

August 22, 2023

Ms. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549–1090

Re: 2023 CAT Funding Proposal (File No. 4-698)

Citadel Securities appreciates the opportunity to provide further comments to the Securities and Exchange Commission (the “Commission”) on the CAT Operating Committee’s proposal to impermissibly offload the costs of the Consolidated Audit Trail (“CAT”) onto market participants (the “2023 Funding Proposal”).¹

In our previous letter,² we detailed numerous issues with the proposal and the broader CAT structure. Among others, we identified multiple areas where the CAT Operating Committee would need to either provide additional information or conduct additional analysis before the Commission could assess a proposed methodology for allocating over *a billion dollars* of CAT costs by the end of 2024, and many more billions in perpetuity. In response, the CAT Operating Committee has flatly refused to meet its burden under the Securities Exchange Act of 1934 (the “Exchange Act”), Commission rules, and basic principles of administrative law; instead, it has largely copy-and-pasted stock responses that it has been repeating for several years (including to argue in support of prior funding proposals that were later withdrawn due to being blatantly inconsistent with the Exchange Act).³

More remarkably, the CAT Operating Committee explicitly threatens the Commission that “the financial viability of the CAT is at risk” unless the Commission votes in favor of the 2023 Funding Proposal.⁴ This transparent attempt to coerce the Commission into prematurely opining on a funding proposal that does not meet basic Exchange Act requirements is completely inappropriate. To the extent there is now an emergency, it is one created by the CAT Operating Committee itself, arising from repeated implementation delays, uncontrolled budgets, and a complete refusal to collaboratively engage with the industry. These self-inflicted wounds do not relieve the CAT Operating Committee of its burden to demonstrate that the 2023 Funding Proposal is consistent with the Exchange Act.

Below, we reiterate key questions that the CAT Operating Committee must answer before the Commission can approve the 2023 Funding Proposal.

¹ 88 Fed. Reg. 17086 (Mar. 21, 2023), available at: <https://www.govinfo.gov/content/pkg/FR-2023-03-21/pdf/2023-05690.pdf> (the “2023 Funding Proposal”).

² See Letter from Citadel Securities (July 14, 2023), available at: <https://www.sec.gov/comments/4-698/4698-224499-470142.pdf> (“Citadel Securities July 2023 Letter”).

³ See Letter from CAT Operating Committee Chair (July 28, 2023), available at: <https://www.sec.gov/comments/4-698/4698-237380-495743.pdf> (“CAT July 2023 Response”).

⁴ CAT July 2023 Response at 35.

I. The 2023 Funding Proposal Does Not Equitably Allocate CAT Costs

The 2023 Funding Proposal fails to answer the most basic of questions: **what percentage of the total costs to build and operate CAT will be borne by Industry Members in practice?**

The CAT Operating Committee has portrayed the 2023 Funding Proposal as allocating 67% of CAT costs to Industry Members,⁵ with the remaining 33% split between the exchanges and FINRA. However, the CAT July 2023 Response confirms that this purported allocation is only a façade and does not accurately reflect the total percentage of costs that will be borne by Industry Members. In particular, the exchanges are explicitly reserving the right to pass-on their allocation of CAT costs to Industry Members.⁶ Given that FINRA also plans to pass-on its allocation,⁷ it is now apparent that *100% of the total costs to build and operate CAT may be borne by Industry Members under the 2023 Funding Proposal.*

The CAT Operating Committee's assertion that the ability for exchanges to pass-on their allocation of CAT costs is "beyond the scope" of this filing⁸ is an *admission* that it has "entirely failed to consider an important aspect of the problem."⁹ Determining how CAT costs ultimately will be allocated is fundamental to assessing whether the proposal is consistent with the Exchange Act. For example, many of the arguments in the record are premised on the exchanges and FINRA being responsible for one-third of the total costs.¹⁰ To the extent this is untrue in practice, the filing must be completely reconsidered, taking into account (a) the impact on market efficiency, competition, and capital formation of allocating this magnitude of additional costs to Industry Members, (b) whether such a lopsided allocation is fair and equitable, and (c) the implications for CAT governance and budget control if the firms governing CAT do not have any skin-in-the-game.¹¹ There is simply no basis to conclude that a filing that results in 100% of CAT costs being allocated to Industry Members is lawful.¹² The Commission should send the CAT Operating Committee back to the drawing board.

⁵ The 2023 Funding Proposal defines "Industry Member" as "a member of a national securities exchange or a member of a national securities association." 2023 Funding Proposal at FN 11.

⁶ CAT July 2023 Response at 9.

⁷ See Letter from FINRA (Apr. 11, 2023) at 7, available at: <https://www.sec.gov/comments/4-698/4698-20164063-334005.pdf> ("If the Funding Model is approved by the Commission, FINRA intends to file a rule change to increase member fees simultaneous with the filing of any proposed rule change to effectuate the Funding Model.")

⁸ CAT July 2023 Response at 9.

⁹ *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

¹⁰ See, e.g., CAT July 2023 Response at 26 ("CAT LLC strongly disagrees with the suggestion that the Participants would not be incentivized to control CAT costs **if they are only responsible for one-third of the CAT costs going forward.**") (emphasis added).

¹¹ We note that the CAT Operating Committee argues that requiring the exchanges to fund costs over the approved budget would "create the wrong incentives," but fails to consider the impact on exchange incentives of passing-through 100% of CAT costs to Industry Members. CAT July 2023 Response at 12.

¹² We note that the CAT Operating Committee also has not demonstrated that allocating 67% of CAT costs to Industry Members is lawful, taking into account that Industry Members are *already* bearing nearly all CAT-related costs (including implementation costs). Commission Rule 613 requires the exchanges to take into account "the costs to members of the plan sponsors, initially and on an ongoing basis, for reporting the data required by the national market system plan." §242.613(a)(1)(vii)(B). Instead of complying with this requirement, the CAT Operating

II. The Proposed Allocation Among Industry Members is Inconsistent with the Exchange Act

With respect to the CAT costs directly allocated to Industry Members, the 2023 Funding Proposal contemplates that these costs will be allocated *among Industry Members* based on executed volume (by shares). Setting aside the constitutional problems we previously identified, several key questions remain unanswered.

1. How will the massive CAT costs be divided-up among Industry Members?

In order to assess the proposal's impact on market competition and liquidity, it is necessary to understand how CAT costs will be allocated among Industry Members in practice. The CAT Operating Committee seeks to avoid this important issue by asserting in its response letter that the CAT costs allocated to Industry Members “may be **entirely passed through** to investors, thereby **alleviating Industry Members of any burden** of funding the CAT (emphasis added).”¹³ However, this statement is patently false – as noted in our previous letter, many broker-dealers will be allocated CAT costs based on their proprietary trading activity (including on-exchange market making) and, therefore, these costs cannot be passed through to another firm.

Therefore, at a minimum, the CAT Operating Committee must determine the percentage of total costs allocated to Industry Members that *cannot be passed through to customers* due to transactions arising from proprietary activity.¹⁴ Conducting an analysis of proprietary vs. customer executed volume is critical to accurately assessing how the CAT costs will be divided-up among Industry Members under the proposed allocation methodology, and whether such an allocation methodology is fair, equitable, and not unfairly discriminatory. This analysis is eminently feasible from the CAT data and should also take into account the aggregate costs that will be borne by affiliated entities, as required by the 2016 CAT NMS Plan.¹⁵

The CAT Operating Committee now acknowledges that prior funding proposals “could impose an outsized adverse financial impact on certain Industry Members.”¹⁶ The 2023 Funding Proposal suffers from the same flaw, and the CAT Operating Committee cannot avoid the issue by falsely suggesting that all CAT costs can be simply passed-on to other market participants.¹⁷ In addition, with respect to those CAT costs that theoretically could

Committee seeks to minimize the importance of these implementation costs by inaccurately asserting that broker-dealers “can pass those compliance costs through to their customers.” CAT July 2023 Response at 16.

¹³ CAT July 2023 Response at 8.

¹⁴ For these purposes, we leave aside the market-wide systems build required to achieve such an outcome, as discussed further below.

¹⁵ See Section 11.2(c) of the 2016 CAT NMS Plan (“takes into consideration affiliations between or among CAT Reporters”). 81 Fed. Reg. 84696 (Nov. 23, 2016) at 84701, available at: <https://www.govinfo.gov/content/pkg/FR-2016-11-23/pdf/2016-27919.pdf>.

¹⁶ 2023 Funding Proposal at 17102.

¹⁷ The CAT Operating Committee also argues it is incorrect to suggest the costs will be allocated to a small group of broker dealers since “almost 700” Industry Members will have an obligation to contribute to historical CAT costs.

be passed-on to customers, the proposal must consider the impact on market liquidity and competition of the resulting increase in overall transaction costs.

2. Does the allocation methodology unfairly discriminate against equities market participants?

The CAT Operating Committee attempts to justify the proposed allocation methodology by asserting that “trading activity provides a reasonable proxy for cost burden on the CAT.”¹⁸ However, this unsubstantiated assertion is disputed by at least one member of the CAT Operating Committee, who details that equities trading volume creates “a relatively low burden on CAT, from a cost-generation perspective, compared to other cost drivers, such as options activity.”¹⁹

Therefore, in order to address this apparent discrepancy, the CAT Operating Committee must demonstrate that the proposed allocation methodology does not unfairly discriminate against equities market participants. In particular, the CAT Operating Committee must provide a more detailed breakdown of equities versus options activity in terms of (a) the cost burden on CAT and (b) the proposed allocation of CAT costs to Industry Members. To the extent participants in the equities markets are unduly subsidizing CAT costs arising from options activity, this could have broader impacts on equity market liquidity, competition, and efficiency that must be assessed under the Exchange Act.

3. Does the allocation methodology unfairly discriminate against retail investors?

Allocating CAT costs among Industry Members based on executed shares means that market participants transacting in lower-priced securities will be allocated a larger share of overall costs since they are likely to execute a larger number of total shares. The CAT Operating Committee recognized that unfair and inequitable outcomes can result from this approach (given that there is no suggestion that executing a transaction in a lower-priced security increases the cost burden on CAT). In particular, since many OTC equity securities are priced at less than a dollar, the proposal *reduces actual executed OTC equities share volumes by 99%* before allocating CAT costs.

However, inexplicably, no similar adjustment is made for sub-dollar NMS stocks. In our previous letter, we detailed that approximately 33% of total retail NMS stock trading activity is now in sub-dollar NMS stocks. This means that, under the 2023 Funding Proposal, retail investor transactions will be allocated a disproportionate percentage of total CAT costs simply due to the securities traded. It is arbitrary, capricious, and unfairly

CAT July 2023 Response at 15. But this argument completely ignores the unfairly discriminatory percentage of total costs that will be borne by a small group of broker-dealers (which bears little relation to either the costs incurred by CAT or the envisaged market-wide benefits). According to the data in the 2023 Funding Proposal, 831 of the 1100 Industry Members would pay less than \$100/month for historical CAT costs. 2023 Funding Proposal Exhibit C.

¹⁸ CAT July 2023 Response at 8.

¹⁹ Letter from FINRA (Apr. 11, 2023) at FN 23, available at: <https://www.sec.gov/comments/4-698/4698-20164063-334005.pdf>.

discriminatory for the CAT Operating Committee to significantly adjust executed share volumes for sub-dollar OTC equity securities but not do the same for NMS stocks. At a minimum, the CAT Operating Committee must explain the differential treatment and analyze the impact on retail investors.

4. Why is the allocation methodology exclusively based on executed shares?

The CAT Operating Committee has not explained why CAT costs are proposed to be allocated based on executed *shares*, rather than executed *notional*. Given the issues identified above, executed notional would likely be a fairer and more equitable approach. We note that Section 31 fees are allocated based on executed notional, which is a comparison frequently invoked by the CAT Operating Committee.²⁰

In addition, in our previous letter, we suggested other potential enhancements to make the allocation among Industry Members more fair and equitable, including: (a) minimum and maximum fee levels, (b) appropriate calibrations for liquidity provision, and (c) consideration of additional metrics (e.g. broker-dealer capital). These suggestions were cursorily dismissed by the CAT Operating Committee, with its response letter stating there was no “explanation for how these general suggestions would fit into any funding model.”²¹ However, many of these concepts were *included in prior funding proposals* put forward by the CAT Operating Committee itself. For example, the 2021 funding proposal included both minimum and maximum fee levels and discounts for market making activities.²² The CAT Operating Committee provided detailed reasoning for incorporating these elements at the time, including that (i) a minimum fee ensures “all Industry Members provide a meaningful contribution to the funding of the CAT,”²³ (ii) a maximum fee “serves as a method to institute a cap on fees in order to fairly allocate costs to Industry Members,”²⁴ and (iii) market maker discounts are designed to ensure the allocation does not “disproportionately affect market makers, thereby leading to a reduction in liquidity and market quality.”²⁵ At a minimum, the CAT Operating Committee must explain why it has apparently changed its position on the importance of these elements as part of a fair and equitable funding proposal that is consistent with the Exchange Act.

5. Why are CAT costs allocated to executing brokers?

As noted above, the CAT Operating Committee has repeatedly claimed that Industry Members will pass-through CAT costs to other market participants, such as institutional and retail investors. And yet, the proposed allocation methodology makes it difficult and

²⁰ Cf. *Encino Motorcars, LLC v. Navarro*, 136 S. Ct. 2117, 2120 (2016) (an “unexplained inconsistency” is a “reason for holding” an action to be “arbitrary and capricious”).

²¹ CAT July 2023 Response at 11.

²² Release No. 34-91555 (Apr. 14, 2021) at 3, available at: <https://www.sec.gov/rules/sro/nms/2021/34-91555.pdf>.

²³ *Id.* at 34. According to the data in the 2023 Funding Proposal, 831 of the 1100 Industry Members would pay less than \$100/month for historical CAT costs under the current proposal. 2023 Funding Proposal Exhibit C.

²⁴ *Id.* at 36.

²⁵ *Id.* at 28.

costly to do so, as billing the executing broker (i.e. the last broker-dealer in the order chain) instead of the originating broker (i.e. the first broker-dealer in the order chain) means that the entire industry will be required to build completely new systems to pass-through CAT fees.

Inexplicably, the CAT Operating Committee continues to refuse to amend the proposal to reduce implementation costs for the industry. In its latest response letter, new vague concerns are raised around billing the originating broker, including (a) the impact of broken data linkages and (b) “aggregation/disaggregation complexity.”²⁶ However, there is no sense of the materiality of these concerns, such as the percentage of transactions that suffer from broken data linkages such that the originating broker cannot be properly identified. In addition, the response letter confusingly suggests that “[s]ome of the largest Industry Members are not involved in the origination of orders or originate few orders in relation to their overall market activity.”²⁷ Since the executing broker and the originating broker will be the same firm for proprietary trading activity, it is unclear who or what this statement is referring to.

This back-and-forth highlights more fundamental CAT governance deficiencies. Industry suggestions are cursorily dismissed for unknown reasons with no consideration of overall costs and benefits. Under Commission Rule 613, the CAT Operating Committee should be taking into consideration the implementation costs associated with its decisions.²⁸ Therefore, even if the originating broker model marginally increases the costs for CAT, it should still be pursued if it results in dramatically lower market-wide implementation costs. This is underscored by the fact that industry members may end-up bearing the vast majority (if not all) of the costs incurred by CAT to implement the originating broker model.

At a minimum, the CAT Operating Committee must fully assess the costs and benefits of the executing broker and originating broker models, including (a) the difference in implementation costs for CAT, and (b) the difference in implementation costs for Industry Members. This analysis must be exposed for public comment before proceeding.

III. The CAT Costs Are Not Reasonable

The Exchange Act requires the equitable allocation of *reasonable* fees. The CAT Operating Committee has not provided the necessary information to enable the Commission (or the commenting public) to conclude that the CAT costs to be allocated under the 2023 Funding Proposal are in fact reasonable.

First, the CAT Operating Committee has studiously avoided providing basic information regarding the historical costs they are seeking to allocate to Industry Members under the 2023 Funding Proposal. This even includes the total amount of these costs – while the rule filing refers

²⁶ CAT July 2023 Response at 4.

²⁷ *Id.* at 3.

²⁸ See §242.613(a)(1)(vii)(B).

to \$338 million in historical costs,²⁹ the latest CAT response letter now suddenly refers to \$519 million.³⁰ And it appears the \$519 million figure only covers until the end of 2022. With full CAT implementation not expected until May 31, 2024,³¹ total historical costs may reach nearly *one billion dollars*.

Furthermore, little detail has been provided regarding the nature of these historical costs. Straightforward questions remain unanswered, such as whether Industry Members may be allocated costs relating to (a) the ongoing litigation between the CAT Operating Committee and the Commission, (b) the period when Thesys was Plan Processor (note that while the proposal excludes certain costs from this period, it does not exclude other significant costs incurred prior to the formal engagement of FINRA in Q2 2019), and (c) the repeated filing of funding models that are not consistent with the Exchange Act.

Without knowing the total amount or other basic information regarding the historical costs that the CAT Operating Committee seeks to allocate under the 2023 Funding Proposal, the Commission is unable to conclude that these historical costs are reasonable and cannot accurately assess the impact of the proposed allocation methodology on overall market liquidity, efficiency, and competition. The CAT Operating Committee has made no attempt to assess the market impact of allocating such massive costs to market participants, such as whether trading activity may decline or bid-offer spreads may widen. Instead, it recklessly argues that allocating these massive costs to market participants is not concerning since there are other “transaction-based fees that are higher than these proposed CAT fees.”³² The CAT Operating Committee has not met its burden to demonstrate that the historical costs to be allocated under the 2023 Funding Proposal are permissible under the Exchange Act.

Second, the CAT Operating Committee has not provided any data or estimates regarding the future cost trajectory. Data showing that actual expenses have typically exceeded budgeted amounts by approximately 20%³³ and that overall CAT expenses have increased by an average of 32% each year under the current Plan Processor³⁴ cause significant concern. However, the 2023 Funding Proposal offers no constraint on costs and does not provide the Commission with the necessary information to determine the anticipated cost trajectory and to assess the impact of the proposed allocation methodology (given this trajectory) on overall market liquidity, efficiency, and competition.

It is all the more critical that sufficient information is provided regarding the CAT costs – historical and future – that are to be allocated under the 2023 Funding Proposal, as the CAT Operating Committee has confirmed that all future CAT fee filings will be immediately effective,

²⁹ 2023 Funding Proposal at Exhibit C.

³⁰ CAT July 2023 Response at 18.

³¹ <https://www.catnmsplan.com/announcements/update-cais-compliance-deadlines>.

³² CAT July 2023 Response at 18.

³³ 2023 Funding Proposal at 17090.

³⁴ See Citadel Securities July 2023 Letter at 8.

thereby compelling market participants to comply.³⁵ Furthermore, once a single CAT fee filing is in place, it will automatically continue in perpetuity until it is replaced by another one approved by the Commission.³⁶

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It is clear that urgent action is required to reverse the current trajectory, and to address the governance failures and spiraling costs. In our previous letter, we provided a comprehensive set of constructive recommendations, all of which were cursorily rejected by the CAT Operating Committee.³⁷ It is not tenable for the CAT Operating Committee to continue to operate without effective oversight or adequate transparency and yet seek to offload all of the associated costs onto market participants. These fundamental issues must be addressed, and the current proposal should be denied.

In connection with comprehensively reviewing the current CAT structure, it is critical that the Commission determine why the CAT operating budget is approximately *5 times* the amount estimated by the CAT Operating Committee and the Commission in 2016.³⁸ This includes determining the relative impact of (a) errors/omissions made in the 2016 estimates (e.g. underestimating the number of CAT records required and the associated technology costs), (b) implementation changes made following the approval of the 2016 CAT NMS Plan,³⁹ and (c) increases in market volumes. Such an assessment will inform subsequent policy initiatives designed to dramatically reduce the overall CAT budget and to fairly and equitably allocate the costs associated with a law enforcement tool designed specifically for the Commission's use (which could include the Commission funding CAT through the established Section 31 process).

We thank the Commission for considering our comments.

Please feel free to call the undersigned with any questions regarding these comments.

Respectfully,

/s/ Stephen John Berger

Managing Director

Global Head of Government & Regulatory Policy

³⁵ CAT July 2023 Response at 30.

³⁶ 2023 Funding Proposal at 17114 (“it is critical that a CAT Fee remain in place at all times.”).

³⁷ See CAT July 2023 Response.

³⁸ When approving the 2016 CAT NMS Plan, the Commission estimated that it would cost \$37.5 million to \$65 million to build CAT and that annual operating costs would range from \$36.5 million to \$55 million. 2016 CAT NMS Plan at 84801.

³⁹ See, e.g., Letter from SIFMA and FIF (July 31, 2023), available at: <https://www.sec.gov/comments/4-698/4698-238359-498762.pdf>.