



August 9, 2010

Via Email to rule-comments@sec.gov

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

**Re: Comment Letter on Securities Exchange Act Release No. 62174 –
Proposed Rule Regarding a Consolidated Audit Trail (File No. S7-11-
10)**

Dear Ms. Murphy:

The staffs of the Financial Industry Regulatory Authority, Inc., New York Stock Exchange, LLC, NYSE Arca, Inc., and NYSE Amex LLC (collectively, the “SROs”) appreciate this opportunity to comment on the Securities and Exchange Commission (“Commission” or “SEC”) rule proposal¹ on the creation and implementation of a consolidated audit trail, as published in the *Federal Register* on June 8, 2010 (the “Proposal”).²

As an initial matter, the SROs stress that we vigorously support the establishment of a consolidated audit trail. The evolution of the U.S. equity markets and the technological advancements in trading systems that have recently taken place have created an environment where a consolidated audit trail is now essential to ensuring the proper surveillance of the securities markets and maintaining the confidence of investors in those markets.

Due to the scope of the Proposal and the profound effect it would have on the SROs, we have set forth below certain views we hold in common. In the first section

¹ See Securities Exchange Act Release No. 62174 (May 26, 2010), 75 FR 32556 (June 8, 2010) (File No. S7-11-10).

² The comments provided in this letter are solely those of the staffs of the SROs; they have not been reviewed or endorsed by the SROs’ Boards of Governors or Boards of Directors. For ease of reference, this letter may use “we” and “SROs” interchangeably, but these terms all refer only to the SROs’ staffs. This letter is focused on overarching issues raised in the Proposal that will affect all of the SROs. Because of the significant impact and importance of the Proposal, the SROs believe it is critical to submit our comments jointly where we share common views on scope and approach.

below, we discuss the concept of a consolidated audit trail, including the need for such an audit trail. Second, we discuss our view that the Commission is overvaluing the benefits of receiving substantially more audit trail information in real-time. Finally, we explain why we believe the Commission's objectives for a consolidated audit trail can be best achieved in a more timely and efficient manner by utilizing and expanding existing SRO systems and protocols, rather than creating an entirely new system that will take several years to build at considerable cost.

1. The Need for a Consolidated Audit Trail

As noted above, the SROs agree with the Commission's overarching concerns expressed in the Proposal and strongly support a consolidated audit trail. Indeed, many of the SROs have been advocating for the establishment of a consolidated audit trail for years as a way to enhance regulators' ability to conduct surveillance of trading activity across multiple markets.³ Over the past several years, technological and market structure evolution have created a situation where comprehensive intermarket surveillance is essential to ensuring the overall integrity of the equity markets. Particularly since the implementation of Regulation NMS in 2007, there has been a significant increase in market linkages, the result of which is that trading activity on one market can have a profound effect on other markets. This, in turn, has led to the realization that market manipulation, by its very nature, is effectuated cross-market where, for example, trading on one market is used to affect a security's price while trading on another market is used to take advantage of that price change. A similar problem exists when surveilling for compliance with rules that prohibit broker-dealers from trading ahead of a customer order, such as limit order protection rules and frontrunning rules. In these cases, the proprietary trading may be executed on one market while the customer trade is executed on another. In fact, it is very plausible that certain market participants, knowing the extent of current regulatory fragmentation, now consciously spread their trading activity across several markets in an effort to exploit this fragmentation and avoid detection.

As the Commission notes in the Proposal, although each market currently requires that certain transaction-related information be reported, the content, format, and level of detail of the information is subject to wide variation across markets. This lack of uniformity in regulatory data aggravates the regulatory gaps between markets and may also provide incentives for market participants to conduct trading activities on a market where less regulatory data is collected on an automated basis. Moreover, any deficiencies in one aspect of the data—or in a particular data pool—not only compromises the ability

³ See, e.g., Comment Letter from Marcia Asquith, Secretary, FINRA, to Elizabeth Murphy, Secretary, Commission, dated April 23, 2010; Comment Letter from Robert Glauber, Chairman and CEO, NASD, to Jonathan G. Katz, Secretary, Commission, dated March 15, 2005; Comment Letter from Barbara Sweeney, Secretary, NASD, to Jonathan G. Katz, Secretary, Commission, dated June 20, 2003.

of an automated surveillance mechanism to identify potentially suspicious trading activity, but also can result in false positives (i.e., flagging trading activity that may appear suspicious based on a limited data set but, in light of all of the activity occurring, may be entirely proper).

As a result of the recent changes in trading strategies and market structure, and the disparities that exist in audit trail requirements from market to market, no single SRO is able to have a comprehensive picture of all trading activity in the U.S. equity markets, on a product-specific, firm-specific, or under certain circumstances, even an order-specific basis. If regulators are to surveil effectively for illicit trading activity, there must be an ability to obtain a complete view of all trading activity across markets. The current systems in place to achieve effective cross-market surveillance, such as the Intermarket Surveillance Group (“ISG”), are incomplete. For example, the ISG audit trail data has numerous shortcomings, including: (1) it does not capture quotes/orders away from a market’s inside market (i.e., those quotes/orders below the best bid or above the best offer); (2) it currently identifies participants of trades only to the clearing broker level, not down to the executing broker level; (3) data submitted by participants is not validated; (4) certain data fields are not mandatory; and (5) there are no service level agreements in place to ensure that participants submit timely and accurate information.

For all of these reasons, the status quo, where each SRO and the SEC work with limited data sets and rely on ISG audit trail data to attempt to see the “big picture,” is unacceptable. The SROs agree with the Commission that a consolidated audit trail is necessary to identify more readily and more efficiently violative trading behavior that may take place across different markets and products. The current process is fraught with informational gaps and relies on antiquated processes that make surveillance of trading activity across multiple markets unreliable and unnecessarily cumbersome. A consolidated audit trail is needed to ensure that audit trail requirements are uniform across markets and that costs are equitably allocated across market participants. It must also provide for direct and more timely access by the SROs and the SEC to audit trail data. As the Commission noted in the Proposal, the SEC’s and SROs’ inability to timely and efficiently access the patchwork of audit trail data that currently exists creates delays in identifying potential market abuses and creating market reconstructions, such as following the events of May 6, 2010.⁴ Thus, the key aspects necessary to ensuring an effective, comprehensive, and efficient consolidated audit trail are: (1) uniform data (both data format and data content across markets); (2) reliable data; and (3) timely access to the data by SROs and the SEC.

We note that a consolidated audit trail also would be a critical step toward consolidated market surveillance, which is needed to ensure that consistent surveillance patterns and standards are applied to the audit trail data. From a cost standpoint, a

⁴ See 75 FR 32556, 32564, 32567.

consolidated audit trail and consolidated market surveillance should achieve economies of scale that ultimately lower costs for both the markets themselves and the market participants. Rather than each SRO separately maintaining its own surveillance staff and surveillance programs that are searching for the same behavior, and thus creating redundancies, certain technology and staff resources can be consolidated into a single enterprise with costs equitably allocated across all SROs. Such consolidation, of course, would not preclude individual SROs from conducting surveillance for unique attributes and rules of its marketplace, ensuring that specialized market expertise continues to inform surveillance and oversight of trading on that market.

2. The Operation of a Consolidated Audit Trail and Real-Time Market Data

Notwithstanding the SROs' support of a consolidated audit trail, the SROs do not support certain aspects of the overall approach proposed by the SEC. The most fundamental concern the SROs have regarding the reporting requirements set forth in the Proposal is that the Commission is significantly overvaluing the regulatory benefits to be achieved by expanded real-time reporting, particularly in light of the extensive information the Commission has proposed for inclusion in real-time reports. The Commission states in the Proposal that it has preliminarily concluded 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."⁵ Consequently, the Commission concludes 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."⁶ In reaching this conclusion, the SEC has significantly overestimated the incremental utility of real-time data over data received on a T+1 basis. In fact, the costs associated with the breadth of real-time reporting proposed by the Commission would be significant and far outweigh the minimal regulatory benefit gained by such a reporting system.

As an initial matter, much of the information the Commission envisions being reported to the consolidated audit trail may be extremely difficult to provide on a real-time basis and would be of limited regulatory value on a real-time basis. For example, populating a beneficial owner(s) field real-time would prove particularly difficult, if not impossible, because of the need for real-time linking of order data in trading systems. Reporting order information for orders involving firm omnibus, allocation, and/or DVP/RVP accounts on a real-time basis would present significant obstacles, in that orders

⁵ *Id.* at 32567.

⁶ *Id.* at 32572.

reported for these accounts will need to be linked to the accounts on whose behalf trades are being executed. Similarly, a single account may have multiple beneficial owners, such as joint and custody accounts, and the Proposal would seemingly require each of those beneficial owners (as well as the person exercising investment discretion for the account originating the order, if different from the beneficial owner(s)) to be identified on every order.

The realities of order handling also make accurate real-time order reporting problematic. As the Proposal acknowledges, a significant number of orders in today's marketplace are handled in a manner other than on a one-for-one basis. Firms may use separate order management systems to intake orders and obtain executions for such orders, without linking the orders together real-time. For example, batch processing and order splitting occur in both pre-trade and post-trade processes. Firms may receive multiple orders and combine them for order handling purposes or may take large orders, split them into multiple orders, and send them out to multiple market centers. Further, batch and split processing are not mutually exclusive concepts. A single order can be both split and batched during its lifecycle. If a single, batched order represents multiple accounts, and each account has multiple beneficial owners, a single order report quickly becomes a morass of information, and with millions of orders occurring each hour, the sheer quantity of information quickly becomes unwieldy and needlessly takes up significant system capacity.

In addition to the undue expense and significant difficulty of producing real-time order data, much of the information the Commission has proposed to be reported real-time has limited real-time regulatory benefit. The simple truth is that analyzing and fully understanding vast amounts of complex data cannot be achieved on a real-time basis. The key utility of real-time data lies in gathering preliminary investigative information about "what happened" (i.e., conducting preliminary market reconstructions). Real-time data is currently used only for limited regulatory functions, generally to test for compliance with rules such as Regulation M and the trade-through and locked-crossed provisions of Regulation NMS, and for conducting other functions, such as high-level identification of securities experiencing rapid price movements, analyzing clearly erroneous events, and performing preliminary market reconstructions. To detect more complex violative trading activity, particularly manipulative conduct that spans several markets, historical data, non-data elements (e.g., news, economic events, etc.), and other information must be gathered and used to analyze audit trail data. Real-time audit trail data does not, in isolation, identify bad conduct because it lacks necessary information elements that are necessary to place the totality of trading activity in its proper and accurate context. In fact, drawing conclusions based solely on real-time data increases the potential for inaccuracy because the data has not gone through the full range of validations, including the time necessary to permit the inevitable corrections, resubmissions, and inclusions of late reports. Relying on real-time data in an effort to identify and address what may appear to be unlawful trading on a near real-time basis may actually create difficulties and

inefficiencies, as opposed to benefits, because order data may skew analysis and result in “false positives.” Moreover, substantial data validation, analysis, mapping and normalization must be conducted before data can be run through surveillance systems, which steps are only further complicated when data is received from multiple markets.

Although an effective audit trail must provide data in a timely manner so that regulators can respond as quickly as possible to questionable trading activity, market surveillance is most effective once regulators have an accurate and complete picture of trading activity. Consequently, from a market surveillance standpoint, reliable and complete data received on a T+1 basis, for example, is generally superior to unvalidated real-time data and still allows regulators to respond in a timely fashion. Automatic thresholds and trading pauses, such as those recently put into place by the SROs, are a superior way to address large, sudden market fluctuations and stop trading activity based solely on market data. This approach, in addition to being significantly more transparent and objective, is preferable to attempting to determine on a real-time basis whether sudden market fluctuations are a result of abusive trading activity.

Finally, the SROs also are concerned that the proposed real-time data reporting scope and framework, including collection, linking, processing and reporting of order data, could strain resources and ultimately have a deleterious impact on order handling and trading systems, particularly at those times when their proper functioning is most critical. The scope of information the Commission proposes to require be reported real-time could place an enormous and unnecessary strain on the resources and systems of both SROs and firms intra-day, leading to potential inefficiencies and delays in the processing of live customer orders and quotes.

Although, for the reasons described above, the SROs do not support the broad real-time reporting requirements set forth in the Proposal, the SROs share the Commission’s concern about enhancing certain aspects of real-time data and support the use of such requirements where possible and where beneficial. Consequently, we believe the Commission should consider a hybrid approach that enhances elements of the quotation and transaction information reported real-time while collecting and reporting more specific order information on a T+1 basis or later. An alternative to the all-encompassing real-time order audit trail set forth in the Proposal would be to standardize and consolidate existing real-time reporting systems (e.g., enhancing trade reporting and quotation systems with standardized and uniform identification of all broker-dealers) and enhance existing reporting requirements where the need is narrowly-focused. For example, certain types of market participants may present unique risks. Thus, the SEC could require some aspects of order audit trail systems, such as mandating identifiers for certain traders on OATS data, to be reported on a real-time basis to enable the SEC and SROs to do quicker preliminary market reconstructions at a much lower cost. The SROs

believe that an approach that is narrowly focused can be implemented on a real-time basis to achieve the critical goals of the Proposal.⁷

3. Using Existing Systems to Create a Consolidated Audit Trail

In the Proposal, the Commission stated that it has preliminarily concluded that it does not believe “retrofitting” existing rules and systems would be a more effective way to achieve the goals of a consolidated audit trail than the creation and implementation of a new central repository.⁸ The SROs strongly disagree with this preliminary conclusion and believe that existing audit trails should be used as the basis for establishing a consolidated audit trail. These systems, which have been in use for years and operate efficiently and effectively, can be expanded in a way that significantly reduces both the costs associated with establishing a consolidated audit trail and the time needed to move toward a fully consolidated audit trail. Many market participants already have systems in place to comply with existing trade reporting and audit trail requirements such as OATS.⁹ Building off of these systems reduces the cost and time necessary to broaden and standardize the information captured in the audit trail because the programming changes needed to comply with an entirely new system are substantially greater than expanding existing protocols. In fact, FINRA intends to expand OATS to all NMS stocks and believes this expansion can be achieved quickly and efficiently because firms already have the technological infrastructure and reporting protocols in place.

Existing trade reporting and order audit trail systems such as OATS can be modified to achieve many of the SEC’s stated goals more easily, economically, and quickly, and the concerns the Commission has expressed in the Proposal with this approach can be addressed without recourse to developing an entirely new central repository. For example, the Commission states that “[w]ithout centralization of the trading data in a uniform electronic format, . . . the Commission’s goals of cross-market comparability and ready access could not be achieved.”¹⁰ Centralization of trading data

⁷ Although the SROs agree with the SEC’s recent emphasis on enhancing the audit trail with respect to trades by large traders, we believe the Commission should strongly consider implementing only those portions of the large trader proposal that would not be affected by, or be redundant of, the implementation of a consolidated audit trail. *See, e.g.*, SIFMA Comment Letter to Large Trader Proposal.

⁸ *See* 75 FR 32556, 32564.

⁹ Although many market participants have systems in place to comply with existing audit trails such as OATS, not all market centers have similar systems in place. Thus, regardless of the method chosen to implement a consolidated audit trail, market centers will incur some costs and will need time to move to a new system, whether an existing system or an entirely new system.

¹⁰ *Id.*

in a uniform format is, in essence, the very definition of a consolidated audit trail. The SROs agree that such centralization is necessary; however, there is no reason that centralization is not achievable through expanding an existing system and providing all SROs, and the Commission, with access to the chosen system. The other rationale the SEC provides for having an initial preference for the creation of a new central repository is the lack of real-time order information available through existing systems. As discussed at length above, the SROs believe that the Commission's goals could be achieved with a more narrow scope of real-time data, which should not preclude the use of an existing system.

In terms of timing, the SROs believe, based on significant experience in the area of market surveillance and attendant systems, that the timeframe set forth in the Proposal for the implementation of a consolidated audit trail, if created and implemented in the way preliminarily suggested by the Commission, is unrealistic because the SEC has significantly underestimated the time necessary to create and integrate an entirely new system with the capabilities to achieve what the SEC envisions. Consequently, the SROs believe that if the Commission moves forward with its proposed plan in establishing a consolidated audit trail, those goals are likely not to be reached in the timeframe anticipated in the Proposal. However, the SROs contend there is a way to achieve a consolidated audit trail in a more timely manner: building off of existing systems would substantially reduce the amount of time necessary to establish a consolidated audit trail, likely by a factor of years, and would minimize, if not eliminate, the regulatory data gaps that exist today.¹¹

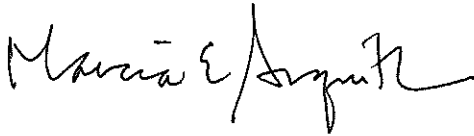
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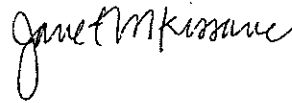
¹¹ Moreover, if the SEC moves forward with mandating the creation of an entirely new system, rather than enhancing existing audit trail requirements, there likely will be negative unintended consequences during this interim development period, which may last several years. It will be difficult to justify any changes or enhancements to existing systems, given the technological challenges and significant resource allocation that will be necessary to devote to developing and implementing a brand new system.

We would welcome the opportunity to discuss the Proposal and our comments with the SEC and its staff. If you have any questions or comments, please do not hesitate to contact either of the undersigned.

Sincerely,



Marcia E. Asquith
Senior Vice President and Corporate
Secretary
FINRA



Janet McGinness Kissane
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cc: Mary L. Schapiro, Chairman
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