



August 9, 2010

VIA EMAIL

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

**RE: Consolidated Audit Trail
File No. S7-11-10**

Dear Ms. Murphy:

Direct Edge Holdings, LLC¹ ("Direct Edge") welcomes the opportunity to comment on the proposal of the Securities and Exchange Commission (the "Commission") to establish a consolidated audit trail (the "Proposal").² Direct Edge supported the creation of a consolidated audit trail prior to the publication of this Proposal³ and appreciates the Commission's efforts to strengthen market surveillance. We encourage the Commission to continue to solicit the input of the industry and knowledgeable vendors throughout this process to ensure that this undertaking is informed by those with the relevant expertise.

The proposed consolidated audit trail ("CAT") system would significantly enhance the capabilities of regulators to police trading across asset classes; replace existing audit trails and consolidate trading and execution data for the asset classes under the Commission's jurisdiction, including credit default swaps; enable regulators to create a more complete timeline of an order's lifecycle; and facilitate large-scale market reconstructions such as the kind the Commission is currently undertaking with respect to the events that impacted the futures and equities markets on May 6, 2010. Because of CAT's importance and the size of the undertaking, it is critical to establish a proper foundation for its success at the outset. Accordingly, our comments focus on broader issues and less so on specific technical aspects of the Proposal.

¹ Direct Edge is currently the fourth-largest exchange operator for the trading of U.S. equity securities. In July, Direct Edge launched its newly licensed exchanges: EDGA Exchange and EDGX Exchange. More information about Direct Edge is available at www.directedge.com.

² See Consolidated Audit Trail, Exchange Act Rel. No. 62174, 75 Fed. Reg. 32556 (June 8, 2010), *available at* <http://sec.gov/rules/proposed/2010/34-62174.pdf>

³ See Direct Edge Comment Letter, Concept Release on Equity Market Structure (File No. S7-02-10), April 28, 2010.

establish a proper foundation for its success at the outset. Accordingly, our comments focus on broader issues and less so on specific technical aspects of the Proposal.

The breadth and costs associated with the Proposal demands a well-reasoned process for determining technological requirements suited to the dynamics of disparate asset classes. The aim for such an approach should be to ensure the sustainability and adaptability of the CAT system so that in five to ten years CAT need not be re-architected due to inadequate diligence during the planning process. To accomplish this, it is critical that the process be informed at every stage by technical implementation realities. If the process fails to properly scope and analyze the relevant technology variables at the outset, the quality of the final product will suffer.

I. Proposal Process

To ensure proper representation of all affected constituents, the specification process, development, funding, and administration of the CAT system needs to align with the needs and requirements of impacted market participants. As a first step in achieving this alignment, the Commission staff should both form and engage in working groups comprised of representatives from the affected constituents. Further, such working groups should ensure representation by impacted technology staff from the affected constituents. The creation of these groups can commence immediately. Since brokers would be developing and managing the systems that would collect and transmit such information to any CAT system, brokers should be directly engaged throughout the process to ensure their concerns are addressed up front. Key technology vendors should also be engaged as well to offer perspective with respect to the competing variables of technology requirements, timing, and cost. Furthermore, confining these bodies to exchanges and national securities associations would undermine one of the Proposal's goals, which is to expand the scope of the CAT system to all asset classes. It cannot be anticipated that this goal would be served by a body that has no meaningful experience in designing systems for such asset classes.

A working group would work with the Commission to develop a request for proposal (the "RFP") for publication by the Commission. As part of the RFP process, a group should be tasked with prioritizing the timing of those deliverables that can achieve the highest return on investment. This means identifying and implementing deliverables through a phased-in approach, facilitating the industry's gradual adoption of new technologies and ensuring earlier returns on the investment in the CAT system. A phased-in approach would require a balance of flexible, yet progress-oriented milestones that would allow the Commission to reassess the costs and benefits of each proposed phase or deliverable of the CAT system. In this regard, we respectfully urge the Commission to refrain from setting artificial implementation timelines too

deep into the process that risk creating unintended tradeoffs that may negatively impact the quality of the CAT system.

An RFP process would enable the costs and benefits of the Proposal to be identified on an itemized basis early in the process, as well as facilitate consideration of a wider range of technology solutions. Bidders with a successful record for managing similar systems would be weighted more heavily than those without such experience, thus favoring organizations such as FINRA, which administers and provides the technology for OATS and TRACE. Further, leveraging existing systems like COATS, OATS, and TRACE is likely to minimize duplication of data collection, reduce implementation costs and ensure quick progress is made toward completing the Proposal. Such assumptions, however, would need to be validated through an RFP process.

The Commission has broadly defined the scope of the CAT system. It is appropriate to consider the range of options at the outset of such an initiative as the Commission has done in its Proposal and, as part of an RFP process, investigate such options before determining which ones should be pursued, modified or reassessed.

II. Scope of the Proposal

The Proposal would expand upon existing data feeds in at least three respects. First, it would collect order information in real time, instead of by end-of-day submissions as OATS does currently. Second, the Proposal would require the provision of the identity of the underlying customer for each order. Third, the Proposal provides for an integrated data set across various asset classes.

Direct Edge is concerned about the relative value and efficacy of collecting and using real-time data when balanced against integrity and utility concerns. Real-time data may be less reliable than information collected after the validations that come with settling a transaction. Real-time data is also likely to have limited utility with respect to the conduct of surveillance as many reports are dependent on identifying the beneficial owner, which may be impossible to do on a real-time basis. More importantly, expectations have not been defined for what real-time data would be used for or how it would be used.

The provision of a market-wide infrastructure for capturing and collecting a unique customer identifier for every order is a significant project unto itself. The Commission has tried for almost a decade to develop the means of identifying customers who regularly trade

significant volumes.⁴ The comment letters for the Commission's most recent proposal to develop the Large Trader Reporting System detail a number of concerns, such as the fact that executions are often not allocated until after execution has occurred.⁵ They also raise questions about maintaining the confidentiality of the data. Expanding this proposal to all customers would only heighten such concerns, which are currently unresolved.

The Proposal suggests that the exchanges and national securities associations are in the best position to determine the requirements for the CAT system. Yet with respect to underlying customer order data, securities exchanges lack adequate expertise to make appropriate recommendations. Since many investment management firms are not exchange members, they are not within the exchanges' jurisdiction and thus, exchanges have limited experience with their technical issues. In regulating their members, it is more important for exchanges to be able to easily identify brokers on both sides of an execution in away markets as this would significantly improve the exchanges' ability to conduct surveillance across markets.

The Proposal contemplates a system that is flexible enough to incorporate data for "any other products that may come under the Commission's jurisdiction," regardless of how they are traded.⁶ As investors are increasingly trading across asset classes, policing the market requires a comprehensive approach. It is also important to note, however, that most asset-backed securities and other debt instruments, including swap instruments, are not exchange traded. Accordingly, the exchanges and national securities associations have limited experience with many of the asset classes under the Commission's jurisdiction and it is not appropriate for exchanges to be primarily responsible for specifying requirements, developing, funding or administering a system that is supposed to be designed to have such compatibility.

III. Governance & Funding

Direct Edge respectfully recommends that the Commission reconsider the structure and governance of the Proposal. The Proposal envisions the processor of the CAT central data repository as a facility of SROs. Further, each SRO and FINRA would own and share in the start-up costs of the central repository. The Proposal is unique as compared to existing National

⁴ See Large Trader Reporting System, Exchange Act Rel. No. 61908, 75 Fed. Reg. 21456 (Apr. 23, 2010); Large Trader Reporting System, Exchange Act Rel. No. 33608, 59 Fed. Reg. 7917 (April 25, 1994); Large Trader Reporting System, Exchange Act Rel. No. 29593, 56 Fed. Reg. 42550 (Aug., 28, 1991).

⁵ See, e.g., letter from Ann Vlcek, Managing Director, Securities Industry and Financial Markets Association to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated June 24, 2010; letter from Kerrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated June 22, 2010.

⁶ Proposal at 50.

Market System Plans in its suggestion to impose regulatory and financial obligations for exchanges with respect to instruments they do not facilitate trading in.

The Commission should consider the myriad implications of SROs owning the plan processor, such as the unanimous consent that would be required for all board actions and the necessity of joint rulemaking filings for instruments that such SROs may not even facilitate trading in. Direct Edge respectfully recommends that the plan processor be owned by the service provider selected through an RFP process and that such provider fall directly under the Commission's jurisdiction. The plan processor should alone handle rulemaking and compliance, subject to oversight by an industry group. Such a structure would ensure continued engagement by the impacted market constituents.

Lastly, the allocation of up-front and ongoing costs for the plan processor have yet to be fully considered, particularly since the plan processor will not be self-funding. In this regard, the mandate for the industry working group needs to include consideration of how such costs will be funded. Such a determination will need to occur prior to the publication of an RFP.

IV. Conclusion

Direct Edge strongly supports the Commission's efforts to enhance cross-market surveillance, but believes that the proper steps need to be taken early in the process to ensure its success. Direct Edge appreciates the opportunity to comment on the Proposal and is ready to be of service to the Commission as it considers ways to bolster market surveillance.

Very truly yours,



Eric W. Hess
General Counsel

cc: Hon. Mary L. Schapiro, Chairman
Hon. Luis A. Aguilar, Commissioner
Hon. Kathleen L. Casey, Commissioner
Hon. Troy A. Paredes, Commissioner
Hon. Elisse B. Walter, Commissioner
Robert W. Cook, Director of Trading and Markets