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August 12, 2010

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

**Re:     *Proposing Release on Consolidated Audit Trail (Release No. 34-62174; File No. S7-11-10)***

Dear Ms. Murphy:

The NASDAQ OMX Group, Inc. ("NASDAQ") appreciates the opportunity to comment on the Securities and Exchange Commission's proposal to require the national securities exchanges and FINRA (collectively, the "SROs") to jointly implement a national market system plan to develop and operate a consolidated audit trail for cash equities and options trading in NMS securities ("Proposing Release"). NASDAQ strongly supports the Commission's efforts to enhance and consolidate the information available for surveillance and oversight of a fragmented securities market. Our comments on the Commission's proposal build upon our unique experience as:

- Operator of five equities and derivatives markets in the U.S. with 690 broker dealer members and three SEC-regulated SROs charged with regulation,<sup>1</sup>
- Member of the existing national market system plans,
- Operator of the securities information processor ("SIP") under the UTP Plan (which currently has 14 SRO members),<sup>2</sup> and

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<sup>1</sup> The NASDAQ Stock Market LLC, NASDAQ OMX PHLX, Inc., and NASDAQ OMX BX, Inc.

<sup>2</sup> Formally known as the "Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privilege Basis."

- Technology provider to 70 exchanges, 34 government regulators and 50 international brokerage clients around the world.<sup>3</sup>

Based on this experience, we believe the following points are critical to developing a consolidated audit trail that will enhance regulation and protect investors at reasonable cost:

***Markets need a consolidated audit trail.*** Market developments and fragmentation among dozens of market centers with varying market structures and levels of transparency have created inefficiencies and potential gaps in cross-market regulation. Complete transparency for regulators is the only way to assure fair and orderly markets.

***Given the major investment expected of the industry, the consolidated audit trail must significantly enhance regulation and have the minimum levels of compliance and administrative complexity necessary to achieve the core regulatory goals.*** We commend the Commission for its forthright assessment of the cost and complexity. While we believe innovative technology exists to meet many of the Commission's goals at significantly lower cost than estimated in the Proposing Release, SROs should be able to weigh the costs and benefits of various designs. This would include ways to leverage certain data in real-time, while collecting and processing other data in near-real-time.

***With limited information on functionality and cost available at this point, the Commission should focus on key principles rather than overly prescriptive initial rules that either settle for little better than the status quo or head in a direction that is ultimately unattainable.*** The key principles to guide the SROs through the development process would include:

- Development of a universal platform that is easily scalable to new products and increased message traffic and allows for technical refreshes as technology changes; utilizes existing industry protocols such as FIX in the new system to minimize programming by firms; and has protections to filter invalid data and avoid data translation problems;
- Presumption in favor of real time to the extent it provides material benefit to regulation at reasonable incremental cost;
- Market participant and ultimate customer information should be uniquely identified across markets and asset classes; and
- Development of a system that significantly enhances surveillance across all trading venues and all broker dealers to avoid regulatory arbitrage or gaps in regulation.

The Commission would retain final approval over the implementation of the consolidated audit trail to ensure that the system implements these key principles.

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<sup>3</sup> NASDAQ recently announced the acquisition of SMARTS, the world's leading provider of surveillance technology to regulators and broker dealers.

***We believe the Commission's timeframe is realistic for top technology providers to deliver a state-of-the-art audit trail at reasonable cost.*** The way to design the best system is to put the consolidated audit trail out for bid and determine what technology firms can deliver. With proper time allotted to refine requirements for the system, NASDAQ believes the system could cost significantly less than the Commission estimates, be launched on much the same schedule as proposed by the Commission, and in all events be fully implemented for NMS securities within the Commission's original two-year target. If necessary, we believe the system could be rolled out to both SROs and firms on an expedited schedule of months or even at the same time.

***Like the Commission, we have little confidence that any existing audit trail could meet these needs even with significant modification.*** Currently several audit trails feeds provide limited and sometimes overlapping information to regulators.<sup>4</sup> None, however, provides granular customer information or comprehensive cross-exchange data. No system combines information for options and equities, much less other related asset classes, or has any real-time capacity. Moreover, the administrative complexity of several of the systems arguably outweighs their utility in current market surveillance.

***The governance of the consolidated audit trail must be structured to avoid paralysis and limit the ability of individual SROs to unilaterally change how the SRO or its members report data.*** The national market system plan, which will have more than a dozen SRO members, will require a strong governance structure that operates by less than unanimous vote with a tie breaking mechanisms. The structure also must limit the ability of individual SROs to make modifications on a unilateral basis that could escalate costs by forcing the operator and firms to absorb costs that do not advance the interests of investors. At the same time, the existence of a consolidated audit trail should not limit the ability of market centers to innovate with new products and market models, particularly where the SRO requesting the change pays the incremental cost.

We believe application of this framework will ensure development of the most comprehensive, cost effective and state-of-the-art consolidated audit trail.

## **I. *The Markets Need a Comprehensive Audit Trail.***

Good regulation is a cornerstone upon which investor confidence is built. NASDAQ, as operator of five equities and derivatives markets in the U.S. (and ten in Europe), has made substantial investments in the surveillance technology operated by our exchanges and by FINRA on our behalf. We believe this impressive computing power, when coupled with market innovations such as automatic execution and broad dissemination of market information, makes it harder for bad actors to operate undetected. At the same time, however, effective regulation is complicated by factors such as market fragmentation, disparate regulation among market centers, cross-market routing of orders, difficulty in identifying the parties behind trading activity and

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<sup>4</sup> In addition, several other systems like OTS for NYSE and NYSE Amex-listed securities and the Electronic Bluesheets provide information upon request by regulators.

trading in related assets that are not regulated by SROs. Ultimately, it is the quality and timeliness of the data available to regulators that will ensure effective regulation of our markets.

As the Commission correctly notes, the markets have been transformed in recent years through changes such as the fragmentation of trading and the proliferation of trading venues. A trader today using a combination of nearly 200 known market centers can cause a cross-market event, influence the closing price of a stock, or otherwise attempt to conceal manipulative conduct. To combat this, the effective regulation of any market requires the virtual reconstruction of all elements of the fragmented market using available market-wide data. The SROs have recognized the need for surveillance across related asset classes. Many have developed sophisticated patterns that compare options and equity data to look for attempts to use one asset class to profit from, or influence the prices of, another asset class.

In all of these situations the necessary information must be retrieved and combined from a number of public and regulatory sources. In some cases this information is available from a feed that can be used in an automated surveillance pattern, while in other cases the information must be gathered in more manual fashion. For example, trade data is used in a significant number of surveillance patterns. For a market-wide view of trade activity in cash equities, an SRO must combine its own trade information with cross-market trade data from one of two available sources, the Intermarket Surveillance Group (“ISG”) Equity Audit Trail or the public data feeds operated by the two SIPs.<sup>5</sup> The SIP feeds do not contain market participant information, thus limiting their usefulness to instances where the only data elements needed are symbol, price, size, time and exchange. The ISG Equity Audit Trail data includes information on the clearing firm, but does not disclose the actual customer behind the trade and does not track the lifecycle of the order and which brokers handled the order. COATS, the primary audit trail for the options market, provides exchange options trade data, but also does not provide customer information or quote data. Other sources such as exchange audit trails can provide additional information. For NASDAQ and FINRA, OATS provides a time sequenced chronology of the lifecycle of the order from when it reaches the broker through execution, modification and cancellation. However, OATS has limited reach and is unable to track an order once it is routed away from NASDAQ. None of the formats are compatible with each other, forcing the SRO to rework the data to run in the same surveillance pattern. Each processing step to rework the data increases the potential for data quality issues. Sometimes it is better from a technology perspective to keep the data segregated and use certain data as secondary resources rather than combining incompatible data into the same pattern.

Significantly, the SIP feeds, ISG Equity Audit Trail, COATS, OATS and, to our knowledge, none of the other SRO audit trails include information on the ultimate customer and beneficial owner behind the trade. Consequently, it is necessary to engage in a time consuming and labor intensive process to reconstruct a trading event that includes individual requests for data from other SROs and the firms involved. This process is thorough and has successfully

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<sup>5</sup> NASDAQ acts as the SIP for the UTP Plan that consolidates information for securities listed on NASDAQ and SIAC acts as the SIP for the CTA Plan that consolidates information for securities listed on NYSE Euronext-owned U.S. markets.

uncovered thousands of manipulations. But it is not efficient and leads to delays while data is retrieved from multiple sources. Even in areas like insider trading where the process is expedited, the Commission and SROs face hurdles to freezing profits from illegal activity before they are spent or leave our jurisdiction. Similarly, although FINRA now provides regulatory services to the majority of U.S. equities exchanges, the data it receives from each one is not necessarily consistent or in the same format or readily comparable to options data. State-of-the-art technology can do better for U.S. investors. We also believe that regulation would benefit from greater integration of market-wide quote, order and trade data with attribution to the responsible firm. This would assist in thwarting order-based manipulations such as layering and spoofing conducted across markets.<sup>6</sup>

In addition, as NASDAQ noted in its comment letter to the Commission's Concept Release, sponsored access relationships complicate our ability to determine the entity responsible for particular activities even when the trades occur on our own markets.<sup>7</sup> We advocated that each sponsored participant must have a separate market participant identifier ("MPID") or other unique means of identification. We believe that the Proposing Release would adequately address these concerns and significantly enhance the overall effectiveness of market regulation in the United States.

## **II. *The Commission Has Proposed a Realistic Time Frame for Developing a State-of-the-Art Consolidated Audit Trail.***

As the Commission rightly notes, the scale of the consolidated audit trail and related data repository is massive and will have significant impact on the industry. The Commission's own estimates predict a total one-time development and implementation cost to the financial industry of approximately \$4 billion and annual costs thereafter of \$2.1 billion. The SROs would incur the costs of developing and operating the plan, audit trail and central repository and developing surveillance patterns to use the consolidated information. Member firms would incur costs to program their systems to collect the required information, report that information in the format accepted by the consolidated audit trail and perform ongoing compliance functions. However, these are just estimates at this point since no technology assessments or requests for proposals have been made.

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<sup>6</sup> Layering is the entry of multiple non-bona-fide orders at incremental price levels on one side of the market in a security with the intent of creating pricing pressure such that an order on the other side of market receives favorable execution. Spoofing is the use of orders that are cancelled to create the appearance of demand in an attempt to draw in other investors and influence the price of a security.

<sup>7</sup> See Comment Letter from Joan Conley, Corporate Secretary, NASDAQ, to Elizabeth Murphy, Secretary, Commission, dated April 30, 2010, at 6. NASDAQ has been a leader in attempting to rationalize the surveillance and regulation of sponsored access. See, e.g., *Risk Management Controls for Brokers or Dealers with Market Access* (File No. S7-03-10), Securities Exchange Act Release No. 61379 (Jan. 19, 2010). NASDAQ also filed and had approved a new sponsored access rule, NASDAQ Rule 4611(d), which contains many provisions of proposed SEC Rule 15c3-5. See Securities Exchange Act Release No. 61345 (Jan. 13, 2010) (approving SR-NASDAQ-2008-104).

The Proposing Release sets very high goals for the system, which will be expected to collect all information for orders and executions for all NMS securities in both equities and options—and do most of this in real time. All of this material is to be kept available for five years in a format that can be retrieved within one hour. The Commission also seeks a “timely expansion” of the audit trail to non-NMS securities, debt securities, primary securities transactions and, ultimately, all other products under its jurisdiction. This will require technology that is easily scalable. We applaud the Commission for aiming high with its goals and focusing on establishing “a broad framework within which the exchanges and associations would provide the details that they believe would result in a functional, cooperative mechanism to create and maintain a consolidated audit trail...”<sup>8</sup> We agree that the SROs are best placed to determine the specifics of the audit trail and how it is administered.

Based on our experience with large technology projects, NASDAQ is of the opinion that leading technology vendors should be able to build and support a consolidated audit trail for significantly less than the estimates in the Proposing Release. We also believe the Commission’s timeframe to implement the consolidated audit trail for NMS securities within two years is realistic and is in line with past experience with for similarly complex projects. If necessary to meet that target, we believe the audit trail could be launched for both SROs and firms at around the same time. To the extent the industry was concerned about a simultaneous “big bang” for firms and SROs, the audit trail might be phased in on a much shorter timeline than one year apart.

The way to design the best system is to put the consolidated audit trail out for bid and see what technology firms can deliver and at what price. This process has delivered high value at low cost in connection with technology projects around the world. We respectfully disagree with those commenters who suggest that we should skip the bidding process and default to an existing system or combination of systems with some as yet undefined enhancements. Perhaps in the end these systems will be selected. But this should be the result of an open process where the best technology is adopted through open competition.

Devoting sufficient time and effort to the design requirements for the system can significantly streamline the development and deployment of the system. Until this design process is complete, it is important to avoid two related risks in the development process. The first is an overly prescriptive Commission rule while we have incomplete technical information on which design and features make the most sense. The second risk is that insufficient time is allocated to develop these requirements, resulting in little better than the status quo or forcing us in a direction that is ultimately unattainable. The Proposing Release would give the SROs 90 days to submit the national market system plan and two additional months to pick a processor for the central repository. During this period the SROs would implement the market system plan, set technology requirements, solicit bids (which would require bidders to develop comprehensive plans and cost estimates for the system) and pick a developer. We are concerned that this is too short a period for the SROs, even acting with all possible speed, to make the decisions necessary

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<sup>8</sup> Proposing Release at 49.

to select a system whether new or based on existing technology. We believe building in scheduling flexibility at the initial stage will go a long way to avoiding operational problems while remaining very close to the Commission's proposed timeline. The Commission, which must approve the national market system plan, would retain full authority to approve the design for the consolidated audit trail.

For similar reasons, we recommend that the Commission delay the requirement that the SROs develop a plan to extend the system to other instruments and asset classes until after a technology provider is selected and the framework of the system has been developed. It would be far better to develop the design for the initial products and leverage this knowledge to later phases. We believe the plan for this expansion should be due one year after the national market system plan goes into effect.

### **III. *Key Principles That Ensure the Consolidated Audit Trail Improves Regulation.***

At this stage the Commission and the SROs should evaluate the consolidated audit trail based on whether the system significantly enhances regulation and has the minimum compliance and administrative complexity necessary to achieve the core regulatory goals. NASDAQ believes that there may be ways to accomplish most or all of the Commission's goals at significantly lower cost than the Commission estimates. However, a meaningful cost benefit analysis of each critical element of the consolidated audit trail is appropriate to determine whether it adds regulatory value commensurate with the cost.

#### **A. Need For a Scalable, Efficient System.**

We believe that the following key principles best ensure that the regulatory goals of the consolidated audit trail are met in a cost efficient manner:

- Development of a universal platform that is easily scalable to new products and increased volume as measured by the following goals:
  - Allows each SRO and participant to maintain its current business model while providing a uniform set of data to the SROs;
  - Trail utilizes existing interface protocols, including the industry standard FIX protocol, in the new system to minimize programming by firms while developing new operational protocols necessary to support a newly designed consolidated audit trail;
  - System provides market participant and ultimate customer information, tracks the complete life cycle of the transaction and includes order data (defined to include quotations) and executions; and

- System avoids data quality issues through data validation safeguards and a structure that reads data as close to the point of origin as possible to avoid data translation errors when data is processed through intermediary applications;
- Presumption in favor of real time to the extent it provides material benefit to regulation at reasonable incremental cost;
- Consolidated audit trail must apply to all trading and reporting venues (registered national securities exchanges and alternative trading systems) and all broker dealers and any affiliates to avoid regulatory arbitrage or gaps in regulation;
- System architecture allows for technical refreshes as technology evolves; and
- Enhanced surveillance across all market centers that makes reasonable use of data, thereby leveling the playing field and reducing the risk of regulatory arbitrage.

#### **B. Real-Time Surveillance Using the Consolidated Audit Trail**

The Proposing Release makes clear the Commission's belief that real time order and execution information would significantly benefit regulation by allowing expedited investigation of anomalous activity. The Commission also preliminarily believes that access to real-time information would assist its examination and enforcement activities and its analysis of market activity such as the event of May 6, 2010. As a result, the Proposing Release would require that all information be available in real time except for certain information that may not be immediately available such as allocations of securities to subaccounts, identity of clearing broker or prime broker for the transaction, unique order identifiers of any contra-side orders, cancelled trade indicators and certain information related to short sales and commissions. The SRO or member would be required to report this information "promptly" once received, but in no circumstance later than midnight of the day that that trade occurs or the responsible reporting party receives the information.

We agree with the Commission that our surveillance operations do benefit from having additional information available in real-time. NASDAQ has been a leader in real-time surveillance of the markets. Our MarketWatch department uses a real time surveillance system that combines equity and options information from our U.S. markets. Last year, this resulted in several hundred referrals to FINRA and the Commission for insider trading, market manipulation, trading practices and other potential rule violations.<sup>9</sup> We believe regulatory programs would be enhanced by additional cross-market information, as the Commission has proposed. However, immediate availability of this voluminous data comes at significant cost.<sup>10</sup>

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<sup>9</sup> In addition, non-real time surveillance identified thousands of additional matters that warranted further investigation.

<sup>10</sup> These costs arise from the practical complexities of real-time reporting. There are more servers, more network bandwidth, more resources, and more complex interfaces in a real-time system. Real-time data delivery



Member firms would also incur cost to collect and disseminate this information in real time, although it may be possible for the firms to leverage internal systems that already track at least some of the required information in real-time in order to conduct their trading, reporting and client service functions.

For these reasons we recommend that the Commission's policy focus on a presumption of real time surveillance where there are material benefits to regulation at reasonable incremental cost. This could be accomplished in stages based on the expertise developed by the plan's governing committee and development proposals presented by the technology bidders. We believe that it makes the most sense to focus in phase 1 on real-time delivery of all execution data with market participant information. Phase 1 would be launched on the same schedule as the consolidated audit trail. These files are comparatively small, less than 10% for equities and 1% for options of the size of the respective quote files. It would immediately benefit the majority of surveillance patterns that utilize trade data. This cross-market information with detailed market participant information would expedite the SROs' ability to monitor and detect rapid price movements, insider trading, frontrunning and trading ahead across venues, trade through, locked and crossed markets, and wash selling. In short, it would take the protracted process we described in Section I and make that information instantly available. We believe this would add significant value to regulation even though, as several commenters correctly note, it is sometimes difficult to identify trends and patterns without the passage of time and more detailed investigation.

After implementation of phase 1, the SROs and the Commission will have the expertise to determine the scope of phase 2, which would extend real-time reporting to the vastly larger volume of order data. While we see some value from having this information to enhance our surveillance of order-based manipulations, such as layering and spoofing, and some enhanced ability to monitor Regulation NMS compliance, we believe these benefits would be less immediate than those from real-time execution data. We also believe this phase of the project could benefit from technology advancements and the general decline in per unit technology costs over time.

Real-time availability of execution and/or order data would also facilitate the identification of cross-market events and their origins. This data, when combined with the latest technology to dissect data and provide trend analysis, could provide heat mapping and graphical tracking of the entire market in ways that have never been available to regulatory staff and the Commission before. We believe the events of May 6<sup>th</sup> show the value of this type of information for same-day review even if the speed of market activity limits the ability of SROs or the Commission to stop the initial event as it is occurring. In the wake of these events, policy makers face many immediate questions: what caused the event, is the problem fixed, is it safe to reopen the market, are emergency measures needed? Currently, we have limited tools to answer these questions in the period immediately after the crisis. More comprehensive real-time data would

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introduces a level of complexity due to the need to handle out of sequence data, data gaps, retransmissions, and network issues. Data storage is one area where the real-time element would not impact cost.

enhance our knowledge and inspire greater public confidence in our decisions and in the markets.

We note that foreign regulators are also focusing on real-time surveillance of the markets. For example, the Investment Industry Regulatory Organization of Canada (“IIROC”) conducts real-time surveillance of trading activity across all Canadian equities markets and the Australian Securities & Investments Commission (“ASIC”) performs similar real-time functions in Australia. Similarly, the United Kingdom’s Financial Services Authority (“FSA”) recently stated that “we face the challenge of maintaining standards of market quality and integrity in a more fragmented environment...For example, we place greater emphasis on trading platforms being effective real-time monitors of their market...”<sup>11</sup> Investors in U.S. markets should have confidence that our regulators have a similar capacity to monitor events in the market as they occur.

**C. Consolidated Audit Trail Must Be Comprehensive In Scope and SROs Must Use the Consolidated Data— Including the Information Available in Real-Time— to Conduct Comprehensive Surveillance.**

We agree with the Commission that the consolidated audit trail must apply to all trading venues in our widely dispersed market, whether national securities exchanges or ATS, and to all broker dealers, affiliates and other registered entities. Anything less would leave significant gaps in the regulatory data available to SROs and the Commission. We also agree with the Proposing Release’s requirement that SROs be required to implement surveillance systems reasonably designed to make use of the consolidated information—including the data available in real-time. The Commission should monitor implementation of the surveillance and consider additional guidance based on the SROs’ experience in executing this mandate. This process may also push the SROs toward more consolidated, or at least coordinated, regulation. This could increase efficiency, decrease overall regulatory costs and eliminate potential regulatory arbitrage, whereby market participants avoid effective regulation at one market center by trading at less well-regulated market centers that offer similar trading services. We believe overall regulation of U.S. markets would benefit from continued consolidation of surveillance.

**D. Opportunities Exist to Reduce the Cost of the Audit Trail.**

We previously noted that leading technology vendors should be able to build and support the consolidated audit trail for considerably less than the Commission estimates. We also highlighted several additional ways to reduce cost, such as limited and/or phased in use of real-time data and validation checks that avoid costly data reconstruction. In addition, the data storage requirements for the consolidated information might be another avenue for cost savings without materially impacting the utility of the audit trail. As a practical matter, most enforcement matters proceed beyond the phase of raw data investigation in a matter of months or a year. While older

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<sup>11</sup> UK FSA, *The FSA’s markets regulatory agenda*, May 2010, at 17.

data may be useful in isolated cases, the need to have that information available within an hour would seem to diminish over time. Perhaps older data could be available next day or on some other time period that would be less burdensome for the system, but would still meet the practical demands of regulators.

We agree with the Commission that in calculating the total cost to the industry of the audit trail it is important to consider offsetting savings from the retirement of redundant data feeds such as OATS, OTS, COATS, ISG Equity Audit Trail and Electronic Bluesheets. In addition, the industry may be able to avoid the costs of compliance with the Commission's proposed Large Trader Reporting System<sup>12</sup> if the consolidated audit trail contains sufficient information to meet those requirements. In the future there may be potential savings if the central repository data may be used to meet firms' record keeping requirements and provide other internal and back office functions if appropriate rules and safeguards are in place. We also believe there will be additional cost savings to SROs as the complexities of the current data systems and manual surveillance steps are replaced once the consolidated audit trail goes live.

#### ***IV. We Share the Commission's Doubts That Existing Audit Trails Would Meet the Commission's Goals.***

The Proposing Release provides an accurate summary of existing audit trails and concludes that the disparate systems are limited in scope and effectiveness and unlikely even with "retrofitting" to fulfill the needs for a consolidated audit trail. We share the Commission's concerns. Even the most complete of the existing systems are at least a decade old. It has been during this decade that the most dramatic and sweeping changes to the market have occurred. It is difficult to see any of them as the catalyst for the revolutionary changes to market surveillance contemplated by the Proposing Release.

Most importantly, none of the systems provides ultimate customer information necessary to provide a true lifecycle of the order and eliminate all of the manual surveillance steps we outlined in Section I. This would negate one of the major goals of the consolidated audit trail. Several of the systems with which we are familiar have difficulty being integrated into surveillance patterns and require multiple steps to match SIP and exchange data. This violates the principle discussed above that the system should receive the data from as close to the point of origin as possible. In many cases the information is entered into the audit trail separately and at a different time than the trader enters the original order data. This two-step process introduces the potential for errors. It is also often difficult to retrofit today's data into specifications that are outdated. Situations periodically occur where different market structures simply do not fit into the existing designs and a long, cumbersome process ensues to make needed changes. No existing audit trail handles more than 5%-10% of the data to be included in the consolidated audit trail and, of course, none has any real-time capability.

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<sup>12</sup> See *Large Trader Reporting System*, Securities Exchange Act Release No. 34-61908 (April 14, 2010), 75 FR 21456 (April 23, 2010).

Consolidating data from different asset classes poses another hurdle because there is no existing audit trail that covers both cash equities and options, let alone the other asset classes that might subsequently be added to the consolidated audit trail. In fact, the existing systems have completely different architectures. The options audit trail COATS— despite its similar sounding acronym to OATS— is controlled by a different organization and uses data provided directly by exchanges, while OATS uses data provided by member firms. COATS does not contain the time that a broker receives an order, whereas OATS does. OATS contains order data while the COATS data feed does not. The format and data protocols of the two systems are not compatible and we question the utility of spending considerable time and resources attempting such a combination without exploring alternatives.

NASDAQ believes it may be easier for firms to comply with a newer system free of the issues noted above. For example, as FINRA acknowledges in its comment letter, the OATS system rejects 425,000 reports on average per day and results in 16,000 help desk calls per year.<sup>13</sup> Moreover, OATS compliance generates a significant percentage of the total number of formal disciplinary actions brought by FINRA each year.<sup>14</sup> NASDAQ recognizes that any complex audit system needs valid data, but we question whether the structural elements of OATS contribute to the problem. In particular, OATS does not read data directly from firms' trading software and uses proprietary protocols rather than industry standards such as FIX. This introduces the potential for errors as data is reconstructed after the fact for OATS reporting. Any reporting errors must be corrected afterwards, delaying availability of complete data. Such errors often result in disciplinary actions that divert regulatory resources from fraud and market manipulation investigations. We think there could be ways to learn from this experience to develop a better audit trail.

Nevertheless, operators of existing audit trails may come forward with proposals to retrofit systems to meet at least some of the Commission's goals. They should get that opportunity as part of the open bidding process. They, like all other bidders, should explain with considerable specificity how the retrofitted system will meet the principles outlined here. We agree with the Commission's preference for a system owned jointly by the SROs. To the extent an existing audit trail is owned by a particular SRO rather than a national market system plan, that SRO should explain how ownership and control of the audit trail would be transferred to the new plan for the consolidated audit trail. Significant detail on the costs of the modification is also needed. Market participants need to know that they are getting their money's worth and whether retrofitting an existing system is really cheaper and faster to implement than starting with a new, more flexible system that is potentially less complex from a compliance perspective. Each

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<sup>13</sup> See Comment Letter from Marcia Asquith, Secretary, FINRA, to Elizabeth Murphy, Secretary, Commission, dated August 9, 2010, at 11.

<sup>14</sup> See, e.g., Richard G. Wallace, *FINRA Priorities and Results*, Law360, March 17, 2010. (word searches of 1090 formal actions resolved by FINRA during 2009 showed that "OATS" was the third most frequently used term, with 172 occurrences, and noting that this data did not include any unpublicized OATS actions involving fines of less than \$10,000) and James Ramage, *Reeling Over Regulations*, Trader Magazine, November 2008 (reaching similar conclusion using public data on fines).

system, whether new or retrofitted, must significantly enhance regulation and accommodate new market structures and new products both today and years into the future.

**V. *The Plan Requires a Strong SRO Governance Structure.***

We agree with the current SRO ownership structure proposed for the consolidated audit trail. The SROs have the obligation to perform regulation in a fair and impartial manner and have a history of working cooperatively under the Commission's guidance to further regulation through national market plans. This structure would not limit the Commission's access to the consolidated audit trail data for its regulatory needs. We also do not see any reason to limit the ability of SROs or their employees to perform the various functions for the audit trail and central repository outlined in the Proposing Release such as processor and chief compliance officer.

The governance of the plan must be structured to avoid paralysis and to limit the ability of individual SROs to unilaterally change how it or its members report data to the audit trail—unless that SRO pays any additional costs. These one-off cost situations should be infrequent if we implement a flexible technology system that can accommodate many trading platforms and be easily modified. However, in situations where the SRO is willing to pay the additional costs, reasonable accommodation for these changes should be made to ensure that the audit trail is not retarding developments that benefit investors. In developing the plan, SROs will have the opportunity to consider what governance structure and voting requirements will achieve these goals. Clearly the plan should avoid unanimous voting requirements and must include some tie breaking mechanism. The SROs may consider an executive committee structure with certain delegated authority and other provisions to ensure that the plan is effective in fulfilling its mission. However, we believe it is important to preserve the general principle of all existing plans that each SRO member should have a voice in matters that affect its exchange license.

The Commission also proposes certain mechanisms to ensure compliance by SROs with the requirements of the plan. While we agree that the success of the plan is dependent upon the efforts of each member, we would expect the Commission's compliance and enforcement efforts to recognize the complexity of what will be implemented. Commission rules should focus on the reasonable design of systems, processes and procedures to fulfill their objectives and patterns and practice of non-compliance rather than looking to any failure as a rule violation. This is particularly important in the context of data errors or similar matters. The plan should have fee recoupment provisions so that the plan administrator can recover reasonable expenses incurred through the error of a particular SRO. We believe these fee recovery provisions, coupled with the risk of Commission disciplinary action for patterns of non-compliance, would be sufficient and that additional penalty provisions in the plan are not necessary. Indeed, we would be concerned about the competitive implications of SROs being able to sanction each other in this manner.

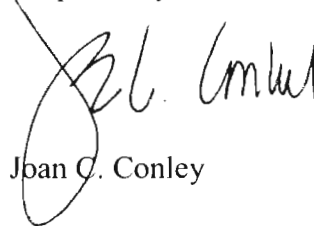
Finally, we note that the plan must provide for the equitable allocation of costs. The Proposing Release contemplates that the start-up and operational costs would be shared by the SROs and FINRA. However, the Proposing Release also contemplates expansion of the consolidated audit trail to products such as debt instruments that in most cases do not trade on

equities exchanges. Some mechanism would be needed to share these costs with the appropriate parties that benefit from these products so that exchanges are not required to subsidize off-exchange activities over which they have no responsibility and from which they derive no revenue.

\* \* \* \* \*

U.S. equities markets are the fairest, deepest, and most efficient in the world due in significant part to effective regulation. NASDAQ believes that an effective and cost efficient consolidated audit trail will be an important enhancement to the regulatory program. We believe the benefits of the new system in terms of investor confidence and market integrity will more than outweigh the cost. We look forward to working with the Commission and our fellow SROs to implement this important proposal.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "J.C. Conley", written over a large, loopy circular flourish.

Joan C. Conley

cc: The Hon. Mary L. Schapiro, Chairman  
The Hon. Kathleen L. Casey, Commissioner  
The Hon. Elisse B. Walter, Commissioner  
The Hon. Luis A. Aguilar, Commissioner  
The Hon. Troy A. Paredes, Commissioner  
Robert W. Cook, Director, Division of Trading and Markets  
James A. Brigagliano, Deputy Director, Division of Trading and Markets  
David Shillman, Associate Director, Division of Trading and Markets