

CLIENT MEMORANDUM

Potential Effects of the Proposed Consolidated Audit Trail on Investment Advisers, Broker-Dealers, and Other Market Participants

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The U.S. Securities and Exchange Commission (the “SEC”) is seeking public comment through July 18, 2016 on a proposed data collection system that, when implemented, will significantly increase the information available to regulators, enhancing their ability to analyze trading activity by broker-dealers, investment advisers, and other market participants.¹ While implementation of this system places direct obligations on self-regulatory organizations (“SROs”) and broker-dealers, it also may have consequences for investment advisers and other market participants that warrant careful consideration. These consequences include: sharing the costs of implementation, duplicative reporting requirements, heightened regulatory scrutiny on trading activity, access to clients’ nonpublic personal identifiable information, and creation of additional access points for potential cyberattacks.

¹ See Exchange Act Release No. 34-77724 (May 17, 2016), 81 FR 30,614 (May 17, 2016) (“Release 77724”). Release 77724 requests general comments on the proposal, but also poses questions on 456 specific aspects and topics.

Potential Effects of the Proposed Consolidated Audit Trail on Investment Advisers, Broker-Dealers, and Other Market Participants

Continued

Background

In July 2012, the SEC adopted Rule 613 of Regulation NMS under the Securities Exchange Act of 1934 (the “Exchange Act”) requiring SROs to submit a national market system plan (“NMS Plan”) to create, implement, and maintain a consolidated audit trail (“CAT”).²

The NMS Plan was submitted to the SEC on February 27, 2015, by the SROs, including, among others: the BATS Exchange, Inc., the Chicago Stock Exchange, Inc., the Financial Industry Regulatory Authority, Inc. (“FINRA”), The NASDAQ Stock Market LLC, and the New York Stock Exchange LLC.³

On April 27, 2016, the SEC unanimously voted to publish for public comment an NMS Plan that would create a central repository (the “Central Repository”) to receive, consolidate, and retain customer and order-flow information from exchanges and broker-dealers at various stages in the lifecycle of an order (e.g., origination, routing, modification, cancellation, and execution).⁴

In the Rule 613 proposing release, the SEC described the current regulatory data infrastructure as outdated and inadequate to enable the SEC to effectively “oversee the SROs, the securities markets and registered broker-dealers” during its examinations and investigations of trading activity across multiple trading venues.⁵ Chair Mary Jo White recently reaffirmed the need for the NMS Plan and the CAT by pointing out the limitations of current audit trail systems separately maintained by the exchanges and FINRA and stating that once the CAT is operational, “it will be one of the world’s most comprehensive and sophisticated financial databases, providing the complete lifecycle of all orders and transactions in the U.S. equity and options markets.”⁶

Among other requirements, the NMS Plan will require SROs and broker-dealers to submit to the Central Repository:

- a unique identifier, provided by the broker-dealer, for the customer submitting the order;
- an identifier, provided by the SRO, for the broker-dealer receiving, originating, routing, or executing the order;

² See Exchange Act Release No. 34-67457 (July 18, 2012), 77 FR 45,722 (Aug. 1, 2012). See also “The SEC Approves New Consolidated Audit Trail Rule,” Willkie Farr & Gallagher LLP Client Memorandum (Aug. 16, 2012) available [here](#).

³ The February 2015 submission amended and replaced in its entirety a proposed NMS plan submitted by the SROs in September 2014.

⁴ See Release 77724, *supra* note 1.

⁵ See Exchange Act Release No. 34-62174 (May 26, 2010), 75 Fed. Reg. 32,556 (June 8, 2010).

⁶ *Statement at an Open Meeting on a Notice of the Consolidated Audit Trail National Market System Plan*, Chair Mary Jo White (Apr. 27, 2016) available [here](#).

Potential Effects of the Proposed Consolidated Audit Trail on Investment Advisers, Broker-Dealers, and Other Market Participants

Continued

- the date and time of the order event; and
- the security symbol, price, size, and order type, and other material terms of the order.

Commissioner Kara M. Stein noted that “[t]he true value of the CAT lies in tracking market orders from start to finish across multiple venues. It will also allow us to see how an order interacts and affects other orders in our markets. Dislocations can be spotted and understood. Abuses can be revealed.”⁷ Commissioner Stein cited the May 12, 2010 “Flash Crash” and the August 24, 2015 trading halt as instances where it took the SEC and its staff months to reconstruct, analyze, and report on those events.

Public Comment

In the April 27 release, the SEC staff requested public comment on a number of different aspects of the NMS Plan in 456 specific questions, including, among others, the costs and benefits; the impact on efficiency, competition, and capital formation; and the appropriateness of the proposed organizational, governance, and managerial framework. In her statement at the April 27 Open Meeting, Chair White highlighted three components of the NMS Plan where “public comment would be particularly beneficial.”⁸

- Accuracy – The NMS Plan would set a maximum initial error rate of 5% for data submitted to and maintained by the Central Repository with expectations of lowering the error rate to 1% over time.
- Initial Clock Synchronization Standard – The NMS Plan would require each participant to synchronize its business clock within 50 milliseconds of the time maintained by the National Institute of Standards and Technology.
- Data Security and Confidentiality – The NMS Plan would seek to protect confidential and sensitive customer-level information at the Central Repository by limiting access to this information to SROs and the SEC for regulatory and oversight purposes.

The NMS Plan was published in the Federal Register on May 17, 2016 and the public comment period is open for 60 days from the publication date. Under Regulation NMS Rule 608, the SEC has 180 days from the publication date to approve or deny the NMS Plan. If the plan is approved, the SROs will then have two months to select a plan processor (the “Plan Processor”) from the remaining bidders (the “Bidders”).⁹ The Plan Processor would be responsible for, among other things, operating the Central Repository, ensuring the security and confidentiality of the data, and publishing technical specifications for data submission by the SROs and broker-dealers to the Central Repository.

⁷ *Statement on the Notice of the Joint Industry Plan on the Consolidated Audit Trail (“CAT”),* Commissioner Kara M. Stein (Apr. 27, 2016) available [here](#).

⁸ *Id.*

⁹ These are FINRA, Fidelity National Information Services Inc. unit SunGard, and Thesys Technologies, LLC.

Potential Effects of the Proposed Consolidated Audit Trail on Investment Advisers, Broker-Dealers, and Other Market Participants

Continued

Economic Impact

In seeking public comment on the NMS Plan, the SEC also prepared a preliminary economic analysis of the proposal, a step the agency had deferred in its initial adoption of Rule 613. The analysis includes a discussion of the economic effects of the plan, including costs of the creation, implementation, and maintenance of the CAT as proposed by the SROs. Of note, the SEC estimates the following:

- initial aggregate implementation costs of the NMS Plan of approximately \$2.4 billion;
- annual operating costs of the NMS Plan of approximately \$1.7 billion;
- initial building costs of the Central Repository of approximately \$92 million based on the Bidders' estimates;
- annual operating costs of the Central Repository of approximately \$135 million based on the Bidders' estimates;
- until the retirement of other regulatory data reporting schemes, duplicative annual audit trail data reporting costs for broker-dealers of approximately \$1.6 billion; and
- similar duplicative annual audit trail data reporting costs for SROs of approximately \$6.9 million.

The NMS Plan notes that the general building and operating costs of the Central Repository would be borne by the SROs and their members.

Potential Impact on Market Participants

The NMS Plan's reporting and related requirements have the potential to affect a wide array of market participants, including investment advisers, and not just the SROs, exchanges, and broker-dealers facing direct obligations under the plan. A few components of the NMS Plan bear noting for investment advisers.

Economic Effects

The SEC's economic analysis not only recognizes the significant costs and uncertainties associated with the implementation of the NMS Plan, but also acknowledges that "the economic effects of the [NMS] Plan depend on decisions that would be made after approval of the [NMS] Plan."¹⁰ We expect it will be difficult for the SROs to absorb all the costs of creating, maintaining, and fulfilling reporting obligations under the NMS Plan. As a result, we would expect these costs to be passed on to customers to some degree – typically broker-dealers in the first instance, and in turn, investment advisers sending orders for execution, and finally investors who may see increases in transaction costs.¹¹

¹⁰ See Release 77724, *supra* note 1.

¹¹ The SEC notes that certain broker-dealers currently pass on the costs associated with the Exchange Act's Section 31 transaction fees. *Id.* at 478.

Potential Effects of the Proposed Consolidated Audit Trail on Investment Advisers, Broker-Dealers, and Other Market Participants

Continued

Market participants with experience with various SEC or SRO reporting obligations may want to offer their views as to the economic effects of the CAT on their firms and the entities and investors on whose behalf they are participating in the markets.

Duplicative Reporting

The NMS Plan anticipates that market participants would have duplicative audit trail data reporting responsibilities for a period of up to two and a half years, preceding the potential retirement of other regulatory data reporting schemes. Rule 613 requires the NMS Plan to provide a method for identifying and eliminating rules and systems that may be rendered duplicative by the CAT, including, for example, FINRA rules that implement the Order Audit Trail System, SEC Rule 17a-25, which requires broker-dealers to submit electronic blue sheet data, and SEC Rule 17h-1, which sets identification and reporting requirements for certain large traders on Form 13H. To the extent that the CAT enables the SEC or SROs to modify or eliminate any rules or regulations to minimize duplicative reporting requirements, market participants may wish to comment on the benefits or other practical outcomes that could result from such streamlined reporting.

Regulatory Scrutiny

The SEC and its staff project that the regulatory activities expected to benefit from improved data quality include surveillance, investigations, examinations, analysis and reconstruction of market events, and analysis in support of rulemaking initiatives. The creation of the Central Repository also will provide the SEC and its staff with the ability to consolidate disparate data into a single source including customer information, allocation records, open/close position information for equities and options, and certain other trade and order information not consistently available in SRO audit trails.

Implementation of the NMS Plan also means that, in time, regulators will be equipped with significantly more and more precise data points with which to select market participants for focused, risk-based examinations.¹² In time, during an examination by the SEC's Office of Compliance Inspections and Examinations, the SEC staff may be able to use the data to recreate trading activity and evaluate – with the benefit of hindsight – a number of different practices and procedures of investment advisers selected for examination to determine whether, among others:

- an adviser's allocation pattern favored certain clients at the expense of others;
- an adviser's practices for choosing broker-dealers actually resulted in best execution for its clients;
- the adviser's trading patterns comported with the adviser's investment strategy;

¹² See Release 77724 *supra* note 1. The SEC indicated that its staff currently uses non-trading data such as Form PF, Form 13-F, Form ADV, and clearing broker reports as a proxy for trading data when selecting investment advisers for examinations. The SEC suggests that the staff will use the information from CAT to select investment advisers for risk-based, more intensive examinations. There is no clear indication yet whether the reporting obligations under Form PF, Form 13-F, Form ADV, and clearing broker reports will be eliminated or reduced. *Id.*

Potential Effects of the Proposed Consolidated Audit Trail on Investment Advisers, Broker-Dealers, and Other Market Participants

Continued

- an adviser's trade blotter matches the trade information provided to the Central Repository; and
- an adviser's compliance or supervisory personnel should have identified suspicious trading or prohibited activities that violated the adviser's policies and procedures.

Thus, the NMS Plan will eventually give regulators a perspective on trading practices not available to them today and that may not always be very apparent to broker-dealers or investment advisers at the time decisions are made.

Privacy

The Central Repository will give the SEC and the Plan Processor significant additional access not only to information about investment advisers, but also to nonpublic personally identifiable information concerning a firm's customers and clients. This access raises a number of areas of potential concern. For example, investment advisers with confidentiality clauses in their advisory agreements – including advisers to private funds with confidentiality clauses regarding fund investors – may be called on to evaluate and resolve contractual obligations under their advisory agreements with reporting obligations that could emerge under the NMS Plan.

Additionally, in an era of increased cyber-security concerns, accumulation of large amounts of personally identifiable information increases the number of access points through which a cyberattack could occur. To the extent sensitive information such as identifiers and other order details are warehoused in a Central Repository, it is hard to overemphasize how critical security measures must be. Any increased vulnerability caused by creation and maintenance of the CAT is, at the least, in tension with the SEC's stated positions regarding the importance of cybersecurity and protecting confidential client information entrusted to an investment adviser.

These and other issues raised by the NMS Plan warrant careful consideration and thoughtful comment as the SEC evaluates the proposed NMS Plan and its eventual path to implementation.

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Potential Effects of the Proposed Consolidated Audit Trail on Investment Advisers, Broker-Dealers, and Other Market Participants

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