

July 19, 2010

**By e-mail**

Securities and Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549-1090  
[rule-comments@sec.gov](mailto:rule-comments@sec.gov)

Re: File Number S-7-11-10  
Consolidated Audit Trail  
Release No. 34-62174

Ladies and Gentlemen,

Liquidnet, Inc. appreciates the opportunity to comment on the Securities and Exchange Commission's rule proposal for a Consolidated Audit Trail.<sup>1</sup> Liquidnet supports the Commission's proposal to implement a consolidated audit trail.

Some market participants have expressed concern about the cost of implementing a consolidated audit trail. It is important to ensure that the consolidated audit trail is implemented in a cost-efficient manner. Current systems, including FINRA's Order Audit Trail System (OATS) and the NYSE's Order Tracking System, provide much of the functionality proposed for the Consolidated Audit Trail. Utilizing the knowledge and experience obtained from the development and operation of these systems will facilitate the efficient implementation of a consolidated audit trail system.

In the long run, a properly-designed system that provides for centralized reporting of data should be more cost-efficient than the current patchwork system for collecting audit trail data.

- First, a consolidated audit trail system would reduce the time that regulatory personnel must expend to request and collect data from market participants on a case-by-case basis.
- Second, it would reduce the time and resources required by market participants to respond to case-by-case requests for data from regulators.
- Third, we anticipate that the system would provide tools for regulators to efficiently access and search the reported data.
- Fourth, a consolidated audit trail would allow for consolidation of multiple reporting systems such as OATS and the NYSE's Audit Trail System into one system.

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<sup>1</sup> Securities Exchange Act Release No. 34-62174 (May 26, 2010), 75 FR 32556 (June 8, 2010), <http://sec.gov/rules/proposed/2010/34-62174fr.pdf> (accessed July 19, 2010). ("Proposing Release")

- Fifth, a consolidated audit trail would assist the rulemaking process because regulators would have more complete access to data upon which to base rule proposals.
- Sixth, as discussed in more detail below, a consolidated audit trail could achieve the same objectives as the Commission's large trader reporting rule proposal,<sup>2</sup> but in a manner that imposes less of a burden on market participants and their customers.
- Seventh, as noted by the Commission, a consolidated audit trail would reduce the cost of reconstructing, analyzing and reporting on significant market events such as those that occurred on May 6, 2010.

While a consolidated audit trail system will provide significant benefits for regulators engaged in market surveillance activity, the potential implementation costs must be taken into account in determining the appropriate scope of an audit trail system. In particular, we are concerned that there will be significant cost involved in moving from an end-of-day order reporting system, similar to the current OATS reporting system, to a real-time reporting system. Accordingly, we would propose that Phase 1 of a consolidated audit trail project be implemented with end-of-day reporting. As Phase 1 is near completion, regulators would be in a better position to evaluate whether to implement real-time reporting for a subsequent phase of the project.

We are interested to see the comments of other market participants regarding the potential benefits and costs of a consolidated audit trail system. We do not want to suggest that a consolidated audit trail system would be simple to implement, because there will be a number of complicated issues to address. But we believe that a consolidated audit trail system is an objective that can be achieved.

We now respond to the specific topics raised in the rule proposal.

#### **Products and Transactions Covered**

We presume that the audit trail would extend beyond equity trading either as part of an initial phase or a subsequent phase. The events of May 6, 2010 demonstrated how linked together various asset classes are, so it is clear there would be significant advantages in having a system that covers multiple asset classes. On the other hand, it would be important to control the scope of the 1<sup>st</sup> phase of an audit trail project to ensure that it can be completed in a timely and cost-efficient manner.

Since we are engaged in equity trading, our comments below are limited to the proposals with respect to equity trading.

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<sup>2</sup> Securities Exchange Act Release No. 34-61908 (April 14, 2010), 75 FR 21456 (April 23, 2010), <http://sec.gov/rules/proposed/2010/34-61908fr.pdf> (accessed July 19, 2010).

### **Orders and Quotations**

We agree with the Commission that the audit trail should apply to all orders, whether proprietary or customer orders. We recommend that the audit trail be limited to firm orders and quotes. To facilitate efficient implementation of a consolidated audit trail, it is important that there is clarity for market participants as to when reporting is required. The Commission's proposed order definition would appear to provide a clear standard as to when reporting is required.

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

The reporting requirements with respect to orders and executions should apply to all broker-dealers, exchanges and alternative trading systems (ATSs). The order and execution reporting requirements should not apply to entities that do not fall within these categories. Orders placed by non-broker entities would be included as part of the audit trail because non-broker entities would be customers of reporting broker-dealers, exchanges and ATSs.

As discussed in more detail below, while we support a phased approach to this project, we believe that Phase 1 of the project should apply to all broker-dealers, exchanges and ATSs, and not just to exchanges.

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

We would recommend for Phase 1 of the audit trail project that data be submitted on an end-of-day basis. As Phase 1 is near completion, the Commission could evaluate the project and consider whether real-time reporting would be appropriate. Limiting Phase 1 of the project to end-of-day reporting would help ensure that a consolidated audit trail could be implemented in a timely and cost efficient manner.

Of course, trade execution data should continue to be reported to the consolidated tape and be available to the consolidated audit trail on a real-time basis.

### **Customer Information**

Where an investment advisor trades on behalf of one or more account beneficiaries, reporting of customer information for an order should be limited to the person or entity exercising investment discretion for the account or accounts originating the order. At the time an order is placed, an investment advisor would not necessarily have disclosed to the broker-dealer the underlying accounts for which the order has been placed. If a trade is not executed, an investment advisor would not typically provide underlying account information to the broker-dealer.

As discussed in more detail below, it would be more practical to disclose underlying account information in relation to executed trades.

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The Commission identifies concerns regarding the protection of customer information. We agree that this is a significant concern that must be addressed. We have expressed concerns in the past about the potential conflicts inherent in private, for-profit entities acting as quasi-regulatory SROs. The fact that such private, for-profit entities would have access to detailed customer information under the rule proposal is a concern. The appropriate solution to address this specific concern (and other concerns that we have raised about for-profit SROs) is the consolidation of the market surveillance and SRO functions within FINRA, which is a not-for-profit entity.

We also would recommend that the operator of the Central Repository and the SRO's participating in the Central Repository be required to implement security policies, processes and practices that are in alignment with industry best practices for the protection of sensitive information. We would recommend that these policies, processes and practices be audited on an annual basis by a third-party expert. The third-party expert should prepare a written report of its audit findings using SAS70 Type 2 reports as a model. A non-confidential summary of the auditor's report should be made publicly available.

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One alternative identified by the Commission for generating customer identifiers would involve the central repository "assigning a unique customer identifier in response to an input by a member of a customer's social security number or tax identification number."<sup>3</sup> One benefit of such a process is that it would not require the involvement of, or impose administrative burdens on, individuals and entities that are not broker-dealers. Special situations, such as accounts with joint owners, would have to be addressed, but this could be accommodated in several ways (for example, by assigning a distinct customer identifier to joint accounts).

It is an important element of any consolidated audit trail system that any administrative burdens on non-broker-dealer customers be minimized and that any confidentiality concerns of non-broker-dealer customers be addressed. In this regard, it is important that the Commission carefully consider the input and recommendations of institutional and retail investors regarding the most efficient implementation of a customer identification system.

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If the consolidated audit trail were to include reporting of customer information, as proposed, it would appear that all of the objectives of the proposed large trader reporting system could be

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<sup>3</sup> Proposing Release, 75 CFR at 32573.

achieved through the proposed consolidated audit trail system.<sup>4</sup> For example, with a consolidated audit trail system, it would not be necessary for large traders to identify their brokers and broker account numbers on Form 13H because the consolidated audit trail would require broker-dealers to include a customer identifier for every customer order.

Similarly, we would envision that the consolidated audit trail would include customer identifiers and allocations for executed trades. If this information is included in the consolidated audit trail, it would appear that the Commission and SROs could run queries to identify customers with significant trading volume. This would address a potential concern presented by the proposed large trader reporting system that large traders might inadvertently fail to identify themselves.

If a consolidated audit trail were adopted as proposed by the Commission, it would appear that the reporting obligation that would remain with a non-broker-dealer customer would be to identify the trading entities that are within the customer's affiliated group and the entities within the customer's affiliated group that collectively make trading decisions. This would appear to be a more manageable reporting obligation for non-broker-dealer customers than the reporting obligation proposed in the Commission's large trader reporting system.

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The requirements under the rule proposal for reporting of customer information will present some level of complexity. For example, in some cases, investment advisors will delegate investment and trading responsibilities to other investment advisors through a sub-advisor relationship. This sub-advisor relationship would not necessarily be disclosed to the broker-dealer, who might only know the identity of the sub-advisor.

A consolidated audit trail could provide for reporting to identify these types of relationships, but this would appear to impose an additional obligation on non-broker-dealer institutional customers to identify these relationships. It is important that each proposed reporting requirement be evaluated so that the expected benefits of including a particular category of data in the consolidated audit trail are balanced against the expected costs. Reporting of sub-advisor information would appear to be an example of a reporting requirement where the costs would outweigh the benefits. While a consolidated audit trail will help reduce the scope of manual information requests by regulators, it is not feasible to assume that a consolidated audit trail would eliminate the need for such requests. Rather, for each item of data, a determination must be made as to whether the benefits of including such item of data in a consolidated audit trail would outweigh the costs. By implementing a consolidated audit trail in phases, the Commission

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<sup>4</sup> A number of market participants commenting on the large trader reporting proposal suggested this for consideration. See, for example, letter dated June 22, 2010 from Karrie McMillan, General Counsel, Investment Company Institute, <http://sec.gov/comments/s7-10-10/s71010.shtml> (accessed July 19, 2010), p. 12.

could limit the scope of Phase 1 with the knowledge that the scope of a consolidated audit trail system could be expanded in subsequent phases, as appropriate.

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As discussed by the Commission in the proposing release, the Commission also must consider any rules in other jurisdictions that would affect the ability of the Commission, the SROs and other market participants to provide customer information to the consolidated audit trail or to utilize such customer information for the intended purposes.

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

The consolidated audit trail system should assign unique identifiers for exchanges and broker-dealers.

**Receipt or origination of an order**

The proposed rule would require participants to report the material terms of every order. The Commission correctly notes that order types might be hard to classify and that “even an order type with the same title may have a different meaning from one exchange to another.”<sup>5</sup> One approach to evaluating these types of issues would be to look at FIX tags, which are standardized identifiers used by industry participants to record, transmit and receive order, execution and other financial data. To the extent that particular identifiers are used in a standardized manner by all industry participants, reporting of the relevant information to a consolidated audit trail is less challenging; to the extent that identifiers for specific types of information are not used in a standardized manner across the industry, reporting of the data would be more challenging, and it would make sense to exclude the data from Phase 1 of an audit trail project.

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The proposed rule would require that a unique order identifier remain with an order throughout its life and be passed through by all routing entities. We would propose as an alternative the approach currently used in OATS where the initial broker that initiates or receives an order generates an order identifier and passes a routing identifier to a second broker or venue to which it routes the order. Upon receipt of the route, the second broker would generate its own order identifier, but it also must report the routing identifier passed from the first routing broker. If the second broker or venue further routes the order to a third broker or venue, the second broker or venue would provide its own routing identifier to the third broker or venue. The third broker or venue would generate its own new order report in which it would include its own order identifier

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<sup>5</sup> Proposing Release, 75 FR at 32575.

along with the routing identifier passed from the second routing broker. Through the linkage of routing identifiers, market surveillance personnel could retrieve a full audit trail of an order (including all "child" routes) without the duplicative step of passing a unique order identifier throughout the life of an order. OATS provides for the transmission of routing identifiers by market participants to facilitate the linkage of routing events. This approach should be considered for the proposed consolidated audit trail system.

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The Commission requests comment in the proposing release "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 or more orders in a manner that would permit regulators to trace the combined order back to its component orders." This approach would work as long as a linking identifier is included in the reports for each of the orders being combined and the report for the combined order. This linking identifier would serve the same purpose as the routing identifier currently used in the OATS system.

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With regard to the generation of unique order identifiers, we would recommend an approach similar to the approach adopted in OATS where order identifiers are unique by broker by day. We would propose that routing identifiers similarly be unique by broker by day, and the broker receiving a route would have to report the identity of the broker that sent the route along with the routing identifier transmitted to it by the routing broker.

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Because of the importance of obtaining an audit trail of the entire lifecycle of an order, we are not clear as to the benefits of a phased approach for the audit trail project where the reporting obligation in Phase 1 is limited to exchanges. As an alternative, we would support a phased approach applicable to all market participants, where Phase 1 is limited to end-of-day reporting.

### **Routing**

Please refer to our comments in the preceding section.

### **Modification, Cancellation, and Execution**

The Commission's proposals with respect to order modifications, cancellations and executions would facilitate the creation of a comprehensive order audit trail. As in the case of the current OATS system, execution data provided to the consolidated audit trail should identify where the trade was publicly reported and have a common identifier that links the audit trail execution reports for the buy and sell orders to the public trade report.



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

The rule proposal provides for the reporting of sub-accounts to which executions are allocated. This information could be reported by the executing broker, as proposed in the rule proposal. Alternatively, this information could be reported by the applicable clearing firm, as long as the executing broker provides the execution identifier to the clearing firm.

It should be noted that sub-account allocations often are made after multiple executions at different prices are combined into a single average price, so a particular allocation could be associated with multiple executions. This should not be a problem, but it should be taken into account in the design of the audit trail system.

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Instead of an execution report identifying a contra-side order, we propose that the separate execution reports generated for the buyer and seller on a trade share the same execution identifier. This is the approach currently used in OATS.

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As noted above, sub-account information should be associated with executions, rather than orders, because institutions would not typically provide allocation information to a broker unless and until an execution has occurred.

### **Clock Synchronization**

We support the Commission's proposals with respect to clock synchronization, which are similar to the current OATS requirements.

### **Central Repository**

A central repository is an important component of the proposed rule's objective, which is to consolidate audit trail information. As noted above, security concerns of market participants must be addressed, particularly in light of the inherent conflict of for-profit market participants engaging in surveillance of competitor activities. We agree with the Commission's proposal to "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>6</sup>

We agree that the Commission should have access to the central repository and that this information should be shared with the Commodity Futures Trading Commission (CFTC). We would

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<sup>6</sup> Proposing Release, 75 FR at 32581.



not support making this data available to any third-parties other than SROs, the Commission, the CFTC and similar governmental entities engaged in surveillance of the financial markets.

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The costs for establishment and maintenance of the central repository should be shared equitably across all market intermediaries, including brokers, exchanges and alternative trading systems. As an example, the current FINRA membership fee structure provides a method for allocating regulatory costs among FINRA members. Having one SRO for the industry would facilitate an equitable allocation of costs.

Each market intermediary, of course, would bear the costs of compliance with its own reporting obligations.

**Compliance with the NMS Plan**

We have no objection to the proposals in this section.

**Proposed Implementation Schedule**

As discussed above, we would prefer to see a phased approach for the audit trail project where Phase 1 effectively consolidates the function currently performed by current systems, such as OATS and the NYSE's Order Tracking System. We would propose that Phase 1 apply to all market participants.

The main complexity of Phase 1 would be the reporting of non-broker customer information. We anticipate that the Commission and the SRO's will seek input from market participants, including institutional and retail investors, to ensure that any concerns with respect to the reporting process are addressed.

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We would like to thank the Commission for the opportunity to comment on this proposal.

Very truly yours,



Howard Meyerson, General Counsel



Vlad Khandros, Market Structure and Public Policy Analyst