

CLIENT MEMORANDUM

SEC Approves National Market System Plan Governing the Consolidated Audit Trail

November 16, 2016

AUTHORS

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On November 15, 2016, the U.S. Securities and Exchange Commission (the “SEC”) voted unanimously to approve the National Market System Plan to create a database designed to track U.S. equity and options markets trading activities, called the Consolidated Audit Trail (the “CAT”) (collectively, the “NMS Plan”). The NMS Plan was jointly submitted by the national exchanges and the Financial Industry Regulatory Authority, Inc. (“FINRA”) to the SEC and details how the exchanges and FINRA (together, “SROs”) and broker-dealers will record and report information over the entire life cycle of orders and transactions in the U.S. equity and options markets. The SEC made changes to the plan as originally submitted which include tightening synchronization standards, increased security requirements and adding additional members to the advisory committee to the entity housing the CAT. The CAT is a data collection system that, upon implementation, will significantly increase the information available to regulators, and will afford regulators the ability to analyze equity and options trading activity by broker-dealers, investment advisers, and other market participants.¹

Within two months of the approval of the NMS Plan, the SROs must select² a plan processor to build and operate the central repository that would receive, consolidate, and retain the trade and order data reported as a part of the CAT.

¹ For additional background on the evolution of the CAT and analysis of the proposed plan, see Willkie Farr Client Memorandum, “Potential Effects of the Proposed Consolidated Audit Trail on Investment Advisers, Broker-Dealers, and Other Market Participants,” May 18, 2016, *available* [here](#).

² Through a two-round voting process where each SRO has a vote.

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SROs will be required to begin reporting to the CAT within one year of approval, with large broker-dealers following within two years of approval and small broker-dealers within three years.

In its consideration of the proposal, the SEC focused on the following key categories that were amended in response to comments received on the initial proposal.

Cybersecurity

The SEC recognized that the CAT—and its central repository that receives, consolidates, and retains customer and order-flow information from exchanges and broker-dealers—will form one of the largest financial databases in the world and, accordingly, the security and confidentiality of such information is extremely important. The NMS Plan data security requirements include those concerning connectivity and data transfer, encryption, storage, access, personally identifiable information, and breach management. To that end, the SEC will require that the NMS Plan processor will further be subject to the full National Institute of Standards and Technology (“NIST”) Cybersecurity Framework. The SEC will also require that all CAT data be encrypted at rest and in transit, and a multifactor authentication will be required to access the data collected by the CAT. The NMS Plan’s Chief Information Security Officer (“CISO”) will be required to review where data is extracted to confirm that the cybersecurity policies and procedures at each extraction point are adequate. The CISO also will be required to report cybersecurity deficiencies, if any.

SROs that access CAT data likewise will be required to maintain information security policies and procedures that are at least as rigorous as those applied to the central repository. The SEC itself also will supplement its policies and procedures with comprehensive protocols that will be specific to the CAT and comparable to those required of the SROs, but which are not mandated in the NMS Plan. Because the SEC views the NMS Plan as part of its regulatory oversight function, it takes the position that it would be inappropriate to bind itself to the standards it applies to regulated entities as a part of the NMS Plan. Nevertheless, the SEC has announced its intention to adhere to a rigorous set of standards that will adequately safeguard CAT data.

Duplicative Reporting

The approved plan contains provisions for gap analysis in order to identify duplicative reporting systems for elimination. The SEC also accelerated the time frame to six months from the date of approval for SRO proposals to retire reporting systems that the CAT will render obsolete, but did not otherwise target specific reporting responsibilities, such as OATS Reporting or Form 13H as filed pursuant to Rule 13h-1 under the Securities Exchange Act of 1934, for elimination.

Governance and Funding

CAT operations are proposed to be housed in a not-for-profit, Delaware limited liability company, to be owned jointly by the SROs (“CAT LLC”). CAT LLC will be managed by the Operating Committee, comprised of all the SROs, each with one vote. As a result of the amendments to the original proposal, the Advisory Committee to CAT LLC, which is to

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provide input to the Operating Committee, will see increased representation from institutional investors and academic leaders as well as the inclusion of a representative from a service bureau that provides CAT reporting services. The Advisory Committee also will have the ability to nominate people to serve on the Operating Committee.

The CAT will be funded by imposing fees upon broker-dealers in connection with the creation and ongoing costs of the CAT itself. The SEC has said that such fees will be both reasonable and equitably allocated. In response to comments, the NMS Plan's funding model excludes consideration of the volume of OTC equity securities and NMS stocks at an ATS for fee-computation purposes. This amendment prevents a scenario where ATS trade volume would have resulted in additional funding obligations for ATS operators.

SRO Reporting

SROs will be required to submit an annual written assessment to the SEC, which will include discussion and analysis of critical technological developments, including upgrades, information security, and industry standards to ensure that the CAT remains at the operational frontier of data collection and storage. The SEC amended the NMS Plan to enhance the specificity of these assessments, including required discussion of back-up restoration capabilities, error reporting and date modifications, and clock synchronization.

SROs also will be required to submit one-time reports once CAT is operational. These reports include: an independent audit of fees incurred by participants; assessments of synchronization before reporting begins; a surveillance-related report; a report that addresses the feasibility of a bulk download by a reporting entity; error and correction reporting; the impact of tiered fees on market liquidity; and an assessment of the impact of a material systems change.

Clock Synchronization

In an effort to enhance the accuracy of CAT reporting and provide better sequencing across markets, the SEC will require SROs to synchronize their clocks to within 100 microseconds of the NIST framework, but not all participants will be held to the 100 microseconds standard. Commissioner Kara M. Stein stated that this dual synchronization scheme is insufficient because it excludes high speed and algorithmic trading activities. Accordingly, the NMS Plan as approved provides for a study on clock synchronization to be completed within the next six months, with additional proposed amendments keyed to the study's findings.

In closing, we note that the approval of the NMS Plan represents the culmination of years of effort and offers the promise to decommission obsolete or duplicative reporting in favor of a streamlined and consolidated data source for regulatory and surveillance purposes.

We will update this client memorandum when the release outlining more of the specifics of the NMS Plan is published, which is expected in the near future.

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