



1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

August 9, 2010

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Consolidated Audit Trail (File No. S7-11-10)

Dear Ms. Murphy:

The Investment Company Institute¹ supports efforts by the Securities and Exchange Commission to develop, implement, and maintain a consolidated audit trail (“CAT”) and a central repository for the CAT data for the trading of listed equities and options.² As significant market participants, our members have a strong interest in ensuring that the securities markets are highly competitive, transparent, and efficient, and that the regulatory structure that governs the markets effectively discourages fraud and manipulation.³ A CAT would provide regulators with comprehensive and timely data necessary to assist them in overseeing the markets and ensuring their fair, efficient, and orderly operation. While we support the goals of the Commission’s proposal, as discussed further below, we have significant concerns regarding the confidential treatment of the proposed CAT data, certain costs of the proposal, and the requirement for providing data in real time.

¹The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$11.18 trillion and serve almost 90 million shareholders.

² See SEC Release No. 62174 (May 26, 2010), 75 FR 32555 (June 8, 2010) (“Release”), available at <http://www.sec.gov/rules/proposed/2010/34-62174.pdf>.

³ Investment companies have been among the largest investors in the domestic financial markets for much of the past 20 years. As a whole, they were one of the largest groups of investors in U.S. companies, holding 28 percent of their outstanding stock at year-end 2009. 2010 Investment Company Fact Book, 50th Edition.

I. Confidentiality, Use of CAT Data, and Real Time Reporting

The proposal would require SROs⁴ and their members to provide detailed information regarding an order to the proposed repository on a real time basis, including information sufficient to identify the customer. This information generally would include the customer name, address, and account information.⁵ In addition, the proposal would require that customers be given a unique identifier. Each SRO and the Commission would have unlimited access to this customer information and all other information in the central repository for purposes of performing their regulatory and oversight responsibilities pursuant to federal securities laws, rules, and regulations.⁶ Specifically, the SROs and the Commission would be able to access all systems of the central repository and all data reported to, and assembled by, the repository. The repository would be subject to the Commission's recordkeeping and inspection authority.

We commend the Commission for recognizing in the Release the sensitivity of providing to the proposed repository customer information and information about customers' "live" orders on a real time basis. We are concerned, however, about how this information will be protected. Without confidential treatment, the disclosure or improper use of customer information could have a detrimental impact on a customer's financial condition, its trading activity, and the markets generally.⁷ Most significantly, any misuse of this information can lead to frontrunning of fund trades, adversely impacting the price of the stock that a fund is buying or selling on behalf of its shareholders. The need for confidentiality regarding the information transmitted to the repository extends to staff at the Commission, the SROs, the SROs' members, and the repository. The information must be used solely for the regulatory purposes described in the proposal. Indeed, we would oppose the adoption of the proposal if the Commission does not strengthen the confidentiality provisions. Several recommendations on how to improve the security of customer information follow.

⁴ Throughout the letter, we use the term "SROs" to refer collectively to the Financial Industry Regulatory Authority and the national securities exchanges.

⁵ Account information would be defined as, at a minimum, the account number, account type, customer type, the date the account was opened, and the large trader identifier (if applicable).

⁶ According to the Release, an SRO would not be prohibited from using the data that it individually collects and provides to the repository for other purposes as permitted by applicable law, rule, or regulation. We question whether an SRO should be permitted to charge for resale and packaging of customer data when the production of that data is mandated by the Commission for regulatory purposes.

⁷ As we have stated in numerous letters to the Commission, the confidentiality of information about fund trades is of significant importance to Institute members. *See, e.g.*, Letters from Paul Schott Stevens, President, Investment Company Institute, to Christopher Cox, Chairman, Securities and Exchange Commission, dated September 14, 2005, August 29, 2006, and September 19, 2008 and Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated April 21, 2010.

First, we recommend that the Commission specifically set forth who would have access to the CAT data, when they could access it, and how they could use it.⁸ We believe that the confidential nature of the information supports limiting access to the CAT data to regulators and repository staff.

Second, we recommend that the Commission require that all of the data sent to the proposed repository be encrypted. It is our belief that an encryption program would be a significant step to ensuring the security of the trade information and customer identity for the limited regulatory purposes stated in the proposal. In addition to encryption, we recommend that the Commission consider a requirement to mask certain data fields or delay reporting of CAT information to the end of the day. As discussed below, the CAT data usually will not be needed on a real time basis. Further, by moving the time of reporting further away from the time of execution, end-of-day reporting would help to address concerns regarding information leakage and the use of the CAT data for frontrunning and other illegal purposes.

Third, we recommend that the Commission and each SRO adopt a comprehensive and robust information security program related to the CAT; the security program and protocols must be frequently updated to ensure their value.⁹ As part of such a program, we recommend that information barriers be established within the Commission and SROs to ensure that the CAT data is used only for regulatory purposes. In addition, there should be an audit trail of the Commission's and SROs' staff access to, and use of, information in the repository to help monitor compliance with appropriate use of the data.¹⁰ We believe that the more people who touch the information, the greater chance for its disclosure or misuse.

⁸ In addition to the Commission identifying who may have access to the data, we believe the systems that hold the data must validate identity and authorization of the user. It is not sufficient to merely be an "authorized user."

⁹ The Commission also should ensure that it, the SROs, and the repository have business continuity plans that include the systems and operations of the CAT and the repository.

¹⁰ This is particularly important given the flow of employees between the regulators and the industry. Moreover, we note that the Commission has had problems with data security. The Commission has been criticized by the U.S. Government Accountability Office for its "significant deficiencies" in its information controls and the Commission's Office of Inspector General has published a report concluding that the Commission does not have effective accountability over laptop computers. This is of troubling concern because the Commission would be privy to this nonpublic and sensitive market data. See *Financial Audit, Securities and Exchange Commission's Financial Statements for Fiscal Years 2007 and 2006* (GAO-08-167) (November 2007) and *Control Over Laptops*, SEC Office of Inspector General (Inspection Report No. 441, March 31, 2008). See, also, *Data Security Vulnerabilities*, SEC Office of Inspector General (Inspection Report No. 477, March 1, 2010). We note that Chairman Schapiro recently testified that the Commission has begun multi-year investments to strengthen the security of its systems, and is committed to taking the steps necessary over the long term to build strong controls. *Oversight of the U.S. Securities and Exchange Commission: Evaluating Present Reforms and Future Challenges*, Testimony by Mary L. Schapiro, Chairman, Securities and Exchange Commission, before the United States House of Representatives Committee on Financial Services Subcommittee on Capital Markets, Insurance and

Fourth, to the extent any person is able to inappropriately access nonpublic information held by the staff at the Commission, SROs, or the proposed repository, we recommend that the Commission, SROs, and repository should have an express legal duty to notify immediately each customer whose nonpublic information may have been accessed. Such notice would enable the customer to take whatever action it deems warranted to address or mitigate potential misuse of the information. To assist the SROs and the proposed repository in quickly identifying instances of security breaches, we recommend that the Commission regularly examine the SROs and the repository, and consider enforcement actions, for failures to comply with their stated policies and procedures to ensure the security and confidentiality of all information submitted to, and maintained by, the repository.

Fifth, we request that the Commission explain how it intends to respond to requests under the Freedom of Information Act ("FOIA") for CAT data within its possession. FOIA Exemption 4 provides an exemption for "trade secrets and commercial or financial information obtained from a person and privileged or confidential." FOIA Exemption 8 provides an exemption for matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." We recommend that the Commission specifically state its intention to exercise its authority to withhold from the public CAT data under these, or other, relevant exemptions.

II. Costs of CAT Proposal and Real Time Reporting

The Commission has acknowledged that the cost of the CAT proposal would be significant, *i.e.*, estimated in the Release at \$4 billion. Accordingly, while we support the concept of a CAT, we question whether there is a less costly means to achieve a CAT than the Commission's proposal (*e.g.*, consolidation of FINRA's OATS with the New York Stock Exchange's OATS and the options industry COATS). We are particularly concerned that the hefty costs of the proposal would be passed to customers. We urge the Commission to be cognizant of this possibility as it considers the costs and burdens of adopting the CAT as proposed.

One opportunity for the Commission to reduce costs as well as concerns regarding the confidentiality of CAT data exists with respect to the proposed requirement for real time reporting of customer and trade information to the CAT. Real time reporting would be extremely expensive and difficult for SROs and broker-dealers to implement because their technology and routing systems would have to be much more robust to capture and relay information as it happens. In addition, we understand that real time reporting would require a complete rewrite of broker-dealer systems, because the data that would be required under the

CAT proposal is not captured currently by the same systems that would transmit the data to a central repository or the SROs. Real time reporting also would amplify concerns related to information leakage, as discussed above.

Importantly, real time reporting to the CAT would be unnecessary because CAT data typically would not be used in real time. For example, the Release states that the Commission and SROs could use the CAT data to review patterns of trading activity. A pattern of trading activity only would appear over the course of several days. Thus, a review would require all of the data for multiple days, and could be accomplished by analyzing data provided at the end of the day for each of those days. Similarly, reviews for trading patterns or manipulative conduct would require regulators to review trades in the futures markets. This information would not be available through the CAT and is not available on a real time basis. Consequently, these reviews also would have to wait until the end of the day and could use CAT data that was produced at the end of the day. Finally, additional data necessary to complete a surveillance or market reconstruction picture, such as information related to subaccounts, the clearing or prime broker, and short sale borrow information, would not be available until midnight of the day that the reportable trading occurs.

We recommend that the Commission implement end-of-day reporting to better balance the costs and burdens of developing and implementing the CAT¹¹ and reduce concerns regarding the confidentiality of reported information. To accommodate regulatory needs, however, the Commission could consider employing real time reporting in limited circumstances to report certain critical items that present a legitimate need for instant access. If the Commission determines to require real time reporting only in certain circumstances, we recommend that the Commission specifically identify those circumstances.

III. Proposed Definition of “Customer” and Real Time Reporting

The proposal would require, for the receipt and origination of each order, information to be reported with respect to the customer that generates the order. Specifically, “customer” would be defined, solely for the purposes of the CAT proposal, to mean 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.¹² In the Release, the Commission explains that it is defining customer in this way because, currently, “additional steps are required to identify the beneficial account holder, such as when the ‘customer’ is an omnibus account” or “due to the common practice for large traders to route their orders

¹¹ Batch reporting is significantly less expensive and difficult to implement than real time reporting.

¹² We request that the Commission clarify the term “beneficial owner” for purposes of the proposal. Although the Release indicates that the customer would be a mutual fund and not individual fund shareholders, the use of the term “beneficial owner” could be interpreted otherwise. Any interpretation that required greater granularity of reporting would create tremendous operational problems for the fund industry in complying with the proposal.

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.”

Complying with the proposed definition of “customer” for purposes of real time reporting under the proposed CAT would not eliminate the operational difficulties associated with identifying the beneficial account holder in these or other similar circumstances. It would, however, have the likely unintended consequence of limiting these practices – practices that are employed, among other reasons, for efficiency, fairness, and price savings for the customer. To avoid this outcome, we recommend that the Commission adopt end-of-day reporting to ease the systems challenges of identifying beneficial account holders in real time and preserve industry practices that have developed to capitalize on economies of scale for customers.

For example, asset managers typically supply only omnibus account information for orders that are combined. Final allocation to the account level is performed at the end of the transaction period so that the asset manager may effectively determine the correct pro-rata allocation to each account to ensure fairness. In contrast, many non-U.S. countries that have required account identifiers on each order’s submission have had to implement strict time and price queuing rules at each exchange, with the result that one account may receive preference over another depending on the timing and amount of executions versus orders. In the United States, it is difficult to see how, if every order has to be submitted at the account level, fills can occur in a way that preserves the basic tenant of fair allocation to multiple accounts.

IV. Overlap with Large Trader Reporting Proposal

Shortly before issuing the proposal to develop and implement a CAT, the Commission proposed the creation of a large trader reporting system (“LTR system”).¹³ The Institute supported the concept of creating a LTR system for some of the same reasons it supports developing a CAT – to improve the availability of market information to the Commission as a means to monitoring the markets, conducting trading analyses, and improving the transparency surrounding current trading practices and market participants.¹⁴ At that time, the Institute voiced concerns, however, with the costs and burdens that would be imposed on investment advisers to registered investment companies under the Commission’s proposed LTR system. The Institute explained that these costs and burdens would be magnified if the Commission also pursued its CAT proposal, and suggested that the Commission harmonize the regulatory reporting requirements where possible to minimize duplicative reporting and eliminate unwarranted costs.

¹³ See SEC Release No. 61908 (April 14, 2010), 75 FR 21456 (April 23, 2010).

¹⁴ See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated June 22, 2010.

Ms. Elizabeth M. Murphy

August 9, 2010

Page 7 of 8

As the Commission considers both of these proposals, we continue to recommend that it eliminate redundancies between the proposals, adopting provisions that produce a single source for each data element necessary to produce a comprehensive CAT.¹⁵ Furthermore, if a CAT is developed, the Commission could obtain reasonably soon the information it needs to fulfill its regulatory responsibilities without imposing undue regulatory burdens on market participants by relying on existing reporting systems and filling in the most important gaps, such as the identity of large traders.¹⁶

* * * * *

If you have any questions on our comment letter, please feel free to contact me directly at (202) 326-5815, Heather Traeger at (202) 326-5920 or Ari Burstein at (202) 371-5408.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

cc: The Honorable Mary L. Schapiro
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes

Robert W. Cook, Director
James Brigagliano, Deputy Director
Division of Trading and Markets

¹⁵ As we previously noted, the only data element from the proposed LTR system that would not be readily available through a CAT would be the identity of a large trader. The Commission's CAT proposal would capture this information by requiring that the large trader identifier be reported to the central repository as part of the identifying customer information. *Id.*

¹⁶ In an effort to balance the needs of the Commission to obtain market information and the burdens and costs of producing market information, we previously recommended that the Commission amend its proposal to establish a LTR system by requiring large traders to: (1) identify themselves to the Commission; (2) provide their identifier (as assigned by the Commission) to broker-dealers that execute transactions on their behalf; and (3) provide the Commission with additional information upon request. We recommended that the Commission eliminate its proposed requirements for large traders to report account information and make quarterly filings. *Id.*

Ms. Elizabeth M. Murphy

August 9, 2010

Page 8 of 8

Andrew J. Donohue, Director
Division of Investment Management
U.S. Securities and Exchange Commission