. The SROs maintain their own audit trail requirements that apply to their members. The Financial Industry Regulatory Authority, Inc. (“FINRA”) uses the Order Audit Trail System (“OATS”), NYSE Regulation, Inc. (the “NYSE”) has the Order Tracking System (“OTS”), and the options exchanges use the Consolidated Options Audit Trail System (“COATS”). EBS and Rule 17a-25 allow broker-

¹ Please see the appendix attached to this memorandum for details on recent SEC initiatives relating to securities trading and market structure.

² 17 CFR 242.600 *et seq.* (2010). The SEC cites Section 11A(a)(3)(B) of the Exchange Act for the authority to promulgate the Proposed Rule. That section provides, in relevant part, that the SEC may require the SROs to act jointly with respect to matters as to which they share authority under the Exchange Act in regulating an NMS for securities.

³ Consolidated Audit Trail, Exchange Act Release No. 62174, 75 Fed. Reg. 32556 (June 8, 2010) (the “Proposing Release”); <http://www.sec.gov/rules/proposed/2010/34-62174.pdf>. Under Rule 600(a)(46) of Regulation NMS, an “NMS Security” is any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options. An “NMS stock” is an NMS security other than an option under Rule 600(a)(47) of Regulation NMS. Rule 600(a)(35) of Regulation NMS defines a “listed option” as any option traded on a registered national securities exchange or automated facility of a national securities association.

dealers to submit electronically trading information that the SEC requests. According to the SEC, however, EBS is designed for use in narrowly-focused enforcement actions involving particular securities and is not suited for large-scale market reconstructions and analyses of trading in multiple stocks subject to high trading volume.

The SEC notes that the SROs in general have detailed audit trail data submission requirements. The SEC believes, however, that given today's high-speed, fragmented, but interconnected markets, there is a heightened need for a single, uniform, cross-market order and execution tracking system that captures more information than that provided by the SROs' audit trail systems. The Proposed Rule represents the SEC's effort to implement such a system.

Scope of Instruments Covered

Under Proposed Rule 613(c)(5), the consolidated audit trail requirement would apply to all secondary market transactions in NMS securities. The SEC states in the Proposing Release that it intends to expand the consolidated audit trail to cover secondary market transactions in equity securities that are not NMS securities; various debt instruments, including asset-backed securities; security-based swaps; and other products that may come under its jurisdiction in the future. The intent is also to expand coverage to primary market transactions in NMS stock and other equity securities that are not NMS stocks, as well as primary market transactions in debt securities.

Orders and Quotations

The Proposed Rule would require that specified information be provided to the central repository, which is discussed more fully below, for every order in an NMS security originated or received by a member of an exchange or FINRA. An "order" would mean (1) any order received by a member of a national securities exchange or national securities association⁴ from any person; (2) any order originated by a member of a national securities exchange or national securities association; or (3) any bid or offer.⁵ The consolidated audit trail therefore would include customer and proprietary orders, as well as quotations in NMS securities.

A member would have to report its origination of an order or a quotation to the central repository, and the SRO that receives the order or quotation would have to report receipt and execution, as applicable, of that order or quotation. Although the SRO must submit its best bids and offers to the central processor, it would not have to submit separately its best bids and offers to the central repository because the member would already have reported the origination of those quotations.

⁴ The only two national securities associations registered with the SEC are FINRA and the National Futures Association (the "NFA"). The NFA has a limited purpose FINRA registration.

⁵ Proposed Rule 613(j)(4).

Persons Required to Provide Information to the Central Repository

Under subparagraphs (c)(5) and (c)(6) of the Proposed Rule, national securities exchanges, national securities associations, and their respective members, would have to provide specified information about each order and reportable event, where a “reportable event” would be, among other things, the receipt, origination, modification, cancellation, routing, and execution, in whole or part, of an order.⁶ Alternative Trading Systems (“ATs”), as broker-dealers required to be FINRA members (*i.e.*, members of a national securities association), would have to provide information to the central repository.

Provision of Information to the Central Repository

The NMS plan would have to provide for an accurate, time-sequenced record of orders, beginning with the receipt or origination of an order by a member of a national securities exchange or national securities association and following the order through the process of routing, modification, cancellation, and execution (in whole or part).⁷ Some information would be reported to the central repository in real time immediately upon the occurrence of a reportable event, while other information would have to be reported promptly, meaning not later than midnight of the day that the reportable event occurred. The following information, set out in Proposed Rule 613(c)(7), would have to be provided in real time:

1. customer information, including the identity of the beneficial owner (name and address) and the person exercising investment discretion for the account originating the order, if different from the beneficial owner. Customer information would also include, among other things, the account number and type (*e.g.*, options), customer type (*e.g.*, retail, institutional), accounting opening date, and large trader identifier (if applicable and assuming that the SEC’s large trader reporting system is adopted).⁸ Each customer, moreover, would be assigned a unique customer identifier, possibly by the central repository.⁹
2. a unique identifier that attaches to the order upon origination or receipt by a member of an exchange or FINRA and remains with the order throughout its life, from origination to execution, and would be included in each report sent to the central repository for a reportable event. In addition, each member originating or receiving an order from a customer, each national securities exchange, each national securities association, and each broker-dealer that subsequently handles the order, would have to include its own

⁶ Proposed Rule 613(j)(5).

⁷ Proposed Rule 613(c)(1).

⁸ See *SEC Proposes Large Trader Reporting System*, http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3318/SEC%20Proposes%20Large%20Trader%20Reporting%20System.pdf.

⁹ Proposed Rule 613(c)(7)(i)(B).

unique identifier. The unique identifier for each such entity would not need to travel with an order throughout its life, but would be attached to the report of each reportable event that the relevant entity sends to the central repository; the reports would be linked at the central repository through the unique order identifier.

3. information about the order. Each member of an exchange and FINRA would need to collect and provide to the central repository certain key items of information about an order as soon as the member receives or originates an order, including the customer information described above. A member would have to report the date and time (to the millisecond) that an order was originated and received. The member would also have to report the material terms of an order, including, among other items:
 - a. the NMS security symbol;
 - b. the type of security;
 - c. price(s) (if applicable);
 - d. size (displayed and non-displayed);
 - e. side (buy/sell);
 - f. order type; and
 - g. any special handling instructions.
4. routing. In addition to the date and time (in milliseconds) of routing, a member or SRO routing an order would need to report the following information each time an order is routed:
 - a. the unique identifier of the broker-dealer or national securities exchange that routes the order;
 - b. the unique identifier of the broker-dealer or national securities exchange that receives the order;
 - c. the identity and nature of the department or desk to which an order is routed if a broker-dealer routes the order internally; and
 - d. the material terms of the order.

A member of an SRO receiving an order would also have to collect and report the information listed above with respect to each order received (*e.g.*, exact time - in milliseconds - that the order was received).

5. information concerning any modifications to the material terms of an order, or partial or full order cancellations, including, among other items, the date and time of the modification or cancellation, the person responsible for such action, the price and remaining size (for a modified order), and other modifications.

Execution information also would have to be collected and reported to the central repository, including execution time, date, price, size, and the capacity of the entity executing the order (*e.g.*, principal, riskless principal, agency), and whether the

execution was reported pursuant to an effective transaction reporting plan or pursuant to the Options Price Reporting Authority (“OPRA”) Plan,¹⁰ and the time of such report.

The SEC recognizes that it may not be feasible or practical to transmit certain information on a real-time basis. The Proposed Rule therefore would require that certain information be transmitted to the central repository promptly after the national securities exchange, national securities association, or member receives the information, but in no instance later than midnight of the day that the reportable event occurs or the national securities exchange, national securities association, or member receives such information. Such information would include the account number for any subaccounts to which an execution is allocated. This information is intended to identify the “ultimate” customer for a trade, *i.e.*, the beneficial owner.

The unique identifier of the clearing broker or prime broker for a transaction, if applicable, would need to be reported to the central repository, as well as the unique identifier of any contra-side order. If the execution were canceled, a canceled trade indicator would have to be reported. In addition, any special settlement terms, if applicable; short sale borrower information and identifier; and the amount of a commission, if any, paid by the customer, and the unique identifier of the broker-dealer to which the commission is paid all would need to be reported.

Clock Synchronization

The NMS plan filed with the SEC would require that each national securities exchange and national securities association, and their members, synchronize their business clocks that are used for purposes of recording the date and time of any event that must be reported under the Proposed Rule. This requirement is intended to ensure an accurate audit trail, given the number of market participants with internal order handling and trading systems that would be reporting information to the central repository. Specifically, each exchange, FINRA, and their members would have to synchronize their clocks to the time maintained by the National Institute of Standards and Technology, consistent with industry standards.

Central Repository

The central repository would be jointly owned and operated by the exchanges and FINRA, and the NMS plan would have to provide, without limitation, the SEC and SROs with access to, and use of, the data reported to and consolidated by the central repository for purposes of performing their respective regulatory and oversight responsibilities pursuant to federal securities laws, rules, and regulations.¹¹ Each of the exchanges and FINRA would be a sponsor of the NMS plan, and as such would be responsible for selecting a plan processor to operate the central repository.

¹⁰ The OPRA Plan governs the dissemination of trade and quotation information for listed options.

¹¹ Proposed Rule 613(e).

The central repository would be responsible for the receipt, consolidation, and retention of all data submitted by the national securities exchanges, national securities associations, and their members under the Proposed Rule and the NMS plan. The central repository would have to collect from the central processors and retain on a current and continuous basis the national best bid and offer (“NBBO”) for each NMS security; transaction reports reported pursuant to an effective transaction reporting plan filed with the SEC pursuant to, and meeting the requirements of, Rule 601 of Regulation NMS; and last sale reports reported pursuant to the OPRA plan filed with the SEC pursuant to, and meeting the requirements of, Regulation NMS. Data would need to be stored in a format compatible with the order and event information reported under the Proposed Rule. This requirement is intended to allow SRO and SEC staff to search easily across order, NBBO, and transaction databases. According to the SEC, NBBO data is useful to regulators in evaluating compliance with federal securities laws, rules, and regulations, such as the duty of best execution under Rule 611 of Regulation NMS. Transaction data generally would be helpful in monitoring for certain market manipulations, the SEC believes.

As noted, national securities exchanges and national securities associations, as well as the SEC, would have access to the central repository for purposes of performing their respective regulatory and oversight responsibilities under the federal securities laws, rules, and regulations. The method of access would have to be designed to include search and reporting functions to optimize the use of the consolidated data. The SEC’s access to the central repository, and access to and use of the data maintained by the central repository, for purposes of performing the SEC’s responsibilities under the federal securities laws, rules, and regulations could not be limited in any way.

The data collected and maintained in the central repository would be subject to data privacy protections. Proposed Rule 613(e)(4)(i) would require the NMS to include policies and procedures, including standards, to be used by the plan processor to ensure the security and confidentiality of all information submitted to, and maintained by, the central repository.

Proposed Rule 613(e)(4)(ii) would require the NMS plan to include policies and procedures, including standards, for the plan processor to use to help ensure the integrity of the information submitted to the central repository. Those policies and procedures would have to be designed to help ensure the timeliness, accuracy, and completeness of the data provided to the central repository by the SROs and their members. The SEC expects the policies and procedures to include validation parameters that would need to be met before data would be accepted into the central repository.

Per Proposed Rule 613(e)(4)(iii), the NMS plan would have to include policies and procedures, including standards, governing how and when the plan processor should reject data provided to the central repository that does not meet validation parameters, and how to retransmit data that was rejected once it has been corrected, as well as how to help ensure that information is being resubmitted. The resubmitted data would need to be subject to validation parameters to ensure that the initial problems with the data have been corrected. The NMS plan also would need to include policies and procedures to ensure the accuracy of the consolidation by the plan processor of the data provided to the central repository.

Proposed Rules 613(h) and 613(g)(4) would require the NMS plan to include mechanisms to ensure compliance by the plan sponsors and their members with the requirements of the plan. The intent is to require the SROs themselves to implement a method to help ensure compliance with the NMS plan, as required under Rule 608 of Regulation NMS.

Surveillance

Proposed Rule 613(f) would require each national securities exchange and national securities association subject to the Proposed Rule, within 14 months of the effectiveness of the NMS plan, to develop and implement a surveillance system, or to enhance existing surveillance systems, reasonably designed to make use of the consolidated information contained in the consolidated audit trail.¹² The SEC is not, however, proposing at this time to require coordination of surveillance across the exchanges and FINRA.

Compliance with the NMS Plan

Under Proposed Rule 613(h), any failure by a national securities exchange or national securities association to comply with the provisions of the NMS plan of which it is a sponsor could be considered a violation of the Proposed Rule. Similarly, members of a national securities exchange or national securities association would have to collect and provide audit trail information to the central repository and comply with clock synchronization requirements. Failure to comply would be a violation of the Proposed Rule and the NMS plan. The SROs would have to file proposed rule changes within 120 days of approval of the Proposed Rule to require compliance by members.

Operation and Administration of the NMS Plan

Proposed Rule 613(b) would require the NMS plan to provide a governance structure to ensure fair representation of the plan sponsors, including a provision to address the voting methodology under which plan sponsors could enact amendments to the plan. Under the Proposed Rule, the NMS plan would include provisions to govern the administration of the central repository, including the selection of a plan processor.¹³

The NMS plan would require the appointment of a chief compliance officer (“CCO”) to review regularly the operation of the central repository. The CCO’s duties would include the establishment of reasonable procedures designed to ensure that the operations of the repository keep pace with technological developments, and to recommend enhancements to help assure the repository’s continued effectiveness.

¹² The SROs would be required to begin reporting information to the central repository within 12 months of the effectiveness of the NMS plan. The SEC is proposing to allow SROs two additional months to update their surveillance systems to allow for testing of new surveillances for some period of time after the SROs begin providing information.

¹³ A “plan processor” within the meaning of Rule 600(55) of Regulation NMS is any SRO or securities information processor acting as an exclusive processor in connection with the development, implementation and/or operation of any facility contemplated by an effective national market plan system.

Plan sponsors would need to address the requirements for admission of new sponsors to, and withdrawal of existing sponsors from, the plan. Moreover, Proposed Rule 613(b)(4) would require that sponsors develop a process for allocating among the plan sponsors the costs associated with implementing and operating the central repository, including a provision addressing the manner in which such costs would be allocated to sponsors that join the plan after it has been approved.

Proposed Implementation Schedule

Exchanges and associations would have to begin providing data to the central repository within one year after the effective date of the NMS plan. Members of the exchanges and associations would have to begin providing required data to the central repository two years after the effective date of the NMS plan.

Summary

The Proposed Rule would require SROs and members of exchanges to report detailed information about orders in NMS securities to a central repository, typically on a real-time basis, to create a consolidated audit trail for such orders. The SEC and SROs would have access to this extensive information, including the identity of the beneficial owner of each account for which an order was originated. Proposed Rule 613, like the SEC's proposed large trader reporting system, could provide the SEC with access to detailed information about persons and entities that are not SEC registrants and might not otherwise be subject to the SEC's jurisdiction.

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APPENDIX

RECENT SEC MARKET STRUCTURE/SECURITIES TRADING INITIATIVES

Action	Description	Reference
Proposed Flash Trading Ban	The SEC has proposed a rule amendment to Rule 601 of Regulation NMS under the Securities Exchange Act of 1934 (the “Exchange Act”) to ban so-called “flash orders.”	Release: Elimination of Flash Order Exception from Rule 602 of Regulation NMS , Exchange Act Release No. 60684, 74 Fed. Reg. 48632 (Sept. 23, 2009). Willkie Memo: SEC Proposes to Ban Flash Trading .
Increased Disclosure by “Dark Pools”	The SEC has proposed to increase the regulation of alternative trading systems that publicly display quotations in consolidated quotation data, so-called “dark pools.”	Release: Regulation of Non-Public Trading Interest , Exchange Act Release No. 34-60997, 74 Fed. Reg. 61209 (Nov. 23, 2009). Willkie Memo: SEC Proposes to Increase Disclosure by Dark Pools .
Market Structure Concept Release	The SEC has requested comment on a variety of market structure issues, including the efficacy of the current market structure, the impact of high-frequency trading on the markets, and “dark” liquidity concerns, such as market fragmentation.	Release: Concept Release on Equity Market Structure , Exchange Act Release No. 61358, 75 Fed. Reg. 3594 (Jan. 21, 2010). Willkie Memo: Further SEC Action on Market Structure Issues .
Proposed Ban on “Naked” Access	The SEC has proposed Rule 15c3-5, which would effectively prohibit a broker-dealer from providing customers with “unfiltered” or “naked” access to an exchange or alternative trading system.	Release: Risk Management Controls for Brokers or Dealers with Market Access , Exchange Act Release No. 61379, 75 Fed. Reg. 4007 (Jan. 26, 2010). Willkie Memo: Further SEC Action on Market Structure Issues .

Action	Description	Reference
Adoption of Short Sale Price Test	The SEC has adopted Rule 201 as part of Regulation SHO under the Exchange Act. The rule restricts the prices at which a security may be sold short if the price of that security decreases by 10% or more from the prior day's closing price.	<p>Release: Amendments to Regulation SHO, Exchange Act Release No. 61595, 75 Fed. Reg. 11232 (Mar. 10, 2010).</p> <p>Willkie Memo: SEC Adopts Short Sale Price Test.</p>
Proposed Large Trader Reporting System	The SEC has proposed a rule to identify certain large traders and require broker-dealers to provide, upon the SEC's request, data on the large traders' activities in NMS securities.	<p>Release: Large Trader Reporting System, Exchange Act Release No. 61908, 75 Fed. Reg. 21456 (Apr. 23, 2010).</p> <p>Willkie Memo: SEC Proposes Large Trader Reporting System.</p>