

# SECURITIES AND EXCHANGE COMMISSION

## 17 CFR PART 242

[Release No. 34-62174; File No. S7-11-10]

**RIN 3235-AK51**

### **Consolidated Audit Trail**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission (“Commission”) is proposing new Rule 613 under Section 11A(a)(3)(B) of the Securities Exchange Act of 1934 (“Exchange Act”) that would require national securities exchanges and national securities associations (“self-regulatory organizations” or “SROs”) to act jointly in developing a national market system (“NMS”) plan to develop, implement, and maintain a consolidated order tracking system, or consolidated audit trail, with respect to the trading of NMS securities.

The Commission preliminarily believes that with today’s electronic, interconnected markets, there is a heightened need for regulators to have efficient access to a more robust and effective cross-market order and execution tracking system. Currently, many of the national securities exchanges and the Financial Industry Regulatory Authority, Inc. (“FINRA”) have audit trail rules and systems to track information relating to orders received and executed, or otherwise handled, in their respective markets. While the information gathered from these audit trail systems aids the SRO and Commission staff in their regulatory responsibility to surveil for compliance with SRO rules and the federal securities laws and regulations, the Commission preliminarily believes that existing audit trails are limited in their scope and effectiveness in varying ways. In addition, while the SRO and Commission staff also currently receive

information about orders or trades through the electronic bluesheet (“EBS”) system, Rule 17a-25 under the Exchange Act,<sup>1</sup> or from equity cleared reports, the information is limited, to varying degrees, in detail and scope.

A consolidated audit trail would significantly aid in SRO efforts to detect and deter fraudulent and manipulative acts and practices in the marketplace, and generally to regulate their markets and members. In addition, such an audit trail would benefit the Commission in its market analysis efforts, such as investigating and preparing market reconstructions and understanding causes of unusual market activity. Further, timely pursuit of potential violations can be important in seeking to freeze and recover any profits received from illegal activity.

**DATES:** Comments should be received on or before August 9, 2010.

**ADDRESSES:** Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission’s Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File No. S7-11-10 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

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<sup>1</sup> 17 CFR 240.17a-25.

All submissions should refer to File No. S7-11-10. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Rebekah Liu, Special Counsel, at (202) 551-5665; Jennifer Colihan, Special Counsel, at (202) 551-5642, or Leigh W. Duffy, Attorney-Adviser, at (202) 551-5928, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

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#### **I. Background**

The U.S. securities markets have undergone a significant transformation over the last few decades, and particularly in the last few years. Regulatory changes and technological advances have contributed to a tremendous growth in trading volume and the further distribution of order flow across multiple trading centers. Today's markets are widely dispersed, with securities often trading on multiple markets, including over-the-counter ("OTC"). Additionally, products that are closely related in nature and objective are also traded on different markets. For example, various markets trade either options on the S&P 500 index,<sup>2</sup> futures on the S&P 500 index,<sup>3</sup> exchange traded funds ("ETFs") based on the S&P 500 index,<sup>4</sup> and options and futures on those ETFs.<sup>5</sup> This dispersion of significant trading volume has led the Commission in the past to ask for comment on how best to enhance the capability of SROs and the Commission to effectively and efficiently conduct cross-market supervision of trading activity.<sup>6</sup>

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<sup>2</sup> The Chicago Board Options Exchange, Incorporated ("CBOE") lists options on the S&P 500 Index (SPX) and on the Mini-S&P 500 Index (XSP) (1/10<sup>th</sup> the value of the S&P 500 Index).

<sup>3</sup> For example, the Chicago Mercantile Exchange Inc. ("CME") offers S&P 500 futures and "E-Mini" futures on the S&P 500 Index (\$50 x S&P 500 Index price).

<sup>4</sup> For example, NYSE Arca, Inc. ("NYSE Arca") lists an ETF based on the S&P 500 SPDR (SPY) and the iShares S&P 500 Index Fund (IVV).

<sup>5</sup> For example, OneChicago, LLC lists futures on the SPY, and CBOE lists options on the iShares S&P 500 Value Index Fund.

<sup>6</sup> See infra Section I.G. (discussing past Commission requests for comment on regulation of intermarket trading).

The individual SROs are responsible for regulating their markets and their members.<sup>7</sup> Further, the Commission has responsibilities to oversee the SROs, the securities markets, and registered broker-dealers, and routinely conducts examinations of or investigations into trading activity as part of its oversight and enforcement programs.<sup>8</sup> The SROs and the Commission need tools to effectively carry out these responsibilities even when trading occurs on multiple markets. For example, it is important that the SRO and Commission staff have order and trade data sufficient to monitor cross-market trading activity, assist with investigations of potential violations of federal securities laws and exchange rules, and perform market reconstructions or other analysis necessary to understand trading activity.<sup>9</sup> Such information also is important to the Commission in carrying out its oversight responsibilities.

The SROs' staff currently uses both EBS<sup>10</sup> and SRO audit trail data to help fulfill their regulatory obligations.<sup>11</sup> Commission staff also uses this data to perform its regulatory oversight

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<sup>7</sup> See, e.g., Sections 6(b)(1), 15A(b)(2), and 19(g) of the Exchange Act, 15 U.S.C. 78f(b)(1), 15 U.S.C. 78o-3(b)(2), and 15 U.S.C. 78s(g).

<sup>8</sup> See, e.g., Sections 2, 6(b)(1), 10, 15(b)(4)(D) and (E), and 19(h) of the Exchange Act, 15 U.S.C. 78b, 15 U.S.C. 78f(b)(1), 15 U.S.C. 78j, 15 U.S.C. 78o(b)(4)(D) and (E), and 15 U.S.C. 78s(h).

<sup>9</sup> As discussed below in Sections II and III, the Commission preliminarily believes that the proposal would improve the ability of regulators to conduct timely and accurate trading analyses for market reconstructions and complex investigations, as well as inspections and examinations. Indeed, the Commission believes that the proposed consolidated audit trail, if implemented, would have significantly enhanced the Commission's ability to quickly reconstruct and analyze the severe market disruption that occurred on May 6, 2010. If approved and implemented, the proposal also would enhance the Commission's ability to similarly respond to future severe market events.

<sup>10</sup> Bluesheets are trading records requested by the Commission and SROs from broker-dealers that are used in regulatory investigations to identify buyers and sellers of specific securities.

<sup>11</sup> The Commission recently published for comment a proposal to establish a large trader reporting system. See Securities Exchange Act Release No. 61908 (April 14, 2010), 75 FR 21456 (April 23, 2010) ("Large Trader Proposal"). Under that proposal, large traders would be issued unique identifiers that they would be required to provide to the broker-

obligations. The Commission and SROs have depended on the bluesheet system for decades to request trading records from broker-dealers needed for regulatory inquiries. Most SROs also maintain their own specific audit trail requirements applicable to their members. As discussed more fully below, for example, the National Association of Securities Dealers (“NASD”)<sup>12</sup> established the Order Audit Trail System (“OATS”)<sup>13</sup> in 1996, and the New York Stock Exchange (“NYSE”) implemented its Order Tracking System (“OTS”)<sup>14</sup> in 1999. Beginning in 2000, several of the current options exchanges implemented the Consolidated Options Audit Trail System (“COATS”).<sup>15</sup>

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dealers that execute transactions on their behalf, and the broker-dealers would be required to maintain, and provide to the Commission upon request, transaction records for each large trader customer. The large trader proposal is designed to address in the near term the Commission's current need for access to more information about large traders and their activities. As discussed below, the Commission anticipates that the proposed consolidated audit trail discussed in this release, which is much broader in scope, would take a significant amount of time to fully implement. This proposal would require that, if the Large Trader proposal is adopted, the large trader identification number be reported to the central repository as part of the identifying customer information. See proposed Rule 613(j)(2).

<sup>12</sup> In 2007, the NASD and the member-related functions of NYSE Regulation, Inc., the regulatory subsidiary of the New York Stock Exchange LLC (“NYSE”), were consolidated. As part of this regulatory consolidation, the NASD changed its name to FINRA. See Securities Exchange Act Release No. 56146 (July 26, 2007), 72 FR 42190 (August 1, 2007). FINRA and the National Futures Association (“NFA”) are currently the only national securities associations registered with the Commission; however the NFA has a limited purpose registration with the Commission under Section 15A(k) of the Exchange Act, 15 U.S.C. 78o-3(k). See also Securities Exchange Act Release No. 44823 (September 20, 2001), 66 FR 49439 (September 27, 2001).

<sup>13</sup> See Securities Exchange Act Release No. 39729 (March 6, 1998), 63 FR 12559 (March 13, 1998) (order approving proposed rules comprising OATS) (“OATS Approval Order”).

<sup>14</sup> See Securities Exchange Act Release No. 47689 (April 17, 2003), 68 FR 20200 (April 24, 2003) (order approving proposed rule change by NYSE relating to order tracking) (“OTS Approval Order”).

<sup>15</sup> See In the Matter of Certain Activities of Options Exchanges, Administrative Proceeding File No. 3-10282, Securities Exchange Act Release No. 43268 (September 11, 2000) (Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the

Currently, there is significant disparity in the audit trail requirements among the exchanges and FINRA, especially with respect to the information captured by each.<sup>16</sup> Further, the information for each must be provided in different formats. The differences result in inconsistent requirements imposed on exchange and FINRA members, and also make it difficult to view trading activity across multiple markets. The lack of uniformity in, and cross-market compatibility of, SRO audit trails can make detection of illegal trading activity carried out across multiple markets and multiple products more difficult. The Commission has voiced concern about the lack of uniformity in, and cross-market compatibility of, the audit trails in the past.<sup>17</sup> The Commission preliminarily believes that these differences may hinder the ability of the SROs and the Commission to effectively view and regulate trading activity across markets.

Further, risks imposed on the markets by violative conduct can be substantially increased by automated trading, as market participants have the ability to trade numerous products and enormous volume in mere seconds. As trading venues have become more automated, and trading systems have become computerized, trading volumes have increased significantly,<sup>18</sup> and trading has become more dispersed across more trading centers and therefore more difficult to monitor and trace.<sup>19</sup> The Commission is concerned that current audit trail requirements are

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Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions) ("Options Settlement Order"). See also, e.g., Securities Exchange Act Release No. 50996 (January 7, 2005), 70 FR 2436 (order approving proposed rule change by CBOE relating to Phase V of COATS).

<sup>16</sup> See infra Sections I.C, I.D, I.E, and I.F.

<sup>17</sup> See infra Section I.G.

<sup>18</sup> For example, consolidated average daily share volume and trades in NYSE-listed stocks increased from just 2.1 billion shares and 2.9 million trades in January 2005, to 5.9 billion shares (an increase of 181%) and 22.1 million trades (an increase of 662%) in September 2009. See Large Trader Proposal, supra note 11, at 21456.

<sup>19</sup> See, e.g., Securities Exchange Act Release No. 61358 (January 14, 2010), 75 FR 3594 (January 21, 2010) ("Concept Release on Equity Market Structure") at 3594-3596.

insufficient to capture in a timely manner all of the information necessary to efficiently and effectively monitor trading activity in today’s highly automated and dispersed markets. The Commission also is concerned that the current lack of cohesive, readily available order and execution information impacts the ability of the SROs and the Commission staff to effectively perform their respective regulatory and oversight responsibilities with respect to trading activity by market participants across markets and products.

**A. Electronic Bluesheets and Rule 17a-25**

The Commission and the SROs frequently request bluesheets from broker-dealers to aid in investigations of possible federal securities law violations and to create market reconstructions.<sup>20</sup> Until the late 1980s, bluesheets consisted of questionnaire forms that Commission and SRO regulatory staff mailed to firms to be manually completed and returned.<sup>21</sup> Obtaining bluesheets in this manner was particularly onerous as there were substantial delays in the production and receipt of the requested information. Additionally, the data was submitted in a variety of formats, making analysis time-consuming, and requests could result in vast amounts of information requiring lengthy manual examination.<sup>22</sup>

In the late 1980s, as the volume of trading and securities transactions dramatically increased, the manual bluesheet system was replaced by the EBS system.<sup>23</sup> The EBS system

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<sup>20</sup> See Securities Exchange Act Release No. 44494 (June 29, 2001), 66 FR 35836 (July 9, 2001) (File No. S7-12-00) (“Rule 17a-25 Adopting Release”), at 35836.

<sup>21</sup> Id.

<sup>22</sup> See Securities Exchange Act Release No. 25859 (June 27, 1988), 53 FR 25029 (July 1, 1988) (approving both the NYSE and the American Stock Exchange’s (“Amex”) rules for the electronic submission of transaction information).

<sup>23</sup> See Rule 17a-25 Adopting Release, supra note 20, at 3–4. See also, e.g., id. and Securities Exchange Act Release Nos. 26235 (November 1, 1988), 53 FR 44688 (November 4, 1988) (approving the CBOE rule for the electronic submission of transaction information); 26539 (February 13, 1989), 54 FR 7318 (February 17, 1989)



allows broker-dealers to electronically submit the requested information in a specific format and transmit it to the Securities Industry Automation Corporation (“SIAC”).<sup>24</sup> SIAC then routes the information to the Commission or to an SRO as applicable.

The EBS system, supplemented by the requirements of Rule 17a-25 under the Exchange Act,<sup>25</sup> currently is used by Commission and SRO regulatory staff primarily to assist the staff in the investigation of possible federal securities law violations primarily involving insider trading and other market manipulations, and to conduct market reconstructions, especially following periods of significant market volatility.<sup>26</sup> In its electronic format, the EBS system provides detailed execution information upon request by the Commission and the SROs’ staff for specific securities during specified time frames.<sup>27</sup> However, because the EBS system is designed for use in narrowly-focused enforcement investigations that generally involve trading in particular securities, it is less useful for large-scale market reconstructions and analyses involving numerous stocks during peak trading volume periods.<sup>28</sup>

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(approving the NASD’s rule for the electronic submission of transaction information); and 27170 (August 23, 1989), 54 FR 37066 (September 6, 1989) (approving the Philadelphia Stock Exchange’s rule for the electronic submission of transaction information).

<sup>24</sup> See Rule 17a-25 Adopting Release, *supra* note 20, at 35836. SIAC is a subsidiary of NYSE Euronext and serves as the securities information processor of the Consolidated Tape Plan (“CTA Plan”), which governs the dissemination of trade information; the Consolidated Quotation Plan (“CQ Plan”), which governs the dissemination of quotation information; and the Options Price Reporting Authority Plan (“OPRA Plan”), which governs the dissemination of trade and quotation information for listed options. In this capacity, it provides real time quotation and transaction information to market participants.

<sup>25</sup> 17 CFR 240.17a-25.

<sup>26</sup> See Rule 17a-25 Adopting Release, *supra* note 20, at 35836.

<sup>27</sup> EBS data does not, however, include the time of execution, and often does not include the identity of the beneficial owner. See *infra* note 147.

<sup>28</sup> A 1990 Senate Report acknowledged the immense value of the EBS system, but noted

In 2000, the Commission proposed Rule 17a-25 under the Exchange Act to supplement the existing EBS system with data elements incorporating institutional and professional trading strategies, to assist regulatory staff in reviewing and analyzing EBS data.<sup>29</sup> Adopted in June 2001,<sup>30</sup> the rule codified the requirement that broker-dealers submit to the Commission, upon request, information on their customer and proprietary securities transactions in an electronic format.<sup>31</sup> Rule 17a-25 requires submission of the same standard customer and proprietary transaction information that SROs request through the EBS system in connection with their market surveillance and enforcement inquiries.<sup>32</sup>

Specifically, for a proprietary transaction, Rule 17a-25 requires a broker-dealer to provide the following information electronically upon request: (1) clearing house number or alpha symbol used by the broker-dealer submitting the information; (2) clearing house number(s) or alpha symbol(s) of the broker-dealer(s) on the opposite side to the trade; (3) security identifier; (4) execution date; (5) quantity executed; (6) transaction price; (7) account number; (8) identity of the exchange or market where the transaction was executed; (9) prime broker identifier; (10) average price account identifier; and (11) the identifier assigned to the account by a depository institution.<sup>33</sup> For customer transactions, the broker-dealer also is required to include

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that “it is designed for use in more narrowly focused enforcement investigations that generally relate to trading in individual securities. It is not designed for use for multiple inquiries that are essential for trading reconstruction purposes.” See S. Rep. No. 300, 101st Cong., 2d Sess. 2-5 (1990), at 48.

<sup>29</sup> See Securities Exchange Act Release No. 42741 (May 2, 2000), 65 FR 26534 (May 8, 2000) (“Rule 17a-25 Proposing Release”).

<sup>30</sup> See Rule 17a-25 Adopting Release, supra note 20.

<sup>31</sup> Id. at 35836, and 17 CFR 240.17a-25.

<sup>32</sup> See e.g. NYSE Rule 410A and FINRA Rule 8211.

<sup>33</sup> See Rule 17a-25(a)(1) and Rule 17a-25(b)(1)-(3), 17 CFR 240.17a-25(a)(1) and 17 CFR 240.17a-25(b)(1)-(3).

the customer's name, customer's address, the customer's tax identification number, and other related account information.<sup>34</sup> The new data elements added by Rule 17a-25 – prime broker identifiers, average price account identifiers, and depository institution account identifiers – assist the Commission in aggregating, without double-counting, securities transactions by entities trading through multiple accounts at more than one broker-dealer.<sup>35</sup>

## **B. Equity Cleared Reports**

In addition to the EBS system and Rule 17a-25, the Commission also relies upon the National Securities Clearing Corporation's ("NSCC")<sup>36</sup> equity cleared report for initial regulatory inquiries.<sup>37</sup> This report is generated on a daily basis by the SROs and is provided to the NSCC, in a database accessible by the Commission, and shows the number of trades and daily volume of all equity securities in which transactions took place, sorted by clearing member. The information provided is end of day data and is searchable by security name and CUSIP

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<sup>34</sup> See Rule 17a-25(a)(2), 17 CFR 240.17a-25(a)(2). Rule 17a-25 also requires broker-dealers to submit, and keep current, contact person information for requests under the rule. This provision was designed to ensure that the Commission could effectively direct its data requests to broker-dealers. See Rule 17a-25 Proposing Release, *supra* note 29, at 26537.

<sup>35</sup> This information was deemed especially necessary for the creation of massive market reconstructions performed by Commission staff. See Rule 17a-25 Adopting Release, *supra* note 20, at 35836.

<sup>36</sup> NSCC is a subsidiary of the Deposit Trust and Clearing Corporation and provides centralized clearing information and settlement services to broker-dealers for trades involving equities, corporate and municipal debt, American depository receipts, exchange traded funds, and unit investment trusts.

<sup>37</sup> The Commission also uses the Options Cleared Report, with data supplied by the Options Clearing Corporation ("OCC"), for analysis of trading in listed options. OCC is an equity derivatives clearing organization that is registered as a clearing agency under Section 17A of the Exchange Act and operates under the jurisdiction of both the Commission and the Commodities Futures Trading Commission ("CFTC").

number.<sup>38</sup> Since the information made available on the report is limited to the date, the clearing firm, and the number of transactions cleared by each clearing firm on each SRO, it basically serves as a starting point for an investigation, providing a tool the Commission can use to narrow down which clearing firms to contact concerning a transaction in a certain security.

### **C. FINRA’s Order Audit Trail System**

In 1996, the Commission instituted public administrative proceedings against the NASD, alleging that it failed to enforce and investigate potential misconduct by its members.<sup>39</sup> In settling the Commission’s enforcement action, the NASD was ordered to design and implement an audit trail to enable it to reconstruct its markets promptly and effectively surveil them.<sup>40</sup> The Commission mandated that the audit trail at a minimum: (1) provide an accurate time-sequenced record of orders and transactions, beginning with the receipt of an order at the first point of contact between the broker-dealer and the customer or counterparty, and further documenting the life of the order through the process including execution, modification and cancellation; and (2) provide for market-wide synchronization of clocks used in connection with the new audit trail system.<sup>41</sup> In response to the order, the NASD created OATS.<sup>42</sup>

Currently, OATS is used to capture order information reported by FINRA members in equity securities listed on the Nasdaq Stock Market, Inc. (“Nasdaq”) and OTC equity

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<sup>38</sup> A CUSIP number is a unique alphanumeric identifier assigned to a security and is used to facilitate the clearance and settlement of trades in the security.

<sup>39</sup> See In the Matter of National Association of Securities Dealers, Inc., Administrative Proceeding File No. 3-9056, Securities Exchange Act Release No. 37538 (August 8, 1996) (Order Instituting Public Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions).

<sup>40</sup> Id. at 11–12.

<sup>41</sup> Id.

<sup>42</sup> See FINRA Rules 7400 to 7470. See also OATS Approval Order, supra note 13.

securities.<sup>43</sup> OATS requires reporting members<sup>44</sup> to record and report to FINRA<sup>45</sup> detailed information covering the receipt and origination of an order,<sup>46</sup> order terms, transmission, and modification, cancellation and execution.<sup>47</sup> Specifically, for each of these stages in the life of an order, FINRA Rule 7440 requires the recording and reporting of the following information, as applicable, including but not limited to:

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<sup>43</sup> FINRA defines an OTC equity security as any equity security that (1) is not listed on a national securities exchange, or (2) is listed on one or more regional stock exchanges and does not qualify for dissemination of transaction reports via the facilities of the Consolidated Tape. See FINRA Rule 7410(1).

<sup>44</sup> A reporting member is a member that receives or originates an order and has an obligation to record and report information under FINRA Rules 7440 and 7450. A member shall not be considered a reporting member in connection with an order if the following conditions are met: (1) the member engages in a non-discretionary order routing process, pursuant to which it immediately routes, by electronic or other means, all of its orders to a single reporting member; (2) the member does not direct and does not maintain control over subsequent routing or execution by the receiving reporting member; (3) the receiving reporting member records and reports all information required under FINRA Rules 7440 and 7450 with respect to the order; and (4) the member has a written agreement with the receiving reporting member specifying the respective functions and responsibilities of each party to effect full compliance with the requirements of Rule 7440 and 7450. See FINRA Rule 7410(o).

<sup>45</sup> Each reporting member must record each item of information required by OATS in electronic form by the end of each business day. See FINRA Rule 7440(a)(3). Reporting members must transmit to OATS a report of order information whenever an order is originated, received, transmitted to another department within the member or to another member, modified, canceled, or executed. Each report shall be transmitted on the day such event occurred if the information is available that day. Order information reports may be aggregated into one or more transmissions. See FINRA Rule 7450(b)(2).

<sup>46</sup> OATS recording and reporting requirements apply to any oral, written, or electronic instruction to effect a transaction in an equity security listed on the Nasdaq Stock Market or an OTC equity security that is received by a member from another person for handling or execution, or that is originated by a department of a member for execution by the same or another member, other than any such instruction to effect a proprietary transaction originated by a trading desk in the ordinary course of a member's market making activities. See FINRA Rule 7410(j).

<sup>47</sup> See FINRA Rules 7440 and 7450.

- for the receipt or origination of the order,<sup>48</sup> the date and time the order was first originated or received by the reporting member; a unique order identifier; the market participant symbol of the receiving reporting member; and the material terms of the order;<sup>49</sup>
- for the internal or external routing of an order, the unique order identifier; the market participant symbol of the member to which the order was transmitted; the identification and nature of the department to which the order was transmitted if transmitted internally; the date and time the order was received by the market participant or department to which the order was transmitted; the material terms of the order as transmitted;<sup>50</sup> the date and time the order is transmitted; and the market participant symbol of the member who transmitted the order;
- for the modification or cancellation of an order, a new unique order identifier; original unique order identifier; the date and time a modification or cancellation was

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<sup>48</sup> FINRA Rule 7440 also requires reporting of the account type; the identification of the department or terminal where an order is received from a customer; the identification of the department or terminal where an order is originated by a reporting member; and the identification of a reporting agent if the agent has agreed to take on the responsibilities of a reporting member under Rule 7450. See FINRA Rule 7440(b).

<sup>49</sup> The specific information required to be reported includes: the number of shares; designation as a buy or sell or short sale; designation of the order as market, limit, stop, or stop limit; limit or stop price; date on which the order expires and if the time in force is less than one day, the time when the order expires; the time limit during which the order is in force; any request by a customer that an order not be displayed, or that a block size be displayed, pursuant to Rule 604(b) of Regulation NMS; any special handling requests; and identification of the order as related to a program trade or index arbitrage trade. See FINRA Rule 7440(b).

<sup>50</sup> The specific information required includes the number of shares to which the transmission applies, and whether the order is an intermarket sweep order. See FINRA Rule 7440(c).

originated or received; and the date and time the order was first received or originated;<sup>51</sup> and

- for the execution of an order, in whole or in part, the unique order identifier; the designation of the order as fully or partially executed; the number of shares to which a partial execution applies and the number of unexecuted shares remaining; the date and time of execution; the execution price; the capacity in which the member executed the transaction; the identification of the market where the trade was reported; and the date and time the order was originally received.<sup>52</sup>

FINRA uses this information to recreate daily market activity for FINRA's market surveillance activities.<sup>53</sup>

#### **D. NYSE's Order Tracking System**

The Commission instituted public administrative proceedings against the NYSE in 1999, alleging that the exchange had failed to detect violations of federal securities laws and its own rules by its independent floor broker members, failed to police for performance-based compensation arrangements involving these members, and failed to adequately surveil them.<sup>54</sup>

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<sup>51</sup> For cancellations or modification, the following information also is required: if the open balance of an order is canceled after a partial execution, the number of shares canceled; and whether the order was canceled on the instruction of a customer or the reporting member. See FINRA Rule 7440(d).

<sup>52</sup> For executions, the reporting member also must report its market participant symbol; its number assigned for purposes of identifying transaction data; and the identification number of the terminal where the order was executed. See FINRA Rule 7440(d).

<sup>53</sup> See OATS Reporting Technical Specifications, January 5, 2010, available at <http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/appsupportdocs/p120686.pdf>.

<sup>54</sup> See In the Matter of New York Stock Exchange, Inc., Administrative Proceeding File No. 3-9925, Securities Exchange Act Release No. 41574 (June 29, 1999) (Order Instituting Public Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Ordering Compliance with Undertakings), at 4–5.

In settling the Commission's enforcement action, the NYSE was ordered to continue its development of an electronic floor system for the entry of order details prior to representation on the exchange floor, as well as to design and implement an audit trail to enable it to effectively surveil and reconstruct its market promptly, and facilitate the NYSE's effective enforcement of the federal securities laws and exchange rules.<sup>55</sup> Like OATS, this audit trail was required to provide an accurate, time-sequenced record of orders, quotations and transactions, documenting the life of an order from receipt through execution or cancellation. The NYSE also was required to provide for synchronization of all clocks used in connection with the audit trail.<sup>56</sup>

In response to the Commission's order, the NYSE created OTS.<sup>57</sup> OTS currently is used for the provision of audit trail data for orders<sup>58</sup> in NYSE and NYSE Amex-listed cash equity securities by NYSE and NYSE Amex members, including for orders in NYSE or NYSE Amex-listed cash equity securities initiated by a NYSE or NYSE Amex member or routed by a NYSE or NYSE Amex member to another market center for execution.<sup>59</sup> OTS is similar in scope to OATS, as detailed information is required to be recorded for the stages of an order's life, from origination and receipt and transmittal, through order modification, cancellation, and/or

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<sup>55</sup> Id. at 28–29.

<sup>56</sup> Id.

<sup>57</sup> See NYSE Rule 132B, and OTS Approval Order, supra note 14.

<sup>58</sup> OTS is applicable to all orders in NYSE-listed securities, regardless of account type (firm or customer). See NYSE Rule 132B(a)(1).

<sup>59</sup> See Securities Exchange Act Release No. 59022 (November 26, 2008), 73 FR 73683 (December 3, 2008). NYSE Alternext adopted NYSE Rules 1-1004 as the NYSE Alternext Equities Rules to govern all cash equities trading on the NYSE Alternext Trading Systems and NYSE Alternext Bonds. In March 2009, NYSE Alternext changed its name to NYSE Amex LLC (“NYSE Amex”) (the successor to Amex, see infra note 73). See Securities Exchange Act Release No. 59575 (March 13, 2009), 74 FR 11803 (March 19, 2009).



execution.<sup>60</sup> Specifically, for each of these stages in the life of an order, OTS requires the recording of the following information, as applicable, including but not limited to:

- for order receipt or origination,<sup>61</sup> the date and time the order is originated or received by a member or member organization; a unique order identifier; market participant symbol; and the material terms of the order;<sup>62</sup>
- for the internal or external routing of an order, the unique order identifier; the identification of the department to which an order was transmitted if transmitted internally; the date and time the order was received by the department receiving a transmitted order; the market participant symbol assigned to the member or member organization receiving the transmitted order or notation that the order was transmitted

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<sup>60</sup> See NYSE Rule 132B and NYSE Amex Equities Rule 132B. Each member or member organization shall, by the end of each business day, record each item of information required to be recorded under the rule in such electronic form as is prescribed by the NYSE (or NYSE Amex) from time to time. See NYSE Rule 132B(a)(3) and NYSE Amex Equities Rule 132B(a)(3). Members and member organizations shall be required to transmit to the NYSE or NYSE Amex, in such format as the applicable exchange may from time to time prescribe, such order tracking information as the exchange may request. See NYSE Rule 132C and NYSE Amex Equities Rule 132C.

<sup>61</sup> Members are also required to report: the identification of the department or terminal where an order is received directly from a customer; and where the order is originated by a member or member organization, the identification of the department (if appropriate) of the member that originated the order. See NYSE Rule 132B(b) and NYSE Amex Equities Rule 132B(b).

<sup>62</sup> The specific information required to be reported includes: number of shares; designation of the order as a buy or sell; designation of the order as a short sale; designation of the order as a market order, limit order, auction market order, stop order, auction stop order, or ISO; security symbol; limit or stop price; type of account; the date on which the order expires, and, if the time in force is less than one day, the time when the order expires; the time limit during which the order is in force; any request by a customer that an order not be displayed pursuant to Rule 604(c) under the Exchange Act; and special handling requests. See NYSE Rule 132B(b) and NYSE Amex Equities Rule 132B(b).

- to a non-member;<sup>63</sup> the material terms of the order as transmitted;<sup>64</sup> and the date and time the order is transmitted; and
- for the modification or cancellation of an order, a new unique order identifier; the original unique order identifier; and the date and time a modification or cancellation was originated or received.<sup>65</sup>

Additionally, the NYSE and NYSE Amex require the recording of detailed information concerning the receipt, cancellation or execution of orders in NYSE and NYSE Amex-listed cash equity securities originated on or transmitted to the exchange floor.<sup>66</sup> Immediately following receipt of an order on the floor, the member receiving the order must record the following information: (1) the material terms of the order;<sup>67</sup> (2) a unique order identifier; (3) the clearing

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<sup>63</sup> The information required to be reported also includes whether the order was transmitted and received manually or electronically; the date the order was first originated or received by the transmitting member or member organization; and, for each order to be included in a bunched order, the bunched order route indicator assigned to the bunched order. See NYSE Rule 132B(c) and NYSE Amex Equities Rule 132B(c).

<sup>64</sup> The information required to be reported includes the number of shares to which the transmission applies. See NYSE Rule 132B(c) and NYSE Amex Equities Rule 132B(c).

<sup>65</sup> For cancellations or modifications, the following information also is required: the order identifier assigned to the order prior to modification; if the open balance of an order is canceled after a partial execution, the number of shares canceled; and whether the order was canceled on the instruction of a customer or the member or member organization. See NYSE Rule 132B(d) and NYSE Amex Equities Rule 132B(d).

<sup>66</sup> See NYSE Rule 123 and NYSE Amex Equities Rule 123, each of which require, among other things, a record of the cancellation of an order, which must include the time the cancellation was entered, and a record of the receipt of an execution report, which must include the time of receipt of the report.

<sup>67</sup> The specific information required includes the security symbol; quantity; side of the market; whether the order is a market, auction market, limit, stop, or auction limit order; any limit or stop price, discretionary price range, discretionary volume range, discretionary quote price, pegging ceiling price, pegging floor price and/or whether discretionary instructions are active in connection with interest displayed by other market centers; time in force; designation as held or not held; and any special conditions. See NYSE Rule 123(e) and NYSE Amex Equities Rule 123(e).

member organization and the identification of the member or member organization recording order details;<sup>68</sup> and (4) modification of terms of the order or cancellation of the order.<sup>69</sup>

Further, once an order is executed, the following information must be recorded: (1) the material terms of the execution;<sup>70</sup> (2) the unique order identifier; (3) the identity of the firms involved in the execution;<sup>71</sup> and (4) certain other information related to the execution.<sup>72</sup>

### **E. Consolidated Options Audit Trail System**

In September 2000, the Commission instituted public administrative proceedings against Amex,<sup>73</sup> CBOE, the Pacific Exchange,<sup>74</sup> and the Philadelphia Stock Exchange<sup>75</sup> for

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<sup>68</sup> The required information also includes the system-generated time of recording order details. See NYSE Rule 123(e) and NYSE Amex Equities Rule 123(e).

<sup>69</sup> See NYSE Rule 123(e) and NYSE Amex Equities Rule 123(e).

<sup>70</sup> The specific information required includes security symbol; quantity; transaction price; and execution time. See NYSE Rule 123(f) and NYSE Amex Equities Rule 123(f).

<sup>71</sup> The specific information required includes the executing broker badge number or alpha symbol; the contra side executing broker badge number or alpha symbol; the clearing firm number or alpha; and the contra side clearing firm number or alpha. See NYSE Rule 123(f) and NYSE Amex Equities Rule 123(f).

<sup>72</sup> The required information includes whether the account for which the order was executed was that of a member or member organization or non-member or non-member organization; the identification of member or member organization which recorded order details; the date the order was entered into an exchange system; an indication as to whether this is a modification to a previously submitted report; settlement instructions; special trade indication (if applicable); and the Online Comparison System control number. See NYSE Rule 123(f) and NYSE Amex Equities Rule 123(f).

<sup>73</sup> Amex was acquired by NYSE Euronext on October 1, 2008. Initially, the successor entity to Amex was established as NYSE Alternext U.S. LLC, but the name was changed in 2009 to NYSE Amex. See Securities Exchange Act Release No. 59575 (March 13, 2009), 74 FR 11803 (March 19, 2009).

<sup>74</sup> In 2001, the Archipelago Exchange LLC (“ArcaEx”) was established as an electronic trading facility for Pacific Exchange’s subsidiary PCX Equities, Inc. (“PCX Equities”). See Securities Exchange Act Release No. 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001). In 2005, Archipelago Holdings, Inc., the parent company of ArcaEx, acquired PCX Holdings, Inc., which included subsidiaries Pacific Exchange (PCX) and PCX Equities. See Securities Exchange Act Release No. 52497 (September 22, 2005), 70 FR 56949 (September 29, 2005). The NYSE merged with Archipelago

failing to uphold their obligations to enforce compliance with exchange rules and the federal securities laws, including those relating to reporting. Specifically, the Commission alleged that they had either conducted no automated surveillance, or inadequate automated surveillance, of trade reporting and consequently failed to adequately detect noncompliance with their rules.<sup>76</sup> In settling the Commission's enforcement action, the exchanges were required to jointly design and implement COATS to enable them to reconstruct markets promptly, surveil them, and enforce compliance with trade reporting, firm quote, order handling, and other rules.<sup>77</sup> The exchanges were required to complete this undertaking in five phases.<sup>78</sup>

In particular, each exchange was required to achieve the following through its audit trail: (1) synchronize trading and support system clocks with all other options exchanges; (2) design and implement a method to merge all options exchanges' reported and matched transaction data on a daily basis in a common computer format; (3) incorporate its quotations and the national best bid and offer as displayed in its market with the merged transaction data so that it could be promptly retrieved and merged in the common computer format with other options exchanges' merged transactions and quotation data; (4) design and implement an audit trail readily retrievable (in the common computer format) providing an accurate, time-sequenced record of electronic orders, quotations and transactions on such exchange, beginning with the receipt of an electronic order, and further documenting the life of the order through the process of execution,

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Holdings in 2006. See Securities Exchange Act Release No. 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006). NYSE Arca is the successor to PCX.

<sup>75</sup> The Philadelphia Stock Exchange was acquired by The NASDAQ OMX Group, Inc. in 2008, and is now called NASDAQ OMX Phlx ("Phlx"). See Securities Exchange Act Release No. 58179 (July 17, 2008), 73 FR 42874 (July 23, 2008).

<sup>76</sup> See Options Settlement Order, supra note 15, at 12.

<sup>77</sup> Id. at 22.

<sup>78</sup> Id. at 22–25.

partial execution, or cancellation; (5) incorporate into the audit trail all non-electronic orders so that such orders were also subject to the audit trail requirements for electronic orders; and (6) design effective surveillance systems to use this newly available data to enforce the federal securities laws and the exchange's rules.<sup>79</sup>

The exchanges subject to the Options Settlement Order fully implemented the requirements in 2005. In addition, the International Securities Exchange, LLC ("ISE"), Boston Options Exchange Group, LLC ("BOX"), the Nasdaq Options Market ("NOM"), and BATS Options Exchange Market ("BATS Options") also comply with the COATS requirements.<sup>80</sup>

A majority of options exchanges require their members to provide the following information with respect to orders entered onto their exchange: (1) the material terms of the order;<sup>81</sup> (2) order receipt time;<sup>82</sup> (3) account type; (4) the time a modification is received; (5) the

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<sup>79</sup> See Options Settlement Order, *supra* note 15, at 22–25.

<sup>80</sup> See Securities Exchange Act Release Nos. 61154 (December 11, 2009), 74 FR 67278 (December 18, 2009), at 67280 (stating "ISE and the other options exchanges are required to populate a consolidated options audit trail ("COATS") system in order to surveil member activities across markets"); 61388 (January 20, 2010), 75 FR 4431 (January 27, 2010), at 4433 (Nasdaq OMX BX filing amending BOX's fee schedule, with similar language as Release No. 61154); and 61419 (January 26, 2010), 75 FR 5157 (February 1, 2010) (BATS Exchange, Inc. ("BATS") represented that BATS Options would comply with the specifications of COATS in submitting data to create a consolidated audit trail, as well as receiving COATS data for its own surveillance purposes).

<sup>81</sup> The specific information required includes option symbol; underlying security; expiration month; exercise price; contract volume; call/put; buy/sell; opening/closing transaction; price or price limit; and special instructions.

<sup>82</sup> The required information also includes identification of the terminal or individual completing the order ticket.

time a cancellation is received; (6) execution time; and (7) the clearing member identifier of the parties to the transaction.<sup>83</sup>

#### **F. Other Audit Trail Requirements**

SRO audit trail rules regarding information on orders for NMS stocks to be recorded by their members, and in some cases provided to the SRO, tend to be less uniform than SRO audit trail rules relating to listed options.<sup>84</sup> Some exchanges and FINRA have detailed audit trail data submission requirements for their members covering order entry, transmittal, and execution.<sup>85</sup> For example, the rules of one exchange require the recording of the following information for each order originating with an exchange participant that is given to or received from another participant for execution, transmitted by an exchange participant to another market, or originating off the exchange and transmitted to an exchange participant, and subsequent execution of any such orders:<sup>86</sup>

- information relating to receipt or transmission of the order, including the material terms of the order;<sup>87</sup> a unique order identifier; the identification of the clearing

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<sup>83</sup> See e.g. BATS Rule 20.7; BOX Chapter V, Section 15; CBOE Chapter VI, Rules 6.24 and 6.51; NOM Rule Chapter V, Section 7; NYSE Amex Rules 153, Commentary .01, and 962; NYSE Arca Rules 6.67, 6.68, and 6.69; and Phlx Rules 1063 and 1080.

<sup>84</sup> For purposes of this release, the Commission does not consider SRO EBS rules to be audit trail rules.

<sup>85</sup> See Chicago Stock Exchange (“CHX”) Article 11, Rule 3(b); FINRA Rules 7400 to 7470 (the OATS rules); Nasdaq Rules 6950 to 6958 (substantially similar to the OATS rules); BX Rules 6950 to 6958 (substantially similar to OATS rules); NYSE Rule 123 and 132B; and NYSE Amex Equities Rule 123 and 132B (OTS rules). See *supra* Sections I.C. and I.D. for a discussion of FINRA’s OATS rules and the NYSE and NYSE Amex’s OTS rules, respectively.

<sup>86</sup> See CHX Article 11, Rule 3(b).

<sup>87</sup> *Id.* The specific information required includes the symbol; number or shares or quantity of security; side of the market; order type; limit and/or stop price; whether the order is agency or proprietary; whether an order is a bona fide arbitrage order; whether the order is short; time in force; designation as held or not held; any special conditions or

- participant and the participant recording the order details; the date and time of order receipt or transmission (if applicable); the market or participant to which the order was transmitted or from which the order was received (if applicable);
- information relating to modifications to or cancellation of the order, including any modifications to the order, any cancellation of all or part of the order; the date and time of receipt and transmission of any modifications to the order or cancellations; and the identification of the party canceling or modifying the order;<sup>88</sup>
  - for executions of the order,<sup>89</sup> in whole or in part, the transaction price; the number of shares or quantity executed; the date and time of execution; the contra party to the execution; and any settlement instructions.<sup>90</sup>

The audit trail rules of the other exchanges incorporate only standard books and records requirements in accordance with Section 17 of the Exchange Act.<sup>91</sup>

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instructions (including any customer display instructions and any all-or-none conditions); and the date and time of any order expiration.

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Id.

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Id.

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Id. The participant also must record the system-generated times of recording this required information. This information must be recorded immediately after the information is received or becomes available. CHX Article 11, Rule 3(c). Additionally, before any such orders are executed, exchange participants must record the name or designation of the account for which the order is being executed. CHX Article 11, Rule 3(d). This rule does not apply to orders sent or received through the exchange's matching system or any other electronic systems the exchange recognizes as providing the required information in a format acceptable to the exchange. See CHX Article 11, Rule 3, Interpretations and Policies .03.

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See e.g. National Stock Exchange ("NSX") Chapter VI, Rule 4.1.; BATS Chapter IV, Rule 4.1; CBOE Rule 15.1 (applicable to CBSX); ISE Stock Exchange Rule 1400; NYSE Arca Equities Rule 2.24; 15 U.S.C. 78q et seq. For example, one exchange only requires its members to make and keep books and records and other correspondence in conformity with Section 17 of the Exchange Act and the rules thereunder, with all other applicable laws and the rules, regulations and statements of policy promulgated thereunder, and with the exchange's rules. See NSX Chapter VI, Rule 4.1.

## G. Prior Commission Request for Comment

The Commission has previously requested comment regarding cross-market regulation, including whether changes should be made to existing audit trail rules, in two concept releases in 2003 and 2004.<sup>92</sup>

In 2003, the Commission sought public comment on a petition submitted by Nasdaq that raised concerns about the impact of market fragmentation on the trading in, and regulation of trading in, Nasdaq-listed securities.<sup>93</sup> Nasdaq, through OATS, collected data from its members trading Nasdaq-listed securities, which the NASD then used to surveil for potential rule violations.<sup>94</sup> Nasdaq requested that the Commission require all SROs trading Nasdaq-listed securities to implement an electronic audit trail identical to OATS.<sup>95</sup> Nasdaq also noted that the available cross-market audit trail information provided by the Intermarket Surveillance Group (“ISG”)<sup>96</sup> was comprised of audit trail information from each of the exchanges and provided two

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<sup>92</sup> See Securities Exchange Act Release Nos. 47849 (May 14, 2003), 68 FR 27722 (May 20, 2003) (File No. S7-11-03) (“Intermarket Trading Concept Release”) and 50700 (November 18, 2004), 69 FR 71256 (December 8, 2004) (File No. S7-40-04) (“Concept Release Concerning Self-Regulation”).

<sup>93</sup> See letter to Jonathan G. Katz, Secretary, Commission, from Edward Knight, Executive Vice President and General Counsel, Nasdaq, dated April 11, 2003 (File No. 4-479) (“Nasdaq Petition”). In particular, Nasdaq was concerned over what it deemed “unequal and inadequate regulation” by other markets trading Nasdaq-listed securities. *Id.* at 2. See also Intermarket Trading Concept Release, *supra* note 92, at 27223.

<sup>94</sup> See Nasdaq Petition, *supra* note 93, at 10, and Intermarket Trading Concept Release, *supra* note 92, at 27224.

<sup>95</sup> See Nasdaq Petition, *supra* note 93, at 11, and Intermarket Trading Concept Release, *supra* note 92, at 27224.

<sup>96</sup> The ISG was created in 1983 and its members include all of the registered national securities exchanges and FINRA. ISG states that its goals are to enhance intermarket surveillance, assure the integrity of trading, and provide investor protection. To achieve these goals, ISG members share data such as audit trail information and short interest data among themselves. ISG provides surveillance tools to supplement its participant members’ existing surveillance systems, such as the ISG Unusual Activity Report and the Consolidated Equity Audit Trail. These reports are made available from SIAC to



day delayed data at the clearing firm level, with time data from non-synchronized clocks.<sup>97</sup>

Nasdaq believed that the information provided by ISG was insufficient to identify potentially violative activity.<sup>98</sup>

In response to the Intermarket Trading Concept Release, the Commission received a variety of comments on intermarket surveillance and order audit trail issues.<sup>99</sup> Of those

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members of ISG and are intended to provide a consolidated view across all markets of trade, quote, and clearing activity. See comment letter from Brian F. Colby, Chairman, Intermarket Surveillance Group, to Jonathan G. Katz, Secretary, Commission, dated June 18, 2003 (“ISG 2003 Comment Letter”) (commenting in response to the Intermarket Trading Concept Release).

<sup>97</sup> See Nasdaq Petition, supra note 93, at 10, and Intermarket Trading Concept Release, supra note 92, at 27224.

<sup>98</sup> See Nasdaq Petition, supra note 93, at 10–11, and Intermarket Trading Concept Release, supra note 92, at 27224.

<sup>99</sup> See comment letters from Darla C. Stuckey, Corporate Secretary, NYSE, to Jonathan G. Katz, Secretary, Commission, dated June 19, 2003 (“NYSE Comment Letter”); Jeffrey T. Brown, General Counsel, Cincinnati Stock Exchange, to Jonathan G. Katz, Secretary, Commission, dated June 19, 2003 (“CSE Comment Letter”); Michael J. Simon, Senior Vice President and Secretary, International Securities Exchange, Inc., to Jonathan G. Katz, Secretary, Commission, dated June 19, 2003 (“ISE Comment Letter”); William O’Brien, Chief Operating Officer, Brut, LLC, to Jonathan G. Katz, Secretary, Commission, dated June 19, 2003 (“Brut Comment Letter”); Kim Bang, President, Bloomberg Tradebook LLC, to Jonathan G. Katz, Secretary, Commission, dated June 20, 2003 (“Bloomberg Tradebook Comment Letter”); Donald D. Kittell, Executive Vice President, Securities Industry Association, to Jonathan G. Katz, Secretary, Commission, dated June 27, 2003 (“SIA Comment Letter”); Edward J. Joyce, President and Chief Operating Officer, CBOE, to Jonathan G. Katz, Secretary, Commission, dated June 30, 2003 (“CBOE Comment Letter”); W. Hardy Callcott, Senior Vice President and General Counsel, Charles Schwab & Co., Inc., to Jonathan G. Katz, Secretary, Commission, dated July 7, 2003 (“Schwab Comment Letter”); Richard Ketchum, General Counsel, Citigroup, to Jonathan G. Katz, Secretary, Commission, dated July 8, 2003 (“Citigroup Comment Letter”); John S. Markle, Associate General Counsel, Ameritrade Holding Corp., to Jonathan G. Katz, Secretary, Commission, dated July 10, 2003 (“Ameritrade Comment Letter”); and Eric Schwartz, Managing Director, Goldman Sachs, and Duncan Niederauer, Co-Chief Executive Officer, Spear, Leeds & Kellogg, to Jonathan G. Katz, Secretary, Commission, dated July 25, 2003 (“Goldman Sachs and Spear, Leeds & Kellogg Comment Letter”).

commenters that addressed the general concept of creating a uniform electronic audit trail, some supported the concept while others did not.<sup>100</sup>

One commenter expressed the view that once broker-dealers have implemented systems necessary to comply with audit trail requirements, it would not be incrementally significant from a cost perspective to supply the same data in a common format to additional SROs, but that there would be a significant cost if the data to be captured and the methods of encoding and delivering the data differed from market to market.<sup>101</sup> This commenter urged the Commission, if it were to require all market centers to adopt audit trail requirements, to ensure that the requirements are uniform and standardized. This commenter recommended a single standard for real time electronic trade and audit trail reporting, which would be applicable to all equity securities traded in the national market regardless of where listed or traded, and where data would be captured in a central depository, aggregated and made immediately available to each relevant market center,

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<sup>100</sup> Of the commenters that clearly commented on the creation of a uniform intermarket audit trail, Citigroup and Goldman Sachs and Spear, Leeds & Kellogg were in favor of the idea, and Bloomberg supported a consolidated audit trail for those SROs trading Nasdaq-listed securities. See Citigroup Comment Letter, supra note 99, at 6; Goldman Sachs and Spear, Leeds & Kellogg Comment Letter, supra note 99, at 3–4; and Bloomberg Tradebook Comment Letter, supra note 99, at 3. Brut, CBOE, and the NYSE did not appear to be in favor of a standardized intermarket audit trail. See Brut Comment Letter, supra note 99, at 5 (arguing for addressing improvements to surveillances falling short of Exchange Act requirements individually instead of “costly and comprehensive technology overhauls”); CBOE Comment Letter, supra note 99, at 2 (explaining that it “supports expanding the use of existing tools and enhancing [SRO] and Commission coordination to strengthen surveillance and to achieve more uniform regulation...” and noting that the Commission could “play a significant role in achieving uniform SRO regulation [by] establishing guiding principles on a variety of areas that affect all SROs.” CBOE also noted that there should be enhanced coordination of SRO regulatory efforts through ISG and through 17d-2 agreements); and NYSE Comment Letter, supra note 99, at 5 (suggesting linking SRO audit trails in the manner of the ISG Consolidated Audit Trail).

<sup>101</sup> See Goldman Sachs and Spear, Leeds & Kellogg Comment Letter, supra note 99, at 3.

possibly through direct electronic data feeds.<sup>102</sup> Likewise, another commenter stated that it would be preferable for there to be one uniform audit trail system, rather than each SRO adopting its own audit trail requirements and systems, to reduce the potential for conflicting rules and regulations and duplicative systems and technology requirements.<sup>103</sup> Another commenter recommended that if the Commission determined that the need for a particular SRO to have enhanced audit trail information outweighs costs to member firms, SROs be required to coordinate efforts so as to reduce duplication of systems and regulatory efforts.<sup>104</sup>

Several commenters urged the Commission to consider the costs to broker-dealer firms of supplying the audit trail data when considering the appropriateness of extending OATS-like audit trail requirements to other market centers.<sup>105</sup> One commenter stated the belief that firms already are required to maintain all of the customer and transaction information that regulators would want under their current books and records requirements and that most firms do not believe there is a justification for requiring firms to spend the money necessary to send this information to

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<sup>102</sup> Id at 4.

<sup>103</sup> See Citigroup Comment Letter, supra note 99, at 6.

<sup>104</sup> See SIA Comment Letter, supra note 99, at 4. One commenter agreed that the Commission would be justified in requiring all SROs trading Nasdaq-listed securities to coordinate electronic audit trail systems with the NASD. See Bloomberg Tradebook Comment Letter, supra note 99. On the other hand, one commenter stated its belief that if there is a legitimate need to improve on the ISG audit trail, the markets should act jointly to do so, without being forced to adopt Nasdaq's proprietary audit trail. See ISE Comment Letter, supra note 99.

<sup>105</sup> See SIA Comment Letter, supra note 99, at 4; Goldman Sachs and Spear, Leeds & Kellogg Comment Letter, supra note 99, at 3 (stating that any decision about extending OATS to other markets should take into account the costs imposed on SROs, market intermediaries and the markets); and Ameritrade Comment Letter, supra note 99, at 3.

every market center where an order may be routed.<sup>106</sup> Another commenter was concerned about the impact on each individual market's structure of mandating uniformity.<sup>107</sup>

Some commenters supported the ISG as a facilitator of a coordinated regulation.<sup>108</sup> One commenter noted that the ISG Consolidated Equity Audit Trail was a valuable supplement to existing SRO market data.<sup>109</sup> One commenter also endorsed the ISG audit trail as well as CSE's Firm Order Submission system,<sup>110</sup> stating that it was preferable to enhance these systems rather than conduct a "mass migration" to OATS.<sup>111</sup> The ISG itself stated that no other market had reported any problems with ISG's timing of the incorporation of the clearing data into the Consolidated Equity Audit Trail, nor with the delivery of its audit trail information.<sup>112</sup>

In 2004, in a release seeking comment on a variety of issues relating to self-regulation,

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<sup>106</sup> See SIA Comment Letter, supra note 99, at 4.

<sup>107</sup> See CSE Comment Letter, supra note 99, at 6–7 (noting that the data formats among exchanges may vary due to structural needs and system designs; thus, while this commenter advocated that exchanges should be required to have internal audit trails tracking orders from inception to execution, it argued that design flexibility be maintained so that exchanges could create the audit trail systems best suited to monitor their markets).

<sup>108</sup> See Ameritrade Comment Letter, supra note 99, at 2; CSE Comment Letter, supra note 99, at 13; ISE Comment Letter, supra note 99, at 4; and NYSE Comment Letter, supra note 99, at 3.

<sup>109</sup> See NYSE Comment Letter, supra note 99.

<sup>110</sup> In its comment letter, CSE stated that its Firm Order Submission system ("FOS") was more comprehensive than OATS and that the exchange had pioneered order audit trail development. See CSE Comment Letter, supra note 99. In its petition, Nasdaq argued that FOS was used voluntarily for settling commercial disputes between traders and was not the meant for surveillance. See Nasdaq Petition, supra note 93, at 4.

<sup>111</sup> See Brut Comment Letter, supra note 99, at 6.

<sup>112</sup> See ISG 2003 Comment Letter, supra note 99.

the Commission again sought public comment on intermarket surveillance.<sup>113</sup> The Commission discussed the individual audit trails developed by several equity markets, COATS, and ISG's clearing level audit trail.<sup>114</sup> The Commission suggested that a more robust intermarket order audit trail for options and equity markets could enhance the surveillance of order flow and requested comment on the issue.<sup>115</sup>

One commenter on the Concept Release Concerning Self-Regulation stated that, because trading in most liquid securities now occurs on multiple markets, no single SRO could capture a complete picture of all the trading in each product, all trading by one broker-dealer, and even all the trading related to a single order.<sup>116</sup> This commenter stated its belief that the lack of uniform order and transaction data creates regulatory gaps and may provide incentives for market participants to conduct activities on markets where less regulatory data is collected on an automated basis.<sup>117</sup> This commenter believed that minimum data-collection standards should be required to ensure adequate regulation across all markets, and that consolidating that data would permit effective intermarket regulation while ensuring that no single market has a competitive advantage.<sup>118</sup>

Another commenter gave an example of how it believed the lack of real time reporting across markets was detrimental to surveillances relating to certain illegal activities. This

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<sup>113</sup> See Concept Release Concerning Self-Regulation, supra note 92, at Sections IV.C and V.A.2.

<sup>114</sup> Id.

<sup>115</sup> Id. at 71277.

<sup>116</sup> See comment letter from Robert R. Glauber, Chairman and Chief Executive Officer, NASD, to Jonathan G. Katz, Secretary, Commission, dated March 15, 2005 ("NASD Comment Letter"), at 10.

<sup>117</sup> Id. at 11.

<sup>118</sup> Id.

commenter stated its belief that “effective surveillances relating to insider trading, market manipulation and stock or options frontrunning in multiple markets can be hindered because away-market data such as order information, position limit reports and large position reports (for options) are not available electronically on a real time or near real time basis to the SRO that has generated an alert or flag in the course of its routine surveillance.”<sup>119</sup> This commenter suggested that consolidating this type of data in real time or near real time would permit SROs to immediately detect and review all aberrational activity in the multiple market centers, which could significantly deter or prevent violative conduct.<sup>120</sup>

Another commenter stated its belief that the lack of a coordinated surveillance system is potentially one of the more significant problems facing the markets, and that as trading strategies become more sophisticated across multiple markets and national borders, the potential for sophisticated fraud also increases.<sup>121</sup> One commenter recommended a consolidated information base that all regulators could access, stating that “having separate and uncoordinated regulatory data is inefficient and detracts from the quality of regulation.”<sup>122</sup> Further, another commenter suggested a voluntary regulatory cooperative, jointly owned by participant exchanges, that would be the central regulator for surveillance, investigations and examinations and would include an electronic interface with the SEC; this commenter believed that the costs of developing an

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<sup>119</sup> See comment letter from Mary Yeager, Secretary, NYSE, to Jonathan G. Katz, Secretary, Commission, dated March 8, 2005, at 8.

<sup>120</sup> Id.

<sup>121</sup> See comment letter from Rebecca T. McEnally, Director, and Linda L. Rittenhouse, Senior Policy Analyst, Centre for Financial Market Integrity, to Nancy M. Morris, Secretary, Commission, dated July 14, 2006, at 6.

<sup>122</sup> See comment letter from Kim Bang, Chief Executive Officer, Bloomberg L.P., to Jonathan G. Katz, Secretary, Commission, dated March 8, 2005, at 4.

intermarket consolidated order audit trail system should be justified by the regulatory value of the data to be captured.<sup>123</sup>

## **II. Basis for Proposed Rule**

As noted above, the U.S. securities markets have experienced a dynamic transformation in recent years. Rapid technological advances and regulatory developments have produced fundamental changes in the structure of the securities markets, the types of market participants, the trading strategies employed, and the array of products traded. Trading of securities has become more dispersed among exchanges and various other trading venues, including the OTC market. The markets have become even more competitive, with exchanges and other trading centers aggressively competing for order flow by offering innovative order types, new data products and other services, and through fees charged or rebates provided by the markets. The Commission preliminarily believes that with today's fast, electronic and interconnected markets, there is a heightened need for a single uniform electronic cross-market order and execution tracking system that includes more information than is captured by the existing SRO audit trails, and in a uniform format. Such a system would enable SROs to better fulfill their regulatory responsibilities to monitor for and investigate illegal activity in their markets and by their members. Further, the Commission preliminarily believes that such a system would enable the Commission staff to better carry out its oversight of the NMS for securities and to perform market analysis in a more timely fashion, whether on one market or across markets.

Each national securities exchange and national securities association must be organized and have the capacity to comply, and enforce compliance by its members, with its rules, and with

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<sup>123</sup> See comment letter from Meyer S. Frucher, Chairman and Chief Executive Officer, Philadelphia Stock Exchange, to Jonathan G. Katz, Secretary, Commission, dated March 9, 2005, at 3.

the federal securities laws, rules, and regulations.<sup>124</sup> The Commission preliminarily believes that the exchanges and FINRA could more effectively and efficiently fulfill these statutory obligations if the SROs had direct, electronic real time access to consolidated and more detailed order and execution information across all markets.<sup>125</sup> Likewise, the Commission has the statutory obligation to oversee the exchanges and associations,<sup>126</sup> and to enforce compliance by the members of exchanges and associations with the respective exchange's or association's rules, and the federal securities laws and regulations.<sup>127</sup> The Commission also preliminarily believes that electronic real time access to consolidated information and more detailed cross market order and execution information also would aid the Commission in carrying out its statutory obligations.

Section 11A(a)(3)(B) of the Exchange Act provides in part that the Commission may, by rule, require SROs to act jointly with respect to matters as to which they share authority under the Exchange Act in regulating a NMS for securities.<sup>128</sup> Pursuant to this authority, the Commission today is proposing a rule that would require all national securities exchanges and national securities associations to jointly submit to the Commission an NMS plan to create, implement, and maintain a consolidated audit trail that would be more comprehensive than any

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<sup>124</sup> See, e.g., Sections 6(b)(1), 19(g)(1) and 15A(b)(2) of the Exchange Act, 15 U.S.C. 78f(b)(1), 78s(g)(1), and 78o-3(b)(2).

<sup>125</sup> The Commission notes that, if adopted as proposed, its Large Trader Proposal would not amend or impact the scope of any of the existing SRO audit trail rules. See Large Trader Proposal, *supra* note 11.

<sup>126</sup> See, e.g., Sections 2, 6(b), 15A(b), and 19(h)(1) of the Exchange Act, 15 U.S.C. 78b, 15 U.S.C. 78f(b), 15 U.S.C. 78o-3(b), and 15 U.S.C. 78s(h)(1).

<sup>127</sup> See, e.g., 19(h)(1) of the Exchange Act, 15 U.S.C. 78s(h)(1).

<sup>128</sup> See Section 11A(a)(3)(B) of the Exchange Act, 15 U.S.C. 78k-1(a)(3)(B).



audit trail currently in existence.<sup>129</sup> The proposed Rule would require the consolidated audit trail to capture certain information about each order for an NMS security, including the identity of the customer placing the order and the routing, modification, cancellation or execution of the order, in real time. In effect, the proposal would create a time-stamped “electronic audit trail record or report” for every order, and each market participant that touches the order would be required to report information about certain reportable events, such as routing or execution of the order.

The Commission preliminarily believes that a consolidated order audit trail, such as the one proposed today, could enhance the ability of the SROs to carry out their obligations to regulate their markets and their members. The Commission also preliminarily believes that the proposed consolidated order audit trail could aid the Commission in fulfilling its statutory obligations to oversee SROs,<sup>130</sup> monitor for the manipulation of security prices,<sup>131</sup> and detect the use of manipulative or deceptive devices in the purchase or sale of a security,<sup>132</sup> as well as to perform market reconstructions.

The Commission preliminarily believes that proposed Rule 613 would benefit the industry, through potential cost reductions, by eliminating the need for certain SRO and Commission rules that currently mandate the collection and provision of information, at least with respect to NMS securities.<sup>133</sup> The Commission also preliminarily believes that the proposal

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<sup>129</sup> See infra Section III for a description of proposed Rule 613.

<sup>130</sup> See, e.g., Sections 6(b)(1) and 19(h) of the Exchange Act, 15 U.S.C. 78f(b)(1) and 78s(h).

<sup>131</sup> See Section 9 of the Exchange Act, 15 U.S.C. 78i.

<sup>132</sup> See Section 10 of the Exchange Act, 15 U.S.C. 78j.

<sup>133</sup> See infra Section VI.A (discussion of benefits of the proposed Rule).

would benefit SROs, as well as the NMS for NMS securities, by ultimately reducing some regulatory costs, which may result in a more effective re-allocation of overall costs.<sup>134</sup>

The Commission recognizes that SRO rules requiring members to capture and disclose audit trail information already exist, and considered whether more modest improvements to existing rules, and corresponding SRO and member systems, would achieve the proposed Rule's objective at lower cost. For example, the Commission considered whether to standardize and expand the order information collected by existing audit trails, the EBS system, Rule 17a-25 and equity cleared reports. Without centralization of the trading data in a uniform electronic format, however, the Commission's goals of cross-market comparability and ready access could not be achieved. Additionally, this approach would not resolve concerns over how long it takes to obtain order and execution information because the data is often not available in real time and is provided only upon request.<sup>135</sup> Similarly, the Commission considered whether assuring access to existing audit trails to other SROs and the Commission would sufficiently advance its goals. Even if SROs could view order activity on a real time basis on other exchanges, this would not eliminate the need for SROs to check multiple repositories to view and obtain order information. Moreover, the information may be captured, stored and displayed in a variety of formats, making comparisons more difficult. The Commission, therefore, preliminarily does not believe that "retrofitting" existing rules and systems would be a more effective way to achieve the goals of the proposed consolidated audit trail than having the requirements contained in a single Commission rule, and a single NMS plan.

As discussed below, the Commission preliminarily believes that existing audit trails are limited in their scope and effectiveness in varying ways. SRO and Commission staff also

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<sup>134</sup> Id.

<sup>135</sup> See infra note 149.

currently obtain information about orders or trades through the EBS system, Rule 17a-25,<sup>136</sup> and from equity cleared reports.<sup>137</sup> However, as discussed below, the information provided pursuant to the EBS system, Rule 17a-25, and the equity cleared reports also is limited, to varying degrees, in detail and scope.

**A. Lack of Uniformity of, and Gaps in, Current Required Audit Trail Information**

As noted above, the type of information relating to orders and executions currently collected by the exchanges and FINRA differs widely. For example, FINRA's OATS rules and NYSE/NYSE Amex's OTS rules (as supplemented by the requirements of NYSE and NYSE Amex Rule 123) both set forth in relative detail the information required to be recorded by a FINRA, NYSE or NYSE Amex member upon receipt or origination of an order; following transmission of an order to another FINRA, NYSE or NYSE Amex member; and following modification, cancellation or execution of such order.<sup>138</sup> In contrast, some other exchanges' rules only require their members to keep records in compliance with the member's recordkeeping obligations under Section 17(a) of the Exchange Act and rules thereunder,<sup>139</sup> rather than requiring that specific information be captured for orders sent to and executed on the exchange.<sup>140</sup> Although Rule 17a-3 under the Exchange Act<sup>141</sup> requires that a member make and keep detailed information with respect to each brokerage order, it does not, for instance, require

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<sup>136</sup> 17 CFR 240.17a-25.

<sup>137</sup> See supra Sections I.A. and I.B. for a description of the EBS system, Rule 17a-25, and equity cleared reports.

<sup>138</sup> See FINRA Rules 7400 through 7470, NYSE Rules 123 and 132B, NYSE Amex Equities Rule 123 and 132B, and supra Sections I.C. and I.D. See also CHX Article II, Rule 3; Nasdaq Rules 6950 to 6958; and BX Rules 6950 to 6958.

<sup>139</sup> 15 U.S.C. 78q(a).

<sup>140</sup> See, e.g., NSX Rules 4.1 and 4.2, NYSE Arca Equities Rule 9.17, and BATS Rule 4.1.

<sup>141</sup> 17 CFR 240.17a-3.

information with respect to the routing of the order, or that each order be assigned a unique order identifier.<sup>142</sup> Similarly, the scope of securities covered by existing audit trail rules also differs among the exchanges and FINRA. FINRA's OATS rules, for instance, apply to orders for equity securities listed on Nasdaq and OTC securities, while OTS captures information for orders in NYSE and NYSE Amex-listed cash equity securities.<sup>143</sup>

While there is no current requirement that all SROs record the same information for orders and executions in the same or different securities, each SRO has a statutory obligation to regulate its market and its members. The Commission is concerned that the lack of uniformity as to the type of audit trail information gathered by the different exchanges and FINRA, and the lack of compatibility in the format of each SRO's audit trail data, may hinder the ability of SRO and Commission staff to effectively and efficiently monitor for, detect, and deter illegal trading that occurs across markets. If a market participant is engaging in manipulative behavior across various markets, but the rules of one market do not require its members to provide detailed information regarding the orders sent to its market, it may be difficult for regulators to determine that trading activity on one market was related to trading activity on another market. For

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<sup>142</sup> Rule 17a-3(a)(6)(i) under the Exchange Act requires that a member keep a memorandum of each brokerage order given or received for the purchase or sale of securities, whether executed or not, showing the terms and conditions of the order and any modification or cancellation thereof; the account for which it was entered; the time the order was received; the time of entry; the execution price; the identity of each associated person, if any, responsible for the account; the identity of any other person who entered or accepted the order on behalf of the customer, or, if a customer entered the order on an electronic system, a notation of that entry; and, to the extent feasible, the time of execution or cancellation. See 17 CFR 240.17a-3(a)(6)(i).

<sup>143</sup> See supra Sections I.C. and I.D. See also supra the discussion in the introduction to Section II relating to the Commission's consideration of whether "retrofitting" existing SRO audit trail rules and systems would achieve the goals of the proposed consolidated audit trail.

example, Section 9 of the Exchange Act expressly prohibits "wash sales."<sup>144</sup> A trader could attempt to disguise such trading by executing various legs of wash transactions on different markets. Individual market surveillance based on individual SRO audit trail data would not always be able to detect this kind of cross-market abuse.

Further, while current order audit trail rules provide a framework for capturing order information, the Commission is concerned that certain information about orders and executions that would be useful to efficient and effective regulation of inter-market trading activity and prevention of manipulative practices is not captured by existing audit trails. Most importantly, the existing audit trails do not require members to provide information identifying the customer submitting an order, the person with investment discretion for the order, or the beneficial owner. The identity of this "ultimate customer," however, often is necessary to tie together potential manipulative activity that occurs across markets and through multiple accounts at various broker-dealers. While the Commission notes that exchange and FINRA regulatory staff, as well as Commission staff, eventually can obtain identifying customer or beneficial account information by submitting requests for information through ISG or to various broker-dealers involved in potentially wrongful activities, this process can result in significant delays in investigating market anomalies or potentially manipulative behavior. The Commission preliminarily believes that gaps such as this in required audit trail information may hinder the ability of regulatory authorities to enforce compliance with SRO rules and the federal securities laws, rules, and regulations in a timely manner.

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<sup>144</sup> See Section 9(a)(1) of the Exchange Act, 15 U.S.C. 78i(a)(1). Wash sales are transactions involving no change in beneficial ownership. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 205 n. 25 (1976).

In addition, an exchange's audit trail information effectively ends when an order is routed to another exchange. For example, although the NYSE's OTS rule requires a NYSE member or member organization to record the fact that an order was transmitted to a non-member, the rules do not require the recording of what subsequently happens to the order.<sup>145</sup> Likewise, FINRA's OATS data collection effectively ends if an order is routed from a member of FINRA to an exchange.<sup>146</sup> As a result, key pieces of information about the life of an order may not be captured, or easily tracked, if an order is routed from one exchange to another, or from one broker-dealer to an exchange. For example, the name, or identifier, of a broker-dealer that initially received an order may be captured by the audit trail of the exchange of which that broker-dealer is a member when the broker-dealer sends the order to the exchange. However, if the order is routed to and executed on a second exchange, the identifying information for that initial broker-dealer may not be captured by the second exchange's audit trail requirements.

Similarly, under current audit trail rules, an incoming order may be assigned an order identifier by the initial receiving exchange; however, if the order is routed to a second exchange, there is no requirement that this order identifier be passed along to or maintained by the second exchange. Thus, one order that is routed across markets can have multiple order identifiers, each unique to one exchange. The Commission preliminarily believes that, from a regulatory standpoint, the lack of standardized cross-market order identifiers can pose significant obstacles and delays in effectively detecting and deterring manipulative behavior because SRO and Commission staff cannot readily collect the necessary data (that is, they cannot readily piece

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<sup>145</sup> See NYSE Rule 132B(c)(3).

<sup>146</sup> See FINRA Rule 7440(c)(6). The Commission understands that FINRA is able to link OATS order information to Nasdaq order and execution data.

together activity related to the same order or the same customer occurring across several markets) to determine whether violative behavior has occurred.

Additionally, the Commission is concerned that the data generated by the EBS system or that is available through the equity cleared reports also lacks items of information needed to match up order and trade information across markets to fully understand a particular trading pattern or to reconstruct a certain type of trading activity. EBS data does not include the time of execution, and often does not include the identity of the beneficial owner.<sup>147</sup> The equity cleared data also lacks the time of execution, as well as time of order receipt, often the identity of the beneficial owner, the identity of the broker-dealer(s) that received and/or executed the order (if different from the clearing broker-dealer), and short sale borrow and fails information. In order to obtain the time an order was received or the identity of the beneficial owner, therefore, SRO or Commission staff may take the additional step of submitting an electronically generated blue sheet request to the clearing broker-dealer identified in the equity cleared report to ask that broker-dealer to identify the beneficial ownership of the account(s) effecting the relevant transactions and/or the introducing broker,<sup>148</sup> and this may take a few steps if the clearing broker-dealer does not know the introducing broker, but only the executing broker (if different). If the beneficial ownership of the account(s) was not specified in the clearing broker-dealer's response, the staff could then ask the introducing broker-dealer for the time an order was received and the beneficial account holder information. Often, additional steps are required to identify the beneficial account holder, such as when the "customer" is an omnibus account.

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<sup>147</sup> If a customer has an account directly with a clearing firm, or if an introducing firm clears its customers' transactions on a fully disclosed basis with the clearing firm, the clearing firm should be able to identify the beneficial owner of the account on its EBS response.

<sup>148</sup> For purposes of this discussion, introducing broker means the broker-dealer that received or originated the order, and that is not also the clearing broker.

Furthermore, the equity cleared data could be duplicative. For example, one side of a trade can appear multiple times in the equity cleared reports because it may be reported by a specialist, a clearing broker-dealer, and the broker-dealer holding the customer's allocation account and the customer's trading account.

The lack of cohesive, readily available order and execution information creates significant hurdles for investigators at both the SROs and at the Commission. In order for SROs to investigate potential violations of their rules and the federal securities laws and rules by their members, the SROs should have the ability to analyze the activities of their members taking place across different market centers. This requires the accumulation and interpretation of data from numerous, disparate sources sometimes presenting inconsistent information. Similarly, the experience of the Commission staff shows that the lack of a consolidated audit trail results in the investment of significant resources to investigate potential market abuses. For example, when investigating potential insider trading and other market manipulations, Commission staff first obtains an equity cleared report to identify the clearing broker-dealers for trades involving the stock under investigation and the trading volume for a particular period of time. Then staff sends document requests to those clearing broker-dealers to identify the broker-dealers that executed trades in the stock over that period of time. This process can be complicated further by potential market manipulators that trade through small introducing brokers or use offshore corporate accounts and prime brokerage or other arrangements to conduct transactions. Commission staff also may request trade data for additional time periods identified during the course of the investigation, resulting in further delays. Commission staff thus often must make multiple requests to broker-dealers to obtain sufficient order information about the purchase or sale of a specific security to be able to adequately analyze trading. These multiple requests and responses



can take a significant amount of time and delay the Commission's efforts to analyze the data on an expedited basis.<sup>149</sup> While the investigative protocols of each SRO may differ from those used by the Commission, in each case, collecting, interpreting and analyzing diverse data sources is labor intensive and time consuming.

The Commission is concerned that inadequacies in the current audit trail rules, EBS system, and equity cleared reports also impede the ability of SRO or Commission staff to promptly analyze trading patterns, particularly to prepare market reconstructions. For example, if Commission staff wants to undertake an analysis of an extreme market movement over a limited period of time, Commission staff would need to analyze audit trail information and EBS submissions of trading data to determine if specific trading strategies, techniques or participants appeared to be associated with the movement. Because of difficulties in linking trades in the audit trails with aggregate day-end trading data in EBS submissions, conducting this analysis is difficult and time-consuming. While the audit trail data could identify the precise execution times of trades by particular clearing broker-dealers, it would not identify the specific customers or beneficial owners involved in the trades. On the other hand, while EBS submissions provide summary trading information for particular accounts at the clearing broker-dealers, they lack execution times for these trades. Further complications can arise due to the common practice for large traders to route their orders through multiple accounts at multiple clearing firms, as well as practices at some firms that use “average price accounts” to effect trades that are eventually settled in multiple proprietary and/or customer accounts. While these practices are not, in

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<sup>149</sup> Rule 17a-25 (as well as the SRO EBS rules) does not specify a definitive deadline by which such information must be furnished to the Commission and, in the Commission's experience, data collected through the EBS system often is subject to lengthy delays, particularly with respect to files involving a large number of transactions over an extended period of time.

themselves, improper, their use makes it more challenging to establish with certainty when trading on behalf of a particular trader was effected during the trading session.

The Commission preliminarily believes that the proposed consolidated audit trail would help alleviate the difficulties faced by Commission staff in performing market reconstructions, such as those described in the above example, by requiring that national securities exchanges, national securities associations, and their members provide order and execution data to one central location, largely on a real time basis, in a uniform electronic format. Having this information readily available in a central location would reduce the need for staff to request and collect such information from multiple broker-dealers and then examine, analyze and reconcile the disparate information provided to accurately “reconstruct” the market.<sup>150</sup>

#### **B. Books and Records Requirements**

Because brokers-dealers often are members of several exchanges and FINRA, they are subject to and must comply with the differing audit trail rules. Brokers and dealers also have a statutory obligation to maintain records in compliance with Commission and SRO rules.<sup>151</sup> As a result of the differing audit trail rules, brokers and dealers may be required to keep records to

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<sup>150</sup> As discussed, the Commission preliminarily believes that the proposal would improve the ability of regulators to conduct timely and accurate trading analyses for market reconstructions and complex investigations, as well as inspections and examinations. Indeed, the Commission believes that the proposed consolidated audit trail, if implemented, would have significantly enhanced the Commission’s ability to quickly reconstruct and analyze the severe market disruption that occurred on May 6, 2010. If approved and implemented, the proposal also would enhance the Commission’s ability to similarly respond to future severe market events.

<sup>151</sup> See Section 17(a)(1) of the Exchange Act, 15 U.S.C. 78q(a)(1), and Rules 17a-3 and 17a-4 under the Exchange Act, 17 CFR 240.17a-3 and 17a-4.

comply with each audit trail rule relating to trading in a certain security. Thus, some broker-dealers may now face significant costs to comply with varying audit trail rules.<sup>152</sup>

### **C. Time Lags**

Current audit trail rules require that an SRO's members submit order and execution information by the end of each business day (in the case of OATS), or in certain cases, upon request by the regulating entity (for instance, like OTS).<sup>153</sup> End-of-day or upon request reporting, by definition, limits regulators' ability to carry out real time cross-market surveillance and investigations of market anomalies. The Commission preliminarily believes that end-of-day reporting, coupled with the current laborious process of identifying the ultimate customer responsible for a particular securities transaction that may take several days, weeks or even months, can impact effective oversight by hindering the ability of SRO regulatory staff to identify manipulative activity close in time to when it is occurring, and respond to instances of potential manipulation quickly. This process also hinders the Commission's ability to detect and investigate potentially manipulative behavior. Manipulative activity by some market participants can result in other market participants, such as retail investors, losing money. The longer that manipulative behavior goes undetected over time, the greater the potential harm to investors. Further, timely pursuit of potential violations can be important in seeking to freeze and recover any profits received from illegal activity.

### **D. Access to Audit Trail Information**

While each SRO has direct access to audit trail information received from its members, as well as its own data relating to orders received and executed on its market, one SRO cannot

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<sup>152</sup> See Goldman Sachs and Spear, Leeds & Kellogg Comment Letter, supra note 99, at 3, and SIA Comment Letter, supra note 99, at 3 (each commenting on the Nasdaq Petition and Intermarket Trading Concept Release).

<sup>153</sup> See supra Sections I.C. and I.D.

directly or easily access the audit trail information collected by other SROs, despite the interconnectedness of today's securities markets and the fact that orders are often routed from one marketplace to another marketplace for execution. In addition, Commission staff itself does not have immediate access to the exchanges' and FINRA's audit trail information, and instead must specifically request that an exchange or FINRA produce its audit trail information.<sup>154</sup>

The Commission notes that ISG provides a framework for the voluntary sharing of information and coordination of regulatory efforts among the exchanges and FINRA to address potential intermarket manipulations and trading abuses. The Commission believes that ISG plays an important role in information sharing among markets that trade the same securities, as well as related securities or futures on the same products.<sup>155</sup> However, the information provided to ISG, which is drawn from each individual exchange's audit trail and books and records, is not in any uniform or comparable format. In addition, information is only submitted to ISG upon a request by one of its members, and the information is not provided by ISG members in real time. Further, the operation of ISG is not subject to the Commission's oversight, including approval of what, and how, information is collected from and shared across SROs. The Commission preliminarily believes that it is now appropriate to mandate a structure whereby the regulatory staff of all exchanges and FINRA, as well as the Commission, can directly access comprehensive uniform cross-market order and execution information in real time pursuant to Commission rule, rather than through an information-sharing cooperative governed only by contract.

#### **E. Scalability of the EBS System and Rule 17a-25**

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<sup>154</sup> The different data fields and unique formats of each SRO audit trail present difficulties for Commission examinations and investigations, where time constraints can make it impractical to manually consolidate diverse data sets.

<sup>155</sup> See supra note 96.

Although the EBS system and Rule 17a-25 can be used to obtain information in conjunction with the SRO audit trail information, the Commission is concerned with the ability of the EBS system, as enhanced by Rule 17a-25, to keep pace with changes in the securities markets over recent years. Various changes in market dynamics have affected the utility of the EBS system and Rule 17a-25. For example, decimal trading has increased the number of price points for securities, and the volume of quotations and orders has correspondingly dramatically increased. Thus, the volume of transaction data subject to reporting under the EBS system can be significantly greater than the EBS system was intended to accommodate in a typical request for data. As a request-based system that is most useful when targeting trading in a specific security for a specific time, the EBS system is not well-suited as a broad-based tool to detect illegal or manipulative activity. The increased use of sponsored access (or other indirect access to an exchange) also has made it more difficult to use the EBS system and Rule 17a-25 to identify the ultimate customer that originates an order because the member broker-dealer through whom an order is sent to an exchange may not know the identity of the underlying customer.<sup>156</sup>

In addition, the increasing number of alternative trading venues creates more opportunities for orders to be routed to other markets and thus can result in delays in producing EBS data as requests must be made to several broker-dealers in the “chain” of an order. Finally, the increased trading of derivative instruments and products also has affected the ongoing effectiveness of the EBS system and Rule 17a-25. A market participant can use derivative

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<sup>156</sup> Indirect access is when a non-member of an exchange accesses an exchange through a member. For example, to comply with regulatory obligations such as Rule 611 of Regulation NMS (17 CFR 242.611), exchanges increasingly rely on indirect access to other exchanges through member broker-dealers of the other exchanges, so called “private linkage” access. Sponsored access is one type of indirect access and is governed by exchange rules. See, e.g., Nasdaq Rule 4611(d). The Commission recently proposed rules that would address sponsored access to exchanges. See Securities Exchange Act Release No. 61379 (January 26, 2010), 75 FR 4713 (January 29, 2010).

instruments and products as a substitute for trading in a particular equity, and likewise engage in illegal trading activity in derivative instruments and products. However, because information related to some derivative instruments over which the Commission has anti-fraud authority (such as security-based swaps) is not included within the EBS data or provided pursuant to Rule 17a-25, the EBS system and Rule 17a-25 are not effective tools for ascertaining activity in those markets or how that activity may be affecting the underlying equity market.<sup>157</sup>

In the Commission staff's experience, the EBS is most effective when investigating or analyzing trading in a small sample of securities over a limited period of time. But even under those circumstances, Commission staff often must make multiple requests to broker-dealers to obtain sufficient order information about the purchase or sale of a specific security to be able to adequately analyze the suspect trading. These multiple requests and responses can take a significant amount of time. The Commission preliminarily believes that the EBS system may no longer be able to fully support the regulatory challenges currently facing SRO and Commission regulatory staff.

The consolidated audit trail that the Commission is proposing today would provide significant improvements in the order and execution information available to SRO and Commission staff in several discrete ways. Among other things, the proposed audit trail would require that national securities exchanges and national securities associations and their members submit uniform order and execution information to a central repository on a real time basis, where possible. National securities exchanges and associations, and their member firms, would be required to identify the person with investment discretion for the order, and beneficial account

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<sup>157</sup> See infra Section III.A for a discussion of the scope of products to be covered by the proposed Rule and the intent to expand the scope to cover other products and transactions.

holder, if different, along with other key information about the customer or proprietary desk that placed or originated the order. The proposed consolidated audit trail also would cover any action taken with respect to the order through execution, or cancellation, as applicable, and thus would allow regulators to more easily trace the order from inception to cancellation or execution.<sup>158</sup>

The Commission preliminarily believes that the proposed audit trail information would greatly enhance the ability of SRO staff to effectively monitor and surveil the securities markets on a real time basis, and thus to detect and investigate illegal activity in a more timely fashion, whether on one market or across markets. The Commission also preliminarily believes that the proposal would improve the ability of Commission and SRO staff to conduct more timely and accurate trading analysis, as well as to conduct more timely and accurate market reconstructions, complex enforcement inquiries or investigations, and inspections and examinations of regulated entities and SROs.

### **III. Description of Proposed Rule**

To help address the deficiencies described above, the Commission is proposing to adopt a rule that would require national securities exchanges<sup>159</sup> and national securities associations<sup>160</sup> to

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<sup>158</sup> The proposed Rule also would require the reporting of certain post-trade information. See infra Section III.D.2.

<sup>159</sup> National securities exchange is defined in Rule 600(a)(45) of Regulation NMS as any exchange registered pursuant to Section 6 of the Exchange Act (15 U.S.C. 78f). 17 CFR 242.600(a)(45).

<sup>160</sup> National securities association is defined in Rule 600(a)(44) of Regulation NMS as any association of brokers and dealers registered pursuant to Section 15A of the Exchange Act (15 U.S.C. 78o-3). 17 CFR 242.600(a)(44). As noted above, see supra note 12, FINRA currently is the only national securities association to which the proposal would apply, as the NFA is restricted to regulating its members who are registered as broker-dealers in security futures products due to its limited purpose registration with the Commission under Section 15A(k) of the Exchange Act, 15 U.S.C. 78o-3(k). The NFA could, of course, seek to expand its current registration. Thus, for ease of reference, this proposal refers to FINRA but the proposed requirements would apply to any national securities association registered with the Commission.

create and implement a consolidated audit trail that captures customer and order event information, in real time, for all orders in NMS securities, across all markets, from the time of order inception through routing, cancellation, modification, or execution.

If adopted, the proposed Rule would require each national securities exchange and national securities association to file jointly with the Commission on or before 90 days from approval of this proposed Rule an NMS plan to govern the creation, implementation, and maintenance of a consolidated audit trail and a central repository.<sup>161</sup> The NMS plan would be required to be filed with the Commission pursuant to, and subject to the requirements of, Rule 608 of Regulation NMS.<sup>162</sup> As such, the proposed NMS plan would be published in the Federal Register and subject to public notice and comment in accordance with Rule 608(b). Further, the NMS plan filed pursuant to the proposed Rule, or any amendment to such a plan, would not become effective unless approved by the Commission or otherwise permitted in accordance with Rule 608.<sup>163</sup>

The Commission would expect the exchanges and FINRA to cooperate with each other and to take joint action as necessary to develop, file, and ultimately implement a single NMS plan to fulfill this requirement. The Commission requests comment on this approach. Specifically, the Commission requests comment on whether requiring the exchanges and associations to act jointly by filing an NMS plan that would contain the requirements for a consolidated audit trail is the most effective and efficient way to achieve the objectives of a

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<sup>161</sup> See infra Section III.F. for a discussion of the central repository. The proposed Rule would explicitly require each national securities exchange and national securities association to be a sponsor of the NMS plan submitted pursuant to the Rule and approved by the Commission. See proposed Rule 613(a)(4).

<sup>162</sup> 17 CFR 242.608. See proposed Rule 613(a)(2).

<sup>163</sup> See proposed Rule 613(a)(5) and 17 CFR 242.608.



consolidated audit trail. Or, should the Commission require the exchanges and associations to standardize or otherwise enhance their existing rules? What approach would be most efficient in improving the ability to monitor cross-market trading, or undertake market analysis or reconstructions, and why?

As discussed in further detail below, the proposed Rule would require that the NMS plan include provisions regarding: (1) the operation and administration of the NMS plan; (2) the creation and oversight of a central repository; (3) the data required to be provided by SROs and their members to the central repository; (4) clock synchronization; (5) compliance by national securities exchanges, FINRA, and their members with the proposed Rule and the NMS plan; and (6) the possible expansion of the NMS plan to products other than NMS securities.

The proposed Rule is designed to allow the national securities exchanges and national securities associations to develop the details of the NMS plan that they believe should govern the creation, implementation and maintenance of the central repository and consolidated audit trail, within the parameters set forth in the proposed Rule. The Commission believes that the national securities exchanges and national securities associations working jointly are in the best position to propose for themselves and their members the specifics of how the consolidated audit trail should be structured and administered. To this end, the proposed Rule contains a broad framework within which the exchanges and associations would provide the details that they believe would result in a functional, cooperative mechanism to create and maintain a consolidated audit trail, as well as certain explicit requirements the NMS plan must meet. As noted above, the proposed NMS plan developed by the exchanges and FINRA would be subject to public comment and approval by the Commission.

#### **A. Products and Transactions Covered**

Proposed Rule 613 would apply to secondary market transactions in all NMS securities, which means NMS stocks and listed options.<sup>164</sup> The Commission ultimately intends for the consolidated audit trail to cover secondary market transactions in other securities, including equity securities<sup>165</sup> that are not NMS securities, corporate bonds, municipal bonds, and asset-backed securities and other debt instruments;<sup>166</sup> credit default swaps, equity swaps, and other security-based swaps; and any other products that may come under the Commission's jurisdiction

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<sup>164</sup> NMS security is defined in Rule 600(a)(46) of Regulation NMS to mean 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. 17 CFR 242.600(a)(46). NMS stock is defined in Rule 600(47) to mean any NMS security other than an option. 17 CFR 242.600(a)(46). A listed option is defined in Rule 600(a)(35) of Regulation NMS to mean any option traded on a registered national securities exchange or automated facility of a national securities association. 17 CFR 242.600(a)(35).

<sup>165</sup> Equity security is defined in Section 3(a)(11) of the Exchange Act to include any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security. See 15 U.S.C. 78c(a)(11).

Rule 3a11-1 under the Exchange Act defines equity security to include any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; any security future on any such security; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so. See 17 CFR 240.3a11-1.

<sup>166</sup> Asset-backed security means a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders; provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases. See 17 CFR 229.1101(c)(1).

in the future. Further, the Commission preliminarily believes that it would be beneficial to provide for the possible expansion of the consolidated audit trail to include information on primary market transactions in NMS stocks and other equity securities that are not NMS stocks, as well as primary market transactions in debt securities.<sup>167</sup> Such information could be used to monitor for violations of certain rules under the Exchange Act, such as Regulation M and Rule 10b-5 under the Exchange Act.<sup>168</sup> Further, FINRA's transaction reporting requirements for debt securities already cover primary market transactions in debt securities,<sup>169</sup> and thus FINRA members should already be recording information relating to such transactions that could be included in an audit trail. The Commission proposes that the scope of the Rule initially be limited to secondary market transactions in NMS securities, however, to allow for a manageable

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<sup>167</sup> A primary market transaction is any transaction other than a secondary market transaction and refers to any transaction where a person purchases securities in an offering. See, e.g., FINRA Rule 6710 (defining two types of primary market transactions for TRACE-eligible securities, a List or Fixed Offering Price Transaction or a Takedown Transaction).

<sup>168</sup> See 17 CFR 242.100 et. seq. and 17 CFR 240.10b-5. Rule 105 prohibits the short selling of equity securities that are the subject of a public offering for cash and the subsequent purchase of the offered securities from an underwriter or broker or dealer participating in the offering if the short sale was effected during a period that is the shorter of the following: (i) beginning five business days before the pricing of the offered securities and ending with such pricing; or (ii) beginning with the initial filing of such registration statement or notification on Form 1-A or Form 1-E and ending with the pricing. Thus, Rule 105 prohibits any person from selling short an equity security immediately prior to an offering and purchasing the security by participating in the offering. The primary market transaction data would allow for the ability to more quickly identify whether any participant in the offering sold short prior to the offering.

Rule 10b-5 prohibits any act or omission resulting in fraud or deceit in connection with the purchase or sale of any security. The primary market transaction data for bonds would allow for identification of the cost basis for bond purchases by intermediaries and make it easier to assess whether subsequent mark-ups to retail investors in primary offerings are fair and reasonable and, if not, whether there has been a violation of the antifraud provisions of the federal securities laws.

<sup>169</sup> See FINRA Rule 6730(a)(5).

implementation of the proposed consolidated audit trail, and because market participants already have experience with audit trails for these types of transactions in these securities.

As discussed above, the Commission believes that implementing a consolidated audit trail for NMS securities would aid the SROs in more effectively and efficiently carrying out their regulatory responsibilities. It would also assist the Commission in carrying out its statutory responsibilities. The Commission further preliminarily believes that a timely expansion of the scope of the consolidated audit trail beyond NMS securities would be beneficial, as illegal trading strategies that the consolidated audit trail would be designed to help detect and deter, such as insider trading, may involve trading in multiple related products other than NMS securities across multiple markets.

For example, the Commission routinely receives information relating to possible upward manipulation of security prices in violation of Sections 9(a) and 10(b) of the Exchange Act,<sup>170</sup> and alleged abusive short selling in the over-the-counter market, which includes FINRA's Bulletin Board and Pink Sheets. If the consolidated audit trail were expanded to cover these securities, it would be possible for SROs and the Commission to make comparisons between current and historical data in a more timely manner than is currently possible, to more quickly determine whether or not a complaint merits additional attention and the corresponding commitment of enforcement resources. Similarly, to the extent that instruments currently not considered NMS securities can be substitutes for long or short positions in NMS securities, having access to an audit trail that documents trading activity in such securities would improve the Commission's ability to make a risk assessment as to information it has received about

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<sup>170</sup> 15 U.S.C. 78i(a) and 78j(b).

possibly manipulative activity.<sup>171</sup> Having ready access to this information in an audit trail also would improve the Commission's inspection process because it would enhance risk assessment and allow for better selection as to which broker-dealers to examine. For example, the information would allow for better trend analysis and outlier identification. It also would improve pre-examination work and the asset verification process,<sup>172</sup> and focus document requests, making the examination process more efficient for the Commission staff and the registrants subject to the process.

To help ensure that such an expansion would occur in a reasonable time and that the systems and technology that would be used to implement the Rule as proposed are designed to be easily scalable, proposed Rule 613(i) would require that the NMS plan contain a provision requiring each national securities exchange and national securities association that is a sponsor of the plan<sup>173</sup> to jointly provide the Commission a document outlining how the sponsors could incorporate into the consolidated audit trail information with respect to: (1) equity securities that are not NMS securities; (2) debt securities, including asset-backed securities; and (3) primary market transactions in NMS stocks, equity securities that are not NMS securities, and debt

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<sup>171</sup> The Commission's Division of Enforcement has recently established an Office of Market Intelligence. This Office, among other things, conducts intake and triage of investor and industry referrals that are received by the Commission each year. Currently, a thorough review of referrals requires extensive resource allocation as the primary source for evaluating trading data is the EBS system. Expansion of the consolidated audit trail to non-NMS securities would allow that Office to evaluate the merits of each referral faster and more effectively, and more efficiently allocate enforcement resources to appropriate cases.

<sup>172</sup> Asset verification is an exam process that attempts to locate independent information to verify certain customer positions, transactions, and balances at broker-dealers.

<sup>173</sup> Sponsor, when used with respect to an NMS plan, is defined in Rule 600(a)(70) of Regulation NMS to mean any self-regulatory organization which is a signatory to such plan and has agreed to act in accordance with the terms of the plan. See 17 CFR 242.600(a)(70).

securities. The sponsors specifically would be required to address, among other things, details for each order and reportable event that they would recommend requiring to be provided; which market participants would be required to provide the data; an implementation timeline; and a cost estimate.

The Commission requests comment on the proposed scope of products to be covered by the consolidated audit trail. Should the consolidated audit trail initially cover securities other than NMS securities? Why or why not? The Commission also requests comment on whether the approach to expand the consolidated audit trail to include the products and transactions specified above represents an appropriate expansion of the consolidated audit trail, and what additional capital commitment would be required by the various market participants to implement such an expansion. Please be specific in your response with respect to different products or transactions (e.g. security-based swaps, or primary market transactions in NMS stocks). Are there other securities or products that should be identified and included in a future expansion? What would be the challenges to any expansion to the products and transactions listed above? Are there any other actions that the Commission or SROs would need to take to be able to expand the audit trail to certain products or transactions? Should the Commission consider expansion to certain products or transactions before others? The Commission also requests comment on an appropriate and realistic time frame for including these other products and transactions in the consolidated audit trail and whether an expansion should be done in phases.

The Commission also requests comment on whether implementation of the proposed Rule, which would apply to NMS securities, would have an impact on trading activity by market participants in products not initially covered by the proposed Rule. The proposed consolidated audit trail is designed to provide the SROs and the Commission a tool to more effectively, and in

a more timely manner, identify potential manipulative or other illegal activity. More timely detection and investigation of such activity may lead to greater deterrence of future illegal activity if potential wrongdoers perceive a greater chance of regulators identifying their activity in a more timely fashion. Do commenters believe that the existence of the proposed audit trail would alter market participants' trading behavior, such as by shifting their trading to products or markets not covered by the proposed Rule to avoid detection of illegal activity using consolidated audit trail data? Would the proposal impact a market participant's analysis of the potential risks and benefits of manipulative activity involving NMS securities? If so, how so? In addition, to the extent commenters believe that market participants may alter their trading behavior, such as by shifting trading to products that are not initially covered by the proposed Rule to avoid detection of manipulative activity, the Commission requests comment on the importance of expanding the consolidated audit trail to cover additional products.

#### **B. Orders and Quotations**

The proposed Rule would require that information be provided to the central repository for every order in an NMS security originated or received by a member of an exchange or FINRA. The proposed Rule would define "order" to mean: (1) any order received by a member of a national securities exchange or national securities association 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.<sup>174</sup> Thus, the proposed consolidated audit trail would cover all orders (whether for a customer or for a member's own account) as well as quotations in NMS stocks and listed

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<sup>174</sup> See proposed Rule 613(j)(4). Bid or offer is defined in Rule 600(a)(8) of Regulation NMS to mean the bid price or the offer price communicated by a member of a national securities exchange or member of a national securities association to any broker or dealer, or to any customer, at which it is willing to buy or sell one or more round lots of an NMS security, as either principal or agent, but shall not include indications of interest. 17 CFR 242.600(a)(8).

options.<sup>175</sup> Each member would be required to report to the central repository the origination of its own orders or quotations, and the SRO to which the member sends its orders and quotations would be required to report receipt and execution, if applicable, of those orders and quotations. Because the origination of the quotations would already be reported to the central repository by the member, an SRO would not be required to separately submit to the central repository its best bids and offers that it is required to submit to the central processors.<sup>176</sup>

The Commission preliminarily believes that the inclusion of orders for a member's own account ("proprietary orders") and their bids and offers in the scope of the consolidated audit trail is necessary and appropriate to effectively and efficiently carry out the stated objectives of the consolidated audit trail. The SROs would not be able to use the consolidated audit trail data to surveil trading by broker-dealers through their proprietary accounts if that information is not included in the audit trail. Further, including proprietary orders and quotations in the consolidated audit trail would permit SROs to harness the intended benefits of the consolidated audit trail to more efficiently monitor for violations of SRO rules where the exact sequence of the receipt and execution of customers orders in relation to the creation and execution of proprietary orders or quotations is important to determine whether or not a violation occurred. For example, SROs would be able to use the consolidated audit trail data to more efficiently monitor for instances where a broker-dealer receives a customer order, then sends a proprietary order to one exchange or updates its quotations on an exchange prior to sending the customer order to another exchange, in possible violation of the trading ahead prohibitions in their rules.<sup>177</sup>

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<sup>175</sup> Quotation is defined in Rule 600(a)(62) of Regulation NMS to mean a bid or an offer. 17 CFR 242.600(a)(62).

<sup>176</sup> See Rule 601 of Regulation NMS, 17 CFR 242.601.

<sup>177</sup> See, e.g., FINRA Rule 5320 and NYSE Arca Equities Rule 6.16.



Another example where information on proprietary orders or quotations would be useful to have included in the consolidated audit trail is in the investigation of a possible “spoofing” allegation. In those cases, a market participant enters and may immediately cancel limit orders or quotations in a specific security with the intent of having those non-bona fide orders or quotations change the national best bid and national best offer (“NBBO”). Because a market participant could conduct this activity across multiple markets, using different accounts, the lack of consolidated data makes it much more difficult to identify the source of the orders or quotations and thus to determine whether the quoted price was manipulated or simply responding to market forces. The Commission therefore preliminarily believes that having information on proprietary orders and quotations in the consolidated audit trail along with customer order information would greatly enhance the ability of the SROs to detect potentially violative activity.

The Commission requests comment on its proposed definition of "order" and the scope of the proposed consolidated audit trail. Specifically, the definition would include orders received and originated by SRO members, as well as quotations originated by SRO members. Should it include quotations? Why or why not? Are there any differences between orders and quotations that should be taken into account with respect to the information that would be required to be provided to the central repository with respect to each bid or offer, or with respect to how, or which entity, should be required to report quotation information to the central repository? For example, the Commission understands that out-of-the-money options generate a high volume of automated quotation updates to reflect changes in the price of the underlying security, yet these series often have very little trading activity. Should this type of quotation be required to be submitted to the central repository? If not, is there any way to distinguish these quotations from other quotations that commenters believe should be reported, such as quotations generated by a

profit-seeking algorithm? What is the magnitude of quotation data compared to order data and trade data, for both NMS stocks and listed options? Please provide any empirical data. Would there be a significant cost savings to the submission and collection of certain quotation information (for example, quotations in listed options) by end-of-day instead of in real time? If so, please quantify.

The Commission also requests comment with respect to including proprietary orders as well as customer orders in the scope of the consolidated audit trail. Specifically, are there any differences between customer orders and proprietary orders that should be taken into account with respect to the information that would be required to be provided to the central repository with respect to proprietary orders? The Commission also requests comment on how, if at all, the consolidated audit trail should take into account instances where an SRO's quotations (which can include orders received from members as well as quotations) are not actionable, such as when an exchange has a systems failure. Should non-firm quotations be marked in the consolidated audit trail to show they are not firm? If so, how would that be accomplished where it is the exchange making the determination its quotations are not firm, not the member that submitted the order or quotation?

### **C. Persons Required to Provide Information to the Central Repository**

Proposed Rule 613 would require, through the mechanism of an NMS plan and exchange and association rules adopted pursuant to an NMS plan, national securities exchanges, national securities associations, and their respective members<sup>178</sup> to provide certain information regarding

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<sup>178</sup> A member of a national securities exchange is defined in Section 3(a)(3)(A) of the Exchange Act to mean: (1) any natural person permitted to effect transactions on the floor of the exchange without the services of another person acting as broker; (2) any registered broker or dealer with which such a natural person is associated; (3) any registered broker or dealer permitted to designate as a representative such a natural

each order and each reportable event<sup>179</sup> to the central repository.<sup>180</sup> The Commission notes that requiring all members to provide certain information would capture alternative trading systems (“ATs”).<sup>181</sup>

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person; and (4) any other registered broker or dealer which agrees to be regulated by such exchange and with respect to which the exchange undertakes to enforce compliance with the provisions of the Exchange Act, the rules and regulations thereunder, and its own rules. Further, for purposes of Sections 6(b)(1), 6(b)(4), 6(b)(6), 6(b)(7), 6(d), 17(d), 19(d), 19(e), 19(g), 19(h), and 21 of the Exchange Act, the term “member” when used with respect to a national securities exchange also means, to the extent of the rules of the exchange specified by the Commission, any person required by the Commission to comply with such rules pursuant to Section 6(f) of this title. See 15 U.S.C. 78c(a)(3)(A).

A member of a registered securities association is defined in Section 3(a)(3)(B) of the Exchange Act to mean any broker or dealer who agrees to be regulated by such association and with respect to whom the association undertakes to enforce compliance with the provisions of the Exchange Act, the rules and regulations thereunder, and its own rules. See Section 3(a)(3)(B) of the Exchange Act, 15 U.S.C. 78c(a)(3)(B). Section 15(b)(8) of the Exchange Act, 15 U.S.C. 78o(b)(8), states that it shall be unlawful for any registered broker or dealer to effect any transaction in, or induce or attempt to induce the purchase or sale of, any security (other than commercial paper, bankers’ acceptances, or commercial bills), unless such broker or dealer is a member of a securities association registered pursuant to Section 15A of the Exchange Act or effects transactions in securities solely on a national securities exchange of which it is a member.

Rule 15b9-1(a) under the Exchange Act, 17 CFR 240.15b9-1(a), generally states that any broker or dealer required by Section 15(b)(8) of the Exchange Act to become a member of a registered national securities association shall be exempt from such requirement if it is a member of a national securities exchange; carries no customer accounts; and has annual gross income derived from purchases and sales of securities otherwise than on a national securities exchange of which it is a member in an amount no greater than \$1,000.

<sup>179</sup> Reportable event would be defined in proposed Rule 613(j)(5) to include, but not be limited to, the receipt, origination, modification, cancellation, routing, and execution (in whole or in part) of an order.

<sup>180</sup> See *infra* Section III.D. for a detailed discussion of the information that would be required to be provided to the central repository, and *infra* Section III.H.2. for a discussion of the requirement that the exchanges and FINRA adopt rules to implement the requirements of the NMS plan for their members.

<sup>181</sup> An ATs is defined in Rule 300(a) of Regulation ATs. See 17 CFR 242.300(a). Regulation ATs requires ATs to be registered as broker-dealers with the Commission, which entails becoming a member of FINRA and fully complying with the broker-dealer regulatory regime. See Concept Release on Equity Market Structure, *supra* note 19, at 3599.

The Commission's intent is to require any entity acting in a broker or dealer capacity that would receive an order from a customer or originate an order for its own account to provide information to the central repository. The Commission requests comment on whether requiring all members of each exchange and association to provide the required information would encompass all broker or dealers or other persons that would receive or originate orders, as defined in the proposed Rule. If not, why not? The Commission requests comment on whether it should, in the alternative, require all brokers and dealers registered with the Commission to provide such information, rather than all members of an exchange or association. Would applying the requirements to registered brokers and dealers encompass all persons that would be able to receive or originate orders as defined in the proposed rule? Are there persons that are not registered as a broker or dealer, and that are not a member of an exchange or association, that would still receive or originate orders in NMS securities? How should the Commission address that situation to promote inclusion of all relevant orders and executions in a consolidated audit trail?

**D. Provision of Information to the Central Repository**

Proposed Rule 613(c)(1) generally would require the NMS plan 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 further documenting the life of the order through the process of routing, modification, cancellation, and execution (in whole or in part). To effectuate this goal, proposed Rule 613(c)(2) would require the NMS plan to require each national securities exchange, national securities association, and

member of such exchange or association to collect and provide to the central repository certain information with respect to orders in NMS securities.<sup>182</sup>

Specifically, the proposed Rule would require the NMS plan to require each national securities exchange and its members to collect and provide to the central repository certain order information for each NMS security registered or listed for trading on such exchange or admitted to unlisted trading privileges on such exchange.<sup>183</sup> The proposed Rule also would require the NMS plan to require each national securities association and its members to collect and provide to the central repository certain order information for each NMS security for which transaction reports are required to be submitted to the association.<sup>184</sup> The Commission requests comment on whether requiring exchanges and their members, and associations and their members, to report information for orders for these securities to a central repository is appropriate, and whether the requirements, as proposed, would cover all NMS securities.<sup>185</sup>

As discussed below in Section III.D.1., certain of the information would be required to be captured and transmitted to the central repository on a real time basis, meaning immediately and with no built in delay from when the reportable event occurs.<sup>186</sup> Other information would be permitted to be captured and transmitted to the central repository promptly after the exchange, association, or member receives the information, but in no instance later than midnight of the day that the reportable event occurs or the exchange, association, or member receives such

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<sup>182</sup> See Sections III.D.1. and III.D.2. below for a detailed discussion of the information that would be required to be provided to the central repository.

<sup>183</sup> See proposed Rule 613(c)(5).

<sup>184</sup> See proposed Rule 613(c)(6).

<sup>185</sup> See infra Section III.F. for a discussion of the central repository.

<sup>186</sup> See proposed Rule 613(c)(3). See supra note 179 for a definition of reportable event.

information.<sup>187</sup> The data collected by the national securities exchanges, national securities associations, and their members would be required to be electronically transmitted to the central repository in a uniform electronic format.<sup>188</sup>

### **1. Information to be Provided to the Central Repository in Real Time**

As discussed above in Section II.A.4., the Commission preliminarily believes that requiring the submission of consolidated audit trail information on a real time basis would help enable more timely cross-market monitoring or surveillance and investigations of, or other responses to, market anomalies. Regulators therefore could more easily and quickly identify manipulative or other undesirable activity. Having the information available in real time would allow the staff of the SROs to run certain cross-market surveillances in real time to ascertain whether anomalous trading activity is occurring, and the SROs could then more quickly begin an investigation into the suspected anomalous trading. Timely pursuit of potential violations can be important in seeking to freeze any profits received from illegal activity before they are spent or otherwise become unreachable (for instance, by being transferred out of the country). The Commission also preliminarily believes that requiring the submission of audit trail information in real time would enable the Commission to access the information on a more timely basis than currently is the case, to support its examination and enforcement activities, as well as its analysis of market activity.<sup>189</sup>

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<sup>187</sup> See proposed Rule 613(c)(4). This requirement to report no later than midnight on the day that the reportable event occurs or the exchange, association or member receives the information would be determined using the local time of the entity reporting the information to the central repository.

<sup>188</sup> See proposed Rule 613(c)(2).

<sup>189</sup> See supra notes 28, 154, and 171 and accompanying text.

The Commission requests comment as to whether it is feasible to require the submission of the proposed audit trail information, as detailed below, to the central repository on a real time basis. If the information is not submitted on a real time basis, when should the information be submitted to the central repository? Would real time order and execution information be useful for cross-market surveillance and investigations of market anomalies? If so, how? If not, why not? Please discuss the costs and benefits of recording and transmitting the data in real time, or not in real time. For example, how would costs differ between submitting end-of-day data compared to real time data? Are there categories of information that would be easier to produce on a real time basis than others? What types of systems modifications by the exchanges, FINRA, and their respective members would be necessary to collect and submit the required audit trail information to the central repository on a real time basis? Please respond with specificity. The Commission further requests comment on whether the requirement to report information in real time should be limited to a specific time period during the day, such as when the markets for trading NMS stocks and listed options are open for trading? Or some other time period? How much lower would the cost be to submit data in real time during trading hours than during the whole day? Or some other time period? Are there practical issues with requiring real time reporting throughout the day? Would requiring data to be submitted in real time all day, as proposed, allow the ability to perform systems maintenance if necessary? If commenters support the requirement to report information in real time, do they believe that there are times during the day when real time reporting may be unnecessary? Why or why not?

Proposed Rule 613(c)(3) would require the NMS plan to require each exchange, association, and member to collect and provide to the central repository on a real time basis

details for each order and each reportable event,<sup>190</sup> as outlined below. Each exchange, association, or member would be required to report the information for each order, for each reportable event, only with respect to an action taken by the exchange, association, or member. For example, if a member receives an order from a customer, the member would be required to report the receipt of that order (with the required information) to the central repository. If the member then routed that order to an exchange for execution, the member would be required to report the routing of that order (with the required information) to the central repository. Likewise, the exchange would be required to report the receipt of that order from the member (with the required information) to the central repository. If the exchange executed the order on its trading system(s), the exchange would be required to report that execution of the order (with the required information) to the central repository, but the member would not also be required to report the execution of the order to the central repository. If the member executed the order in the over-the-counter market, however, rather than routing the order to an exchange (or other market center) for execution, the member would be required to report the execution of the order to the central repository.

#### **i. Customer Information**

The proposed Rule specifically would require, for the receipt or origination of each order, information to be reported to the central repository with respect to the customer that generates the order -- specifically, the beneficial owner(s) of the account originating the order and the person exercising investment discretion for the account originating the order, if different from the beneficial owner.<sup>191</sup> As discussed above in Section II.A.1, such information generally is

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<sup>190</sup> See supra note 179 for a definition of reportable event.

<sup>191</sup> The proposed Rule would define “customer” to mean the beneficial owner(s) of the account originating the order and the person exercising investment discretion for the



neither required nor captured on existing audit trails. While Rule 17a-25 requires broker-dealers to electronically submit information about customer and proprietary securities trading, such information is required to be submitted to the Commission only upon request. The Commission preliminarily believes that the usefulness of audit trail information for purposes of effective enforcement and cross-market surveillance of trading activity would be greatly improved by having the identity of the customer electronically attached to the report of the receipt or origination of each order that is sent to the central repository.<sup>192</sup>

The proposed Rule would require that the NMS plan require, for the receipt or origination of an order, the provision to the central repository of information of sufficient detail to identify the customer.<sup>193</sup> The Commission preliminarily believes that the customer name and address would be sufficient detail to identify the customer. In addition, the proposed Rule would require the provision of customer account information, which would be defined in proposed Rule 613(j)(2) to include but not be limited to: (1) the account number; (2) account type (e.g. options); (3) customer type (e.g., retail, mutual fund, broker-dealer proprietary); (4) the date the account was opened; and (5) the large trader identifier (if applicable).<sup>194</sup> The Commission preliminarily believes that information on the type of account and when it was opened would be important to investigations of potential insider trading. For example, knowing when in time the

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account originating the order, if different from the beneficial owner(s). See proposed Rule 613(j)(1). The Commission notes that this proposed definition of customer is only for purposes of proposed Rule 613, and what information would be required to be collected and disclosed by members to the central repository. The Commission does not intend to alter the responsibilities that broker-dealers are already subject to pursuant to SRO rules, or the federal securities laws, rules or regulations or other laws, with respect to the customers (for example, suitability rules, see, e.g. NASD Rule 2310).

<sup>192</sup> See supra Section II.A.

<sup>193</sup> See proposed Rule 613(c)(7)(i)(A).

<sup>194</sup> See proposed Rule 613(c)(7)(i)(C). See also Large Trader Proposal, supra note 11.

customer opened the account in relation to the suspicious trading activity, or whether the customer changed account authorization to permit options trading just before suspicious options trading, could be evidence of intent. The Commission notes that currently any member receiving orders from a customer would be required, as part of its compliance with its books and records requirements,<sup>195</sup> to take reasonable and appropriate steps to ensure the accuracy of the customer information received. This should not change, if this proposal were adopted, with respect to customer information recorded and provided to the central repository.

The proposed Rule also would require a unique customer identifier for each customer.<sup>196</sup> The unique customer identifier should remain constant for each customer, and have the same format, across all broker-dealers. This unique customer identifier would serve a similar purpose to a customer's social security number or tax identification number, obviating the need to include that information in the consolidated audit trail data. The Commission is not proposing to mandate the method for achieving this requirement, so as to allow those entities subject to the proposed Rule flexibility to determine the most practical way to accomplish the requirement of having unique customer identifiers. However, one alternative could be to have the central repository be responsible for assigning a unique customer identifier in response to an input by a member of a customer's social security number or tax identification number. If the customer already has been assigned a unique identifier because of a prior request by another member, the central repository would provide to the member that same identifier. If no unique identifier has previously been assigned, the central repository could assign a new one. Access to this part of the central repository's functionality could be more tightly controlled than access to the

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<sup>195</sup> See, e.g., Rules 17a-3, 17a-4, and 17a-25 under the Exchange Act, 17 CFR 240.17a-3, 17a-4, and 17a-25.

<sup>196</sup> See proposed Rule 613(c)(7)(i)(B).

consolidated audit trail data, to help ensure the confidentiality of the social security or tax identification numbers.

The Commission requests comment as to whether each item of information regarding the customer is necessary for an effective consolidated audit trail. Is there any additional data that should be included to help identify the customer submitting the order? The Commission also requests comment on the proposed definition of customer. For example, should the definition only include the person exercising investment discretion? Should the definition include the beneficial owner? Should the customer information requirement also include a unique identifier for the particular computer algorithm used by the firm to generate the order, if applicable? Is there a better way to identify in the audit trail individual algorithmically-generated trading strategies? Should each trading desk at a member be required to have its own unique customer identifier, to the extent the trading desk is originating orders for the account of the member? This information on specific algorithms or trading desks could be useful to focus an inspection or investigation, if regulators could tell from the audit trail data that there was a pattern of suspicious trading activity from a specific algorithm or desk.

The Commission requests comment as to what systems modifications, if any, would be required for members to collect and to provide this customer identification information to the central repository. Do broker-dealers currently keep this information electronically? If not, what changes would need to be made to collect and provide this information for existing accounts to the central repository? What would be the cost of converting this information into an electronic, accessible and linked format? Please be specific in your response. Further, the Commission requests comment on whether there are laws or other regulations in non-U.S. jurisdictions that would limit or prohibit a member from obtaining the proposed customer information for non-

U.S. customers. If so, what are they? How do members currently obtain such information for such customers? If there are special difficulties in obtaining customer information from non-US jurisdictions, how should the consolidated audit trail be modified or otherwise reflect that difficulty?

The Commission requests comment on other possible ways to develop and implement unique customer identifiers. For example, who should be responsible for generating the identifier? The Commission also requests comment on whether a unique customer identifier, together with the other information with respect to the customer that would be required to be provided under the proposed Rule, is sufficient to identify individual customers. Are there any concerns about how the customer information will be protected? If so, what steps should be taken to ensure appropriate safeguards with respect to the submission of customer information, as well as the receipt, consolidation, and maintenance of such information in the central repository.

In addition, the Commission requests comment on whether the requirement to provide customer information to the central repository in real time would impact market participants' trading activity? If so, how so? For example, would market participants be hesitant to engage in certain legal trading activity because of a concern about providing customer information in real time? Would market participants shift their trading activity to products or markets that do not require the capture of customer information to avoid compliance with this requirement of the proposed Rule? If so, how should the Commission address those concerns? On the other hand, would enhanced surveillance of the markets as a result of the consolidated audit trail attract additional trading volume to the U.S. markets?

**ii. National Securities Exchange, National Securities Association and Broker-Dealer Identifier Information**

Each member originating or receiving an order from a customer, and each national securities exchange, national securities association, and member that subsequently handles the order, would be required to include its own unique identifier in each report it sends to the central repository for a reportable event. Such an identifier would allow the Commission and SRO staff to determine which member facilitated the transaction and assist in assessing compliance with various SRO or Commission rules, such as the limit order display rule (Rule 604 of Regulation NMS).<sup>197</sup> This is especially important for ensuring that individual customer orders are handled and executed in accordance with SRO and Commission rules. In addition, routing decisions are an important aspect in assessing order execution quality and compliance with a member's duty of best execution. Further, if applicable, the member receiving an order from a customer would be required to report an identifier specifying the branch office and the registered representative at the member receiving the order. These identifiers would be unique to the exchange, association, member, branch office, and registered representative.

The proposed Rule would not require that these unique identifiers "travel" with an order throughout its life, but would require that the unique identifier of each member or SRO that is taking an action with respect to the order be attached to the report of each reportable event that the member, exchange or association is reporting to the central repository. Each report in the life of the order would be able to be linked together at the central repository through the unique order identifier. Therefore, the Commission preliminarily does not believe that the unique identifier of each member or market that touches an order needs to travel with the order for the life of the order as long as the unique identifier of the member or exchange taking the action is included. For example, if Member A receives an order from a customer, Member A would be required to

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<sup>197</sup> 17 CFR 242.604.

report the receipt of that order to the central repository and include Member A's unique identifier. If Member A then routed that order to another member, Member B, Member A would be required to report the routing of that order to the central repository and include Member A's unique identifier as well as the unique identifier of Member B. Likewise, Member B would be required to report the receipt of that order from Member A to the central repository and include the unique identifiers of Member A and Member B. If Member B then routed the order to Exchange A for execution, Member B would be required to report the routing of the order to the central repository and include the unique identifier of Member B and Exchange A, but not Member A.

The Commission requests comment as to who should be responsible for generating unique identifiers for national securities exchanges, national securities associations, and their members. Would it be feasible for each national securities exchange, national securities association, or member to develop its own identifier for this purpose? The Commission also requests comment on the level of specificity for each unique member identifier – should it be designed to identify the firm, trading desk or individual registered representative? What are the advantages or disadvantages of requiring a unique identifier that would allow identification of an individual registered representative as opposed to just the member entity? The Commission also requests comment on procedures or safeguards market participants believe are necessary or appropriate so that these unique identifiers are routed accurately.

### **iii. Receipt or Origination of an Order**

The proposed Rule would require the NMS plan to require members of each of the exchanges and FINRA 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 as described above. The proposed Rule would require the member to report the date and time (to the millisecond) that an order was originated or received.<sup>198</sup> The member also would be required to report the material terms of the order.<sup>199</sup> Material terms of the order would be defined to include, but not be limited to, the following information: (1) the NMS security symbol; (2) the type of security; (3) price(s) (if applicable); (4) size (displayed and non-displayed); (5) side (buy/sell); (6) order type; (7) if a sell order, whether the order is long, short, or short exempt;<sup>200</sup> (8) if a short sale, the locate identifier; (9) open/close indicator; (10) time in force (if applicable); (11) whether the order is solicited or unsolicited; (12) whether the account has a prior position in the security; (13) if the order is for a listed option, option type (put/call), option symbol or root symbol, underlying symbol, strike price, expiration date, and open/close; and (14) any special handling instructions.<sup>201</sup>

The information described would assist the SROs, and the Commission as well, in determining the exact time of order receipt or origination, as well as provide a record of all of the original material terms of an order. The entry time of orders can be critical information in enforcement cases. In insider trading investigations, for example, the entry time of the order may be a critical piece of evidence in determining whether or not an individual acted with the

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<sup>198</sup> See proposed Rule 613(c)(7)(i)(H). Requiring time to the millisecond is consistent with current industry standards. The SIPs currently support millisecond time stamps. See, e.g. SIAC's CQS Output Specifications Revision 40 (January 11, 2010); SIAC's CTS Output Specifications Revision 55 (January 11, 2010); and Nasdaq's UTP Plan Quotation Data Feed Interface Specifications Version 12.0a (November 9, 2009).

<sup>199</sup> See proposed Rule 613(c)(7)(i)(I).

<sup>200</sup> A broker or dealer must mark all sell orders of any equity security as long, short, or short exempt. See Rule 200(g)(1) under the Exchange Act, 17 CFR 242.200(g)(1). A sell order may be marked short exempt only if the conditions of Rule 201(c) or (d) under the Exchange Act are met (17 CFR 242.201(c) and (d)). See Rule 200(g)(2), 17 CFR 242.200(g)(2).

<sup>201</sup> See proposed Rule 613(j)(3).

requisite scienter to violate the federal securities laws. Similarly, in investigating possible market abuse violations, such as trading ahead of a customer order, the relationship between order origination, the terms of the order, and order entry of various other orders on multiple venues, may be at issue. As noted above, requiring that the time of a reportable event be reported in milliseconds is consistent with current industry standards. The Commission requests comment on whether this is an appropriate time standard. Do commenters believe that the time standard should be shorter? If so, what should be the standard, and why? Would requiring a shorter time standard for reporting actually provide more precision in the timing of events? How would your answer be impacted by the extent to which market participants' clocks are synchronized? Alternatively, do commenters believe that it would be more appropriate to require in the proposed Rule that the time of reporting be consistent with industry standards, rather than including a specific time standard (recognizing that the SROs could choose to include a specific time standard in the NMS plan)?

An open/close indicator currently is required to be submitted to exchanges for listed option orders<sup>202</sup> and indicates whether the trade is opening a new position or increasing an existing position rather than closing or decreasing an existing position. The open/close indicator provides information to more easily track the size and holding time for individual positions, and thus to more easily track open interest and short interest. In addition, an open/close indicator could be used to indicate when a buy order in a stock is a buy to cover on a short sale. This information is useful in investigating short selling abuses and short squeezes. For example, a build up of a large short position by one investor along with the spreading of rumors may be indicative of using short selling as a tool to potentially manipulate prices. Information on when

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<sup>202</sup> See, e.g., CBOE Rule 6.51; BATS Rule 20.7; and ISE Rule 1404.



the position decreases is also useful for indicating potential manipulation, insider trading, or other rule violations. Information on whether the account has a prior position in the security is useful in a number of investigations. For example, the ability to easily determine whether an order adds to a position, along with the timing of the order, is particularly important in detecting and investigating portfolio pumping or marking the close. Also, information on whether the account has a prior position may be important in investigating “layering” or “spoofing.” Layering and spoofing are manipulations where orders are placed close to the best buy or sell price with no intention to trade in an effort to falsely overstate the liquidity in a security.

The Commission intends that the items of information required to be reported to the central repository for the receipt or origination of an order, at a minimum, include substantially all of the information currently required to be reported, or provided upon request, under the exchanges’ and FINRA’s existing order audit trail rules, as well as the EBS system rules and Rule 17a-25 under the Exchange Act. The Commission requests comment as to whether there are any items of information that are required to be recorded and reported by existing audit trail rules, or to be provided to the SROs or Commission upon request, that are not included within the proposed Rule that commenters believe should be included. If there are, please identify each item of information and discuss why you believe that such information should be included in the proposed consolidated audit trail. The Commission also requests comment on whether there are items of information included in the current SRO audit trails, and which are proposed to be included in the consolidated audit trail, that are unnecessary for surveillance, investigative or other regulatory purposes. If so, what are these data elements and why are they not necessary as part of a consolidated audit trail? Are they relevant for other purposes? The Commission further requests comment on whether it should require, as part of the disclosure of special handling

instructions, the disclosure of an individual algorithm that may be used by a member or customer to originate or execute an order, and if so, how such an algorithm should be identified.

As noted above, members currently are required to indicate whether an order would open or close a position for listed options.<sup>203</sup> The Commission requests comment as to what extent members currently obtain or have access to this information from their customers, or track this information for their own proprietary orders, for all NMS securities. If members currently do obtain this information, is the information collected and stored electronically? If members currently do not have access to or obtain this information for customer orders, what would be the impact of the proposed requirement to collect and provide this information to the central repository? What would be the costs, if any, of collecting and providing this information? Please explain and quantify any potential impact or costs.

The proposed Rule does not specify exact order types (e.g., market, limit, stop, pegged, stop limit) to be included as material terms of an order because order types may differ across markets, and even an order type with the same title may have a different meaning from one exchange to another. Further, markets are frequently creating new order types and eliminating existing order types. In addition, the Commission notes that it may be difficult to distinguish between an “order type” and a special handling instruction, such as “do not display.” The Commission therefore preliminarily believes that it would not be practical to include in the proposed Rule a list of order types in the required information to be reported to the central repository. The Commission notes, however, that the SROs may choose to include more detail in the NMS plan. The Commission requests comment on this approach. The Commission also requests comment as to whether there are other items of information that would be required to be

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Id.

reported to the central repository that have, or may have, different meanings across different exchanges. If so, what are they? How should these differences be addressed in the proposed Rule?

The proposed Rule also would require the NMS plan to require each member of an exchange or FINRA to “tag” each order received or originated by the member with a unique order identifier that would be reported to the central repository and that would stay with that order throughout its life, including routing, modification, execution, and cancellation.<sup>204</sup> The members, exchanges, and FINRA would be required to pass along the unique order identifier with the order when routing the order, and the unique order identifier would be required on each reportable event report. For example, Member ABC that receives an order from a customer would immediately assign it a unique order identifier, and would report that identifier to the central repository along with the rest of the required information. If Member ABC subsequently routed the order to another member, Member DEF, Member ABC would be required to pass along to Member DEF the unique order identifier, as well as to attach the unique order identifier when reporting the routing of the order to the central repository. If Member DEF routed the order to Exchange A for execution, Member DEF would pass along to Exchange A with the order the unique order identifier, and would attach the identifier on the report of the route sent to the central repository. Exchange A would be required to attach the unique order identifier when reporting receipt of the order, and an execution of the order (if applicable) to the central repository.

The Commission recognizes that the reality of how orders are routed and executed often is complex, and that it likely is not feasible to anticipate how the proposed requirement for a

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<sup>204</sup> See proposed Rule 613(c)(7)(i)(D).

unique order identifier would or would not apply to each different factual scenario. For example, members may often execute customer orders on a “riskless principal” basis,<sup>205</sup> rather than on an agency basis. The Commission preliminarily believes that it would not be practical or feasible to “link” through related unique order identifiers the customer order(s) and the member’s proprietary order(s) from which the customer order is given an allocation. Rather, the Commission envisions that the member would create a new unique order identifier for each proprietary order, and that the manner in which the execution of the customer order would be “linked” with one (or more) proprietary order(s) (if at all) would be through the inclusion of the unique order identifier for the contra-side order(s) on the report of the execution of the customer order sent to the central repository.<sup>206</sup> However, in a situation where a member merely broke up a larger customer order into smaller orders and sent those orders, on an agency basis, to multiple markets for execution, the Commission preliminarily believes that the unique order identifier of the original customer order should carry through in some manner to the individual smaller orders that result when the original order is broken up. For example, it may be necessary to attach two unique order identifiers to an order – the original order identifier (i.e. parent order) and the individual smaller order identifier (i.e. child order). Alternatively, the unique order identifier of the parent order could be modified to carry through to the child orders (for example, the parent

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<sup>205</sup> For example, a member receives a customer order, and rather than sending the customer order as an agency order to an exchange or other marketplace to execute, the member creates an order for its proprietary account that it sends to an exchange or other marketplace to be executed. Once an execution occurs in the proprietary account, the member would then execute the customer order against its proprietary account. This process can be complicated by the member receiving and handling more than one customer order at a time, and creating one or more proprietary orders to send to one or more markets, and the manner in which the member allocates executions from its proprietary account among the customer orders.

<sup>206</sup> See proposed Rule 613(c)(7)(vi)(C).

order could have an identifier ABC and the child orders could have identifiers of ABC1 and ABC2).

The Commission preliminarily believes that a unique order identifier that is essentially transferred along with an order from origination through execution or cancellation is useful for a consolidated audit trail. The use of such an identifier would allow the SROs and the Commission to efficiently link all events in the life of an order and help create a complete audit trail across markets and broker-dealers that handle the order. In this manner, being able to link the parent order with the child orders through the unique order identifiers would allow for ease of tracking of the original parent order throughout its life. While the Commission believes that a unique order identifier is an important data element for the consolidated audit trail, the Commission is not proposing at this time to mandate the format of such an identifier or how the identifier would be generated.

The Commission requests comment on whether, and why, a unique order identifier that would stay with the order for the life of the order is useful or essential for an effective consolidated audit trail. In addition, the Commission requests comment on whether there is an alternative to a unique order identifier that would stay with the order for the life of the order. For example, would permitting each member or SRO that receives an order from another member or SRO to attach its own unique identifier to an order allow the SROs to efficiently link all events in the life an order and ensure the creation of a complete audit trail across each market and broker-dealer that handled the order? The Commission requests comment on the feasibility and merits of the manner in which it proposes unique order identifiers be handled for riskless principal transactions. The Commission also requests comment on the feasibility and merits of requiring that a unique order identifier be attached to an order, as well as the multiple orders that

may result if the original order is subsequently broken up into several orders, in a manner that would permit regulators to trace the subsequent orders back to the original single order. The Commission also requests comment on the feasibility and merits of requiring that a unique order identifier be attached to an order that is the result of a combination of two more orders in a manner that would permit regulators to trace the combined order back to its component orders. The Commission further requests comment as to how unique order identifiers could be generated for both electronic and manual orders, and who should be responsible for generating them. Given the significant number of orders (including quotations) for which information would be required to be collected and provided to the central repository pursuant to the proposed Rule, the Commission requests comment on the feasibility of allowing unique order identifiers to be re-used. If unique order identifiers were to be re-used, at what point should that be allowed? Are there any concerns with re-use that should be addressed? Additionally, the Commission requests comment on whether it is feasible to require unique order identifiers if the consolidated audit trail is implemented in the proposed phased approach? For example, is it appropriate to require that national securities exchanges and national securities associations comply with this requirement before their members are required to do so?

The Commission also requests comment on procedures or safeguards market participants may wish to establish to ensure that unique order identifiers are routed and reported accurately. Further, the Commission requests comment on what systems modifications, if any, would be required in order to “tag” every order with a unique order identifier. Please respond to each question with specificity.

#### **iv. Routing**

The proposed Rule would require that the NMS plan require the collection and reporting to the central repository of all material information related to the routing of an order.

Specifically, the proposed Rule would require the reporting of the following information each time an order is routed by the member or SRO that is doing the routing: (1) the unique order identifier; (2) the date on which an order was routed; (3) the exact time (in milliseconds) the order was routed; (4) the unique identifier of the broker-dealer or national securities exchange that routes the order; (5) the unique identifier of the broker-dealer or national securities exchange that receives the order; (6) the identity and nature of the department or desk to which an order is routed if a broker-dealer routes the order internally;<sup>207</sup> and (7) the material terms of the order.<sup>208</sup>

Further, the proposed Rule would require the collection and reporting by the SRO or member receiving an order of the following information each time a routed order is received: (1) the unique order identifier; (2) the date on which the order is received; (3) the time at which the order is received (in milliseconds); (4) the unique identifier of the broker-dealer or national securities exchange receiving the order; (5) the unique identifier of the broker-dealer or national securities exchange routing the order; and (6) the material terms of the order.<sup>209</sup>

This information would allow regulatory staff to easily identify each member or exchange that “touches” the order during its life, as well as the dates and times at which each member or exchange receives and reroutes the order, and any changes that may be made to the original terms of the order along the way. The Commission preliminarily believes that this

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<sup>207</sup> Internal routing information can be a critical element in assessing whether a member may be disadvantaging customer orders, either by trading ahead of customer orders, or by executing orders as principal at prices inferior to the NBBO.

<sup>208</sup> See proposed Rule 613(c)(7)(ii).

<sup>209</sup> See proposed Rule 613(c)(7)(iii).

information for orders that are routed would allow the Commission and SROs to efficiently track an order from inception through cancellation or execution.

The Commission requests comment as to whether such information regarding the routing of orders is useful or necessary for an effective consolidated audit trail. Should any additional information be included in the consolidated audit trail relating to routing? The Commission requests comment as to what systems modifications, if any, would be required to provide this information. Do members currently have, or have access to, this information? If not, what changes would need to be made to collect this information for existing accounts for submission to the central repository? Do commenters believe that it would be necessary to achieve the purposes of the proposed Rule to require information from each member or SRO that “touches” an order? Please explain with specificity why or why not. Is it feasible to require information relating to the routing of orders if the consolidated audit trail is implemented in the proposed phased approach? For example, is it appropriate to require that national securities exchanges and national securities associations comply with this requirement before their members are required to do so?

**v. Modification, Cancellation, and Execution**

The proposed Rule would require the NMS plan to require that information be reported to the central repository concerning any modifications to the material terms of an order or partial or full order cancellations. The national securities exchange, national securities association, or member handling the order at the time would be required to immediately report to the central repository the following information: (1) the unique order identifier, (2) the date and time (in milliseconds) that an order modification or cancellation was originated or received; (3) the identity of the person responsible for the modification or cancellation instruction; (4) the price



and remaining size of the order, if modified; and (5) other modifications to the material terms of the order.<sup>210</sup> Information pertaining to order modifications and cancellations would assist the Commission and SROs in identifying all changes made to an order and the persons and broker-dealers responsible for the changes.

The proposed Rule also would require the following information on full or partial executions of orders to be collected and reported to the central repository: (1) the unique order identifier; (2) the execution date; (3) the time of execution (in milliseconds); (4) the capacity of the entity executing the order (whether principal, agency, or riskless principal); (5) the execution price; (6) the size of the execution; (7) the unique identifier of the national securities exchange or broker-dealer executing the order;<sup>211</sup> and (8) whether the execution was reported pursuant to an effective transaction reporting plan or pursuant to the OPRA Plan, and the time of such report.<sup>212</sup>

The Commission preliminarily believes that the required execution information, in combination with the proposed information pertaining to order receipt or origination, modification, or cancellation, would provide regulators with a comprehensive, near real time view of all stages and all participants in the life of an order. The proposed Rule would allow the Commission and SROs to identify, for a particular transaction, every member and national securities exchange involved in the receipt or origination, routing, modification, and execution (or cancellation) of the order. This order information, including the readily accessible customer information, should help regulators investigate suspicious trading activity in a more timely manner than currently possible.

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<sup>210</sup> See proposed Rule 613(c)(7)(iv).

<sup>211</sup> Each national securities exchange and national securities association would have its own unique identifier, as well as each broker-dealer (member) (see supra Section III.D.1.ii.).

<sup>212</sup> See proposed Rule 613(c)(7)(v).

Additionally, the requirement to report whether and when the execution of the order was reported to the consolidated tape<sup>213</sup> should allow regulators to more efficiently evaluate certain trading activity. For example, trading patterns of reported and unreported transactions may cause the staff of an SRO or the Commission to make further inquiry into the nature of the trading to determine whether the public was receiving accurate and timely information regarding executions and that market participants were continuing to comply with the trade reporting obligations under SRO rules. Similarly, patterns of reported and unreported transactions could be indicia of market abuse, including failure to obtain best execution for customer orders or possible market manipulation. Being able to more efficiently compare the consolidated order execution data with the trades reported to the consolidated tape could thus be an important component of overall surveillance activity.

As discussed above, the Commission recognizes that the execution of orders often is complex.<sup>214</sup> For example, a customer order may be executed on a riskless principal basis. When a member receives a customer order, rather than sending the customer order as an agency order to an exchange or other marketplace for execution, the member creates an order for its proprietary account that it sends to an exchange or other marketplace to be executed. Once an execution occurs in the proprietary account, the member would then execute the customer order against its proprietary account. This process can be complicated by the member receiving and handling more than one customer order at a time, and creating one or more proprietary orders to

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<sup>213</sup> Id. See also infra Section III.F.1. for a discussion of the requirement in proposed Rule 613(e)(5) that the NMS plan require the central repository to receive and retain on a current and continuing basis (i) the national best bid and national best offer for each NMS security, (ii) transaction reports reported pursuant to a transaction reporting plan filed with the Commission pursuant to, and meeting the requirements of, Rule 601 of Regulation NMS, and (iii) last sale reports reported pursuant to the OPRA Plan.

<sup>214</sup> See supra notes 205-206 and accompanying text.

send to one or more markets, and the manner in which the member allocates executions from its proprietary account among the customer orders. Each proprietary order would have a unique order identifier that is different from, and not linked to, the unique order identifier for the original customer order. How should the reporting to the central repository of the execution of the proprietary orders and the customer order be handled? As noted above, the Commission envisions that the manner in which the execution of the customer order would be “linked” with one (or more) of the proprietary order(s) would be through the inclusion of the unique order identifier for the contra-side order(s) on the report of the execution of the customer order sent to the central repository.<sup>215</sup> Is this practical? Is there another method by which to link the execution of the customer order to the proprietary orders? Is it necessary to do so to achieve the purposes of the consolidated audit trail?

The Commission requests comment on whether the information proposed to be collected and reported would be sufficient to create a complete and accurate audit trail. Is there additional information that should be collected and reported? If yes, please describe the information and the value its collection and reporting would add to the consolidated audit trail.

## **2. Information to be Collected Other Than in Real Time**

While the majority of order and execution information would be required to be transmitted to the central repository on a real time basis, the Commission recognizes that this may not be practical or feasible for all information because the information may not be known at the time of the reportable event.<sup>216</sup> Thus, the Commission is proposing that certain information be transmitted to the central repository promptly after the national securities exchange, national

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<sup>215</sup> See supra note 206 and accompanying text.

<sup>216</sup> For example, a member may receive an order during the day from an advisory customer but not know to which sub-accounts to allocate execution of the order until later in the day.

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.<sup>217</sup> The Commission preliminarily believes that this proposed time frame would provide sufficient time for an exchange, association, or a member to obtain the information required to be reported while still allowing regulators to access the information for regulatory purposes on a more timely basis than today.

Each national securities exchange, national securities association and their members would be required to report the account number for any subaccounts to which an execution is allocated.<sup>218</sup> By requiring that this data be included in the consolidated audit trail, regulators would be able to more easily identify the “ultimate” customer for the trade. The Commission preliminarily believes that it would be useful to know the account number as well as the required information on the beneficial owner. For example, a person or groups of persons could trade through a single account or numerous accounts. Because individual traders may use multiple accounts at multiple broker-dealers, being able to identify the beneficial owner of the underlying accounts aids in the identification and investigation of suspicious trading activity. Similarly, traders may seek to hide manipulative activity from regulatory oversight by trading anonymously through omnibus accounts. In those instances, linking the trade to the individual trader requires the market center to be able to identify both the accounts trading and the beneficial owner or owners of those accounts to determine what person or group of persons is directing the specific trades at issue. Requiring the identity of the ultimate customer electronically to be attached to each order would make this information easily accessible and searchable and thus would greatly

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<sup>217</sup> See proposed Rule 613(c)(4).

<sup>218</sup> See proposed Rule 613(c)(7)(vi)(A).

improve the usefulness of audit trail information for purposes of effective enforcement and cross-market surveillance.

Each national securities exchange, national securities association and their members also would be required to report the unique identifier of the clearing broker or prime broker for the transaction, if applicable, and the unique order identifier of any contra-side order.<sup>219</sup> Finally, if the execution is cancelled, a cancelled trade indicator would be required to be reported. In addition, the proposed Rule also would require the reporting of any special settlement terms for the execution, 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(s) to whom the commission is paid.<sup>220</sup>

Broker-dealers have a duty of best execution.<sup>221</sup> Since commissions can be charged

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<sup>219</sup> See proposed Rule 613(c)(7)(vi)(B) and (C).

<sup>220</sup> See proposed Rule 613(c)(7)(vi)(D), (E), and (F).

<sup>221</sup> A broker-dealer has a legal duty to seek to obtain best execution of customer orders. See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 269-70, 274 (3d Cir.), cert. denied, 525 U.S. 811 (1998); Certain Market Making Activities on Nasdaq, Securities Exchange Act Release No. 40900 (Jan. 11, 1999) (settled case) (citing Sinclair v. SEC, 444 F.2d 399 (2d Cir. 1971); Arleen Hughes, 27 SEC 629, 636 (1948), aff'd sub nom. Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949)). See also Order Execution Obligations, Securities Exchange Act Release No. 37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996) (“Order Handling Rules Release”). A broker-dealer’s duty of best execution derives from common law agency principles and fiduciary obligations, and is incorporated in SRO rules and, through judicial and Commission decisions, the antifraud provisions of the federal securities laws. See Order Handling Rules Release, 61 FR at 48322. See also Newton, 135 F.3d at 270. The duty of best execution requires broker-dealers to execute customers’ trades at the most favorable terms reasonably available under the circumstances, i.e., at the best reasonably available price. Newton, 135 F.3d at 270. Newton also noted certain factors relevant to best execution - order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market. Id. at 270 n.2 (citing Payment for Order Flow, Exchange Act Release No. 33026 (Oct. 6, 1993), 58 FR 52934, 52937-38 (Oct. 13, 1993) (Proposed Rules)). See In re E.F. Hutton & Co., Securities Exchange Act Release No. 25887 (July 6, 1988). See also Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006, 55008-55009 (November 2, 1994) (“Approval of

either explicitly through a separate fee or implicitly in the transaction price, the lack of easily accessible commission fee data alongside transaction price data may make it hard to identify the “all-in” price of execution and, thus, hard to determine whether the obligation to seek best execution was met.<sup>222</sup> In addition, broker-dealers also must comply with just and equitable principles of trade under NASD rules that require them to charge fair commissions and mark-ups (mark-downs), and the lack of easily accessible commission fee data may make it hard to determine whether just and equitable principles of trade have been observed.<sup>223</sup> Also, FINRA rules prohibit certain quid pro quo arrangements in the distribution of IPOs.<sup>224</sup>

The Commission requests comment on the usefulness and necessity of requiring the reporting of each of these items of information to achieve the stated objectives of the consolidated audit trail. Are there practical difficulties associated with providing this information as proposed? Is there additional information that would be useful or necessary in this regard? For example, the proposed Rule would require the reporting of a cancelled trade indicator, for executions that are cancelled. Should the proposed Rule require separate identification of trades that are broken pursuant to the rules of the applicable SRO at the request

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Payment for Order Flow Final Rules”). See also Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005) (“NMS Adopting Release”), at 37537 (discussing the duty of best execution).

<sup>222</sup> The term “all-in” price is intended to capture the total costs for executing a trade.

<sup>223</sup> See FINRA Rule 2010 and IM-2440-1.

<sup>224</sup> See FINRA Rule 5130. The Rule ensures that: (1) FINRA members make bona fide public offerings of securities at the offering price; (2) members do not withhold securities in a public offering for their own benefit or use such securities to reward persons who are in a position to direct future business to members; and (3) industry insiders, including FINRA members and their associated persons, do not take advantage of their insider position to purchase “new issues” for their own benefit at the expense of public customers. For example, information on commissions could help detect a transaction in the secondary market between an underwriter and an investor at an excessively high commission rate that is a “quid pro quo” for the underwriter allocating shares in a “hot” IPO to the investor.

of one party to a transaction or upon the SRO's own motion, and trades that are cancelled by mutual agreement of the parties? Why or why not? The Commission also requests comment on whether the proposed requirement to report the identity of the clearing broker would provide sufficient information on "give-up" arrangements,<sup>225</sup> or whether additional information should be required to be reported.

The Commission requests comment on the proposed time frame for reporting of this information. The Commission is proposing that the information not required to be reported in real time be reported promptly after receipt, but in no event later than midnight on the day the reportable event occurs or the exchange, association, or member receives the information. While one of the objectives of the proposed Rule is to collect data on a real time basis, the Commission understands that certain information may not be available at the time of the reportable event (e.g., the execution or cancellation). The Commission, however, believes such information should be provided promptly after receipt, meaning as soon as possible given the capabilities of a market participant's systems. While the Commission is proposing that the information be reported promptly, the proposed Rule also would provide an objective time limit for providing the information – no later than midnight on the day the event occurs or the information is received by the exchange, association, or member. Is the proposed time frame reasonable with respect to the information that would be required to be reported? Should the proposed Rule only require that information be reported promptly after receipt? How should promptly be measured?

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<sup>225</sup> In a typical give-up arrangement, a broker-dealer that is not a member of an exchange (Broker-dealer A) may route the order to another broker-dealer that is a member of an exchange (Broker-dealer B) for execution on that exchange. If Broker-dealer B is not also a clearing member of the exchange, it may "give-up" the execution of that order to another broker-dealer that is a clearing member of that exchange (Broker-dealer C). Further, there may be a corresponding "flip" of the trade from Broker-dealer C's account to the account of the broker-dealer that is the clearing firm for Broker-dealer A.

Alternatively, should the proposed Rule only require that information not available at the time the reportable event occurs be reported no later than midnight on the day the information was received? How would this standard impact the usefulness of the consolidated audit trail?

#### **E. Clock Synchronization**

The Commission believes that clock synchronization is necessary 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. Therefore, proposed Rule 613(d) would provide that the NMS plan filed with the Commission include a requirement that each national securities exchange and national securities association, and their members, synchronize their business clocks that are used for the purposes of recording the date and time of any event that must be reported under the proposed Rule. The proposed Rule would require each exchange, FINRA, and their members to synchronize their clocks to the time maintained by the National Institute of Standards and Technology (“NIST”), consistent with industry standards.<sup>226</sup> Exchanges, associations, and the members would be required to synchronize their business clocks in accordance with these requirements within four months after effectiveness of the NMS plan.<sup>227</sup>

The Commission is not proposing to set a standard within which the clocks must be synchronized to the NIST (e.g., to within one second of the NIST clock), in recognition of how quickly technology can improve and increase the speed at which orders are handled and executed. Rather, the Commission is proposing that the clocks be synchronized “consistent with industry standards.” The exchanges and FINRA would be able, however, to set a limit in the NMS plan to be filed with the Commission. Also, in recognition of the pace at which technology

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<sup>226</sup> See proposed Rule 613(d)(1).

<sup>227</sup> See proposed Rule 613(a)(3)(ii).



improves, the proposed Rule provides that the NMS plan shall require each national securities exchange, national securities association, and its respective members to annually evaluate the actual synchronization standard adopted to consider whether it should be shortened, consistent with changes in industry standards.<sup>228</sup> When engaging in this annual evaluation, exchanges, associations, and members could take into account the feasibility of shortening the time standard, and whether shortening the standard would allow for the conveyance of additional meaningful information to the consolidated audit trail.

The Commission requests comment on whether this approach is practical and would provide for sufficient flexibility in determining how closely to synchronize clocks. Is the proposed Rule's requirement that each exchange, association, and member synchronize its clocks in accordance with the time maintained by NIST reasonable? To what extent do SROs and their members currently synchronize clocks? Please answer with specificity. Would synchronization as proposed require significant systems modifications on behalf of national securities exchanges, national securities association, or their respective members? Is it reasonable to require clocks to be synchronized with the time maintained by NIST within a time frame that is "consistent with industry standards"? Is there another standard that should be used by the Commission? The Commission also requests comment on the feasibility of requiring the exchanges, FINRA, and their members to comply with these requirements within four months of effectiveness of the NMS plan.

#### **F. Central Repository**

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<sup>228</sup> See proposed Rule 613(d)(2).

The proposed Rule would require that the NMS plan provide for the creation and maintenance of a central repository, which would be a facility of each exchange and FINRA.<sup>229</sup> The central repository would be jointly owned and operated by the exchanges and FINRA, and the NMS plan would be required to provide, without limitation, the Commission and SROs with access to, and use of, the data reported to and consolidated by the central repository for the purpose of performing their respective regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations. Each of the exchanges and FINRA would be a sponsor of the plan,<sup>230</sup> and as such would be responsible for selecting a plan processor to operate the central repository.<sup>231</sup>

The Commission requests comment on the need for a central repository to receive and retain the consolidated audit trail information. Are there alternatives to creating a central repository for the receipt of order audit trail information? The Commission also requests comment on whether it is practical or appropriate to require the exchanges and FINRA to jointly own and operate the central repository.

### **1. Responsibilities of Central Repository to Collect, Consolidate, and Retain Information**

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 pursuant to the proposed Rule and the NMS plan.<sup>232</sup> Further, the central repository would be required to collect from the central processors and retain on a current and

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<sup>229</sup> See proposed Rule 613(e)(1).

<sup>230</sup> See *supra* note 173 for a definition of a plan sponsor in Rule 600(a)(70) of Regulation NMS, 17 CFR 242.600(a)(70).

<sup>231</sup> See *infra* Section III.I. for a definition and discussion of the plan processor.

<sup>232</sup> See proposed Rule 613(e)(1).

continuous basis the NBBO for each NMS security, transaction reports reported pursuant to an effective transaction reporting plan filed with the Commission 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 Commission pursuant to, and meeting the requirements of, Rule 608 of Regulation NMS.<sup>233</sup> The central repository would be required to maintain this NBBO and transaction data in a format compatible with the order and event information reported pursuant to the proposed Rule.

This requirement is intended to allow SRO and Commission staff to easily search across order, NBBO, and transaction databases. The Commission preliminarily believes that having the NBBO information in a format compatible with the order audit trail information would be useful for enforcing compliance with federal securities laws, rules and regulations. The NBBO is used by regulators to evaluate members for compliance with numerous regulatory requirements, such as the duty of best execution or Rule 611 of Regulation NMS.<sup>234</sup> Regulators would be able to compare order execution information to the NBBO information on a more timely basis because the order and execution information would be available on a real time basis and all of the information would be available in a compatible format in the same database. The SROs also may enjoy economies of scale by adopting standard cross-market surveillance parameters for

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<sup>233</sup> See proposed Rule 613(e)(5). The central repository would be required to retain the information collected pursuant to subparagraph (c)(7) and (e)(5) of the proposed Rule in a convenient and usable standard electronic data format that is directly available and searchable electronically without any manual intervention for a period of not less than five years. The information would be required to be available immediately, or if immediate availability could not reasonably and practically be achieved, any search query would be required to begin operating on the data not later than one hour after the search query is made. See proposed Rule 613(e)(6).

<sup>234</sup> See Rule 611 of Regulation NMS, 17 CFR 242.611. See also ISE Rule 1901, NYSE Arca 6.94, and Phlx Rule 1084.

these types of violations. This information also would be available to the Commission to assist in its oversight efforts.

The Commission also preliminarily believes that requiring the central repository to collect and retain in its database the transaction information in a format compatible with the order execution information would aid in monitoring for certain market manipulations. As discussed above, the proposed Rule would require that each report of the execution (in whole or in part) of an order sent to the central repository include a notation as to whether the execution was reported to the consolidated tape pursuant to an effective transaction reporting plan or the OPRA Plan.<sup>235</sup> This requirement should allow regulators to more efficiently evaluate certain trading activity. For example, trading patterns of reported and unreported trades may cause the staff of an SRO to make further inquiry into the nature of the trading to determine whether the public was receiving accurate and timely information regarding executions and that market participants were continuing to comply with the trade reporting obligations under SRO rules. Similarly, patterns of reported and unreported transactions could be indicia of market abuse, including failure to obtain best execution for customer orders or possible market manipulation. Being able to more efficiently compare the consolidated order execution data with the trades reported to the consolidated tape could thus be an important component of overall surveillance activity.

The Commission requests comment on the usefulness or necessity of requiring the central repository to collect and retain in a format compatible with the order audit trail information the NBBO and transaction report information to help achieve the stated objectives of the consolidated audit trail. Do commenters believe that it is important for achieving the purposes of

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<sup>235</sup> See supra Section III.D.1.v.

the consolidated audit trail? If so, why? If not, why not? What are the advantages and disadvantages of maintaining transaction information separately from order and execution data included in the consolidated audit trail? Should the transaction information be included in the consolidated audit trail report? The Commission requests comment on whether the requirement that the transaction and NBBO information be maintained in a format compatible with the order information is practical. Would this requirement achieve the goal of helping SRO and Commission staff conduct searches and run surveillances across databases?

The Commission has recently required that issuers report certain data in interactive data format such as XBRL.<sup>236</sup> This proposal does not specify any particular or required data format, but allows the SROs to select a data format. Should the Commission require that the data be transmitted or stored in any particular format? What are the relative merits of flat data files, relational data files, and interactive data files? What other formats should be considered? In what format can the SROs and their members efficiently transmit data? In what format would the data required in the proposal be most easily accessed?

The proposed Rule would require the NMS plan to require the central repository to retain the information collected pursuant to subparagraph (c)(7) and (e)(5) of the proposed Rule in a convenient and usable standard electronic data format that is directly available and searchable electronically without any manual intervention for a period of not less than five years. The information would be required to be available immediately, or if immediate availability could not reasonably and practically be achieved, any search query would be required to begin operating on the data not later than one hour after the search query is made.<sup>237</sup>

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<sup>236</sup> See Securities Act Release No. 9002 (January 30, 2009), 74 FR 6776 (February 10, 2009) (Interactive Data to Improve Financial Reporting adopting release) (File No. S7-11-08).

<sup>237</sup> See proposed Rule 613(e)(6).

The Commission preliminarily believes that the information (or the results of a query searching the information) should generally be available immediately. However, the Commission recognizes that the results of an electronic search query may not be immediately available because, for instance, the system must check an extremely large number of records to answer the query or the system may need to retrieve records from electronically archived data. In the case of archived data, the Commission preliminarily proposes requiring that the search query would need to begin operating on the data not later than one hour after the query is made. The Commission requests comment as to whether one hour would be reasonable amount of time to allow for accessing archived data. Under current technological limitations, how long should it take to access, in an electronic query with no manual intervention, archived data of the type to be held by the central repository? The Commission also requests comment on whether it should mandate a time standard, such as one hour, in the proposed Rule. Further, the Commission requests comment on whether the central repository should be required to retain this information for longer or shorter than five years. The Commission also requests comment on the cost impact of these proposed record retention requirements. For example, could comparable functionality be obtained at lower cost with a different standard (for example, what would be the cost comparison for one hour versus two hours)?

## **2. Access to Central Repository and Consolidated Audit Trail Information and Confidentiality of Consolidated Audit Trail Information**

Each national securities exchange and national securities association, as well as the Commission, would have access to the central repository for purposes of performing its respective regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations. Such access would include access to all systems of the central repository, and

access to and use of the data reported to and consolidated by the central repository.<sup>238</sup> The proposed Rule also would require that the NMS plan provide that such access to and use of such data by each exchange, association, and the Commission for the purpose of performing its regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations shall not be limited.<sup>239</sup> In addition, the proposed Rule would require that the NMS plan include a provision requiring the creation and maintenance by the central repository of a method of access to the consolidated data.<sup>240</sup> This method of access would be required to be designed to include search and reporting functions to optimize the use of the consolidated data.

The Commission's access to the central repository, and access to and use of the data maintained by the central repository, for purposes of performing the Commission's responsibilities under the federal securities laws, rules, and regulations could not be limited in any way.<sup>241</sup> The Commission requests comment as to whether the proposed Rule as proposed would accomplish this objective? If not, why not? If not, please provide comment as to an alternative or additional way to accomplish this objective. The Commission also requests comment on the advantages or disadvantages of Commission ownership or co-ownership of the data maintained by the central repository.

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<sup>238</sup> See proposed Rule 613(e)(2)

<sup>239</sup> Id.

<sup>240</sup> See proposed Rule 613(e)(3).

<sup>241</sup> As noted above, the central repository would be a facility of each exchange and FINRA (see supra note 229 and accompanying text), and as such, subject to the Commission's recordkeeping and inspection authority. See, e.g., Section 17 of the Exchange Act, 17 U.S.C. 78q. Further, any amendment to the NMS plan would be filed with the Commission pursuant to Rule 608 of Regulation NMS, and would not become effective unless approved by the Commission or otherwise as permitted in accordance with the requirements of Rule 608. See proposed Rule 613(a)(5), and Rule 608(a) and (b) of Regulation NMS, 17 CFR 242.608(a) and (b).

As discussed above, the proposed Rule would require the reporting of customer information, as well as information about “live” orders, to the central repository on a real time basis. The Commission recognizes the sensitivity of this information, and believes that maintaining the confidentiality of, and limiting the use of, the data is essential. Without such protections, broker-dealers and the investing public could be at risk for security breaches that would potentially have a detrimental impact on their financial condition, as well as their trading activity and the markets. The consolidated data also would include information about members’ trading activities on competitors’ markets. The Commission therefore is proposing several requirements designed to limit access to, and help assure confidentiality and proper use of, the information.

As noted above, the proposed Rule would limit the use of the consolidated data by the SROs for purposes of performing their respective regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations.<sup>242</sup> This proposed restriction would not prevent any SRO from using the data that it individually collects and provides to the central repository pursuant to the proposed Rule for other purposes as permitted by applicable law, rule or regulation.

The Commission requests comment as to whether access to the consolidated audit trail information should be limited to the SROs and the Commission, or whether there should be other access allowed. For example, should SROs or the central repository be allowed to make the data available to third parties, such as for academic research? If so, should the data be permitted to be sold to help offset costs? By SROs? By the central repository? If so, should there be set

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<sup>242</sup> See proposed Rules 613(e)(2). See also proposed Rule 613(e)(4)(i) (requiring in part that the NMS plan include a provision requiring all plan sponsors and their employees to agree not to use the consolidated data for any purpose other than surveillance and regulatory purposes).



parameters? If the data were made available to third parties, what protections should be put in place to ensure the confidentiality of the data? Are there particular data elements that are more sensitive and should not be sold to help ensure the privacy of any individual and proprietary information? Are there particular data elements that would pose fewer concerns if released on a significant time lag? How long would such a time lag need to be? What other concerns might arise from the use of the data for non-regulatory purposes? Would use of the data provide certain market participants with undue information advantages over other market participants, increasing informational asymmetry in the markets? Would the provision of market data to third parties affect the willingness of market participants to trade in the U.S. markets? On the other hand, would enhanced surveillance of the markets as a result of the consolidated audit trail attract additional trading volume to the U.S. markets? What would be the implications, if any, under the financial privacy provisions of the Gramm-Leach-Bliley Act?<sup>243</sup> The Commission also requests comment as to whether, and to what extent, other regulators, such as the Commodity Futures Trading Commission, should have access to the data? For instance, to what extent do commenters believe it would be beneficial for the Commission to work with other regulators to collectively share information each regulator has with respect to products and trading activity under its jurisdiction, to help the Commission and other regulators carry out their respective oversight of products and trading activity within their own jurisdiction? Would such sharing of information help the Commission better understand the impact of trading in other markets on trading activity and products within the Commission's jurisdiction?

The Commission also requests comment on the feasibility of, and need for, a method of access to the consolidated data that includes search and reporting functions. In addition, the

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<sup>243</sup> 15 U.S.C. 6801–6809.

Commission requests comment as to whether, in addition to requiring the central repository to provide a method of access, the central repository should be required to bear the cost of making available the raw order data received by the central repository, for purposes of using that data to perform regulatory functions. Commenters are requested to provide cost estimates for the provision of this data by the central repository to the SROs and the Commission.

Proposed Rule 613(e)(4)(i) also would require that the NMS plan 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. The plan sponsors, and employees of the plan sponsors and central repository, would be required to agree to use appropriate safeguards to ensure the confidentiality of such data, and not to use such data for other than for surveillance regulatory purposes.<sup>244</sup> The Commission is not proposing to mandate the content or format of the policies and procedures and standards that would be required. Rather, the Commission believes that the SROs themselves are in the best position to determine how best to implement this requirement.

The Commission requests comment generally on the issue of appropriate safeguards to be put in place by the SROs and the central repository to help ensure confidentiality. Are there specific safeguards that the SROs and the central repository could use to ensure the confidentiality and appropriate usage of the data collected and submitted pursuant to the proposed Rule? For example, should the proposed Rule require that SROs put in place specific information barriers or other protections to help ensure that data is used only for regulatory purposes? Should there be an audit trail of the SROs' personnel access to, and use of,

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<sup>244</sup> See proposed Rule 613(e)(4)(i). However, a plan sponsor would be permitted to use the data that it submits to the central repository for regulatory, surveillance, commercial, or other purposes as otherwise permitted by applicable law, rule or regulation. Id.

information in the central repository to help monitor for compliance with appropriate usage of the data? Should the requirement that the NMS plan include policies and procedures to be used by the plan processor to ensure the security and confidentiality of information submitted to, and maintained by, the central repository be expanded to include the content of any searches or queries performed by the SROs or the Commission on the data? What should be required? Please be specific in your answer.

The Commission would establish appropriate protections within the agency to help ensure the confidentiality of the records.

### **3. Reliability of Data Collected and Consolidated**

An audit trail is only as reliable as the data used to create it. The Commission believes that it is critical to the integrity of the consolidated audit trail that the data submitted by the national securities exchanges, national securities associations and their members be submitted in a timely manner, and be accurate and complete. Proposed Rule 613(e)(4)(ii) therefore would require that the NMS plan 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. Specifically, the policies and procedures would be required 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 Commission expects that these policies and procedures would include the creation of certain validation parameters that would need to be met before data would be accepted into the central repository.

The proposed Rule also would require that the NMS plan 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 these validation parameters. Further, the

proposed Rule would require the NMS plan to include policies and procedures that would govern how to re-transmit data that was rejected once it has been corrected, and how to help ensure that information is being resubmitted.<sup>245</sup> The Commission expects that re-transmitted data would also be subject to the validation parameters to assure that the initial problem(s) with the data has been corrected.

In addition, the proposed Rule would require that the NMS plan include policies and procedures to ensure the accuracy of the consolidation of the data by the plan processor provided to the central repository. Again, the Commission notes that it is not proposing to mandate the form and content of such policies and procedures. Rather, it believes the SROs would be in a better position to determine how best to implement this requirement. The Commission requests comment on these proposed requirements. Is this approach practical to ensure the integrity of the data? Are there any alternative methods that would achieve the same purpose that are preferable? How much latency would result from a validation procedure?

As noted above, the Commission believes it is critical to the integrity of the consolidated audit trail that data submitted to the central repository be submitted in a timely manner and be accurate and complete. To support this objective, as discussed below in Sections III.H.1 and III.H.2, the proposed Rule also would require the NMS plan to include mechanisms to ensure compliance by the plan sponsors and their members with the requirements of the plan.<sup>246</sup> The purpose of the provisions, with respect to SRO compliance, is to require the SROs themselves to implement a method to help ensure compliance with the NMS plan, as is required by Rule 608 of Regulation NMS. Although the Commission is not proposing to mandate the format of the mechanism, the Commission preliminarily believes that it could include the imposition of penalties

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<sup>245</sup> See proposed Rule 613(e)(4)(iii).

<sup>246</sup> See proposed Rule 613(h)(3) and Rule 613(g)(4).

on an SRO in the event an SRO failed to comply with any provision of the NMS plan. Further, the Commission preliminarily believes that the mechanism to help ensure compliance by members could include the imposition of fines on a member, subject to the rules of the SRO of which it is a member, in the event a member failed to comply with the requirements of the NMS plan or the SRO's rules.

### **G. Surveillance**

Proposed Rule 613(f) would require each national securities exchange and national securities association subject to the proposed Rule to develop and implement a surveillance system, or enhance existing surveillance systems, reasonably designed to make use of the consolidated information contained in the consolidated audit trail. The proposed Rule would require each national securities exchange and national securities association to implement such new or enhanced surveillance system within fourteen months after effectiveness of the NMS plan.<sup>247</sup> Currently, SROs are required to surveil members' trading activity for compliance with federal securities laws, rules, and regulations, such as rules relating to front running, trading ahead, market manipulation, and quote rule violations, as well as other Commission and SRO rules. The Commission understands that although SROs carry out certain surveillances in real time, such as for looking for pricing anomalies or other indicators of erroneous transactions, most surveillance currently is not done on a real time basis. The Commission preliminarily believes the systems that carry out this surveillance should be updated, or new systems should be

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<sup>247</sup> See proposed Rule 613(a)(3)(iv). The SROs would be required to begin reporting information to the central repository within twelve months after effectiveness of the NMS plan. The Commission is proposing to allow SROs two additional months (for a total of fourteen months) to update their surveillance systems to allow for testing of new surveillances for some period of time after the SROs begin providing information. The Commission requests comment on this time period. Should it be longer? Shorter? If so, why?

created, to make use of the consolidated audit trail information that would be generated and maintained by the central repository, otherwise the purpose of requiring a consolidated audit trail would not be achieved.

The Commission generally requests comment on this proposed requirement, as well as the proposed timing for compliance. To what extent do SROs currently conduct surveillance of trading on their markets on a real time basis? To what extent could SROs make effective use of the proposed consolidated information to enhance or update their existing surveillance and regulation? How would SROs be able to enhance or change their existing surveillance and regulation to make use of the proposed consolidated information? Would the benefits of surveillance that the SROs would be able to undertake be justified by the costs of providing information to the central repository on a real time basis? Under the proposed Rule, national securities exchanges and national securities associations would be required to implement or enhance their surveillance systems prior to their members being required to provide information pursuant to the proposed Rule. Do commenters believe that surveillance systems should be in place in advance of member compliance or should these requirements happen simultaneously, or otherwise?

The Commission is not proposing at this time to require coordinated surveillance across exchanges and FINRA. Rather, the Commission intends that each SRO would be responsible for surveillance of its own market and its own members using the consolidated audit trail information. The Commission would, however, encourage any coordinated surveillance efforts by the SROs, such as through a plan approved pursuant to Rule 17d-2 under the Exchange

Act,<sup>248</sup> or a regulatory services agreement among one or more SROs. The Commission requests comment on whether it should undertake to require coordinated surveillance.

## **H. Compliance with the NMS Plan**

### **1. Exchanges and Associations**

Any failure by a national securities exchange or national securities association that is a sponsor of the NMS plan to comply with the requirements of the NMS plan would undermine the effectiveness of the proposed Rule. Therefore, the Commission would consider full compliance by these entities with the NMS plan of the utmost importance. To this end, the proposed Rule would provide that each national securities exchange and national securities association shall comply with the provisions of the NMS plan of which it is a sponsor submitted pursuant to the proposed Rule and approved by the Commission.<sup>249</sup> In addition, the proposed Rule would provide that 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.<sup>250</sup> For example, a failure to provide required information to the central repository, a failure to develop and implement a surveillance system or enhance existing surveillance systems reasonably designed to make use of the consolidated data in the central repository, or any limitation on the ability of an SRO or the Commission to access and use the data maintained by the central repository for regulatory purposes would violate the proposed Rule. The

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<sup>248</sup> 17 CFR 240.17d-2. For example, the exchanges have entered into an agreement for the allocation of regulatory responsibilities pursuant to Rule 17d-2 under the Exchange Act concerning the surveillance, investigation, and enforcement of insider trading rules pertaining to members of the NYSE and FINRA who are also members of at least one of the other participating SROs. See Securities Exchange Act Release No. 58806 (File No. 4-566) (October 17, 2008), 73 FR 63216 (October 23, 2008).

<sup>249</sup> See proposed Rule 613(h)(1)

<sup>250</sup> See proposed Rule 613(h)(2).

Commission recognizes that its staff, and the SRO staff, may have to undertake certain technical actions to access the data, such as arranging for a live feed, querying the system, or upgrading systems to be able to receive the data. The Commission preliminarily would not view having to take such technical actions, by themselves, as a limitation. The Commission notes that the proposed Rule would require the central repository to maintain the data in a convenient and usable standard electronic data format that is directly available and searchable electronically without any manual intervention for a period of not less than five years. The information would be required to be available immediately, or if immediate availability could not reasonably and practically be achieved, any search query would be required to begin operating on the data not later than one hour after the search query is made.<sup>251</sup> The Commission requests comment on whether other types of technical actions should not be viewed as an impermissible limitation on access. The Commission further notes that Rule 608(c) under the Exchange Act provides that “[e]ach self-regulatory organization shall comply with the terms of any effective national market system plan of which it is a sponsor or a participant.”<sup>252</sup> Thus, under this proposed Rule, the Commission may take any action authorized under the Exchange Act to discipline national securities exchanges and national securities associations for failure to comply with a rule under the Exchange Act.

The proposed Rule also would require that the NMS plan include a mechanism to ensure compliance by the sponsors with the requirements of the plan.<sup>253</sup> The purpose of this provision is to require the SROs themselves to implement a method to help ensure compliance with the NMS plan, as is required by Rule 608 of Regulation NMS. Although the Commission is not proposing

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<sup>251</sup> See proposed Rule 613(e)(6) and supra note 237 and accompanying text.

<sup>252</sup> 17 CFR 242.608(c)

<sup>253</sup> See proposed Rule 613(h)(3).



to mandate the format of the mechanism, the Commission preliminarily believes that it could include the imposition of penalties on an SRO in the event an SRO failed to comply with any provision of the NMS plan. The Commission request comments on the types of sanctions or penalties that would be appropriate for the plan sponsors to levy for failure of an SRO to comply with the terms of the NMS plan.

## **2. Members**

Any failure by a member of a national securities exchange or national securities association that is a sponsor of the NMS plan to collect and provide to the central repository the required audit trail information also would undermine the effectiveness of the proposed Rule. Therefore, the Commission would consider full compliance by these entities with the NMS plan of the utmost importance.

To implement the proposed requirement that the NMS plan require the submission of certain information to the central repository by the members of the exchange and association sponsors of the plan, each exchange and association would be required to file with the Commission pursuant to Section 19(b)(2) of the Exchange Act<sup>254</sup> and Rule 19b-4 thereunder,<sup>255</sup> a proposed rule change to require its members to comply with the requirements of the proposed Rule and the NMS plan.<sup>256</sup> The SROs would be required to file these proposed rule changes by 120 days after approval of the proposed Rule. The Commission preliminarily believes that this proposed time frame would provide the SROs sufficient time to file their proposed rule changes

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<sup>254</sup> 15 U.S.C. 78s(b)(2).

<sup>255</sup> 17 CFR 240.19b-4.

<sup>256</sup> See proposed Rule 613(g)(1). This provision in the proposed Rule echoes the requirement contained in Rule 608 that provides “each self-regulatory organization also shall, absent reasonable justification or excuse, enforce compliance with any such plan by its members and persons associated with its members. 17 CFR 242.608(c).

after the NMS plan has been approved,<sup>257</sup> as the SRO rule filings would be substantially based on the content of the NMS plan.

Further, the proposed Rule would directly require each member to (1) collect and submit to the central repository the information required by the Rule, and (2) comply with the clock synchronization requirements of the proposed Rule.<sup>258</sup> In addition, the proposed Rule would require that the NMS plan include a provision that by subscribing to and submitting the plan to the Commission, each exchange and association that is a sponsor to the plan agrees to enforce compliance by its members with the provisions of the plan.<sup>259</sup>

Finally, the proposed Rule would require the NMS plan to include a mechanism to ensure compliance with the requirements of the plan by the members of a national securities exchange or national securities association that is a sponsor of the NMS plan submitted pursuant to this Rule and approved by the Commission.<sup>260</sup> The purpose of this provision is to require the SROs to implement a method to help ensure compliance with the NMS plan and the corresponding SRO rules by their members. Although the Commission is not proposing to mandate the format of the mechanism, the Commission preliminarily believes that it could include the imposition of fines on a member by an SRO of which it is a member in the event the member failed to comply with any provision of the NMS plan or the SRO's rules implementing the NMS plan. Any action taken

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<sup>257</sup> The proposed Rule would require that the NMS plan be filed within 90 days of approval of the proposed Rule. See proposed Rule 613(a)(1).

<sup>258</sup> See proposed Rule 613(g)(2).

<sup>259</sup> See proposed Rule 613(g)(3).

<sup>260</sup> See proposed Rule 613(g)(4).

against the member, including the imposition of the fine by the SRO, would be subject to the requirements of the SRO's other rules.<sup>261</sup>

The Commission requests comment on these provisions regarding members' compliance with the proposed Rule and the NMS plan. Do commenters believe that these provisions would encourage members' compliance with the proposed Rule and the NMS Plan? If so, why? If not, what other provisions would be necessary or appropriate to promote compliance? What mechanisms should be part of a plan to promote compliance by members? Would it appropriate to include violations of the proposed Rule, the NMS plan, or the SRO's rules implementing the NMS plan within existing SRO rules that impose minimum fines for violations of certain SRO rules?<sup>262</sup> Would the exchanges or associations have to amend their rules to implement such a requirement? If so, how would they have to amend their rules? Are there other alternatives that would more effectively help ensure the accuracy and reliability of the information reported to the central repository by members? Would requiring the SROs to file their proposed rule changes to implement the requirements of the NMS plan with respect to the members within 120 days after approval of the proposed Rule provide sufficient time for SROs to draft the proposed rule changes? If not, why not?

## **I. Operation and Administration of the NMS Plan**

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<sup>261</sup> See Sections 6(b)(6), 6(b)(7), and 6(d)(1) of the Exchange Act, 15 U.S.C. 78f(b)(6), 78f(b)(7), and 78f(d)(1). See also, e.g., FINRA Rule 9217, CHX Article 12, Nasdaq OMX BX Rule 9216 and IM-9216 and NYSE Rule 476A.

<sup>262</sup> See, e.g., FINRA Rule 9217 (providing for the imposition of fines in lieu of commencing a formal disciplinary proceeding for violations of certain rules, including the recording and reporting requirements of the OATS rules) and NYSE Rule 476A (providing for the imposition of fines in lieu of commencing a formal disciplinary proceeding for violations of certain rules, including the OTS rules).

The proposed Rule would require that the NMS plan include a governance structure to ensure fair representation of the plan sponsors.<sup>263</sup> The rule as proposed gives flexibility to the SROs to devise a governance structure as they see fit. The proposed rule would require the NMS plan to include a provision addressing the percentage of votes required by the plan sponsors to effectuate amendments to the plan.<sup>264</sup> For example, the plan sponsors could determine to provide each plan sponsor one vote on matters subject to a vote.<sup>265</sup> Or, if there was a concern that this method would result in “blocs” of plan sponsors under common control exerting control in a one-sponsor, one-vote system, the SROs could choose another alternative to ensure fair representation.

Further, most existing NMS plans require unanimous consent from the plan sponsors to effect an amendment.<sup>266</sup> The Commission recognizes the unanimous consent requirement could be desirable because it helps to ensure that no plan sponsor is forced to comply with requirements with which it is unable to comply, or forced by the other sponsors to pay fees. However, a unanimous consent requirement also could allow one plan sponsor to effectively “veto” a provision

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<sup>263</sup> See proposed Rule 613(b)(1).

<sup>264</sup> See proposed Rule 613(b)(3).

<sup>265</sup> For example, Section 4.3 of the OPRA Plan provides that, except as otherwise provided, each of the members of the Management Committee shall be authorized to cast one vote for each Member that he or she represents on all matters voted upon by the Management Committee, and action of the Management Committee shall be authorized by the affirmative vote of a majority of the total number of votes the members of the Management Committee are authorized to cast, subject to the approval of the Commission whenever such approval is required under applicable provisions of the Exchange Act, and the rules of the Commission adopted thereunder. Action of the Management Committee authorized in accordance with the OPRA Plan shall be without prejudice to the rights of any Member to present contrary views to any regulatory body or in any other appropriate forum.

<sup>266</sup> See, e.g., Securities Exchange Act Release Nos. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009) (order approving the Options Order Protection and Locked/Crossed Market Plan) and 17638 (March 18, 1981), 22 S.E.C. Docket 484 (March 31, 1981) (order approving the OPRA Plan).

desired by all other plan sponsors for competitive reasons, or permit one sponsor to lag behind in making updates to its systems or rules that would benefit the industry as a whole. The Commission proposes to allow the plan sponsors to determine whether to include in the NMS plan to be filed with the Commission a unanimity requirement for effectuating amendments to the plan, or some other convention.

The Commission also recognizes that the scope or purpose of the proposed NMS plan may differ from existing plans. The Commission requests comment on whether there are lessons from previous experience that suggest that the governance structure of the NMS plan to be filed with the Commission should differ from existing plans. The Commission requests comment on these provisions relating to the governance structure of the plan. Should the Commission require certain governance standards to ensure efficient cooperation, or should the exchanges and association be allowed to create a governance structure of their own choosing? What are the relative merits of unanimity or super majority requirements? What are the relative merits of alternative voting mechanisms and other governance structures available to the plan sponsors? Should the voting mechanism vary by the type of decision or should different decision making bodies have authority over different types of decisions to avoid situations where no decision is made because the sponsors cannot agree? How should the governance and voting mechanisms be set up to avoid inefficient operations or paralysis? Should there be limits on the time frames given to make decisions? Should there be mechanisms to resolve impasses once a decision has taken a certain amount of time? The Commission also requests comment on whether the scope of the plan, including the requirements on broker-dealers members, and the expectation of improved surveillances for investor protection dictate that the governance structure should differ from existing plans. In particular, should the SRO sponsors be required to include in the governance

structure and decision-making authority representatives of members to address member interests and independent representatives chosen specifically to address investor and other public interests?

The proposed Rule also would require that the NMS plan include provisions to govern the administration of the central repository, including the selection of a plan processor. A “plan processor” is defined in Rule 600 of Regulation NMS to mean 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 system plan.<sup>267</sup>

The Commission expects that the plan sponsors would engage in a thorough analysis and formal competitive bidding process to choose the plan processor. As proposed, the plan sponsors would be required to select a person to act as the plan processor for the central repository no later than two months after the effectiveness of the national market system plan.<sup>268</sup> The Commission preliminarily believes that this time frame would provide the plan sponsors with sufficient time to choose the plan processor, while providing that such entity would be in place with enough time to create and build the central repository to receive data from the SROs within one year after effectiveness of the NMS plan and from the members within two years after such effectiveness.

The Commission requests comment as to whether the proposed Rule should include specific requirements detailing the process for selection of a plan processor. Should the Commission require specific minimum requirements or standards that a plan processor should meet? If so, what requirement or standards would be necessary or appropriate? Should the plan processor be a non-SRO? Would this promote impartiality on the part of the plan processor?

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<sup>267</sup> See 17 CFR 242.600(55).

<sup>268</sup> See proposed Rule 613(a)(3)(i).

The Commission also requests comment on the proposed time frame to choose the plan processor. Is it too short? Too long? If so, why? Please be specific in your response.

The proposed Rule also would require that the NMS plan contain a requirement that a Chief Compliance Officer (“CCO”) be appointed to regularly review the operation of the central repository.<sup>269</sup> The CCO would be expected to establish reasonable procedures designed to make sure the operations of the central repository keep pace with technical developments. To the extent upgrades or other changes are necessary to assure the central repository’s effectiveness, the CCO would be responsible for making recommendations for enhancements to the nature of the information collected and the manner in which it is processed.

The Commission requests comment on the necessity for a CCO to oversee the operation of the central repository. If commenters support the proposal to require a CCO, should the proposed Rule include a requirement that the CCO be independent from the plan sponsors and their members? That is, should the CCO be required to not have any actual or potential conflicts of interest with respect to the plan sponsors and their members (e.g. such as prior or future employment with a plan sponsor or member, or a material business relationship with a plan sponsor or member)? What are the risks of allowing a CCO who is affiliated or associated with a plan sponsor or its members? What types of conflicts of interest should be avoided? Are there any specific qualifications that a CCO should possess? Should there be a specific process in place for appointing a CCO or for removing a CCO for failure to perform his or her assigned duties? Should there be a limit to the number of years a CCO may serve as such?

The plan sponsors also would be required to include in the NMS plan a provision addressing the requirements for the admission of new sponsors to the plan and the withdrawal of

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<sup>269</sup> See proposed Rule 613(b)(5).

sponsors from the plan.<sup>270</sup> Proposed Rule 613(b)(4) also would require that the 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 who join the plan after it was approved. Various NMS plans have developed different ways to ensure that a fair cost or “new participant fee” is assessed upon new plan sponsors.<sup>271</sup> For example, when determining a new participation fee, the OPRA Plan requires that the following factors be considered: (1) the portion of costs previously paid by OPRA for the development, expansion and maintenance of OPRA’s facilities which, under generally accepted accounting principles, would have been treated as capital expenditures and would have been amortized over the five years preceding the admission of the new member; (2) an assessment of costs incurred and to be incurred by OPRA for modifying the OPRA System or any part thereof to accommodate the new member, which are not otherwise required to be paid or reimbursed by the new Member; and (3) previous fees paid by other new members. The plan sponsors could choose to include in the NMS plan to be filed a similar provision or develop a new method for determining the cost to join the plan that would better suit the NMS plan proposed to be required by this Rule.

The Commission requests comment on whether the rule or plan should specify a method for allocating costs among the plan sponsors. The Commission also requests comment as to what provisions the exchanges and FINRA should include in the NMS plan relating to the admission of new plan sponsors and the withdrawal of existing plan sponsors. Should the Commission specify the process for the admission of new plan sponsors? What are the concerns, if any, that should be taken into account when providing for the admission of new plan sponsors?

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<sup>270</sup> See proposed Rule 613(b)(2).

<sup>271</sup> See e.g. Section 7.1 of OPRA Plan.



The Commission requests comment on all aspects of the proposed Rule relating to governance and administration of the NMS plan.

#### **J. Proposed Implementation Schedule**

While the Commission preliminarily believes a comprehensive consolidated audit trail would be useful as soon as possible, the Commission also believes that it would be prudent to implement the Rule at a measured pace to ensure that all market participants are fully able to meet the requirements of the proposed Rule. Therefore, the proposed Rule would provide that the proposed data collection and submission requirements would first apply to national securities exchanges and national securities associations, but not to their individual members. As part of operating their businesses, the national securities exchanges and national securities associations are accustomed to handling large volumes of data and many already have in place electronic trading, routing and reporting systems.<sup>272</sup> Further, under the proposal the exchanges would not be responsible for providing to the central repository, for each order, information relating to the customer. The Commission therefore preliminarily believes these systems could more readily and quickly be modified than the members' systems to comply with the requirements of the proposed Rule.

Specifically, proposed Rule 613(a)(3)(iii) would require the exchanges and associations to provide to the central repository the data to be required by the Rule within one year after effectiveness of the NMS plan. Members of the exchanges and associations would be required to begin providing to the central repository the data required by the proposed Rule two years after effectiveness of the NMS plan, which would be one year following the implementation deadline

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<sup>272</sup> For example, as part of COATS compliance, the options exchanges are required to have in place systems to electronically capture all order, transaction, and quotation information on the exchange.

for the national securities exchanges and national securities associations.<sup>273</sup> This phased approach is designed to allow members additional time to implement systems changes necessary to begin providing the information to the central repository and to develop procedures designed to capture customer and order information that they may not have previously been required to collect to comply with other Commission and SRO rules.

The Commission requests comment on the proposed implementation time periods. Are these time periods practical or feasible? Should they be shorter? Longer? Please provide detailed reasons in your response. As proposed, the national securities exchanges and national securities associations would be required to submit data to the central repository for one year before their members are required to submit data. Is requiring the exchanges and FINRA to provide data before requiring their members to do so a feasible way to phase in compliance with the proposed rule? How would this phased-in approach affect the quality of the data and the number of available data items in the audit trail? Are there alternative ways to phase in implementation that would be more practical? For instance, should the Commission consider requiring all exchanges and FINRA and their respective members to begin reporting a subset of the data initially, and phase in the collection of additional data over time? Should the Commission require all exchanges, FINRA, and their members to implement the proposed requirements first for NMS stocks, then for listed options? Or vice versa? How should the Commission take into consideration any concern commenters might have that market participants might shift manipulative or other illegal trading activity to products or markets not covered by the proposed Rule in its analysis of whether, or how, to phase in compliance with the proposed Rule across products classes (meaning, NMS stock and listed options)? If so, how?

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<sup>273</sup> See proposed Rule 613(a)(3)(v).

Should ATSS,<sup>274</sup> including so-called dark pools,<sup>275</sup> be required to implement the proposed requirements before broker-dealers that are not registered as ATSS? Would ATSS be able to more quickly comply with the proposed recording and reporting requirements, since they generally are highly automated and their business may be more narrowly focused than, for example, broker-dealers that engage in a customer, proprietary, and/or market making business? Are there any cost savings associated with a phased approach to implementation? Would additional unnecessary costs be incurred by implementing the plan in a phased-in approach? Please provide data to support your views.

#### **IV. Request for Comments**

We request and encourage any interested person to comment generally on the proposed Rule. In addition to the specific requests for comment throughout the release, the Commission requests general comment on all aspects of proposed Rule 613 of Regulation NMS. The Commission encourages commenters to provide information regarding the advantages and disadvantages of each aspect of the proposed Rule. The Commission invites commenters to provide views and data as to the costs and benefits associated with the proposed Rule. The Commission also seeks comment regarding other matters that may have an effect on the proposed Rule. We request comment from the point of view of national securities exchanges, national securities associations, members, investors, and other market participants. With regard

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<sup>274</sup> See supra note 181.

<sup>275</sup> Dark pools are ATSS that do not provide their best-priced orders for inclusion in the consolidated quotation data. In general, dark pools offer trading services to institutional investors and others that seek to execute large trading interest in a manner that will minimize the movement of prices against the trading interest and thereby reduce trading costs. Dark pools fall within the statutory definition of an exchange, but are exempted if they comply with Regulation ATSS. See Concept Release on Equity Market Structure, supra note 19, at 3599, and supra note 181.

to any comments, we note that such comments are of great assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments.

## **V. Paperwork Reduction Act**

Certain provisions of the proposal contain “collection of information requirements” within the meaning of the Paperwork Reduction Act of 1995 (“PRA”)<sup>276</sup> and the Commission has submitted them to the Office of Management and Budget (“OMB”) for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The title of the new collection of information is “Creation of a Consolidated Audit Trail Pursuant to Section 11A of the Securities Exchange Act of 1934 and Rules Thereunder.”

### **A. Summary of Collection of Information under Proposed Rule 613**

#### **1. Creation and Filing of an NMS Plan**

As detailed above, the proposed Rule would require each national securities exchange and national securities association to jointly file with the Commission, on or before 90 days from approval of the proposed Rule, an NMS plan to govern the creation, implementation, and maintenance of a consolidated audit trail and central repository for the collection of information for NMS securities.<sup>277</sup> The NMS plan would be required to require each exchange or association and its respective members to provide certain data to the central repository in compliance with proposed Rule 613.<sup>278</sup> The NMS plan also would need to include certain specified provisions

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<sup>276</sup> 44 U.S.C. 3501 *et. seq.*

<sup>277</sup> *See* proposed Rule 613(a)(1) and *supra* Section III.

<sup>278</sup> *See* proposed Rule 613(c) and *supra* Section III.D.

related to administration and operation of the plan,<sup>279</sup> and the operation of the central repository.<sup>280</sup> Further, the NMS plan would be required to include certain provisions related to compliance by the exchanges and associations and their members with the requirement of the proposed Rule and the NMS plan.<sup>281</sup>

Each national securities exchange and national securities association would be required to be a sponsor of the NMS plan.<sup>282</sup> The Commission preliminarily believes that requiring the proposed NMS plan would impose a paperwork burden on national securities exchanges and national securities associations associated with preparing and filing the joint NMS plan.

## 2. Report

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<sup>279</sup> For example, the NMS plan would be required to include provisions: (1) to ensure fair representation of the plan sponsors; (2) for administration of the central repository; (3) addressing the requirements for admission of new plan sponsors and withdrawal of existing plan sponsors; (4) addressing the percentage of votes required by the plan sponsors to effectuate amendments to the plan; (5) addressing the manner in which the costs of operating the central repository would be allocated among the national securities exchanges and national securities associations that are sponsors of the plan, including a provision addressing the manner in which costs would be allocated to new sponsors to the plan. See proposed Rule 613(b).

<sup>280</sup> For example, the NMS plan would be required to include a provision requiring the creation and maintenance by the central repository of a method of access to the data, including search and reporting functions. See proposed Rule 613(e)(3). Additionally, the NMS plan would be required to include policies and procedures, including standards, to be used by the plan processor to: (1) ensure the security and confidentiality of all information submitted to, and maintained by, the central repository; (2) ensure the timeliness, accuracy, and completeness of the data provided to the central repository; (3) require the rejection of data that does not meet validation parameters and the retransmission of corrected data; and (4) ensure the accuracy of the consolidation by the plan processor of the data provided to the central repository. See proposed Rule 613(e)(4).

<sup>281</sup> The NMS plan would be required to include: (1) a provision that by subscribing to and submitting the plan to the Commission, each national securities exchange and national securities association that is a sponsor to the plan agrees to enforce compliance by its members with the provisions of the plan; and (2) a mechanism to ensure compliance by the sponsors of the plan with the requirements of the plan. See proposed Rule 613(g)(3) and (h)(3).

<sup>282</sup> See proposed Rule 613(a)(5).

Rule 613(i) also would require the national securities exchanges and national securities associations to jointly provide to the Commission a document outlining how such national securities exchanges and national securities associations would propose to incorporate into the consolidated audit trail information for: (1) equity securities that are not NMS securities; (2) debt securities; and (3) primary market transactions in NMS stocks, equity securities that are not NMS securities and debt securities.<sup>283</sup> This report would be required to specify in detail the data that would be collected and reported by each market participant, an implementation timeline, and a cost estimate. The Commission preliminarily believes that requiring the proposed report would impose a paperwork burden on national securities exchanges and national securities associations associated with preparing and submitting the report to the Commission.

### **3. Rule Filings by National Securities Exchanges and National Securities Associations**

Each national securities exchange and national securities association would be required to file with the Commission, pursuant to Section 19(b)(2) of the Exchange Act and Rule 19b-4 thereunder,<sup>284</sup> a proposed rule change to require its members to comply with the requirements of the proposed Rule and the NMS plan submitted pursuant to the proposed Rule and approved by the Commission of which the national securities exchange or national securities association is a sponsor.<sup>285</sup> The burden of filing such proposed rule change would already be included under the collection of information requirements contained in Rule 19b-4 under the Exchange Act.<sup>286</sup>

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<sup>283</sup> See proposed Rule 613(i).

<sup>284</sup> 15 U.S.C. 78s(b)(2) and 17 CFR 240.19b-4.

<sup>285</sup> See proposed Rule 613(g)(1).

<sup>286</sup> See Securities Exchange Act Release No. 50486 (October 5, 2004), 69 FR 60287, 60293 (October 8, 2004) (File No. S7-18-04) (describing the collection of information requirements contained in Rule 19b-4 under the Exchange Act). The Commission has submitted revisions to the current collection of information titled “Rule 19b-4 Filings

#### 4. Collection and Retention of NBBO and Last Sale Data

The central repository would be required to collect and retain on a current and continuing basis the national best bid and national best offer for each NMS security, transaction reports reported pursuant to a transaction reporting plan filed with the Commission pursuant to, and meeting the requirements of, Rule 601 of Regulation NMS, and last sale reports reported pursuant to the OPRA Plan.<sup>287</sup> The central repository would be required to retain this information for a period of not less than five years.<sup>288</sup>

#### 5. Data Collection and Reporting

The proposed Rule would require each national securities exchange, national securities association, and any member of such national securities exchange or national securities association to collect and electronically provide to the central repository details for each order and reportable event documenting the life of an order through the process of routing, modification, cancellation, and execution (in whole or in part).<sup>289</sup> The proposed Rule would require the collection and reporting to the central repository of some information that national securities exchanges, national securities associations, and their members already are required to collect, and under certain circumstances, report to a third party, in compliance with existing Commission<sup>290</sup> and SRO requirements.<sup>291</sup> The proposed Rule would, however, require

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with Respect to Proposed Rule Changes by Self-Regulatory Organizations” (OMB Control No. 3235-0045). According to the last submitted revision concluded as of August 5, 2008, the current collection of information estimates 1,279 total annual Rule 19b-4 filings with respect to proposed rule changes by self-regulatory organizations.

<sup>287</sup> See proposed Rule 613(e)(5); 17 CFR 242.601.

<sup>288</sup> See proposed Rule 613(e)(6).

<sup>289</sup> See proposed Rule 613(c)(1) and *supra* Section III.D.

<sup>290</sup> For example, Rule 17a-3 requires broker-dealers to maintain the following information that would be captured by the proposed Rule: customer name and address; time an order was received; and price of execution. 17 CFR 240.17a-3. Also, Rule 17a-25 requires

exchanges, associations, and their members to report to the central repository information not required to be currently collected and reported pursuant to existing SRO audit trail rules.

For example, although members of national securities exchanges and national securities associations already should know the identity of their customers, and in some instances may be required to provide that information to the Commission or SRO staff upon request,<sup>292</sup> the requirement to electronically capture and report detailed information sufficient to identify the customer to the central repository, in real time, would be new. Further, although some existing audit trail requirements include a unique order identifier,<sup>293</sup> the proposed Rule's requirement that the unique order identifier remain with the order throughout its entire life, across markets and market participants, would go beyond the current requirements. In addition, although such members currently have unique market participant identifiers ("MPIDs"), such MPIDs may

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brokers to maintain the following information with respect to customer orders: date on which the transaction was executed; account number; identifying symbol assigned to the security; transaction price; the number of shares or option contracts traded and whether such transaction was a purchase, sale, or short sale, and if an option transaction, whether such was a call or put option; the clearing house number of such broker or dealer and the clearing house numbers of the brokers or dealers on the opposite side of the transaction; prime broker identifier; the customer's name and address; the customer's tax identification number; and other related account information. 17 CFR 240.17a-25. This information would be captured by the proposed Rule. See also Section 17(a) of the Exchange Act, 15 U.S.C. 78q(a), and Rules 17a-1 and 17a-4 under the Exchange Act, 17 CFR 240.17a-1 and 17 CFR 240.17a-4.

<sup>291</sup> The audit trail rules of several of the national securities exchanges and FINRA require the following information be recorded: Date order was originated or received by a member, security or option symbol, clearing member organization, order identifier, market participant symbol, number of shares executed, designation of order as short sale, limit order, market order, stop order or stop limit order, account type or number, date and time of execution, and execution price and size. See BOX Ch. V, Section 4; BX Rule 6955; FINRA Rule 7440; Nasdaq Options Market Chapter IX, Section 4; Nasdaq Rule 6955; NYSE Rule 132B; and NYSE Amex Equities Rule 132B. This information would be captured pursuant to the proposed Rule.

<sup>292</sup> See supra Section I.A. (discussing Rule 17a-25 and the EBS system).

<sup>293</sup> See supra Section I.C. (discussing the requirements of FINRA's OATS).



differ across markets, whereas the proposed Rule would require that each member have a unique identifier that is the same across all markets. The proposed requirements to report whether an order opens or closes a position for NMS stocks, and to report borrow information, also are not required to be marked on orders by current SRO or Commission rules. Further, much of the information that would be required for the first time to be reported to the central repository would be reported in real time, as the event is occurring.

## **6. Central Repository**

The proposed Rule would require that the central repository be responsible for the receipt, consolidation, and retention of all data submitted to the central repository by the national securities exchanges, national securities associations, and their members.<sup>294</sup> The proposed Rule also would require that (1) the central repository retain the information collected pursuant to subparagraph (c)(7) and (e)(5) of the proposed Rule in a convenient and usable standard electronic data format that is directly available and searchable electronically without any manual intervention for a period of not less than five years, and (2) the information be available immediately, or if immediate availability cannot reasonably and practically be achieved, that any search query begin operating on the data not later than one hour after the search query is made.<sup>295</sup> The Commission notes that a plan processor would be responsible for operating the central repository in compliance with the proposed Rule and the NMS plan.

### **B. Proposed Use of Information**

#### **1. Creation and Filing of NMS Plan**

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<sup>294</sup> See proposed Rule 613(e)(1). The Commission notes that a plan processor would be responsible for operating the central repository in compliance with the proposed Rule and the NMS plan.

<sup>295</sup> See proposed Rule 613(e)(6).

As discussed in detail above, the NMS plan would govern the creation, implementation, and maintenance of a consolidated audit trail for NMS securities, which would aid the Commission and national securities exchanges and national securities associations in effectively and efficiently carrying out their regulatory responsibilities. The information that would be collected pursuant to the NMS plan would allow the SROs to more efficiently monitor trading activity in the securities markets, and would facilitate the Commission and the national securities exchanges and national securities associations' trading reconstruction efforts as well as enhance their monitoring, enforcement, and regulatory activities.

## **2. Report**

As the Commission states above in Section III.A., it ultimately intends for the proposed consolidated audit trail, if adopted, to be expanded to cover other securities, including equity securities that are not NMS securities, corporate bonds and other debt instruments; credit default swaps and other security-based swaps; and any other products that may come under the Commission's jurisdiction in the future. Further, the Commission preliminarily believes that it would be beneficial to expand the consolidated audit trail to include information on primary market transactions in NMS stocks and other equity securities that are not NMS stocks, as well as primary market transactions in debt securities. The Commission preliminarily believes that a timely expansion of the scope of the consolidated audit trail beyond NMS securities would be beneficial as illegal trading strategies that the consolidated audit trail would be designed to help detect and deter, such as insider trading, may involve trading in multiple related products other than NMS securities across multiple markets.

To help ensure that such an expansion would occur in a reasonable time and that the systems and technology that would be used to implement the Rule as proposed are designed to be

easily scalable, proposed Rule 613(i) would require that the NMS plan contain a provision requiring each national securities exchange and national securities association that is a sponsor of the plan to jointly provide to the Commission within two months after effectiveness of the NMS plan a document outlining how the sponsors would incorporate into the consolidated audit trail information with respect to: (1) equity securities that are not NMS securities; (2) debt securities; and (3) primary market transactions in NMS stocks, equity securities that are not NMS securities, and debt securities. The sponsors specifically would be required to address, among other things, details for each order and reportable event that they would recommend requiring to be provided; which market participants would be required to provide the data; an implementation timeline; and a cost estimate. The Commission would be able to use the information contained in the report in its consideration and analysis of whether to expand the consolidated audit trail.

### **3. Collection and Retention of NBBO and Last Sale Data**

As discussed above, the requirement that the central repository collect and retain the NBBO and transaction data in an electronic format compatible with the order and event information collected pursuant to the proposed Rule is intended to allow SRO and Commission staff to easily search across order, NBBO, and transaction data bases. The Commission preliminarily believes that having the NBBO information in an electronic format compatible with the order audit trail information would be useful for SROs to enforce compliance with federal securities laws, rules and regulations.<sup>296</sup> The Commission also preliminarily believes that

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<sup>296</sup> The NBBO is used by SROs and the Commission to evaluate members for compliance with numerous regulatory requirements, such as the duty of best execution or Rule 611 of Regulation NMS. See Rule 611 of Regulation NMS, 17 CFR 242.611. See also ISE Rule 1901, NYSE Arca 6.94, and Phlx Rule 1084. An SRO would be able to compare order execution information to the NBBO information on a more timely basis because the order and execution information would be available on a real time basis and all of the information would be available in a compatible format in the same database. The SROs

requiring the central repository to collect and retain in its database the transaction information in a format compatible with the order execution information would aid the SROs in being able to monitor for certain market manipulations.<sup>297</sup>

#### **4. Data Collection and Reporting**

As discussed above, the Commission preliminarily believes that the data collection and reporting requirements of the proposed Rule would enhance the ability of SRO staff to effectively monitor and surveil the securities markets and thus detect and investigate potentially illegal activity in a more timely fashion, whether on one market or across markets. Further, the Commission preliminarily believes that the ability to access such data would improve the ability of SRO staff to conduct timely and accurate trading analysis for market reconstructions and complex enforcement inquiries or investigations, as well as inspections and examinations. Further, the Commission preliminarily believes that the ability to access such data would aid the Commission staff in its regulatory and market analysis efforts.

#### **5. Central Repository**

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also may enjoy economies of scale by adopting standard cross-market surveillance parameters for certain types of violations.

<sup>297</sup> See supra Section III.D.1.v. As discussed above, the proposed Rule would require that each report of the execution (in whole or in part) of an order sent to the central repository include a notation as to whether the execution was reported to the consolidated tape pursuant to an effective transaction reporting plan or the OPRA Plan. This requirement should allow regulators to more efficiently evaluate certain trading activity. For example, trading patterns of reported and unreported trades may cause the staff of an SRO or the Commission to make further inquiry into the nature of the trading to ensure that the public was receiving accurate and timely information regarding executions and that market participants were continuing to comply with the trade reporting obligations under SRO rules. Similarly, patterns in the reported and unreported transactions could be indicia of market abuse, including failure to obtain best execution for customer orders or possible market manipulation. Being able to more efficiently compare the consolidated order execution data with the trades reported to the consolidated tape could thus be an important component of overall surveillance activity.

The central repository would be required to receive and retain the data required to be submitted by the national securities exchanges, national securities associations, and their members pursuant to the proposed Rule. SROs and Commission staff would then have access to the data for regulatory purposes, as discussed above.

**C. Respondents**

**1. National Securities Exchanges and National Securities Associations**

Proposed Rule 613 would apply to all of the fourteen national securities exchanges and to one national securities association (FINRA) currently registered with the Commission.

**2. Members of National Securities Exchanges and National Securities Associations**

Proposed Rule 613 would apply to the approximately 5,178 broker-dealers that are currently registered with the Commission and are members of the national securities exchanges or FINRA.<sup>298</sup>

**D. Total Annual Reporting and Recordkeeping Burden**

**1. Burden on National Securities Exchanges and National Securities Associations**

**a. Creation and Filing of NMS Plan**

Proposed Rule 613 would require the national securities exchanges and FINRA to jointly file with the Commission a joint NMS plan to govern the creation, implementation, and maintenance of a consolidated audit trail and a central repository. The Commission estimates that it would take each national securities exchange and national securities association approximately 840 burden hours of internal legal, compliance, information technology, and

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<sup>298</sup> This is the number of broker-dealers filing FOCUS Reports at year-end 2008. FOCUS Reports are required to be filed by all registered broker-dealers, with a few exceptions. Excluded from this number were recently established broker-dealers that had yet to become active, or broker-dealers no longer doing business that had yet to deregister.

business operations time to develop and file the NMS plan, including the required provisions regarding governance, administration, and operation of the plan.<sup>299</sup>

The Commission preliminarily expects that national securities exchange and national securities association respondents may incur one-time external costs for outsourced legal services to develop and draft the NMS plan. While the Commission recognizes that the amount of legal outsourcing used may vary from SRO to SRO, the staff estimates that on average, each national securities exchange and national securities association would outsource 50 hours of legal time to develop and draft the NMS plan, for a capital cost of approximately \$20,000 for each national securities exchange and national securities association resulting from outsourced legal work.<sup>300</sup> Therefore, the Commission preliminarily estimates that the average one-time initial burden of developing and filing the NMS plan would be 840 burden hours plus \$20,000 external costs for outsourced legal counsel per SRO, for an aggregate estimated burden of 12,600 hours plus \$300,000 external costs.

Once the national securities exchanges and national securities associations have established the NMS plan, the Commission estimates that, on average, each national securities exchange and national securities association would incur 192 burden hours annually to ensure

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<sup>299</sup> The Commission derived the total estimated burdens from the following estimates, which are based on the Commission's understanding of, and burden estimates for, existing NMS plans: (Attorney at 400 hours) + (Compliance Manager at 100 hours) + (Programmer Analyst at 220 hours) + (Business Analyst at 120 hours). The Commission preliminarily believes that the cost of developing and filing the NMS plan pursuant to the proposed Rule would be comparable to the cost to create other existing NMS plans, recognizing that the proposed Rule may include more detail as to what must be incorporated and addressed in the NMS plan implementing the proposed Rule.

<sup>300</sup> Based on industry sources, the Commission estimates that the hourly rate for outsourced legal services in the securities industry is \$400 per hour.

that the NMS plan is up to date and remains in compliance with the proposed Rule,<sup>301</sup> for an aggregate estimated burden of 2,880 hours.

**b. Report**

The Commission estimates that it would take each national securities exchange or national securities association approximately 420 burden hours of internal legal, compliance, business operations and information technology staff time to create the report required by the proposed Rule.<sup>302</sup> The Commission also expects that each national securities exchange and national securities association respondent may incur one-time external costs for outsourced legal services helping to prepare the report. Commission estimates that on average, each national securities exchange and national securities association would outsource 25 hours of legal time to create the report, for an aggregate one-time capital cost of approximately \$10,000.<sup>303</sup> Therefore, the Commission preliminarily estimates that the one-time initial burden of drafting the report required by the proposed Rule would be 420 burden hours plus \$10,000 external costs for outsourced legal counsel per SRO, for an aggregate estimated burden of 6,300 hours and \$150,000 external costs.

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<sup>301</sup> The Commission derived the total estimated burdens from the following estimates, which are based on prior Commission experience with burden estimates: (Attorney at 64 hours) + (Compliance Manager at 64 hours) + (Programmer Analyst at 64 hours) = 192 burden hours.

<sup>302</sup> The Commission derived the total estimated burden from the following estimates, which assumes preparation of the report would impose approximately half of the approximate burden of preparing the Plan, reflects half of the approximate burden of drafting and filing the NMS plan, and the Commission's preliminary view that the cost of preparing the report would not be as extensive as the drafting and filing of the NMS plan: (Attorney at 200 hours) + (Compliance Manager at 50 hours) + (Programmer Analyst at 110 hours) + (Business Analyst at 60 hours) = 420 burden hours per SRO.

<sup>303</sup> The Commission derived the total estimated burden for outsourced legal counsel based on the assumption that the report required by the proposed Rule would require approximately half the effort of drafting and filing the proposed NMS plan.

### c. Data Collection and Reporting

The proposed Rule would require the collection and reporting on a real time basis of some information that national securities exchanges and national securities associations already collect to operate their business, and are required to maintain in compliance with Section 17(a) of the Exchange Act and Rule 17a-1 thereunder.<sup>304</sup> For instance, the Commission believes that exchanges keep records pursuant to Section 17(a) of the Exchange Act and Rule 17a-1 thereunder in electronic form, of the receipt of all orders entered into their systems, as well as records of the routing, modification, cancellation, and execution of those orders. However, the proposed Rule would require each SRO to collect and report additional and more detailed information, and to report the information to the central repository in real time in a specified uniform format. The Commission anticipates that exchanges may need to enhance or replace their current systems to be able to comply with the proposed information collection and reporting requirements of the proposed Rule.

The Commission recognizes that the extent to which a particular SRO would need to make systems changes would differ depending upon the SRO's current market structure and existing systems. However, the Commission preliminarily estimates that, on average, the initial one-time burden per national securities exchange and national securities association for development and implementation of the systems needed to capture the required information and transmit it to the central repository in a specified format in compliance with the proposed Rule to be 2,200 hours.<sup>305</sup> Further, the Commission estimates that, on average, each exchange and

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<sup>304</sup> 15 U.S.C. 78q(a); 17 CFR 240.17a-1.

<sup>305</sup> The Commission derived the total estimated burdens from the following estimates, which reflect the Commission's experience with, and burden estimates for, SRO systems changes, and discussions with market participants: (Attorney at 100 hours) +



association would incur approximately 40 hours of outsourced legal counsel legal time for the development and implementation of systems needed to capture the required information and transmit it to the central repository, and a one time software and hardware cost of \$4,542,940 per SRO to develop and implement the necessary systems. Therefore, the Commission preliminarily estimates that the average one-time initial burden per national securities exchange and national securities association for development and implementation of the systems needed to capture the required information and transmit it to the central repository in a specified format in compliance with the proposed Rule would be 2,200 burden hours plus \$16,000 costs for outsourced legal counsel and \$4,542,940 for hardware and software costs,<sup>306</sup> for an aggregate estimated burden of 33,000 hours and \$68,384,100 external and systems costs.

Once a national securities exchange or national securities association has established the appropriate systems required for collection and transmission of the required information to the central repository in a specified format, the Commission preliminarily believes that it would be necessary for each national securities exchange or national securities association to undertake efforts to ensure that their system technology is up to date and remains in compliance with the proposed Rule, which could include personnel time to monitor each SRO's reporting of the required data and the maintenance of the systems to report the required data; activity related to adding extra systems capacity to accommodate new order types that would need to be reported to

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(Compliance Manager at 80 hours) + (Programmer Analyst at 1,960 hours) + (Business Analyst at 60 hours) = 2,200 burden hours per SRO.

<sup>306</sup> These estimates are based on the Commission's previous experience with, and cost estimates for, SRO systems changes, and discussions with market participants. See Securities Exchange Act Release No. 50870 (December 16, 2004), 69 FR 77424, (December 27, 2004) ("Regulation NMS Reproposing Release") at 77480 (discussing costs to implement Rule 611 of Regulation NMS). Although the Commission recognizes that the substance of Rule 611 of Regulation NMS is not the same as the proposed Rule, the Commission preliminarily believes that the scope of the systems changes would be comparable.

the central repository; or implementing changes to trading systems which might result in additional reports to the central repository. The Commission preliminarily estimates that, on average, it would take a national securities exchange or national securities association approximately 4,975 hours per year to ensure that the system technology is up to date and remains in compliance with the proposed Rule.<sup>307</sup> The Commission also estimates that it would cost, on average, approximately \$1.25 million per year per SRO to continue to comply with the proposed requirements to provide information to the central repository, including costs to maintain the systems connectivity to the central repository and purchase any necessary hardware, software, and other materials.<sup>308</sup> Therefore, the Commission preliminarily estimates that the average ongoing annual burden per SRO would be approximately 4,975 hours plus \$1.25 million external costs to maintain the systems necessary to collect and transmit information to the central repository, for an aggregate estimated annual burden of 74,625 hours and \$18,750,000 external systems costs.

#### **d. Central Repository**

The proposed Rule would require national securities exchanges and national securities associations to jointly establish a central repository tasked with the receipt, consolidation, and retention of the reported order and execution information. The central repository thus would need its own system(s) to receive, consolidate, and retain the electronic data received from the

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<sup>307</sup> The Commission derived the total estimated burdens from the following estimates, which reflect the Commission's preliminary view that annual ongoing costs would be approximately half the costs of developing and implementing the systems to capture the required information and transmit it to the central repository, and discussions with market participants: (Attorney at 1,500 hours) + (Compliance Analyst at 1,600 hours) + (Programmer Analyst at 1,375 hours) + (Business Analyst at 500 hours) = 4,975 burden hours per SRO.

<sup>308</sup> This estimate includes an estimated cost of approximately \$10,000 per month to maintain systems connectivity to the central repository, including back-up connectivity. This estimate is based on discussions with a market participant.

SROs and their members. The system would be required to be accessible by the sponsors and the Commission for regulatory purposes, with validation parameters allowing the central repository to automatically check the accuracy and completeness of the data submitted, and reject data not conforming to these parameters. It is anticipated that the burdens of development and operation of the central repository would be shared among the plan sponsors.

The Commission staff preliminarily estimates that there would be an average initial one-time burden of 17,500 hours per plan sponsor for development and implementation of the systems needed to capture the required information in compliance with the proposed Rule.<sup>309</sup> Further, the Commission estimates that each exchange and association would incur software and hardware costs of approximately \$4 million per plan sponsor related to systems development. Therefore, the Commission preliminarily estimates a one-time initial burden of 17,500 hours per plan sponsor, plus software and hardware costs of approximately \$4 million related to systems development,<sup>310</sup> for an aggregate estimated burden of 262,500 hours and \$60 million in external systems costs.

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<sup>309</sup> The Commission derived the total estimated burdens based on the following estimates, which are based on information provided to the Commission regarding the development of reporting systems for the collection, consolidation, and dissemination of quotation and last sale data and discussions with market participants: (Attorney at 3,000 hours) + (Compliance Manager at 4,000 hours) + (Programmer Analyst at 7,500 hours) + (Business Analyst at 3,000 hours) = 17,500 per SRO. This figure excludes the number of burden hours required to create and file the NMS plan.

<sup>310</sup> This cost estimate includes the estimated costs that each exchange and association would incur for software and hardware costs related to systems development. This cost estimate also would encompass (1) costs related to engaging in an analysis and formal bidding process to choose the plan processor, and (2) any search undertaken to hire a CCO. See proposed Rule 613(a)(3)(i) (the plan sponsors would be required to select a person to act as a plan processor for the central repository no later than two months after the effectiveness of the NMS plan) and 613(b)(5) (the plan sponsors would be required to appoint a CCO to regularly review the operation of the central repository to assure its continued effectiveness in light of market and technological developments, and make any

Once the plan sponsors have established the systems necessary for the central repository to receive, consolidate, and retain the required information, the Commission estimates that the burden per plan sponsor to ensure that the system technology and functionality is up to date and remains in compliance with the proposed Rule would be 192 hours per year, for an estimated aggregate burden per year of 2,880 hours.<sup>311</sup> The estimated burden would include actions taken to regularly review the operation of the central repository to assure its continued effectiveness and to determine the need for enhancements to accommodate the information required to be collected, or new information collected, and the manner in which the data is processed, as well as periodic assessments of the adequacy of the system technology and functionality of the central repository.

After the central repository systems have been developed and implemented, there would be ongoing costs for operating the central repository, including the cost of paying the CCO; the cost of systems and connectivity upgrades or changes necessary to receive, consolidate, and store the reported order and execution information from SROs and their members; the cost, including storage costs, of collecting and maintaining the NBBO and transaction data in a format compatible with the order and event information collected pursuant to the proposed Rule; the cost of monitoring the required validation parameters, which would allow the central repository to automatically check the accuracy and completeness of the data submitted and reject data not conforming to these parameters consistent with the requirements of the proposed Rule; and the cost of compensating the plan processor. The Commission preliminarily assumes that the plan

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appropriate recommendations for enhancements to the nature of the information collected and the manner in which the information is processed).

<sup>311</sup> The Commission derived the total estimated burdens from the following estimates, which are based on prior Commission experience with burden estimates: (Attorney at 16 hours) + (Compliance Manager at 16 hours) + (Programmer Analyst at 16 hours) = 48 burden hours per quarter, or 192 burden hours per year.

processor would be responsible for the ongoing operations of the central repository. The Commission estimates that these costs would be approximately \$100 million in external costs to the plan processor for operation of the central repository per year, or approximately \$6,666,666 per plan sponsor per year.<sup>312</sup>

**e. Collection and retention of the NBBO and transaction reports**

The proposed Rule would require that the central repository collect and retain on a current and continuous basis the NBBO for each NMS security, transaction reports reported pursuant to an effective transaction reporting plan, and last sale reports reported pursuant to the OPRA Plan. The central repository would be required to maintain this NBBO and transaction data in a format compatible with the order and event information collected pursuant to the proposed Rule.<sup>313</sup> Further, the central repository would be required to retain the information collected pursuant to paragraphs (c)(7) and (e)(5) of the proposed Rule in a convenient and usable standard electronic data format that is directly available and searchable electronically without any manual intervention for a period of not less than five years. The information would be required to be available immediately, or if immediate availability could not reasonably and practically be achieved, any search query would be required to begin operating on the data not later than one hour after the search query is made.<sup>314</sup>

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<sup>312</sup> The Commission derived the total estimated burdens based on discussions with market participants. The estimated annual cost includes an annual salary for a CCO of \$703,800. This figure is based on a \$391 per-hour figure for a Chief Compliance Officer from SIFMA's Management & Professional Earnings in the Securities Industry 2008, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead.

<sup>313</sup> See proposed Rule 613(e)(5).

<sup>314</sup> See proposed Rule 613(e)(6).

The Commission preliminarily has included in the burden estimates to the plan sponsors of developing and implementing the systems necessary to capture the order audit trail information (see supra Section V.D.1.d) the: (1) initial one-time hour burden per plan sponsor for development and implementation of the systems at the central repository necessary to receive and retain this NBBO and last sale information; (2) associated software and hardware costs; and (3) ongoing costs of receiving and retaining the NBBO and last sale information.<sup>315</sup>

The Commission estimates that the ongoing external costs to receive the NBBO and last sale data from the SIPs would be approximately \$1,370 per year.<sup>316</sup>

## 2. Members

The Commission preliminarily believes that the proposed Rule would require the collection and reporting in real time of much of the information that registered broker-dealers already maintain in compliance with existing regulations.<sup>317</sup> For example, Section 17 of the Exchange Act and Rule 17a-3 thereunder mandate that broker-dealers keep certain records of orders handled during the course of business.<sup>318</sup> Certain information also is required to be

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<sup>315</sup> See supra Section V.D.1.d.

<sup>316</sup> The Commission derived this estimate based on the average current cost of obtaining consolidated quotation and transaction information from existing quotation and transaction reporting plans.

<sup>317</sup> See Section 17(a) of the Exchange Act, 14 U.S.C. 78q(a), and Rules 17a-3, 17a-4, and 17a-25 under the Exchange Act, 17 CFR 240.17a-3, 17 CFR 240.17a-4, and 17 CFR 240.17a-25; see also, e.g., BATS Rule 20.7; BOX Chapter V, Section 4; CBOE Chapter VI, Rule 6.24; CHX Article 11, Rule 3; FINRA Rule 7440; Nasdaq Options Market Chapter IX, Section 4; NYSE Rule 132B; and NYSE Amex Equities Rule 132B.

<sup>318</sup> 15 U.S.C. 78q et seq.; 17 CFR 240.17a-3. Generally, broker-dealers must keep a memorandum of each brokerage order, including the following information: the terms and conditions of an order or instructions; the account for which an order was entered; time of order entry and receipt and, to the extent feasible, time of execution; any modifications or cancellations (and, to the extent feasible, time of cancellation); execution price; and the identity of each associated person, if any, responsible for the account. See Rule 17a-3(a)(6)(i) under the Exchange Act, 17 CFR 240.17a-3(a)(6)(i).

collected and reported by broker-dealers in compliance with a Commission request pursuant to Rule 17a-25 under the Exchange Act.<sup>319</sup> The proposed Rule would, however, require SRO members to collect and report additional information for each order in a specified uniform format. In addition to the new information, the members also would be required to report most of the information on a real time basis to the central repository, which is not currently required. The Commission anticipates that SRO members would need to either enhance or replace their current order handling, trading, and other systems to be able to collect and report the required order and reportable event information to the central repository as required by the proposed Rule.

The Commission recognizes that the extent to which a particular member would need to make systems changes or replace existing systems would differ depending upon the member's current business operations and systems. The Commission preliminarily believes that members that rely mostly on their own internal order routing and execution management systems would need to make changes to or replace such systems to collect and report the required order and reportable event information to the central repository as required by the proposed Rule. The Commission estimates that there are approximately 1,114 of these types of members.<sup>320</sup> The Commission preliminarily estimates the average initial one-time burden to develop and

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Broker-dealers also are required to keep a record for each cash and margin account they hold, and the name and address of the beneficial owner of each such account. See Rule 17a-3(a)(9) under the Exchange Act, 17 CFR 240.17a-3(a)(9).

<sup>319</sup> See supra Section I.A for a detailed discussion of what information is required to be submitted upon request to the Commission pursuant to Rule 17a-25 under the Exchange Act, 17 CFR 240.17a-25.

<sup>320</sup> This number includes members that are clearing brokers-dealers that carry customer accounts; broker-dealers that accept customer monies but do no margin business; introducing brokers that clear proprietary securities transactions; ATSS registered with the Commission; other clearing firms; and registered market makers. This number was derived from annual FOCUS reports filed with the Commission for the year ending in 2008.

implement the needed systems changes to capture the required information and transmit it to the central repository in compliance with the proposed Rule for these members would be approximately 6,530 burden hours.<sup>321</sup> The Commission also preliminarily estimates that these members would, on average, incur approximately \$1.5 million in one-time external costs for hardware and software to implement the systems changes needed to capture the required information and transmit it to the central repository.<sup>322</sup> Therefore, the Commission preliminarily estimates that the average one-time initial burden per member would be 6,530 hours and \$1.5 million, for an estimated aggregate burden of 7,274,420 hours and \$1,671,000,000.

This number would likely overestimate the costs for some of these members and underestimate it for others. For example, it may overestimate the cost for ATSS as opposed to members that engage in a customer and proprietary (or market marking) business, in part because of the narrower business focus of some ATSS.<sup>323</sup> The Commission also recognizes that some or all of these members may contract with one or more outside vendors to provide certain front-end order management systems. The third-party vendor may make changes to its systems

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<sup>321</sup> The Commission derived the total estimated burdens on the following estimates, which reflect the Commission's previous experience with, and burden estimates for, broker-dealer systems changes, and discussions with market participants: (Attorney at 1,240 hours) + (Compliance Manager at 1,540 hours) + (Programmer Analyst at 2,750 hours) + (Business Analyst at 1000 hours) = 6,530 hours.

<sup>322</sup> These estimates are based on the Commission's previous experience with, and cost estimates for, broker-dealer systems changes, and discussions with market participants. See Regulation NMS Reproposing Release, supra note 306, at 77480 (discussing costs to implement Rule 611 of Regulation NMS). Although the Commission recognizes that the substance of Rule 611 of Regulation NMS is not the same as the proposed Rule, the Commission preliminarily believes that the scope of the systems changes would be comparable.

These estimated hour burdens and systems costs would include the burden and costs, if any, that would be incurred by members to obtain the required customer information, including beneficial ownership, store it electronically, and transmit it to the central repository.

<sup>323</sup> See Regulation NMS Reproposing Release, supra note 306, at 77480.



to permit the members that use the system to capture and provide the required information to the central repository. Likewise, some or all of these members may contract with outside vendors to provide back-office functionality. These third-party vendors may make changes to their systems to permit the members that use the systems to capture and provide the required information to the central repository. The cost of these changes may be shared by the various members that use the systems, and thus may result in a reduced cost to an individual member to implement changes to its own systems to comply with the requirements of the proposed Rule.

Once such a member has established the appropriate systems and processes required for collection and transmission of the required information to the central repository, the Commission estimates that the proposal would impose on each member ongoing annual burdens associated with, among other things, personnel time to monitor each member's reporting of the required data and the maintenance of the systems to report the required data; activity related to adding extra systems capacity to accommodate new order types that would need to be reported to the central repository; or implementing changes to trading systems which might result in additional reports to the central repository. The Commission preliminarily estimates that, on average, it would take a member of a national securities exchange or national securities association approximately 3,050 burden hours per year continued compliance with the proposed Rule.<sup>324</sup> The Commission also estimates that it would cost, on average, approximately \$756,000 per year per member to maintain the systems connectivity to the central repository and purchase any

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<sup>324</sup> The Commission derived the total estimated burdens on the following estimates, which reflect the Commission's preliminary view that ongoing costs would be approximately half of the costs of developing and implementing the systems to comply with the proposed Rule: (Attorney at 800 hours) + (Compliance Manager at 1,000 hours) + (Programmer Analyst at 500 hours) + (Business Analyst at 750 hours) = 3,050 burden hours.

necessary hardware, software, and other materials.<sup>325</sup> Therefore, the Commission preliminarily estimates that the average ongoing annual burden per member would be approximately 3,050 hours, plus \$756,000 external costs to maintain the systems necessary to collect and transmit information to the central repository, for an estimated aggregate annual burden of 3,397,700 hours and \$842,184,000.

The Commission preliminarily believes that other members generally would rely on functionality provided by third parties to electronically capture the required information and transmit it to the central repository in real time. For purposes of the proposed Rule, the Commission assumes that these members, which could include broker-dealers defined as “small entities” for purposes of the Regulatory Flexibility Act,<sup>326</sup> generally do not clear transactions and may not possess their own internal order routing and execution management systems, but instead rely on third-party providers for such functionality. Further, the Commission assumes that many of these members currently do not themselves report order or trade information and instead rely on their clearing firms or other third parties to do it for them. These smaller members may look for “turn key” systems that could provide the functionality required by the proposed Rule. As such, the Commission preliminarily believes that these members would not undertake a fundamental restructuring of their business to comply with the proposed Rule. Instead, they might continue to rely on their clearing broker-dealer, or they might purchase a standardized software product provided by a third party that would provide the functionality to electronically capture the required information and transmit it to the central repository in real time. The

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<sup>325</sup> This estimate includes an estimated cost of approximately \$10,000 per month to maintain systems connectivity to the central repository, including back-up connectivity. This estimate is based on discussions with a market participant.

<sup>326</sup> See infra Section IX.

Commission estimates that there are approximately 3,006 of these types of members.<sup>327</sup> For these members, Commission staff preliminarily estimates the average external cost to compensate a third party, whether the clearing broker-dealer or other third party, for software that would provide the necessary functionality to electronically capture the required information and transmit it to the central repository, would be approximately \$50,000 per member.<sup>328</sup> In addition, the Commission preliminarily estimates that each of these members, on average, would incur a one-time burden of 140 hours to incorporate this functionality.<sup>329</sup> Therefore, the Commission preliminarily estimates an initial aggregate burden of 420,840 hours and \$150,300,000.

Once such a member has procured the appropriate third party system(s) for collection and transmission of the required information to the central repository, the Commission preliminarily estimates that such a member would continue to incur, on average, an external cost of \$50,000 annually to compensate a third party, whether the clearing broker-dealer or for software that

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<sup>327</sup> This number includes introducing broker-dealers that do not clear transactions. This number excludes non-clearing firms that specialize in direct participation programs; non-clearing firms that sell insurance products; and non-clearing firms that are underwriters and retailers of mutual funds because these firms do not deal in NMS securities. This number was derived from annual FOCUS reports filed with the Commission for the year ending in 2008.

<sup>328</sup> This estimate is based on the Commission's previous experience with, and burden estimates for, broker-dealer systems changes. See Regulation NMS Reproposing Release, *supra* note 306, at 77480 (discussing costs to implement Rule 611 of Regulation NMS). Although the Commission recognizes that the substance of Rule 611 of Regulation NMS is not the same as the proposed Rule, the Commission preliminarily believes that the scope of the systems changes would be comparable.

<sup>329</sup> The Commission derived the estimated burdens from the following estimates, which are based on prior Commission experience with burden estimates: (Attorney at 50 hours) + (Compliance Manager at 50 hours) + (Programmer Analyst at 40 hours) = 140 hours.

These estimated hour burdens and systems costs would include the burden and costs, if any, that would be incurred by members to obtain the required customer information, including beneficial ownership, store it electronically, and transmit it to the central repository.

would provide the necessary functionality to capture the required information and transmit it to the central repository. The Commission also preliminarily estimates that each such member would incur a cost for compliance personnel necessary to oversee continued compliance with the proposed Rule, which would result in 64 burden hours annually for such member.<sup>330</sup> Therefore, the Commission preliminarily estimates an aggregate ongoing burden of 192,384 hours and \$150,300,000 to ensure compliance with the proposed Rule.

The Commission requests specific comments on each of its estimates with respect to the estimated burden and costs on members to comply with the proposed Rule. In particular, the Commission requests comment on the specific types and amount of costs, as well as internal staff burden, that would be incurred to modify members' order handling, trading, and other systems to comply with the proposed Rule. The Commission requests comment whether, and if so how, the estimated costs would be impacted if the members did not have to provide the information in proposed Rule 613(c)(7)(vi) and (vii) (the non-real time information).<sup>331</sup> For instance, would requiring the reporting to the central repository of the account numbers for any subaccounts to which an execution is allocated, and the amount of a commission, if any, paid by the customer and the unique identifier of the broker-dealer(s) to whom the commission is paid, require changes to systems other than order handling and execution systems?

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<sup>330</sup> The Commission bases this estimate on a full-time Compliance Manager spending approximately 2 days per quarter of his time on overseeing ongoing compliance with the proposed Rule.

<sup>331</sup> Proposed Rule 613(c)(7)(vi) would require the reporting to the central repository of the following information: (1) the account number for any subaccounts to which the execution is allocated (in whole or part); (2) the unique identifier of the clearing broker or prime broker, if applicable; (3) the unique order identifier of any contra-side order(s); (4) special settlement terms, if applicable; (5) short sale borrow information and identifier; and (6) the amount of a commission, if any, paid by the customer, and the unique identifier of the broker-dealer(s) to whom the commission is paid. Proposed Rule 613(c)(7)(vii) would require the reporting to the central repository of a cancelled trade indicator, if the trade is cancelled.

#### **E. Collection of Information is Mandatory**

Each collection of information discussed above would be a mandatory collection of information.

#### **F. Confidentiality**

The proposed Rule would require that the information to be collected and electronically provided to the central repository would only be available to the national securities exchanges, national securities association and the Commission for the purpose of performing their respective regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations.<sup>332</sup> Further, the national market system plan submitted pursuant to the proposed Rule would be required to include policies and procedures to ensure the security and confidentiality of all information submitted to the central repository, and to ensure that all plan sponsors and their employees, as well as all employees of the central repository, shall use appropriate safeguards to ensure the confidentiality of such data and shall agree not to use such data for any purpose other than surveillance and regulatory purposes.<sup>333</sup>

#### **G. Retention Period of Recordkeeping Requirements**

National securities exchanges and national securities associations would be required to retain records and information pursuant to Rule 17a-1 under the Exchange Act.<sup>334</sup> Members would be required to retain records and information in accordance with Rule 17a-4 under the Exchange Act.<sup>335</sup>

#### **H. Request for Comments**

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<sup>332</sup> See proposed Rule 613(e)(2).

<sup>333</sup> See proposed Rule 613(e)(4)(i).

<sup>334</sup> 17 CFR 240.17a-1.

<sup>335</sup> 17 CFR 240.17a-4.

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comment to: (1) evaluate whether each proposed collection of information is necessary for the performance of the functions of the agency, including whether the information shall have practical utility; (2) evaluate the accuracy of the agency's estimate of the burden of each proposed collection of information; (3) enhance the quality, utility, and clarity of the information to be collected; and (4) minimize the burden of each collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

## **VI. Consideration of Costs and Benefits**

The Commission is sensitive to the anticipated costs and benefits of the proposed Rule and requests comments on the costs and benefits of the proposed Rule. The Commission encourages commenters to identify, discuss, analyze, and supply relevant data regarding any such costs or benefits.

### **A. Benefits**

Proposed Rule 613 would require all national securities exchanges and national securities associations to jointly submit to the Commission an NMS plan to create, implement, and maintain a consolidated audit trail. The proposed consolidated audit trail would capture, in real time, certain information about each order (including quotations) for an NMS security, including the identity of the customer placing the order, and the details of routing, modification, cancellation, and execution (in whole or in part). In effect, an "electronic audit trail report" would be created for every event in the life of the order. The consolidated audit trail would be maintained by a central repository, and all exchanges, FINRA and the Commission would have access to the consolidated audit trail data for regulatory purposes.

The Commission preliminarily believes that proposed Rule 613 would significantly aid each of the exchanges and FINRA in carrying out its respective statutory obligations to be organized and have the capacity to comply, and enforce compliance by its members, with its rules, and with the federal securities laws, rules, and regulations. Likewise, the Commission believes that proposed Rule 613 would significantly aid the Commission in its ability to oversee the exchanges and associations, and to enforce compliance by the members of exchanges and associations with the respective exchange's or association's rules, and the federal securities laws and regulations. The proposed consolidated audit trail also would aid the Commission in its efforts to limit the manipulation of security prices, and to limit the use of manipulative or deceptive devices in the purchase or sale of a security. Further, the proposal would benefit exchanges, FINRA, and Commission staff by improving the ability of exchanges, FINRA and Commission staff to conduct more timely and accurate trading analysis for market reconstructions, complex enforcement inquiries or investigations, as well as inspections and examinations.

Specifically, the Commission preliminarily believes that, as proposed, Rule 613 would enable exchanges and FINRA to more effectively and efficiently detect, investigate, and deter illegal trading activity, particularly cross-market illegal activity, in furtherance of their statutory obligations. In addition, the Commission preliminarily believes that proposed Rule 613 would enhance the ability of the Commission staff in its regulatory and market analysis efforts. The proposed rule would achieve these objectives in several ways. First, proposed Rule 613 would require the central repository to collect the same data on customer and order event information from each exchange, FINRA, and all members of the exchanges and FINRA, in a uniform format. Currently, the scope and format of audit trail information relating to orders and

executions differs, sometimes significantly, among exchanges and FINRA. Thus, by requiring that all exchanges, FINRA and their members submit uniform customer and order event data to the central repository in a uniform format that would more readily allow for consolidation, the proposed Rule would allow regulators to more easily, and in a more timely manner, surveil potential manipulative activity across markets and market participants. The Commission preliminarily believes that this increased efficiency would enhance the ability of SRO and Commission staff to detect and investigate manipulative activity in a more timely manner, whether the activity is occurring on one market or across markets (or across different product classes). Timely pursuit of potential violations can be important in, among other things, seeking to freeze and recover any profits received from illegal activity.

The Commission also preliminarily believes that the proposed consolidated audit trail would enhance the ability of SRO and Commission staff to regulate the trading of NMS securities by requiring that key pieces of information currently not captured in existing audit trails be reported to the proposed consolidated audit trail. For example, proposed Rule 613 would require that the customer that submits or originates an order be identified in the consolidated audit trail. In addition, the proposed Rule would require the assignment of unique identifiers for each order, each customer, and each broker-dealer and SRO that handles an order. Further, the proposed Rule would greatly enhance the ability to track an order from the time of order inception through routing, modification, cancellation, and execution. The Commission preliminarily believes that this information would allow regulators to more easily track potential manipulative activity across markets and market participants, and would place SRO and Commission staff in a better position to surveil whether exchange rules, as well as federal securities laws, rules and regulations, are complied with.



The proposal also would require that most of the required audit trail information be submitted on a real time basis. Most existing audit trails currently collect information on orders at the end of the day, or upon request, rather than in real time.<sup>336</sup> Other order and execution information, such as EBS data and Rule 17a-25 data, is provided to the Commission only upon request. The proposed consolidated audit trail would require that certain information about orders and executions be provided on a real time basis. The Commission preliminarily believes that this requirement could significantly increase the ability of SRO and Commission staff to identify and investigate manipulative activity in a more timely manner.<sup>337</sup>

The Commission preliminarily believes that the proposal also would benefit exchanges, FINRA, and Commission staff by improving the ability of exchanges, FINRA and Commission staff to conduct timely and accurate trading analysis for market reconstructions, complex enforcement inquiries or investigations, as well as inspections and examinations. Today, trading activity is widely dispersed among various market centers, and one or more related orders for one or more securities or other related products may be routed to multiple broker-dealers and more than one exchange, or be executed in the OTC market. Thus, SRO and Commission regulatory staff investigating potentially illegal behavior may have to collect information from multiple broker-dealers and then examine, analyze and reconcile the disparate information provided in widely divergent formats to accurately reconstruct all trading activity during a particular time frame in the course of investigating potentially manipulative activity. Obtaining the necessary order and execution information and undergoing the necessary analysis to determine whether any wrongdoing exists based on the information available today requires substantial investment of time and effort on behalf of regulatory authorities. Under proposed

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<sup>336</sup> See supra Sections I.C., I.D., II.A., and V.A.5.

<sup>337</sup> See supra Section III.D.1.

Rule 613, regulatory authorities would be able to access all information about events in the life of an order or related orders, and obtain critical information identifying the customer (or beneficial owner) behind the order(s) directly from the central repository in a uniform format. Thus, the Commission preliminarily believes that ability of SRO and Commission staff to conduct timely and accurate trading analysis for market reconstructions, complex enforcement inquiries and investigation, as well as inspections and examinations, would be significantly improved.

The Commission also preliminarily believes that the proposal would benefit SROs, as well as the NMS for NMS securities, by ultimately reducing some regulatory costs, which may result in a more effective re-allocation of overall costs. For example, by providing a more comprehensive and searchable database, the Commission preliminarily believes that the consolidated audit trail would significantly decrease the amount of time invested by SRO staff to determine whether any illegal activity is occurring either on one market or across markets. Currently, SRO regulatory staff may need to submit multiple requests to its members during the course of an investigation into possible illegal activity, or submit multiple requests to ISG to obtain audit trail information from other SROs about trading in a particular security, and then commit significant staff time to collating and analyzing the data produced. The proposal would benefit the Commission in similar respects. For example, Commission staff often must submit numerous requests to members after the Commission receives information from equity cleared reports in an attempt to identify the ultimate customer (or beneficial account holder) that entered the order or orders in question. Substantial Commission staff resources currently are invested in analyzing the data that is received in response to these requests.

Under proposed Rule 613, SRO regulatory staff would have immediate, easily searchable access to the consolidated audit trail data through the central repository for purposes of conducting surveillance, investigations, and enforcement activities. Commission staff likewise would have more efficient and timely access for purposes of conducting risk assessments of referrals received, investigations, and enforcement activities, and for purposes of conducting market reconstructions or other analysis. Thus, the Commission preliminarily believes that the proposal would benefit SRO and Commission staff, as well as the market for NMS securities as whole, by providing immediately accessible audit trail information to regulatory staff, which would in turn reduce staff time and effort that would otherwise be needed to collect and analyze audit trail information and allow such staff time and effort to be redirected to more effective uses, possibly even allowing the staff to engage in more investigations. In other words, if the costs per investigation decreased because of efficiencies in the proposed consolidated audit trail information, SRO or Commission staff may be able to review and investigate a greater amount of suspicious activity.

Likewise, the Commission preliminarily believes that proposed Rule 613 would benefit the exchanges, FINRA, the Commission, and the members of SROs, as well as investors and the public interest, by reallocating the overall cost of regulating the markets for NMS securities on an ongoing basis toward more efficient regulation. For instance, the Commission preliminarily believes that the proposed consolidated audit trail would eliminate the need for certain SRO and Commission rules that currently mandate the collection and provision of information, at least with respect to NMS securities. As noted above, many exchanges and FINRA each have their own disparate audit trail rules. Thus, a member of the various exchanges and FINRA could be subject to the audit trail rules of, and be required to submit different information to, more than

one exchange and FINRA. The Commission intends that the proposed consolidated audit trail replace the need to have disparate SRO audit trail rules. If proposed Rule 613 were adopted, and the consolidated audit trail was implemented, the Commission preliminarily believes that the exchanges and FINRA would not need to have separate and disparate audit trail rules that apply to NMS securities applicable to their members. Thus, the Commission preliminarily believes that the proposed consolidated audit trail would ultimately result in the ability of SROs to repeal their existing audit trail rules because SRO audit trail requirements would be encompassed within proposed Rule 613. Similarly, the proposed consolidated audit trail also may render duplicative and thus unnecessary certain data obtained from the EBS system pursuant to Rule 17a-25 (and the SRO rules implementing the EBS system), and from the equity cleared data, at least as it relates to NMS securities. SRO and Commission staff instead would be able to access the audit trail information for every order directly from the central repository.<sup>338</sup>

The Commission requests comment on any ongoing cost savings to SROs or their members that could be achieved by the proposal. Are there any other systems or technologies that could be replaced by the proposed audit trail? Would additional Commission action be required to achieve cost savings due to redundant rules or systems? Are there any new systems or technology requirements that could offset these potential cost savings? To what extent would any cost savings amount to a reallocation of resources towards more effective or efficient uses? Please provide specific examples. The Commission also requests comment as to whether the proposed Rule should require the NMS plan to include provisions relating to transition from the existing audit trails to the proposed consolidated audit trail.

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<sup>338</sup> The Commission notes that, if the proposed Rule were adopted, the SROs would need to consider the continued need for their existing audit trail rules until such time that their members begin complying with the requirements of the proposed Rule.

As discussed above, the Commission preliminarily believes that the proposal would significantly enhance the ability of SRO staff to efficiently and effectively regulate their market and their members, including detecting and investigating potential manipulative activity. The Commission also preliminarily believes that the proposed consolidated audit trail would benefit the Commission in its regulatory and market analysis efforts. More timely detection and investigation of potential manipulative activity may lead to greater deterrence of future illegal activity if potential wrongdoers perceive a greater chance of regulators identifying their activity in a more timely fashion. To the extent investors consider the improvement in regulators' ability to detect and investigate wrongdoing as significant to their investment decisions, investor trust, which is a component of investor confidence, is improved and investors may be more willing to invest in the securities markets.<sup>339</sup> An increase in investor participation in the securities markets, at least to the extent that the increase is allocated efficiently, can potentially benefit the securities markets as a whole, through better capital formation. Thus, the Commission preliminarily believes that the proposed consolidated audit trail would benefit the NMS for NMS securities by encouraging more efficient and potentially a higher level of capital investment.

The Commission requests comment on how the proposal would impact investor protections and investor confidence. In particular, would the consolidated audit trail better align investor protections to the expectations that investors have about their protections? What would be the economic effect of the potential changes to investor protections or to better alignment of those protections with investor expectations? Would any of the anticipated benefits of the proposed Rule be mitigated if market participants alter their trading behavior, such as by shifting their trading activity to products or markets that do not require the capture of customer

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<sup>339</sup> See Guiso, Sapienza, and Zingales, "Trusting the Stock Market," available at <http://ssrn.com/abstract=811545>.

information to avoid compliance with the requirements of the proposed Rule? If so, please explain how so, and what, if any, steps the Commission should take in response.

The Commission also preliminarily believes that proposed Rule 613 would enhance the overall reliability of audit trail data that is available to the Commission and SRO regulatory staff. Because the proposed Rule would require that the NMS plan include policies and procedures, including standards, to be used by the plan processor to ensure the timeliness, accuracy, and completeness of the audit data submitted to the central repository, there would be an automatic check on the incoming audit trail data submitted by exchanges and FINRA, and their members, for reliability and accuracy. The Commission expects that these policies and procedures would include validation parameters that would need to be met before audit trail data would be accepted into the central repository, and that the central repository would reject data that did not meet certain validation parameters, and require resubmission of corrected data. Thus, the Commission preliminarily believes that the integrity of audit trail information available to the Commission and to the regulatory staff of the exchanges and FINRA would be enhanced and safeguarded by the provisions applicable to the central repository pursuant to proposed Rule 613.

## **B. Costs**

As discussed below, the Commission acknowledges that there likely would be significant up-front costs to implement the proposal. However, the Commission preliminarily believes that SRO and Commission staff, as well as SRO members, would realize other cost savings and benefits.

### **1. Creation and Filing of NMS Plan**

The proposed Rule would require the exchanges and FINRA to jointly develop and file an NMS plan to create, implement and maintain a consolidated audit trail that would capture

customer and order event information in real time for all orders in NMS securities, across all markets, from the time of order inception through execution, cancellation or modification.<sup>340</sup>

Exchanges and FINRA would be expected to undertake any joint action necessary to develop and file the NMS plan, and there would be attendant costs in doing so. For example, the Commission anticipates that exchange and FINRA staff would need to meet and draft the required terms and provisions of the NMS plan.<sup>341</sup> The Commission preliminarily believes that the existing exchanges and FINRA would incur an aggregate one-time cost of approximately \$3,503,100 to prepare and file the NMS plan.<sup>342</sup> Once exchanges and FINRA have established the NMS plan,

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<sup>340</sup> See proposed Rule 613(c)(1), (c)(3), (c)(7); see also *supra* Sections III.A., III.B., III.D., and V.A.5.

<sup>341</sup> As discussed above in Section III, these required provisions include provisions relating to: a governance structure to ensure the fair representation of the plan sponsors; administration of the plan, including the selection of the plan processor; the admission of new sponsors of the NMS plan and the withdrawal of existing sponsors from the plan; the percentage of votes required by the plan sponsors to effectuate amendments to the plan; the manner in which costs of operating the central repository would be allocated among the exchanges and FINRA, including a provision addressing the manner in which costs would be allocated to new sponsors of the plan; the appointment of a Chief Compliance Officer; the provision stating that by subscribing to and submitting the plan to the Commission each plan sponsor agrees to enforce compliance by its members with the provisions of the plan; and the provision requiring the creation and maintenance by the central repository of a method of access to the consolidated data that includes search and reporting functions. See proposed Rules 613(b), 613(e)(3), and 613(g)(3). The NMS plan also would be required 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 the central repository; to ensure the timeliness, accuracy, and completeness of the data provided to the central repository; to require the rejection of data provided to the central repository that does not meet the validation parameters set out in the plan and the re-transmission of corrected data; and to ensure the accuracy of the processing of the data provided to the central repository. See proposed Rule 613(e)(4).

<sup>342</sup> This figure includes internal personnel time and external legal costs. Commission staff estimates that each exchange and association would expend (400 Attorney hours x \$305 per hour) + (100 Compliance Manager hours x \$258 per hour) + (220 Programmer Analyst hours x \$193 per hour) + (120 Business Analyst hours x \$194 per hour) = \$213,540. The \$305 per-hour figure for an Attorney; the \$258 per hour figure for a Compliance Manager; the \$193 per hour figure for a Programmer Analyst; and the \$194 per hour figure for a Business Analysis (Intermediate) are from SIFMA's Management &

the Commission estimates that, on average, each exchange and FINRA would incur a cost of \$48,384 per year to ensure that the plan is up to date and remains in compliance with the proposed Rule,<sup>343</sup> for an estimated aggregate annual cost of \$725,760.

In estimating the costs for creation of the NMS plan, the Commission considered exchange and FINRA staff time necessary for preparing and filing the plan with the Commission. The Commission also considered the cost of outsourced legal services. The Commission requests comment on whether there are additional costs that would contribute to the expense of creating and filing the NMS plan. Please describe any such cost in detail and provide an estimate of the costs. In estimating the ongoing costs of the NMS plan, the Commission considered exchange and FINRA staff time necessary for periodically reviewing the plan in light of current market trends and technology. The Commission requests comment on these estimates and what types of costs would be incurred to keep the plan up to date.

## **2. Synchronizing Clocks**

The proposed Rule would require each exchange and FINRA, and the members of each exchange and FINRA, to synchronize its business clocks that are used for the purpose of recording the date and time of any reportable event that must be reported pursuant to the proposed Rule to the time maintained by the National Institute of Standards and Technology,

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Professional Earnings in the Securities Industry 2008, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead. Commission staff also estimates that each exchange and association would outsource, on average, 50 hours of legal time, at an average hourly rate of \$400. Thus, the Commission preliminarily estimates, on average, a total cost of \$233,540 per SRO. See supra Section V.D.1.a. (discussing PRA costs for developing and filing the NMS plan).

<sup>343</sup> Commission staff estimates that annually each exchange and association would expend (64 Attorney hours x \$305 per hour) + (64 Compliance Manager hours x \$258 per hour) + (64 Programmer Analyst hours x \$193 per hour) = \$48,384, to ensure that the NMS plan is up to date and remains in compliance with the proposed Rule. See supra note 301.



consistent with industry standards.<sup>344</sup> As part of the initial implementation of the consolidated audit trail, the exchanges, FINRA and their members therefore would have to ensure that their business clocks are synchronized with the time maintained by the National Institute of Standards and Technology. The proposed Rule also would require that the NMS plan provide for the annual evaluation of the synchronization time standard to determine whether it should be shortened, consistent with industry standards.<sup>345</sup>

The Commission recognizes that the cost to each SRO and member to synchronize their clocks consistent with the proposed requirements would vary depending upon the SRO or member's existing systems. The Commission preliminarily believes, however, that most SROs and their members currently synchronize their clocks, and that therefore the SROs and their members would not incur significant costs to comply with this requirement.<sup>346</sup> The Commission recognizes that each individual member or SRO's costs may vary depending upon their current synchronization practices, their business structure, their order management and trading systems, and their geographic diversity. The Commission preliminarily estimates that an SRO or member that would need to make system changes to comply with the requirement would incur an average one-time initial cost of approximately \$9,650.<sup>347</sup>

The Commission also preliminarily estimates that there would be an average ongoing annual cost of approximately \$11,580 to each exchange, FINRA, and member to synchronize

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<sup>344</sup> See proposed Rule 613(d)(1).

<sup>345</sup> See proposed Rule 613(d)(2).

<sup>346</sup> See CHX Rule 4, Interpretations and Policies .02; FINRA Rule 7430; NYSE and NYSE Amex Equities Rule 123, Supplementary Material .23; NYSE and NYSE Amex Equities Rule 132A; and NYSE Arca Options Rule 6.20.

<sup>347</sup> Commission staff estimates that, on average, each exchange, association, and member would expend 50 hours of information technology time, at a cost of \$193 per hour to make systems changes to comply with the requirement that clocks be synchronized. This estimate is based on discussions with market participants.

their business clocks to the time maintained by the National Institute of Standards and Technology, consistent with industry standards.<sup>348</sup> Further, the Commission preliminarily estimates that there would be an average cost to exchanges, FINRA and their members of approximately \$6,192 per SRO or member to annually evaluate the synchronization time standards to determine whether it should be shortened, consistent with industry standards.<sup>349</sup>

As stated above, the Commission preliminarily believes that the costs to the SROs and their members associated with synchronizing their clocks would not be significant because most SROs and their members currently synchronize their clocks. The Commission requests comments on whether commenters agree. If not, what costs would be incurred? Please be specific as to the type of changes necessary and the costs of making them. Further, the proposed Rule would require that all SROs and their members synchronize to same time standard and to the same level of accuracy. The Commission requests comment on its estimate of the cost to SROs and their members of initializing synchronizing business clocks, the ongoing costs for maintaining accurate synchronization, and the costs associated with annual evaluation of the synchronization time standard. Would SROs or their members incur costs, and if so, what types of costs?

### **3. Costs to Provide Information**

As discussed above in Section V.A.5, the Commission preliminarily believes that the proposed Rule would require the collection and reporting on a real time basis of some information that national securities exchanges and national securities associations already record

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<sup>348</sup> Commission staff estimates that each exchange, association and member would expend approximately five hours of information technology time, per month, at \$193 per hour. This estimate is based on discussions with industry participants.

<sup>349</sup> This estimate assumes that each SRO or member would expend (16 Programmer Analyst hours x \$193 per hour) + (16 Business Analyst hours x \$194 per hour) = \$6,192 to carry out this annual evaluation.

to operate their business, and are required to maintain in compliance with Section 17(a) of the Exchange Act and Rule 17a-1 thereunder.<sup>350</sup> However, the proposed Rule would require each SRO to collect and report additional and more detailed information, and to report the information to the central repository in real time in a specified format. Based on discussions with SROs, the Commission anticipates that exchanges would need to enhance or replace their current systems to be able to comply with the proposed information collection and reporting requirements of the proposed Rule.

Likewise, the Commission preliminarily believes the proposed Rule would require the collection of much of the information that registered broker-dealers already maintain in compliance with existing regulations.<sup>351</sup> The proposed Rule, however, would require members to collect additional information for each order and, in addition to the new information, the members also would be required to report most of the information on a real time basis to the central repository in a specified uniform format. Based on discussions with members, the Commission anticipates that the SRO members would need to enhance or replace their current order handling, trading and other systems to be able to collect and report the required order and reportable event information to the central repository as required by the proposed Rule.

The Commission recognizes that the extent to which a particular SRO or member would need to make systems changes would differ depending upon the SRO's market structure (e.g., floor vs. electronic) and systems, or the member's current business operations and systems. The

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<sup>350</sup> 15 U.S.C. 78q(a) et. seq.; 17 CFR 240.17a-1. Rule 17a-1 requires an exchange or association to keep and preserve at least one record of all documents or other records that shall be received by it in the course of its business as such and in the conduct of its self-regulatory activity. This would include records of the receipt of all orders entered into their systems, as well as records of the routing, modification, cancellation, and execution of those orders. The Commission understands that SROs have automated this process and thus keep these records in electronic format.

<sup>351</sup> See supra notes 317 to 319 and accompanying text.

Commission preliminarily estimates that the average one-time, initial cost to exchanges and FINRA to put in place the systems necessary to identify, collect and transmit the consolidated audit trail information to the central repository would total approximately \$5 million per SRO,<sup>352</sup> for an aggregate estimated cost of \$75 million for all SROs. In estimating this cost, the Commission has considered SRO staff time necessary to build new systems or enhance existing systems to comply with the proposed Rule.<sup>353</sup> In addition, the Commission estimated costs for system hardware, software, and other materials.<sup>354</sup> What other types of costs might SROs incur? Please be specific in your response.

Once an SRO has implemented the changes necessary to collect and transmit the required information to the central repository as required by the proposed Rule, the Commission estimates that each SRO would incur, on average, an annual ongoing cost of \$2.5 million to ensure compliance with the proposed Rule,<sup>355</sup> for an estimated ongoing annual aggregate cost of \$37.5 million for all SROs.

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<sup>352</sup> The Commission based this estimated cost on the Commission's previous experience with, and burden estimates for, SRO systems changes and discussions with market participants. See Regulation NMS Reproposing Release, supra note 306, at 77480 (discussing costs of implementing Rule 611 of Regulation NMS). Although the Commission recognizes that the substance of Rule 611 is not the same as the proposed Rule, the Commission preliminarily believes that the scope of systems changes would be comparable.

<sup>353</sup> Commission staff estimates that each exchange and association would expend (100 Attorney hours x \$305 per hour) + (80 Compliance Manager hours x \$258 per hour) + 1,960 Programmer Analyst hours x \$193 per hour) + 60 Business Analyst hours x \$194) = \$441,060 to develop and implement the systems needed to capture the required information and transmit it. In addition, the Commission estimates that each exchange and association would expend 40 hours of outsourced legal time at an average rate of \$400 per hour. See supra note 305.

<sup>354</sup> Commission staff estimates that the cost for system hardware, software, and other materials would be \$4,542,940. See supra note 306 and accompanying text.

<sup>355</sup> Commission staff estimates that each exchange and association would expend

The Commission understands that many members, particularly smaller members, currently rely on third parties to report information required to be reported pursuant to SRO audit trail or other rules. For example, a member that is an introducing broker who sends all of its customer order flow to a clearing broker currently may rely on that clearing broker for reporting purposes. The Commission preliminarily believes that these members would not undertake a fundamental restructuring of their business to comply with the proposed Rule. Instead, they might continue to rely on their clearing broker-dealer, or they might look for the ability to purchase a standardized software product provided by a third party that would provide the functionality to electronically capture the required information and transmit it to the central repository in real time. The costs of this approach are likely to be significantly lower than the costs to a member that enhances its own systems, or creates new systems, to comply with the proposed requirements to report information to the central repository. The Commission estimates that there are approximately 3,006 of these types of members, and that the average cost to such members to compensate a third party, whether a clearing broker-dealer or other third party, for software that would provide the necessary functionality to electronically capture the required information and transmit it to the central repository would be approximately \$50,000 per member.<sup>356</sup> In addition, the Commission estimates that, on average, each member would

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(1,500 Attorney hours x \$305 per hour) + (1,600 Compliance Manager hours x \$258 per hour) + (1,375 Programmer Analyst hours x \$193 per hour) + (500 Business Analyst hours x \$194 per hour) to ensure that the systems technology is up to date and remains in compliance with the proposed Rule, for a total of \$1,250,675. In addition, Commission staff estimates that each exchange and association would expend approximately \$1.25 million on system hardware, software, connectivity and other materials. These estimates reflect the preliminary view that ongoing costs to maintain compliance with the proposed Rule would be half of the initial costs. See supra notes 307 and 308.

<sup>356</sup> See supra note 328. The Commission based this estimated cost on the Commission's previous experience with, and burden estimates for, broker-dealer systems changes. See Regulation NMS Reproposing Release, supra note 306, at 77480 (discussing costs of

incur a one-time cost of \$35,870 to incorporate the new functionality into its existing systems to ensure compliance with the proposed Rule.<sup>357</sup> Thus, the Commission preliminarily estimates that each of these members would incur, on average, a one-time cost of \$85,870, for an estimated aggregate cost of \$258,125,220.

The Commission also preliminarily estimates that each of these members would continue to incur, on average, annual costs of \$66,512 to ensure continued compliance with the proposed Rule.<sup>358</sup>

Do commenters believe that smaller members would likely rely on third parties to provide a functionality that would provide required data to the central repository? Why or why not? Would it be more cost effective for a small member to enhance existing systems or create new systems to comply with the proposed Rule? Why or why not? What would be the costs associated with each approach? Should members that currently rely on another party to report, such as their clearing broker, be able to have their clearing firms report on their behalf? Why or why not? How would allowing third-party reporting impact the ability to report data in real time? Would the manner in which these members currently maintain customer information

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implementing Rule 611 of Regulation NMS). Although the Commission recognizes that the substance of Rule 611 is not the same as the proposed Rule, the Commission preliminarily believes that the scope of systems changes would be comparable.

<sup>357</sup> Commission staff estimates that annually each of these types of members would expend (50 Attorney hours x \$305 per hour) + (50 Compliance Manager hours x \$258 per hour) + (40 Information Analyst hours x \$193 per hour) = \$35,870 to incorporate the new functionality into its existing systems.

These costs would include any systems or other changes necessary to obtain the required customer information, including the identity of the beneficial owner, and electronically storing it for transmittal to the central repository with the order information.

<sup>358</sup> This estimate is based on a cost of \$50,000 per year to compensate a third party for the functionality to capture the required information and transmit it to the central repository, and a cost of \$16,512 for personnel time to oversee compliance with the proposed Rule (64 hours Compliance Manager x \$258 per hour). See supra note 330.

create practical difficulties for providing the beneficial ownership information, or additional burdens that have not been taken into account in estimating costs? For example, is customer information stored electronically? What is the impact of the manner in which this information is currently stored on the Commission's cost estimates?

The Commission preliminarily estimates that there are 1,114 members that would undertake their own development changes to implement the proposed Rule.<sup>359</sup> The Commission preliminarily estimates that the average one-time, initial cost to these members for development, including programming and testing of the systems necessary to identify, collect and transmit the consolidated audit trail information to the central repository, would be approximately \$3 million per member,<sup>360</sup> for an estimated aggregate cost of \$3,342,000,000. This number would likely overestimate the costs for some of these members and underestimate it for others. For example, it likely overestimates the cost for ATSS as opposed to broker-dealers that have a customer and proprietary, or market-making, business, in part because of the narrower business focus of some ATSS. The Commission recognizes that some of these members may contract with one or more

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<sup>359</sup> See supra Section V.D.2 and note 320.

<sup>360</sup> Commission staff estimates that each member would expend (1,240 Attorney hours x \$305 per hour) + (1,540 Compliance Manager hours x \$258 per hour) + (2,750 Programmer Analyst hours x \$193 per hour) + (1,000 Business Analyst hours x \$194 per hour) = \$1,500,270 to develop and implement the systems needed to capture the required information and transmit it. In addition, the Commission estimates that the cost for system hardware, software, and other materials would be approximately \$1.5 million. This estimate is based on the Commission's previous experience with, and burden estimates for, broker-dealer systems changes. See Regulation NMS Reproposing Release, supra note 306, at 77480 (discussing cost estimates for implementing Rule 611 of Regulation NMS). Although the Commission recognizes that the substance of Rule 611 is not the same as the proposed Rule, the Commission preliminarily believes that the scope of systems changes would be comparable.

These costs would include any systems or other changes necessary to obtain the required customer information, including the identity of the beneficial owner, and electronically storing it for transmittal to the central repository with the order information.

outside vendors to provide certain front-end order management systems. The third-party vendor may make changes to its systems to permit the members that use the system to capture and provide the required information to the central repository. Likewise, some of these members may contract with outside vendors to provide back-office functionality. These third-party vendors may make changes to their systems to permit the members that use the systems to capture and provide the required information to the central repository. The cost of these changes may be shared by the various members that use the systems, and thus may result in a reduced cost to an individual member to implement changes to its own systems to comply with the requirements of the proposed consolidated audit trail.

The Commission requests comment on this estimate. Specifically, what types of costs would members incur building new systems, or enhancing existing systems, to comply with the proposed Rule? Would members need to expand their capacity as part of any systems upgrades? What would be the costs associated with this? Would the manner in which these members currently maintain customer information create practical difficulties for providing the beneficial ownership information, or additional burdens that have not been taken into account in estimating costs? For example, is customer information stored electronically? What is the impact of the manner in which this information is currently stored on the Commission's cost estimates?

Once these members have largely implemented the changes necessary to collect and report the required order and reportable event information to the central repository as required by the proposed Rule, the Commission estimates that each such member would incur, on average, an annual ongoing cost of approximately \$1.5 million,<sup>361</sup> for an estimated aggregate ongoing

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<sup>361</sup> Commission staff estimates that each member would expend (800 Attorney hours x \$305 per hour) + (1,000 Compliance Manager hours x \$258 per hour) + (500 Programmer Analyst hours x \$193 per hour) + (750 Business Analyst hours x \$194 per hour) =



cost of \$ 1,671,000,000. These estimates would cover the costs associated with continued compliance with the proposed Rule.<sup>362</sup>

The Commission requests comment on what ongoing costs SROs and their members would incur to continue to collect and report the required information in compliance with the proposed Rule. What types of costs would be included? Are there differences in the costs that SROs and their members would incur? Why or why not.

The proposal would require the transmission of information in real time to the central repository. The Commission preliminarily believes that this approach would have greater benefits and would be lower cost than an alternative of transmitting all reports in batch mode. Real time submission could simply require a "drop copy" of a reportable event be sent to the central repository at the same time that the reportable event is otherwise occurring. Batching, however, would require the build up of reports to be sent periodically, and the amount of data sent in a batch could be significantly larger than the data sent in real time. The Commission requests comment on the technology requirements and other costs of real time transmission of information versus periodically batching the reports. Would real time reporting be more or less costly than batch reporting? Please explain with specificity why or why not and provide cost estimates. If real time reporting would be more expensive, are the greater costs justified by the benefits of real time reporting described above? If batch reporting is the better alternative, what should be the frequency of the batch reporting and why? Does the answer depend on the type of security? The Commission also requests comment on what types of systems changes SROs and

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\$744,000 to ensure that the systems technology is up to date and remains in compliance with the proposed Rule. In addition, Commission staff estimates that each member would expend approximately \$756,000 on system hardware, software, connectivity and other materials. These estimates reflect the preliminary view that ongoing costs to maintain compliance with the proposed Rule would be half of the initial estimated costs.

<sup>362</sup> See supra Section V.D.2.

members would need to make to implement the proposed Rule and NMS plan requirements, and the attendant costs. What specific types or items of information, if any, would be required to be reported to the central repository by a member that would not already be collected and maintained in an automated format?

#### **4. Cost of Enhanced Surveillance Systems**

Pursuant to the proposed Rule, exchanges and FINRA also would be required to develop and implement a surveillance system, or enhance existing surveillance systems, reasonably designed to make use of the consolidated information collected through the proposed consolidated audit trail.<sup>363</sup> The Commission preliminarily estimates that the average one-time cost to implement this requirement would be approximately \$10 million for each exchange and FINRA, for an estimated aggregate cost of \$150 million.<sup>364</sup> The Commission also estimates, on average, ongoing annual costs associated with the enhanced surveillance would be approximately \$2,610,600,<sup>365</sup> for an estimated aggregate, ongoing cost of \$39,159,000. Based on discussions with market participants, the Commission recognizes that these estimated costs may vary, perhaps significantly, based on the market model utilized by a particular SRO. For certain SROs, these figures may overestimate the costs associated with developing or enhancing surveillance systems, while for others, it may underestimate the costs. The Commission requests

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<sup>363</sup> See proposed Rule 613(f).

<sup>364</sup> This estimate is based on discussions with market participants. This estimate does not separately break out personnel time versus system costs.

<sup>365</sup> Commission staff estimates that each member would expend (3,600 Senior Compliance Examiner hours x \$212 per hour) and (1,800 Information Analyst hours x \$193 per hour) to operate and monitor the enhanced surveillance systems and carry out surveillance functions. In addition, Commission staff estimates that each member would expend approximately \$1.5 million on system hardware, software, connectivity and other technology per year on an on-going basis for this purpose. These estimates are based on discussions with a market participant.

comment on whether these figures accurately estimate the costs for developing or enhancing surveillance systems to comply with the proposed Rule for the SROs. Would these figures be lower or higher for SROs whose trading systems are fully electronic? Would the cost estimates be higher or lower for those SROs that have a trading floor? What other considerations would impact individual SRO costs? Please be specific in your response.

The Commission also requests comment on whether SROs would be able to enhance their existing surveillance and regulation to make use of the proposed consolidated information or would they need to develop new surveillance systems to comply with the proposed Rule? How would SROs enhance their current surveillance systems? What would be the costs associated with updating current systems as opposed to developing new surveillance systems? Would it be more cost efficient to establish coordinated surveillance across exchanges and FINRA, rather than having each SRO be responsible for surveillance on its own market using the consolidated data? What would be the costs associated with developing consolidated cross-market surveillance?

## **5. Central Repository System**

The central repository would be responsible for the receipt, consolidation, and retention of all the data required to be submitted by the exchanges and FINRA, and their members. The proposed Rule also would require that the central repository collect and retain on a current and continuous basis the NBBO for each NMS security, transaction reports reported pursuant to an effective transaction reporting plan, and last sale reports reported pursuant to the OPRA Plan. The central repository would be required to maintain the NBBO and transaction data in a format compatible with the order and event information collected pursuant to the proposed Rule. Further, the central repository would be required to retain the information collected pursuant to

paragraphs (c)(7) and (e)(5) of the proposed Rule in a convenient and usable standard electronic data format that is directly available and searchable electronically without any manual intervention for a period of not less than five years. The information shall be available immediately, or if immediate availability cannot reasonably and practically be achieved, any search query must begin operating on the data not later than one hour after the search query is made.<sup>366</sup>

The central repository thus would need its own system(s) to receive, consolidate, and retain the electronic data received from the plan sponsors and their members, as well as to collect and retain the NBBO and last sale data. The system would be required to be accessible and searchable by the sponsors and the Commission for regulatory purposes,<sup>367</sup> with validation parameters allowing the central repository to automatically check the accuracy and the completeness of the data submitted, and reject data not conforming to these parameters. It is anticipated that the costs of development and operation of the central repository would be shared among the plan sponsors. The Commission preliminarily estimates a one-time initial cost to create the central repository, its systems and structure, of approximately \$120 million for an average cost of approximately \$8 million per plan sponsor.<sup>368</sup>

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<sup>366</sup> See proposed Rule 613(e)(6).

<sup>367</sup> The proposed Rule would require that the central processor create and maintain a method of access to the consolidated data. See proposed Rule 613(e)(3). The Rule requires that this method of access would be designed to include search and reporting functions to optimize the use of the consolidated data. The cost of creating a method of access to the consolidated audit trail data is included within the overall systems cost estimate.

<sup>368</sup> Commission staff estimates that each exchange and association would expend (3,000 Attorney hours x \$305 per hour) + (4,000 Compliance Manager hours x \$258 per hour) + (7,500 Programmer Analyst hours x \$193 per hour) + (3,000 Business Analyst hours x \$194 per hour) = \$3,976,500 to create the central repository. In addition, the Commission estimates that the cost per exchange or association for system hardware, software, and other materials would be approximately \$4 million. See *supra* Section V.D.1.d. and note 309.

Does this estimate accurately reflect SRO staff time needed to create the central repository as well as the costs for any hardware, software and other materials required? Are there other cost components to creating the central repository the Commission should consider? Is the creation of a central repository as described in the proposed Rule for collection and consolidation of data the most cost effective way to achieve the objective of creation of a consolidated audit trail? Are there other alternatives the Commission should consider? Please describe the costs associated with any alternatives described.

Once the plan sponsors have established the systems necessary for the central repository to receive, consolidate, and retain the required information, the Commission estimates that ongoing annual costs to operate the central repository would be approximately \$100 million,<sup>369</sup> which would be approximately \$6.6 million per year per plan sponsor. The Commission also estimates that each plan sponsor would incur, on average, ongoing costs of \$48,384 per year for

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This estimate includes the estimated costs that each exchange and association would incur for software and hardware costs related to systems development. This cost estimate also would encompass (1) costs related to engaging in an analysis and formal bidding process to choose the plan processor, and (2) any search undertaken to hire a CCO. See proposed Rule 613(a)(3)(i) (the plan sponsors would be required to select a person to act as a plan processor for the central repository no later than two months after the effectiveness of the NMS plan) and 613(b)(5) (the plan sponsors would be required to appoint a CCO to regularly review the operation of the central repository to assure its continued effectiveness in light of market and technological developments, and make any appropriate recommendations for enhancements to the nature of the information collected and the manner in which the information is processed).

<sup>369</sup> See supra Section V.D.1.d. This cost estimate includes ongoing costs for operating the central repository, including the cost of systems and connectivity upgrades or changes necessary to receive, consolidate, and retain and store the reported order information from SROs and their members; the cost, including storage costs, of collecting and maintaining the NBBO and transaction data in a format compatible with the order and event information collected pursuant to the proposed Rule; the cost of monitoring the required validation parameters; the cost of compensating the plan processor; and an ongoing annual cost of \$703,800 to compensate the CCO. See supra note 312.

actions taken to review the operation and administration of the central repository.<sup>370</sup> In addition, the Commission estimates that the central repository would incur an ongoing cost of \$1,370 per year to purchase the NBBO and last sale data feeds from the SIPs.<sup>371</sup>

The Commission request comment on these estimated costs. Does this estimate accurately reflect the cost of storing data in a convenient and usable standard electronic data format that is directly available and searchable, without any manual intervention, for a period of not less than 5 years? Would these costs estimates change if the scope of the consolidated audit trail were expanded to include equity securities that are not NMS securities; corporate bonds, municipal bonds, and asset-backed securities and other debt instruments; credit default swaps, equity swaps, and other security-based swaps? What systems or other changes would be necessary to accommodate these other products? How would those changes impact costs?

## **6. SRO Rule Filings**

The exchanges and FINRA also would be required to file proposed rule changes to implement the provisions of the NMS plan with respect to their members.<sup>372</sup> The Commission notes that the exchanges and FINRA would be able to use the NMS plan as a roadmap to draft the content of their required proposed rule changes. The Commission also notes that the rule filing format and process is not new to the exchanges or to FINRA.<sup>373</sup> The Commission

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<sup>370</sup> Commission staff estimates that annually each exchange and association would expend (64 Attorney hours x \$305 per hour) + (64 Compliance Manager hours x \$258 per hour) + (64 Programmer Analyst hours x \$193 per hour) = \$48,384 to ensure and review the operation and administration of the central repository. See supra note 343 and accompanying text.

<sup>371</sup> See supra Section V.D.1.e.

<sup>372</sup> See proposed Rule 613(g)(1).

<sup>373</sup> The Commission notes that, for its 2009 fiscal year (October 1, 2008 to September 30, 2009), the then existing twelve exchanges and FINRA filed approximately 1,308

estimates that the aggregate cost of each SRO filing a proposed rule change to implement the NMS plan to be approximately \$590,175.<sup>374</sup>

## **7. Expansion of the proposed consolidated audit trail**

The proposed Rule would require the plan sponsors to jointly provide to the Commission a report outlining how the sponsors would incorporate into the consolidated audit trail information with respect to: (1) equity securities that are not NMS securities; (2) debt securities; and (3) primary market transactions in equity securities that are not NMS securities, in NMS stocks, and in debt securities. The sponsors would be required to address, among other things, details for each order and reportable events that they would recommend requiring to be provided; which market participants would be required to provide the data; an implementation schedule; and a cost estimate. Thus, the exchanges and FINRA would need to, among other things, undertake an analysis of technological and computer system acquisitions and upgrades that would be required to incorporate such an expansion. The Commission preliminarily estimates that the one-time cost to the exchanges and FINRA to create and file with the Commission a

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proposed rule changes in the aggregate pursuant to Section 19(b) and Rule 19b-4 thereunder.

<sup>374</sup>

This figure was calculated as follows: (129 Attorney hours x \$305) = \$39,345 x 15 SROs= \$590,175. Commission staff estimates that each exchange and association would expend approximately 129 hours of legal time x \$305 to prepare and file a complex rule change. See Securities Exchange Act Release No. 50486 (October 4, 2004), 69 FR 60287 (October 8, 2004) (File No. S7-18-04). The \$305 per-hour figure for an attorney is from SIFMA's Management & Professional Earnings in the Securities Industry 2008, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead. See Securities Exchange Act Release No. 59748 (April 10, 2009), 74 FR 18042, 18093 (April 20, 2009) (S7-08-09) (noting the Commission's modification to the \$305 per hour figure for an attorney).

report for expanding the scope of the consolidated audit trail would be approximately \$1,751,550 for a one-time cost of \$116,770 per SRO.<sup>375</sup>

Does this estimate accurately reflect the expenses, including SRO staff time and systems analyses, which SROs would incur in preparing the required report? Are there other costs components that should be considered in determining costs associated with preparing the required report? Please provide details on any additional costs that should be considered.

## **8. Other Costs**

Proposed Rule 613 would specifically require, for the receipt or origination of each order, information to be reported to the central repository with respect to the ultimate customer that generates the order. Specifically, members would be required to report to the central repository information about the beneficial owner of the account originating the order and the person exercising investment discretion for the account originating the order, if different from the beneficial owner, and each customer would be identified by a unique customer identifier. Thus, information about "live" orders, as well as overall order and execution information for a particular customer, would be available in the central repository. In recognition of the sensitivity of this data, the proposed Rule requires the NMS Plan 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.

However, a potential cost could be incurred if the security and confidentiality of the information submitted to the central repository is breached, either by malfeasance or accident. In

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<sup>375</sup> Commission staff estimates that each member would expend (200 Attorney hours x \$305 per hour) + (50 Compliance Manager hours x \$258 per hour) + (110 Programmer Analyst hours x \$193 per hour) + (60 Business Analyst hours x \$194 per hour) + (25 Outsourced Legal Counsel hours x \$400 per hour) = \$116,770 to create and file with the Commission a report for expanding the scope of the consolidated audit trail. See supra Section V.D.1.b and note 302.



either case, if identifying information about customers and their trading is made public -- contrary to the expectations and intentions of the customers -- the Commission preliminarily believes that this may have a negative effect on the securities markets. Specifically, investors may be less willing to allocate their capital to the securities markets if their expectation that their personal identifying and trading information will be adequately protected by the central repository is not met. Under these circumstances, there could be a reduction in the capital invested in the markets for NMS securities by investors, to the detriment of the U.S. securities markets overall.

Proposed Rule 613 also would require that the NMS plan include policies and procedures, including standards, for the plan processor to use to ensure the integrity of the information submitted to the central repository. Specifically, the proposed Rule requires that the policies and procedures be designed to ensure the timeliness, accuracy, and completeness of the data provided to the central repository by the exchanges, FINRA and their members, and to require the rejection of data provided if the data does not meet validation parameters, and the retransmission of such data. The Commission notes that, despite such safeguards for ensuring the integrity of the audit trail data, the information submitted by the exchanges, FINRA and their members could be inaccurate, either due to system or human error. If the reliability of the data is compromised, this could reduce the usefulness of the consolidated audit trail data for regulatory purposes.

Are there any other non-tangible costs associated with potential breaches of the integrity or confidentiality of the data required to be submitted to the central repository that the Commission should consider?

## **9. Total Costs**

Based on the assumptions and resulting estimated costs discussed above, the Commission preliminarily estimates the initial aggregate cost the exchanges and FINRA would incur to comply with the proposed Rule, other than costs related to creating and operating the central repository, would be approximately \$231 million,<sup>376</sup> and ongoing aggregate annual costs would be approximately \$77.7 million.<sup>377</sup> In addition, the exchanges and FINRA would incur an initial aggregate cost of approximately \$120 million to set up the central repository,<sup>378</sup> with ongoing annual costs to operate the central repository of approximately \$101 million.<sup>379</sup> For SRO members that would make changes to their own order management and trading systems to comply with the proposed Rule,<sup>380</sup> we estimate the initial aggregate one-time cost for

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<sup>376</sup> This aggregate cost estimate includes the aggregate one-time cost of preparing and filing the NMS plan (\$3,503,100); the aggregate average one-time cost for each exchange and FINRA to synchronize clocks consistent with the proposed requirements (\$144,750); the aggregate average one-time cost for each exchange and FINRA to identify, collect and transmit the consolidated audit trail information to the central repository (\$75 million); the aggregate average one-time cost for each exchange and FINRA to develop and implement surveillance systems, or enhance existing surveillance systems (\$150 million); the aggregate one-time cost for each exchange and FINRA to file proposed rule changes to implement the provisions of the NMS plan with respect to their members (\$590,175); and the aggregate one-time cost to the exchanges and FINRA of jointly providing to the Commission a report outlining how the exchanges and FINRA would expand the scope of the consolidated audit trail (\$1,751,550).

<sup>377</sup> This aggregate cost estimate includes the aggregate average ongoing annual cost to ensure that the plan is up to date and remains in compliance with the proposed Rule (\$725,760); the aggregate average ongoing annual cost to synchronize clocks consistent with industry standards (\$173,700); the aggregate average ongoing annual cost to evaluate the synchronization standards (\$92,880); the aggregate average ongoing annual cost to ensure that each exchange and FINRA is providing information in compliance with the proposed Rule (\$37.5 million); and the aggregate average ongoing annual cost associated with enhanced surveillance (\$39,159,000).

<sup>378</sup> See supra note 368.

<sup>379</sup> See supra notes 369 to 371 and accompanying text.

<sup>380</sup> We preliminarily estimate there are 1,114 of these broker-dealers, including all clearing firms and alternative trading systems. See supra note 320.

implementation of the proposed Rule would be approximately \$3.4 billion<sup>381</sup> and aggregate ongoing annual costs would be approximately \$1.7 billion.<sup>382</sup> For SRO members that are likely to rely on a third party to comply with the proposed Rule (such as their clearing broker),<sup>383</sup> we estimate the initial aggregate one-time cost for implementation of the proposed Rule would be approximately \$287 million<sup>384</sup> and ongoing annual costs would be approximately \$253 million.<sup>385</sup> Therefore, for all SROs and members, we estimate that the total one-time aggregate cost to implement the proposed Rule would be approximately \$4 billion and the total ongoing aggregate annual costs would be approximately \$2.1 billion.

### **C. Request for Comment**

The Commission requests general comment on the costs and benefits of proposed Rule 613 of Regulation NMS discussed above, as well as any costs and benefits not already described

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<sup>381</sup> This aggregate cost estimate includes the aggregate average one-time cost for such members to identify, collect and transmit the consolidated audit trail information to the central repository (\$3,342,000,000); and the aggregate average initial cost for such members to synchronize clocks consistent with the proposed requirements (\$10,750,100).

<sup>382</sup> This aggregate cost estimate includes the aggregate average ongoing annual cost for such members to identify, collect and transmit the consolidated audit trail information to the central repository (\$1,671,000,000); and the aggregate average ongoing annual cost for such members to annually evaluate the synchronization time standards and perform any necessary synchronization adjustments (\$19,798,008).

<sup>383</sup> We preliminarily estimate there are 3,006 of these broker-dealers, mainly including non-clearing broker-dealers. See supra note 327.

<sup>384</sup> This aggregate cost estimate includes the aggregate average initial cost for such members to identify, collect and transmit the consolidated audit trail information to the central repository (\$258,125,220); and the aggregate average initial cost for such members to synchronize clocks consistent with the proposed requirements (\$29,007,900).

<sup>385</sup> This aggregate cost estimate includes the aggregate average ongoing annual cost for such members to identify, collect and transmit the consolidated audit trail information to the central repository (\$199,935,072); and the aggregate average ongoing annual cost for such members to annually evaluate the synchronization time standards and perform any necessary synchronization adjustments (\$53,422,632).

which could result from the proposed Rule. The Commission also requests data to quantify any potential costs or benefits.

The Commission requests comment on what, if any, would be the impact of the proposed Rule on competition among the exchanges and other non-exchange market centers? If commenters believe there would be an impact on competition, please explain and quantify the costs or benefits of such impact. If commenters believe that there would be a cost, what steps could the Commission take to mitigate such costs?

The Commission also requests comment on whether the requirements of the proposed Rule, such as the requirement to provide detailed information to the central repository on a real time basis, would have an impact on any form of legal trading activity engaged in by market participants, or the speed with which trading occurs. For example, would requiring additional information to be attached to an order when the order is routed from one member or exchange to another - such as the unique order identifier - impact the speed with which routing and trading occurs? If not, why not? If so, why? If there would be an impact, do commenters believe that the impact would be negative? Why or why not? Also, would the requirement to provide customer and order information to the central repository in real time impact market participant trading activity? If so, how so? If commenters believe the impact would provide a benefit, please explain and quantify. If commenters believe that the impact would impose a cost, please explain and quantify. For example, would market participants be hesitant to engage in certain legal trading activity because of a concern about providing customer and order information in real time? Would market participants shift their trading activity to products or markets that do not require the capture of customer information to avoid compliance with this requirement of the proposed Rule? If so, how should the Commission address those concerns? Please be specific in

your responses. The Commission requests comment on any other changes to behavior that commenters believe may result from application of the proposed Rule. For example, do commenters believe that the proposal would cause illegal trading activity to shift to products or markets not covered by the proposed Rule? If so, should that impact the scope of the proposed Rule? If so, how so? If not, why not?

## **VII. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation**

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation.<sup>386</sup> In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact such rules would have on competition.<sup>387</sup> Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. As discussed below, the Commission's preliminary view is that the proposed Rule should promote efficiency, competition, and capital formation.

Section 11A(a)(3)(B) of the Exchange Act provides in part that the Commission may, by rule, require SROs to act jointly with respect to matters as to which they share authority under the Exchange Act in regulating a national market system for securities.<sup>388</sup> Proposed Rule 613 would require all national securities exchanges and national securities associations to jointly

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<sup>386</sup> 15 U.S.C. 78c(f).

<sup>387</sup> 15 U.S.C. 78w(a)(2).

<sup>388</sup> See Section 11A(a)(3)(B) of the Exchange Act, 15 U.S.C. 78k-1(a)(3)(B).

submit to the Commission an NMS plan to create, implement, and maintain a consolidated audit trail for NMS securities. Under the proposal, pursuant to the NMS plan, and SRO rules adopted thereunder to implement the plan, national securities exchanges and national securities associations, as well as their members, would be required to provide detailed order and execution data to a central repository to populate a consolidated audit trail.<sup>389</sup>

#### **A. Competition**

The Commission considered the impact of proposed Rule 613 on the national securities exchanges, national securities associations, and their members that trade NMS securities. The Commission begins its consideration of potential competitive impacts with observations of the current structure of the markets for trading NMS securities.

The industry for the trading of NMS securities is a competitive one, with reasonably low barriers to entry and significant competition for order flow. The intensity of competition across trading platforms that trade NMS securities has increased dramatically in the past decade as a result of technological advances and regulatory changes. This increase in competition has resulted in decreases in market concentration, more competition among market centers, a proliferation of trading platforms competing for order flow, and decreases in trading fees.

In addition, the Commission, within the past five years, has approved applications by BATS,<sup>390</sup> Direct Edge,<sup>391</sup> Nasdaq,<sup>392</sup> and C2<sup>393</sup> to become registered as national securities

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<sup>389</sup> See supra Section III.D. for a detailed description of the required data.

<sup>390</sup> See Securities Exchange Act Release No. 58375 (August 18, 2008), 73 FR 49498 (August 21, 2008) (order approving BATS Exchange's application for registration as a national securities exchange).

<sup>391</sup> See Securities Exchange Act Release No. 61698 (March 12, 2010), 75 FR 13151 (March 18, 2010) (order approving EDGA Exchange and EDGX Exchange's applications for registration as national securities exchanges).

exchanges for trading equities, approved proposed rule changes by two existing exchanges – the ISE<sup>394</sup> and CBOE<sup>395</sup> - to add cash equity trading facilities to their existing options business; and approved proposed rule changes by two existing exchanges – Nasdaq and BATS – to add options trading facilities to their existing cash equities business.<sup>396</sup>

The Commission believes that competition among trading venues for NMS stocks has been facilitated by several Commission rules: Rule 611 (the Order Protection Rule), which encourages quote-based competition between market centers; Rule 605, which empowers investors and brokers to compare execution quality statistics across trading venues; and Rule 606, which enables customers to monitor the order routing practices. Similarly, there is rigorous competition among the options exchanges that has been facilitated by regulatory efforts. These include the move to multiple listing,<sup>397</sup> the extension of the Commission’s Quote Rule to options,<sup>398</sup> the prohibition against trading outside of the national best bid and offer,<sup>399</sup> the

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<sup>392</sup> See Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (File No. 10-131) (order approving Nasdaq’s application for registration as a national securities exchange).

<sup>393</sup> See Securities Exchange Act Release No. 61152 (December 10, 2009), 74 FR 66699 (December 16, 2009) (order approving C2 Options Exchange’s application for registration as a national securities exchange).

<sup>394</sup> See Securities Exchange Act Release No. 54528 (September 28, 2006), 71 FR 58650 (October 4, 2006) (order approving rules to govern trading equities).

<sup>395</sup> See Securities Exchange Act Release No. 55389 (March 2, 2007), 72 FR 10575 (March 8, 2007) (order approving CBOE Stock Exchange LLC as a facility of CBOE).

<sup>396</sup> See Securities Exchange Act Release Nos. 57478 (March 12, 2008), 73 FR 14321 (March 18, 2008) (order approving rules governing the trading of options on the Nasdaq Options Market, LLC); and 61419 (January 26, 2010), 75 FR 5157 (February 1, 2010) (order approving rules governing the trading of options on BATS Options Exchange, Inc.).

<sup>397</sup> See Securities Exchange Act Release No. 26870 (May 26, 1989), 54 FR 23963 (June 5, 1989) (S7-25-87).

<sup>398</sup> See Securities Exchange Act Release No. 43591 (November 17, 2000), 65 FR 75439 (December 1, 2000).

adoption of market structures on the floor-based exchanges that permit individual market maker quotations to be reflected in the exchange's quotation,<sup>400</sup> and the Minimum Quoting Increment Pilot Program.<sup>401</sup>

The broker-dealer industry also is a highly competitive industry with low barriers to entry. Most trading activity is concentrated among several dozen large participants, with thousands of small participants competing for niche or regional segments of the market. The reasonably low barriers to entry for broker-dealers are evidenced, for example, by the fact that the average number of new broker-dealers entering the market each year between 2001 and 2008 was 389.<sup>402</sup>

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<sup>399</sup> See Securities Exchange Act Release No. 60405 (July 30, 2009), 74 FR 39362 (August 6, 2009) (approved of Options Order Protection and Locked/Crossed Market Plan).

<sup>400</sup> See, e.g., Securities Exchange Act Release No. 47959 (May 30, 2003), 68 FR 34441, 34442 (June 9, 2003) (SR-CBOE-2002-05) (adopting, among other things, amendments to incorporate firm quote requirements in CBOE's rules).

<sup>401</sup> On January 26, 2007, the then-existing six options exchanges implemented a pilot program to quote certain options series in thirteen classes in one-cent increments ("Minimum Quoting Increment Pilot Program"). Nasdaq became a participant in the Minimum Quoting Increment Pilot Program on March 31, 2008, when it commenced trading on its options platform, and BATS became a participant in the Pilot Program on February 26, 2010, when it commenced trading on BATS Options. Since 2007, the Minimum Quoting Increment Pilot Program has been extended and expanded several times. See, e.g., Securities Exchange Act Release Nos. 56276 (August 17, 2007), 72 FR 47096 (August 22, 2007) (SR-CBOE-2007-98); 56567 (September 27, 2007), 72 FR 56396 (October 3, 2007) (SR-Amex-2007-96); 57579 (March 28, 2008), 73 FR 18587 (April 4, 2008) (SR-Nasdaq-2008-026); 60711 (September 23, 2009), 74 FR 49419 (September 28, 2009) (SR-NYSEArca-2009-44); and 61061 (November 24, 2009), 74 FR 62857 (December 1, 2009) (SR-NYSEArca-2004-44).

<sup>402</sup> This number is based on a Commission staff review of FOCUS Report filings reflecting registered broker-dealers from 2001 through 2008. The number does not include broker-dealers that are delinquent on FOCUS Report filings. New registered broker-dealers for each year during the period from 2001 through 2008 were identified by comparing the unique registration number of each broker-dealer filed for the relevant year to the registration numbers filed for each year between 1995 and the relevant year.



There are approximately 5,178 registered broker-dealers, of which approximately 890 are small broker-dealers.<sup>403</sup> To limit costs and make business more viable, the small participants often contract with bigger participants to handle certain functions, such as clearing and execution, or to update their technology. Larger broker-dealers often enjoy economies of scale over smaller broker-dealers and compete with each other to service the smaller broker-dealers, who are both their competitors and customers.

In the Commission's preliminary judgment, the costs of proposed Rule 613 would not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. In industries characterized by easy entry and intense competition, the viability of some of the competitors may be sensitive to regulatory costs. Nonetheless, the Commission preliminarily believes that the overall marketplace for NMS securities would remain highly competitive, despite the costs associated with implementing proposed new Rule 613, even if those costs influence the entry or exit decisions of some individual broker-dealer firms.

As discussed above in Sections V and VI, the Commission acknowledges that the proposal would entail significant costs of implementation. In particular, requiring national securities exchanges, national securities associations, and their members to capture the required information and provide it to the central repository in a uniform format, in particular information that is not currently captured under the existing audit trail or other regulatory requirements, would likely require significant one-time initial expenses to enhance or modify existing order handling, trading, and other systems. In addition, national securities exchanges and national

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<sup>403</sup> These numbers are based on a review of 2007 and 2008 FOCUS Report filings reflecting registered broker-dealers, and discussions with SRO staff. The number does not include broker-dealers that are delinquent on FOCUS Report filings.

securities associations would need to enhance or create new surveillance procedures to use the consolidated audit trail information. Preliminarily, the Commission does not believe that these implementation expenses would impose an undue burden on competition among SROs or among other market participants. The Commission preliminarily believes that the requirements associated with the proposed Rule are necessary and appropriate, and would apply uniformly to all national securities exchanges, national securities associations and their members, and thus would not result in an undue burden on competition.

As discussed above in Section II, the approach of proposed new Rule 613 would advance the purposes of the Exchange Act in a number of significant ways. The Commission preliminarily believes that proposed Rule 613 should aid each of the exchanges and FINRA in carrying out its statutory obligation to be organized and have the capacity to comply, and enforce compliance by its members, with its rules, and with the federal securities laws, rules, and regulations. Likewise, the Commission believes that proposed Rule 613 should aid the Commission in fulfilling its statutory obligation to oversee the exchanges and associations, and to enforce compliance by the members of exchanges and associations with the respective exchange's or association's rules, and the federal securities laws and regulations. The proposed consolidated audit trail also would aid the Commission in its efforts to limit the manipulation of security prices, and to limit the use of manipulative or deceptive devices in the purchase or sale of a security. By potentially decreasing the opportunities for illegal activity and market manipulation, the proposed Rule should promote fair competition among market participants on the basis of effective regulation. Further, by imposing uniform audit trail requirements on all SROs and their members, and thus removing any incentive to compete based on regulation (or lack thereof), Commission preliminarily believes that the proposed Rule would allow SROs and

their members to more effectively compete on other terms such as the services provided, price, and available liquidity.

Based on the analysis above, the Commission preliminarily believes that the proposal would not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. However, we seek comment on the impact of the proposed Rule on competition. The Commission requests comment on what, if any, would be the impact of the proposed Rule on competition among the exchanges and other non-exchange market centers? If commenters believe there would be an impact on competition, please explain and quantify the costs or benefits of such impact. For example, as noted above, exchanges would have access through the central repository to trading information about their competitors' customers. Do commenters believe that access to this information would have an impact on competition among exchanges? If so, please explain what the potential impact could be, and whether you believe that such impact would be an adverse. If so, please further address what, if any, steps the Commission should take in the proposed Rule to address such concerns.

## **B. Capital Formation**

As discussed above in Section II, proposed Rule 613 is intended to enhance the ability of the SROs and the Commission to more efficiently and in a more timely manner monitor trading in NMS securities across all markets and market participants, which should further the ability of the SROs and the Commission staff to effectively enforce SRO rules and federal securities laws, rules and regulations. For example, the proposed consolidated audit trail would ensure that all orders are tracked from origination to execution or cancellation. Further, the consolidated audit trail would provide information on any modifications or routing decisions made with regard to an order. The Commission preliminarily believes that the proposed audit trail information would

greatly enhance the ability of its staff to effectively monitor and surveil the securities markets. This enhanced ability of the SROs and Commission staff to enforce the federal securities laws, rules, and regulations should help ensure that market participants that engage in fraudulent or manipulative activities are identified more swiftly, which should deter future attempts to do the same. In general, the faster fraudulent or manipulative activity is identified and action is taken, the more likely ill-gotten gains will remain available to pay penalties or compensate victims.

The Commission preliminarily believes that by enhancing the SROs' and the Commission's ability to enforce the federal securities laws, rules and regulations, proposed Rule 613 could help maintain or increase investor confidence in the fairness of the securities markets. Investor confidence may increase as the potential for the detection of illegal activity is increased and the risk of investment loss due to undetected illegal activity decreases. Bolstering investor confidence in the fairness of the securities markets may increase the level of investment, which could promote capital formation to the extent that the increase is allocated efficiently. This would promote capital formation because as capital is better allocated, issuers with the most productive capital needs may be better able to raise capital.

### **C. Efficiency**

Proposed Rule 613 would require the creation and maintenance of a consolidated audit trail, which the Commission preliminarily believes would greatly enhance the ability of SRO staff to effectively monitor and surveil the securities markets, and thus detect illegal activity in a more timely manner, whether on one market or across markets. With an audit trail designed to help the SROs reconstruct and analyze time-sequenced order and trading data, the SROs could more quickly investigate the nature and causes of unusual market movements or trading activity and initiate investigations and take regulatory actions where warranted. An increase in detected

and prosecuted violations of the securities laws, rules, and regulations would likely act as deterrent to future violations. Likewise, the ability of the Commission to better understand unusual market activity, such as during a period of intense volatility, could lead to better oversight, or more focused regulation where warranted, of the causes of such activity. For example, the possibility of more prompt detection of illegal activity would likely deter future abusive or manipulative trading activity from being used to manipulate market prices to artificial levels or by accelerating a declining market in one or several securities. Thus, the Commission preliminarily believes that proposed Rule 613 would help to ensure that markets function efficiently. As a result, the Commission preliminarily believes that the proposed consolidated audit trail would help promote the efficient functioning of markets, which should help enhance the protection of investors and further the public interest.

Further, the Commission preliminarily believes that the proposed Rule, by creating one central repository to which each national securities exchange, national securities association, and their members would be required to provide the same data in the same format, could reduce or eliminate the need for each individual SRO to have its own disparate requirements. Elimination of often inconsistent regulation on members would promote efficiency because members would no longer be required to submit disparate data to multiple regulators pursuant to multiple, and sometimes inconsistent, SRO and Commission rules.

The Commission requests comment on all aspects of this analysis and, in particular, on whether the proposed consolidated audit trail would place a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act, as well as the effect of the proposal on efficiency, competition, and capital formation. The Commission also requests comment on the impact, if any, of the proposed Rule on investors' trading activities. Would the

proposed Rule impact investors' incentives to engage in certain types of legal trading in NMS securities, or other products, on the exchanges or OTC markets that would be subject to the proposed Rule? If so, why, and what impact would that have on the competitiveness of the U.S. markets? Would the proposed Rule impact market participants' incentives to engage in certain types of illegal trading activity in products other than NMS securities or in other markets? If so, how so, and what if any steps should the Commission take to address the expected changes in behavior? Commenters are requested to provide empirical data and other factual support for their views.

### **VIII. Consideration of Impact on the Economy**

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"<sup>404</sup> the Commission must advise the Office of Management and Budget as to whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in: (1) an annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease); (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation.

The Commission requests comment on the potential impact of proposed Rule 613 on the economy on an annual basis, on the costs or prices for consumers or individual industries, and on competition, investment or innovation. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

### **IX. Initial Regulatory Flexibility Act Analysis**

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<sup>404</sup> Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

The Regulatory Flexibility Act (“RFA”)<sup>405</sup> requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. Section 603(a)<sup>406</sup> of the Administrative Procedure Act,<sup>407</sup> as amended by the RFA, generally requires the Commission to undertake a regulatory flexibility analysis of all proposed rules, or proposed rule amendments, to determine the impact of such rulemaking on “small entities.”<sup>408</sup>

Proposed Rule 613 of Regulation NMS would require the national securities exchanges and national securities associations to jointly develop and file with the Commission a NMS plan to implement and maintain a consolidated audit trail. Pursuant to such NMS plan, and rules that would be adopted by the SROs to implement the plan, national securities exchanges and national securities associations, as well as their members, would be required to provide data to a central repository to populate a consolidated audit trail.<sup>409</sup>

#### **A. Reasons for the Proposed Rule**

The Commission preliminarily believes that with today’s electronic, interconnected markets, there is a heightened need for regulators to have efficient access to a more robust and effective cross-market order and execution tracking system. As discussed above, currently many of the national securities exchanges and FINRA have audit trail rules and systems to track information relating to orders received and executed, or otherwise handled, in their respective

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<sup>405</sup> 5 U.S.C. 601 et seq.

<sup>406</sup> 5 U.S.C. 603(a).

<sup>407</sup> 5 U.S.C. 551 et seq.

<sup>408</sup> The Commission has adopted definitions for the term small entity for the purposes of Commission rulemaking in accordance with the RFA. Those definitions, as relevant to this proposed rulemaking, are set forth in Rule 0-10, 17 CFR 240.0-10. See Securities Exchange Act Release No. 18451 (January 28, 1982), 47 FR 5215 (February 4, 1982) (File No. AS-305).

<sup>409</sup> See proposed Rule 613(c) and supra Sections III.B. and III.D.

markets. While the information gathered from these audit trail systems aids the SRO and Commission staff in their regulatory responsibility to surveil for compliance with SRO rules and the federal securities laws and regulations, the Commission preliminarily believes that existing audit trails are limited in their scope and effectiveness in varying ways.<sup>410</sup> In addition, while the SRO and Commission staff also currently receives information about orders and/or trades through the EBS system, Rule 17a-25,<sup>411</sup> and from equity cleared reports, the information is limited, to varying degrees, in detail and scope.<sup>412</sup>

The creation and implementation of a consolidated audit trail, as proposed, would enable regulators to better fulfill their regulatory responsibilities to monitor for and investigate potentially illegal activity in the NMS for securities in a more timely fashion, whether on one market or across markets. A consolidated audit trail also would enhance the ability of the Commission in investigating and preparing market reconstructions, and in understanding the causes of unusual market activity. Further, timely pursuit of potential violations can be important in seeking to freeze and recover any profits received from illegal activity.

## **B. Objectives and Legal Basis**

Each national securities exchange and national securities association must be organized and have the capacity to comply, and enforce compliance by its members, with its rules, and with the federal securities laws, rules, and regulations.<sup>413</sup> Likewise, the Commission oversees the

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<sup>410</sup> See supra Section II.A.

<sup>411</sup> 17 CFR 240.17a-25.

<sup>412</sup> See supra Sections I.A and I.B. for a description of the EBS system, Rule 17a-25, and equity cleared reports.

<sup>413</sup> See, e.g., Sections 6(b)(1), 19(g)(1) and 15A(b)(2) of the Exchange Act, 15 U.S.C. 78(f)(b)(1), 78s(g)(1), and 78o-3(b)(2).



exchanges and associations,<sup>414</sup> and enforces compliance by the members of exchanges and associations with the respective exchange's or association's rules, and the federal securities laws and regulations.<sup>415</sup> The Commission preliminarily believes that the exchanges, FINRA and the Commission itself could more effectively and efficiently fulfill these statutory obligations to oversee and regulate the NMS if the SROs and the Commission had direct access to more robust, and timely, order and execution information across all markets.

The Commission is proposing Rule 613 under the authority set forth in Exchange Act Sections 2, 3(b), 5, 6, 11, 11A, 15, 15A, 17(a) and (b), 19, 23(a), and 36 thereof, 15 U.S.C. 78b, 78c(b), 78e, 78f, 78k-1, 78o, 78o-3, 78q(a) and (b), 78s, 78w(a), and 78mm.

### **C. Small Entities Subject to the Proposed Rule**

#### **1. National Securities Exchanges and National Securities Associations**

The proposed Rule would apply to national securities exchanges registered with the Commission under Section 6 of the Exchange Act and national securities associations registered with the Commission under Section 15A of the Exchange Act. None of the national securities exchanges registered under Section 6 of the Exchange Act or national securities associations registered with the Commission under Section 15A of the Exchange Act that would be subject to the proposed Rule are "small entities" for purposes of the RFA.<sup>416</sup>

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<sup>414</sup> See, e.g., Sections 2, 6(b), 15A(b), and 19(h)(1) of the Exchange Act, 15 U.S.C. 78(b), 15 U.S.C. 78(f)(6), 15 U.S.C. 78o-3(b), and 15 U.S.C. 78(h)(1).

<sup>415</sup> See, e.g., 19(h)(1) of the Exchange Act, 15 U.S.C. 78(h)(1).

<sup>416</sup> See 17 CFR 240.0-10(e). Paragraph (e) of Rule 0-10 states that the term "small business," when referring to an exchange, means any exchange that has been exempted from the reporting requirements of Rule 601 of Regulation NMS, 17 CFR 242.601, and is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined in Rule 0-10. Under this standard, none of the exchanges subject to the proposed Rule is a "small entity" for the purposes of the RFA. FINRA is not a small entity as defined by 13 CFR 121.201.

## **2. Broker-Dealers**

Proposed Rule 613(g) would apply to all broker-dealers that are members of a national securities exchange or national securities association. Commission rules generally define a broker-dealer as a small entity for purposes of the Exchange Act and the Regulatory Flexibility Act if the broker-dealer had a total capital of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared, and it is not affiliated with any person (other than a natural person that is not a small entity).<sup>417</sup>

The Commission estimates that as of December 31, 2008, there were approximately 890 Commission-registered broker-dealers that would be considered small entities for purposes of the statute. Each of these brokers-dealers, assuming that they are all members of one or more national securities exchange or FINRA, would be required to comply with the proposed Rule.

### **D. Reporting, Record Keeping, and Other Compliance Requirements**

Proposed Rule 613(g)(2) would impose new reporting and record keeping requirements on small broker-dealers. While certain elements of order and execution information that such small broker-dealers would be required to collect and submit to the central repository are already required to be maintained by broker-dealers pursuant to Rules 17a-3 and 17a-25 under the Exchange Act or the SRO audit trail rules, the proposed Rule would require the collection of additional information that is not required to be collected under these rules. Further, small broker-dealers would be responsible for complying with the proposed Rule's requirements for reporting to the central repository the required order and transaction data.

The proposed Rule would require that most of the information collected be reported on a real time basis, rather than on an "as requested" basis, and that all required information be

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<sup>417</sup> See 17 CFR 240.0-10(c).

submitted in a uniform format. Accordingly, the Commission preliminarily believes that even those small broker-dealers that already have systems in place for submitting order and transaction information to regulators upon request, or to comply with existing SRO audit trail rules, would need to make modifications to their existing order handling and trading systems to comply with the proposed Rule, or rely on outside vendors to provide a functionality that would provide information to the central repository.

### **E. Duplicative, Overlapping, or Conflicting Federal Rules**

As stated above, broker-dealers are subject to record keeping and reporting requirements under Rules 17a-3 and 17a-25 under the Exchange Act. Rule 17a-3 requires that broker-dealers maintain records that would capture some of the same information required to be collected and submitted pursuant to the proposed Rule.<sup>418</sup> Also, as part of the Commission's existing EBS system, pursuant to Rule 17a-25 under the Exchange Act, the Commission requires registered broker-dealers to keep records of some of the information that would be captured by proposed Rule 613.<sup>419</sup>

However, data collected pursuant to Rules 17a-3 and 17a-25 is limited in scope and is provided to the Commission only upon request. The proposed Rule would require the collection

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<sup>418</sup> See 17 CFR 240.17a-3. Pursuant to Rule 17a-3, broker-dealers are, for example, required to maintain the following information that would be captured by the proposed rule: customer name and address; time an order was received; and price of execution.

<sup>419</sup> See 17 CFR 240.17a-25. Pursuant to Rule 17a-25, broker-dealers are, for example, required to maintain the following information with respect to customer orders that would be captured by the proposed Rule, and provide it to the Commission upon request: date on which the transaction was executed; account number; identifying symbol assigned to the security; transaction price; the number of shares or option contracts traded and whether such transaction was a purchase, sale, or short sale, and if an option transaction, whether such was a call or put option; the clearing house number of such broker or dealer and the clearing house numbers of the brokers or dealers on the opposite side of the transaction; prime broker identifier; the customer's name and address; the customer's tax identification number; and other related account information.

of significantly more information<sup>420</sup> and would require that most of the information about orders and executions be provided to the central repository on a real time basis, not merely be stored and provided upon request. Thus, the Commission preliminarily believes that while these Federal rules overlap with certain requirements of the proposed Rule, the scope and purpose of the proposed Rule is more expansive than what is currently required and will more efficiently provide regulators with the information needed to effectively surveil trading activity across markets.

#### **F. Significant Alternatives**

Pursuant to 3(a) of the RFA, the Commission must consider the following types of alternatives: (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) clarification, consolidation, or simplification of compliance and reporting requirements under the Rule for small entities; (3) the use of performance rather than design standards; and (4) and exemption from coverage of the proposed Rule, or any part thereof, for small entities.

The Commission has considered whether it would more be more cost effective to enhance existing systems to achieve the proposed Rule's objective, rather than create a central repository. For example, the Commission considered expanding the scope of the information

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Such additional information would include: a unique customer identifier for each customer; a unique identifier that would attach to the order at the time the order is received or originated by the member and remain with the order through the process of routing, modification, cancellation, and execution (in whole or in part); a unique identifier of the broker-dealer receiving or originating the order; the unique identifier of the branch office and registered representative receiving or originating the order; the date on which the order is routed; time at which the order is routed (in milliseconds); and if the order is executed, in whole or in part, the account number for any subaccounts to which the execution is allocated; the unique order identifier of any contra-side order(s); and the amount of a commission, if any, paid by the customer, and the unique identifier of the broker-dealer(s) to whom the commission is paid.

collected by existing audit trails, the EBS system, and/or Rule 17a-25, but determined that this approach would not result in the creation of a comprehensive consolidated audit trail. Under such an approach, SROs would still need to check multiple repositories of data to gather information about trading activity occurring across markets. Further, the goal of capturing data in a uniform format would be complicated if data were collected by multiple repositories. In addition, this approach would not resolve concerns over how long it takes to obtain data when it is not available in real time, but only required to be provided upon request. Without the centralization of data in a uniform electronic format, the Commission preliminarily believes that the goals of the proposed Rule could not be achieved.

The Commission preliminarily believes that proposing a new uniform audit trail rule that would apply equally across all SROs and their members would be more efficient and effective than requiring each SRO to separately amend and enhance its existing order audit trail or EBS rules and systems, and amending Rule 17a-25. The scope of the proposed audit trail – requiring each member and SRO to report the same information for each order, for each reportable event, in a uniform format, in real time, across all markets – is fundamentally different than what is collected under existing order audit trails, the EBS system, and Rule 17a-25.

The Commission also has considered allowing certain small broker-dealers to submit certain trading data in a manual, rather than an electronic, format.<sup>421</sup> However, the Commission preliminarily does not believe that the intent and objectives of proposed Rule 613 could be achieved if small broker-dealers are subject to differing compliance or reporting requirements, such as manual reporting of data, or timetables. The Commission preliminarily believes that to be effective the consolidated audit trail should contain order and execution information from all

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<sup>421</sup> See 17a-25 Adopting Release, supra note 20, at 35839–35840.

broker-dealers, including small broker-dealers, in a uniform electronic format. Without this information, the SROs and the Commission would not have a complete and timely cross-market audit trail to utilize in their regulatory oversight of small broker-dealers, their customers, and the securities markets. Further, the Commission preliminarily believes that the timetable contained in the proposed Rule, which would give brokers-dealers two years after effectiveness of the NMS plan to implement the proposed requirements to collect and report the required information to the central repository, would allow small broker-dealers sufficient time to modify existing systems, or procure third party functionality, to comply with the proposed Rule.<sup>422</sup>

Further, the Commission preliminarily believes that it has drafted the proposed Rule to be as straightforward as possible to achieve its objectives. Any simplification, consolidation or clarification of the Rule should occur for all entities, not just small broker-dealers. The Commission does not propose to dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the proposed Rule. However, in order to provide consistent, comparable data to the central repository, the nature of the information collected is a design standard.

The Commission would be able to rely on its exemptive authority under Section 36 of the Exchange Act to grant relief, when necessary, to small broker-dealers from the requirements of the proposed Rule. The Commission preliminarily believes that a wholesale exemption from the proposed Rule for small broker-dealers, however, would make it harder for the Commission and SROs to recognize the anticipated benefits of the consolidated audit trail.

#### **G. Solicitation of Comments**

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<sup>422</sup> See supra notes 326-330 and accompanying text and notes 356-358 and accompanying text.

The Commission invites commenters to address whether the proposed Rule would have a significant economic impact on a substantial number of small entities, and, if so, what would be the nature of any impact on small entities. The Commission requests that commenters provide empirical data to support the extent of such impact.

## **X. Statutory Authority**

Pursuant to the Exchange Act and particularly, Sections 2, 3(b), 5, 6, 11A, 15, 15A, 17(a) and (b), 19, and 23(a) thereof, 15 U.S.C. 78b, 78c(b), 78e, 78f, 78k-1, 78o, 78o-3, 78q(a) and (b), 78s and 78w(a), the Commission proposes Rule 613 of Regulation NMS, as set forth below.

### **Text of Proposed Rule**

#### **List of Subjects in 17 CFR Part 242**

Brokers, Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, Title 17, Chapter II, of the Code of Federal Regulations is proposed to be amended as follows.

### **PART 242 — REGULATIONS M, SHO, ATS, AC, AND NMS AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES**

1. The authority citation for part 242 continues to read as follows:

**Authority:** 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a-23, 80a-29, and 80a-37.

2. Add § 242.613 to read as follows:

#### **§ 242.613 Consolidated Audit Trail.**

- (a) Creation of a National Market System Plan Governing a Consolidated Audit Trail.

- (1) Each national securities exchange and national securities association shall jointly file on or before [90 days from approval of this rule] a national market system plan to govern the

creation, implementation, and maintenance of a consolidated audit trail and central repository as required by this section.

(2) The national market system plan, or any amendment thereto, filed pursuant to this section shall be filed with the Commission pursuant to §242.608.

(3) The national market system plan submitted pursuant to this section shall require each national securities exchange and national securities association to:

(i) By two months after effectiveness of the national market system plan jointly (or under the governance structure described in the plan) select a person to be the plan processor;

(ii) By four months after effectiveness of the national market system plan synchronize their business clocks and by four months after effectiveness of the national market system plan require members of each such exchange and association to synchronize their business clocks in accordance with paragraph (d) of this section;

(iii) By one year after effectiveness of the national market system plan provide to the central repository the data specified in paragraph (c) of this section;

(iv) By fourteen months after effectiveness of the national market system plan implement a new or enhanced surveillance system(s) as required by paragraph (f) of this section; and

(v) By two years after effectiveness of the national market system plan require members of each such exchange and association to provide to the central repository the data specified in paragraph (c) of this section.

(4) Each national securities exchange and national securities association shall be a sponsor of the national market system plan submitted pursuant to this section and approved by the Commission.



(5) No national market system plan filed pursuant to this section, or any amendment thereto, shall become effective unless approved by the Commission or otherwise permitted in accordance with the procedures set forth in §242.608.

(b) Operation and Administration of the National Market System Plan.

(1) The national market system plan submitted pursuant to this section shall include a governance structure to ensure fair representation of the plan sponsors, and administration of the central repository, including the selection of the plan processor.

(2) The national market system plan submitted pursuant to this section shall include a provision addressing the requirements for the admission of new sponsors of the plan and the withdrawal of existing sponsors from the plan.

(3) The national market system plan submitted pursuant to this section shall include a provision addressing the percentage of votes required by the plan sponsors to effectuate amendments to the plan.

(4) The national market system plan submitted pursuant to this section shall include a provision addressing the manner in which the costs of operating the central repository will be allocated among the national securities exchanges and national securities associations that are sponsors of the plan, including a provision addressing the manner in which costs will be allocated to new sponsors to the plan.

(5) The national market system plan submitted pursuant to this section shall require the appointment of a Chief Compliance Officer to regularly review the operation of the central repository to assure its continued effectiveness in light of market and technological developments, and make any appropriate recommendations for enhancements to the nature of the information collected and the manner in which it is processed.

(c) Data Collection.

(1) The national market system plan submitted pursuant to this section shall 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 further documenting the life of the order through the process of routing, modification, cancellation, and execution (in whole or in part) of the order.

(2) The national market system plan submitted pursuant to this section shall require each national securities exchange, national securities association, and member to collect and provide to the central repository the information required by paragraph (c)(7) of this section in a uniform electronic format.

(3) The national market system plan submitted pursuant to this section shall require each national securities exchange, national securities association, and member to collect and provide to the central repository the information required by paragraphs (c)(7)(i) through (v) of this section on a real time basis.

(4) The national market system plan submitted pursuant to this section shall require each national securities exchange, national securities association, and member to collect and provide to the central repository the information required by paragraphs (c)(7)(vi) and (vii) of this section 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 occurred or the national securities exchange, national securities association, or member receives such information.

(5) The national market system plan submitted pursuant to this section shall require each national securities exchange and its members to collect and provide to the central repository

the information required by paragraph (c)(7) of this section for each NMS security registered or listed for trading on such exchange or admitted to unlisted trading privileges on such exchange.

(6) The national market system plan submitted pursuant to this section shall require each national securities association and its members to collect and provide to the central repository the information required by paragraph (c)(7) of this section for each NMS security for which transaction reports are required to be submitted to the association.

(7) The national market system plan submitted pursuant to this section shall require each national securities exchange, national securities association, and any member of such exchange or association to collect and electronically provide to a central repository details for each order and each reportable event, including, but not limited to, the following information:

- (i) For the original receipt or origination of the order:
  - (A) Information of sufficient detail to identify the customer;
  - (B) A unique customer identifier for each customer;
  - (C) Customer account information;
  - (D) A unique identifier that will attach to the order at the time the order is received or originated by the member and remain with the order through the process of routing, modification, cancellation, and execution (in whole or in part);
  - (E) The unique identifier of the broker-dealer receiving or originating the order;
  - (F) The unique identifier of the branch office and registered representative receiving or originating the order;
  - (G) Date of order receipt or origination;
  - (H) Time of order receipt or origination (in milliseconds); and
  - (I) Material terms of the order.

- (ii) For the routing of an order, the following information:
  - (A) The unique order identifier;
  - (B) Date on which the order is routed;
  - (C) Time at which the order is routed (in milliseconds);
  - (D) The unique identifier of the broker-dealer or national securities exchange routing the order;
  - (E) The unique identifier of the broker-dealer or national securities exchange receiving the order;
  - (F) If routed internally at the broker-dealer, the identity and nature of the department or desk to which an order is routed; and
  - (G) Material terms of the order.
- (iii) For the receipt of an order, the following information:
  - (A) The unique order identifier;
  - (B) Date on which the order is received;
  - (C) Time at which the order is received (in milliseconds);
  - (D) The unique order identifier of the broker-dealer or national securities exchange receiving the order;
  - (E) The unique identifier of the broker-dealer or national securities exchange routing the order; and
  - (F) Material terms of the order.
- (iv) If the order is modified or cancelled, the following information:
  - (A) Date the modification or cancellation is received or originated;
  - (B) Time the modification or cancellation is received or originated (in milliseconds);

- (C) Price and remaining size of the order, if modified;
- (D) Other changes in material terms of the order, if modified; and
- (E) Identity of the person giving the modification or cancellation instruction.
- (v) If the order is executed, in whole or in part, the following information:
  - (A) The unique order identifier;
  - (B) Date of execution;
  - (C) Time of execution (in milliseconds);
  - (D) Execution capacity (principal, agency, riskless principal);
  - (E) Execution price and size;
  - (F) The unique identifier of the national securities exchange or broker-dealer

executing the order; and

(G) Whether the execution was reported pursuant to an effective transaction reporting plan or the Options Price Reporting Authority Plan.

(vi) If the order is executed, in whole or in part:

(A) The account number for any subaccounts to which the execution is allocated (in whole or part);

(B) The unique identifier of the clearing broker or prime broker, if applicable;

(C) The unique order identifier of any contra-side order(s);

(D) Special settlement terms, if applicable;

(E) Short sale borrow information and identifier; and

(F) The amount of a commission, if any, paid by the customer, and the unique identifier of the broker-dealer(s) to whom the commission is paid.

(vii) If the execution is cancelled, a cancelled trade indicator.

(8) All plan sponsors and their members shall use the same unique customer identifier and unique broker-dealer identifier for each customer and broker-dealer.

(d) Clock Synchronization. The national market system plan submitted pursuant to this section shall require each national securities exchange, national securities association, and member of such exchange or association subject to this section to:

(1) Synchronize on its business clocks that are used for the purposes of recording the date and time of any reportable event that must be reported pursuant to this section to the time maintained by the National Institute of Standards and Technology, consistent with industry standards; and

(2) Evaluate annually the synchronization standard to determine whether it should be shortened, consistent with changes in industry standards.

(e) Central Repository.

(1) The national market system plan submitted pursuant to this section shall provide for the creation and maintenance of a central repository. Such central repository shall be responsible for the receipt, consolidation, and retention of all data submitted pursuant to this section.

(2) Each national securities exchange, national securities association, and the Commission shall have access to the central repository, including all systems operated by the central repository, and access to and use of the data reported to and consolidated by the central repository under paragraph (c) of this section, for the purpose of performing its respective regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations. The national market system plan submitted pursuant to this section shall provide that such access to and use of such data by each national securities exchange, national securities

association, and the Commission for the purpose of performing its regulatory and oversight responsibilities pursuant to the federal securities laws, rules, and regulations shall not be limited.

(3) The national market system plan submitted pursuant to this section shall include a provision requiring the creation and maintenance by the central repository of a method of access to the consolidated data that includes search and reporting functions.

(4) The national market system plan submitted pursuant to this section shall include policies and procedures, including standards, to be used by the plan processor to:

(i) Ensure the security and confidentiality of all information submitted to the central repository. All plan sponsors and their employees, as well as all employees of the central repository, shall agree to use appropriate safeguards to ensure the confidentiality of such data and shall agree not to use such data for any purpose other than surveillance and regulatory purposes. Nothing in this paragraph (i) shall be construed to prevent a plan sponsor from using the data that it submits to the central repository for regulatory, surveillance, commercial, or other purposes as otherwise permitted by applicable law, rule, or regulation;

(ii) Ensure the timeliness, accuracy, and completeness of the data provided to the central repository pursuant to paragraph (c) of this section;

(iii) Require the rejection of data provided to the central repository pursuant to paragraph (c) of this section that does not meet these validation parameters and the retransmission of corrected data; and

(iv) Ensure the accuracy of the consolidation by the plan processor of the data provided to the central repository pursuant to paragraph (c) of this section.

(5) The national market system plan submitted pursuant to this section shall require the central repository to collect and retain on a current and continuing basis and in a format compatible with the information collected pursuant to paragraph (c)(7) of this section;

(i) The national best bid and national best offer for each NMS security;

(ii) Transaction reports reported pursuant to an effective transaction reporting plan filed with the Commission pursuant to, and meeting the requirements of, §242.601; and

(iii) Last sale reports reported pursuant to the Options Price Reporting Authority Plan filed with the Commission pursuant to, and meeting the requirements of, §242.608.

(6) The national market system plan submitted pursuant to this section shall require the central repository to retain the information collected pursuant to paragraphs (c)(7) and (e)(5) of this section in a convenient and usable standard electronic data format that is directly available and searchable electronically without any manual intervention for a period of not less than five years. The information shall be available immediately, or if immediate availability cannot reasonably and practically be achieved, any search query must begin operating on the data not later than one hour after the search query is made.

(f) Surveillance. Every national securities exchange and national securities association subject to this section shall develop and implement a surveillance system, or enhance existing surveillance systems, reasonably designed to make use of the consolidated information contained in the consolidated audit trail.

(g) Compliance by Members.

(1) Each national securities exchange and national securities association shall file with the Commission pursuant to section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)) and §240.19b-4 on or before [120 days from approval of this rule] a proposed rule change to require



its members to comply with the requirements of this section and the national market system plan submitted pursuant to this section and approved by the Commission of which the national securities exchange or national securities association is a sponsor.

(2) Each member of a national securities exchange or national securities association that is a sponsor of the national market system plan submitted pursuant to this section and approved by the Commission shall collect and submit to the central repository the information required by paragraph (c) of this section and shall comply with the synchronization requirements of paragraph (d) of this section.

(3) The national market system plan submitted pursuant to this section shall include a provision that by subscribing to and submitting the plan to the Commission, each national securities exchange and national securities association that is a sponsor to the plan agrees to enforce compliance by its members with the provisions of the plan.

(4) The national market system plan submitted pursuant to this section shall include a mechanism to ensure compliance with the requirements of the plan by the members of a national securities exchange or national securities association that is a sponsor of the national market system plan submitted pursuant to this section and approved by the Commission.

(h) Compliance by National Securities Exchanges and National Securities Associations.

(1) Each national securities exchange and national securities association shall comply with the provisions of the national market system plan submitted pursuant to this section and approved by the Commission of which it is a sponsor.

(2) Any failure by a national securities exchange or national securities association to comply with the provisions of the national market system plan submitted pursuant to this section

and approved by the Commission of which it is as sponsor shall be considered a violation of this section.

(3) The national market system plan submitted pursuant to this section shall include a mechanism to ensure compliance by the sponsors of the plan with the requirements of the plan.

(i) Other Securities and Other Types of Transactions. The national market system plan submitted pursuant to this section shall include a provision requiring each national securities exchange and national securities association to jointly provide to the Commission within two months after effectiveness of the national market system plan a document outlining how such exchanges and associations would propose to incorporate into the consolidated audit trail information with respect to equity securities that are not NMS securities, debt securities, primary market transactions in NMS stocks, primary market transactions in equity securities that are not NMS securities, and primary market transactions in debt securities, including details for each order and reportable event that would be required to be provided, which market participants would be required to provide the data, an implementation timeline, and a cost estimate.

(j) Definitions.

(1) The term customer shall mean:

(i) The beneficial owner(s) of the account originating the order; and

(ii) The person exercising investment discretion for the account originating the order, if different from the beneficial owner(s);

(2) The term customer account information shall include, but not be limited to, account number, account type, customer type, date account opened, and large trader identifier (if applicable).

(3) The term material terms of the order shall include, but not be limited to, the NMS security symbol, security type, price (if applicable), size (displayed and non-displayed), side (buy/sell), order type; if a sell order, whether the order is long, short, short exempt; if a short sale, the locate identifier, open/close indicator, time in force (if applicable), whether the order is solicited or unsolicited, whether the account has a prior position in the security; if the order is for a listed option, option type (put/call), option symbol or root symbol, underlying symbol, strike price, expiration date, and open/close, and any special handling instructions.

(4) The term order shall mean:

(i) Any order received by a member of a national securities exchange or national securities association from any person;

(ii) Any order originated by a member of a national securities exchange or national securities association; or

(iii) Any bid or offer.

(5) The term reportable event shall include, but not be limited to, the receipt, origination, modification, cancellation, routing, and execution (in whole or in part).

By the Commission.

Elizabeth M. Murphy  
Secretary

May 26, 2010