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Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

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

Dear Ms. Murphy:

The Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") is submitting this comment letter on the proposal ("Proposal") by the Securities and Exchange Commission ("SEC" or "Commission") to require the U.S. self-regulatory organizations ("SROs") to act jointly in developing a national market system plan to develop, implement, and maintain a consolidated order audit trail ("CAT") for national market system ("NMS") securities.¹ As discussed in more detail below, CBOE supports the development of a national, consolidated audit trail for stocks and options. We believe that the SROs, in coordination with the SEC, can construct a highly useful tool for surveillance, enforcement, and market reconstructions. At the same time, we are mindful of the high costs that may be involved in a state-of-the-art system, and believe that a CAT can be constructed in a less expensive and burdensome manner than proposed while achieving all the aims the SEC is seeking. Our detailed comments are below.

Summary of the Proposal

The SEC has proposed that the SROs, including the national securities exchanges and the Financial Industry Regulatory Authority ("FINRA"), develop an NMS plan for a consolidated order tracking system. The Commission believes that, with today's speedy, electronic, and interconnected markets, there is a heightened need for a single uniform electronic cross-market order and execution tracking system. The Proposal would have the SROs jointly submit an NMS plan for a CAT to the Commission within 90 days, with one year thereafter for the SROs to

¹ Securities Exchange Act Release No. 62174 (May 26, 2010), 75 FR 32556 (June 8, 2010).

develop the system and another year for broker-dealers to be ready to submit data to the system. The system would capture certain information about each order for an NMS security,² including the identity of the customer placing the order (through a unique customer identifier) and an identifier unique to each order, and would track the order from receipt through the routing, modification, and cancellation or execution of the order. The information would be captured in real time and be sent by SROs or their members to a central repository. The orders included in the CAT would be agency orders, proprietary orders, and any bid or offer quote. SROs would have one year from effectiveness of the NMS plan to begin submitting required data to the central repository and broker-dealers would have to do so within two years. SROs would each have to develop or enhance surveillance procedures to make use of the information contained in the CAT.

Comments on the Proposal

CBOE recognizes there are potential benefits to be obtained from a CAT, and agrees that a central repository with uniform data submitted from all markets could enhance SRO and SEC oversight of the markets. In that sense, we support the implementation of a CAT. In particular, a CAT that contains a customer identifier on an order by order basis would enhance significantly the audit trails of the markets. Moreover, uniformity in data captured by markets and submitted to a central repository would result in a highly useful market surveillance tool in today's electronic, high-speed, linked markets. We do, however, have issues with the breadth, expense, and timetable of the Proposal, and believe that a CAT can be constructed in a simpler manner than proposed while providing all of the major benefits envisioned by the Commission. The remainder of this letter explains how this can be achieved.

Our first concern relates to the expense of the Proposal. There is no doubt in our mind that the CAT described in the Proposal would be extraordinarily expensive to build and maintain and would impose substantial costs on SROs and broker-dealers. There is also no doubt that these costs would be passed on from SROs to their members/participants and from broker-dealers to customers. These costs would not be trivial for investors and users of the securities markets. There are easy ways to reduce these costs. First, a CAT could be constructed by leveraging existing SRO experience with audit trail systems and imposing uniformity across markets in these systems. Specifically, the SEC could require all equity markets to have the same Order Audit Trail System- ("OATS") like requirements, similar to FINRA, and combine that with the existing Consolidated Options Audit Trail System- ("COATS") like requirements, which all options markets already have in place. With respect to the options exchanges in particular, uniform COATS rules have already been adopted by all options exchanges, who support the systems that allow their members to comply with COATS. COATS begins tracking at the point when an order is systematized on an exchange and documents the life of an order

² An NMS security is defined in Rule 600 of the Securities Exchange Act of 1934 to include all listed stocks and all listed options.

through the process of execution, partial execution or cancellation. Among other things, COATS provides that each option exchange synchronize its trading supporting electronic system time clock with all other option exchanges, subject to requirements. COATS reports include merged files that contain order, quote (top of market quote only) and transaction data. COATS contains the primary data elements of the proposed CAT except for customer id and routing broker information.³

We are not proposing to adopt the current COATS or OATS formats and layouts as the CAT standard. However, we believe a new audit trail could be developed that leverages off the SROs' collective experience in working with COATS, OATS and other audit trails. A new, enhanced CAT, which could prescribe common formats and layouts and could incorporate customer and routing broker information or equivalent information, could be designed during the development phase of the NMS plan. The CAT would reflect a uniform standard for all SROs. The existing COATS currently in use by the options exchanges, existing OATS in use by FINRA, and other existing audit trails in use by SROs could each be revised by the respective SRO to conform to the new formats and layouts. Each also could be revised by the respective SRO to allow equity and options audit trails to be readily consolidated through the CAT. We believe that allowing each SRO to enhance their existing audit trail infrastructures to conform to the new standard would result in a system that produces all of the information needed for surveillance, enforcement, and market reconstruction in the most efficient and cost-effective manner. In this regard, the Commission should follow the adage of not letting the perfect be the enemy of the good.

To be clear, how the audit trail formats and layouts are ultimately designed is a separate question from how the SROs will jointly construct and operate the CAT. In addition, it is a separate question from how each SRO will develop or enhance existing surveillance systems to make use of the consolidated information. The introduction of a CAT as another surveillance and oversight tool for the SROs and SEC should not be viewed as a step toward making radical changes to the way in which self-regulation operates or somehow mandating the consolidation of market surveillance functions. The existing model of multiple SROs, each responsible for regulating its own market, has for the most part well served the objective of sound regulation. This model has permitted the specialized knowledge that each SRO has concerning its own

³ Today, in addition to COATS, the options exchanges also have various other consolidated options data tools and resources at their disposal to obtain customer id and routing broker information. For example, this includes but is not limited to the Large Option Position Reporting system ("LOPR"). Through LOPR, which is the option industry version of a "large trader" report, the options exchanges and FINRA require firms to file a report to identify each aggregate same side of the market position that exceeds a threshold number of option contracts (200 for the vast majority of products). To the extent necessary, if at all, more detailed customer id and routing broker information can also be obtained through electronic blue sheeting and other sources.

unique rules and procedures to be brought to bear to the regulation of its market. 0It also fosters competition in the development of new, more efficient, regulatory systems, which also benefits the overall quality of regulation. While it may make sense for SROs to agree to have a single entity conduct surveillance for certain types of conduct or for one SRO to contract with another SRO to perform a surveillance function, such as through 17d-2 or regulatory services agreements, we believe that the best answer is not to delegate market regulation to a sole or “single member” self-regulator.

Second, we have real doubts about the need to have the information submitted to the central repository in real time. While the Proposal would require real time reporting, it contains little or no explanation of the particular benefits anticipated through real time reporting or analysis of the value of those perceived benefits versus the associated costs. Without knowing the particular objective, it is extremely difficult to comment on the extent to which real time reporting would advance or detract from the end goal or if other means would be just as effective and cost efficient. It is also extremely difficult to identify the particular data elements that would be critical for real time reporting. Generally, each SRO conducts various forms of “real time,” intra-day surveillances on the activity occurring in their markets, such as for firm quote or book trade throughs. However, almost all SRO surveillance runs are conducted end-of-day or post-settlement. Enforcement inquiries probe past behavior, not real time trading. Market reconstructions happen after the fact. While there might be occasions every now and then when it would be *helpful* to an SRO or the SEC to access additional information beyond what they already have about a market occurrence during the course of a trading day, the incremental utility of real time access to the additional information for these events does not justify the enormous costs imposed by real time submission, validation and consolidation of the data into a usable form. It would be very expensive for SROs and members to build systems to submit and amass the required data in real time. Moreover, given the increased speed of order submission, quote changes, and order cancellation, modifications, and executions, a real time submission requirement could strain the systems capacities and computer resources of SROs and many member firms. Our strong preference would be for submission of information to the central repository through a batch process after the close of the trading day involved.⁴ This one change, combined with our suggestion of leveraging of the SROs’ experience in working with COATS, OATS and other audit trails to form the CAT, would save enormous costs and resources while still producing a state-of-the-art CAT.⁵

⁴ To the extent that the SEC firmly believes that one or more data elements is critical to access in real time, it should identify those elements and the particular need they would serve, and limit the real time submission to those elements.

⁵ Additionally, generally our belief is that next day (T+1) data, which incorporates additional information such as cleared trade data, is a better report resource for generating surveillance and compliance reviews.

Third, with respect to real time reporting, we particularly question the need to include market maker quotes real time in the CAT. SROs already maintain a large amount of data on market maker quotes. This data, while captured individually in real time, is amassed collectively for post-trade day surveillance and compliance review by individual SROs. With the advent of Regulation NMS and penny trading in options, the speed of quote changes has increased dramatically. Flickering quotes are an ongoing occurrence in the stock markets. The pace and amount of quote changes is exponentially greater in the options markets. For each stock, there are dozens, if not a hundred or more, individual options series, all of whose quotes change constantly in response to a change in the underlying stock's quote. It would be a mammoth undertaking and require a gigantic transmission capability for options exchanges to transmit quote information in real time to the CAT. This prospect could tax systems and present significant costs. At the same time, there would be little, if any, incremental benefit to consolidating market maker quote information. For these reasons, the SEC should delete the proposed requirement that all market maker quotes to be submitted to the CAT, and while there may be some justification for top of book, we are not sure it would justify the associated costs. Instead, the SEC should consider taking the same approach as is currently used for COATS – which contains order, quote (top of market quote only) and transaction data for all market participants. Any other quote information not passed onto the CAT would continue to be maintained and utilized by the individual exchanges. If the SEC would need more quote detail, the respective exchange could provide the data upon request. The approach strikes an appropriate balance because it would still assist in developing a useful CAT and enhancing consolidated surveillance, while mitigating unnecessary data transmission, storage and expense for data that generally have no value except on an individual exchange compliance level. As the options exchanges already maintain market maker quote information, it makes far more sense for them to relay any necessary information on quotes to the CAT after the close of trading, to the extent any reporting of quotation information is determined to be necessary.⁶ In addition, it is unclear under the Proposal as to whether the market makers who submit quotes, the exchanges that disseminate quotes, or both, would submit the required information to the CAT. We believe that it would be redundant for both the market makers and the exchanges to submit this information to the CAT. We recommend that the exchanges be permitted to submit information on market maker quotes to the CAT. Market makers who submit quotes to an exchange would have no obligation other than to correctly identify themselves to the exchange as the party submitting the quotation. The exchange could add the rest of the required information (participant identifier, unique order identifier, etc.) to the quote and transmit it to the CAT.

Fourth, the Proposal should make clear that a broker-dealer would have no obligation to report to the CAT order information that it has reported to an exchange. There is no need for such a broker-dealer to separately report because the exchanges would capture all the information and pass it onto the CAT. Other broker-dealers in an order's "lifecycle" – such as a

⁶ Of course, if a market maker enters an order with another broker-dealer to handle, that order would be treated as any other order under the CAT NMS plan.

non-member broker-dealer that routes an order to an exchange member for execution - would need to report information on the customer id and order routing history to the CAT. Also, to the extent that a broker-dealer provides an exchange with the customer id for orders received from a non-broker-dealer customer (or corresponding customer id and order routing information for an agency order received from another broker-dealer), there should not be a separate obligation to report to the CAT placed on that broker-dealer either. At a minimum, these scenarios illustrate instances where more efficiencies can be achieved and redundancies reduced in the reporting process. A particular example is the instance of an options floor broker (or order entry firm) that only enters proprietary trades or agency orders received from other broker-dealers. Similar to market makers, the exchanges already capture all the information that such an options floor broker would have on its proprietary or agency executions through COATS, so it would be redundant and unnecessary for the floor broker to have to separately report to the CAT. In the instance where a floor broker (or order entry firm) receives a customer order directly from a non-broker dealer customer and enters that order onto an exchange, the member similarly should not be obligated to separately report to the CAT if it provides the exchange with the customer id to be passed-through to the CAT by the exchange.

Fifth, we question the need for a large trader reporting system if the CAT is approved.⁷ The objectives of the large trader reporting system would be met by the CAT. As each order in the CAT would include the unique customer identifier, we see little benefit in forcing the industry to adopt a large trader reporting system. Moreover, it would be very burdensome for broker-dealers to attempt to implement a large trader reporting system at the same time they are determining how to implement policies, procedures, and systems to fulfill their CAT reporting obligations. To the extent the Commission believes there remains a need to separately identify large traders, we believe that proposal and the CAT Proposal should be reconciled. For example, perhaps the large trader id and customer id could be combined in some manner and the need to separately identify a large trader id eliminated. We also believe it is critical, appropriate and reasonable for SROs (not just the SEC) to have the ability to request data on large traders pursuant to the proposed rule.

Aside from the efficiency and cost saving recommendations discussed above, we have several recommendations to improve the operation of the NMS plan governing the operation of the CAT. First, we have serious qualms about the Proposal's requirement that an NMS plan be submitted by the SROs within ninety days of the adoption of the Proposal. This is an extremely short period of time for the various SROs to coordinate and develop a comprehensive and workable plan for such a large undertaking. We believe that granting the SROs more time, for example a nine- to twelve-month period, to submit an NMS plan for a CAT would result in a more developed plan and effective RFP, SOW and SLA. Beyond some of the complex technological, administrative and regulatory undertakings, the contemplated NMS plan also

⁷ The SEC proposed the adoption of rules to create a large trader reporting system in Securities Exchange Act Release No. 61908 (April 14, 2010), 17 FR 21455 (April 23, 2010).

raises some unique issues – such as privacy and confidentiality considerations and the introduction of an NMS plan chief compliance officer – which may necessitate additional analysis. A nine- to twelve-month timeline for the plan’s development also seems well within keeping with similar undertakings, such as the Options Regulatory Surveillance Authority (“ORSA”) NMS plan, which took approximately one year to develop and one year to implement, and COATS, which took approximately three years to implement. Moreover, lengthening the time for the plan development phase will increase greatly the likelihood that full implementation by the SROs and broker-dealers would occur within two years after approval of the plan (as proposed) or possibly sooner. A ninety day period for development of a plan would almost certainly result in amendments, additional programming and increased costs to adjust a hastily constructed plan, and thus republications of the amendments. The end result would be that the period until implementation by the SROs is longer and more costly than if they had more time to develop the initial plan submission in the first place.

Second, rather than simply requiring the SROs to jointly develop a plan, it would be more helpful if the SEC, SROs, and representatives of other affected parties meet at a roundtable to discuss the CAT and the elements needed to produce a successful undertaking of this magnitude. Based upon feedback from the roundtable, the SROs could then convene to develop the NMS plan. As far as the plan development, we believe the U.S. subgroup of the Intermarket Surveillance Group (“ISG”) would be the appropriate forum through which to coordinate among the SROs.

Third, the Proposal should include only the elements needed for a CAT, and then leave it up to the SROs, SIP and involved vendors to develop the specifications for the data elements to be specified in the NMS plan, which would ultimately be subject to public comment and SEC approval. The CAT will be a very complicated endeavor that will entail a multitude of technical aspects. Management of the CAT should be left up to the NMS plan participants. The SEC should be satisfied if the data elements it seeks to be captured by the CAT are indeed transmitted to the central repository. For example, rather than have a rule requiring that each order specify information of sufficient detail to identify a customer, a unique customer id, and customer account information, the NMS plan participants might devise a system for tracking this information through a single data element and reference to a customer database. As another example, rather than requiring a unique order identifier for each order (in addition to each broker-dealer’s and SRO’s unique order identifiers), the NMS plan participants might devise a system to “daisy chain” routing information to reconstruct each order’s lifecycle. As yet one more example, the NMS plan participants should determine appropriate clock synchronization protocols. We also question the need for the CAT to contain all the data elements proposed. Items that are not essential for a CAT can, to the extent necessary, be obtained upon request to the broker-dealer.

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CBOE appreciates the opportunity to comment on the Proposal. As discussed above, we agree with the general aim to create a CAT that is uniform across markets, but believe that the Proposal can be modified in significant ways to reduce its huge costs while producing a workable CAT. We stand ready to work with the Commission on the Proposal and would be happy to discuss our ideas further with SEC staff.

Sincerely,

A handwritten signature in red ink that reads "Edward J. Joyce". The signature is written in a cursive, flowing style.

Edward J. Joyce
President & Chief Operating Officer