

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-80783; File No. SR-FINRA-2017-013)

May 26, 2017

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change to Eliminate Requirements That Will Be Duplicative of CAT

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on May 15, 2017, Financial Industry Regulatory Authority, Inc. (“FINRA”) (f/k/a National Association of Securities Dealers, Inc. (“NASD”)) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to eliminate the Order Audit Trail System (“OATS”) rules in the FINRA Rule 7400 Series and to amend FINRA’s electronic blue sheet (“EBS”) rules, Rules 8211 and 8213, to reflect changes to these rules once members are effectively reporting to the consolidated audit trail (“CAT”) and the CAT’s accuracy and reliability meet certain standards as described below.

The text of the proposed rule change is available on FINRA’s website at <http://www.finra.org>, at the principal office of FINRA and at the Commission’s Public Reference Room.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

(1) Background

Bats BYX Exchange, Inc.; Bats BZX Exchange, Inc.; Bats EDGA Exchange, Inc.; Bats EDGX Exchange, Inc.; BOX Options Exchange LLC; C2 Options Exchange, Incorporated; Chicago Board Options Exchange, Incorporated; Chicago Stock Exchange, Inc.; FINRA; International Securities Exchange, LLC; Investors’ Exchange LLC; ISE Gemini, LLC; ISE Mercury, LLC; Miami International Securities Exchange LLC; MIAX PEARL, LLC; NASDAQ BX, Inc.; NASDAQ PHLX LLC; The NASDAQ Stock Market LLC; National Stock Exchange, Inc.; New York Stock Exchange LLC; NYSE MKT LLC; and NYSE Arca, Inc. (collectively, the “Participants”) filed with the Commission, pursuant to Section 11A of the Exchange Act<sup>3</sup> and Rule 608 of Regulation NMS thereunder,<sup>4</sup> the National Market System Plan Governing the Consolidated Audit Trail (the “CAT NMS Plan” or “Plan”).<sup>5</sup> The Participants filed the Plan to

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<sup>3</sup> 15 U.S.C. 78k-1.

<sup>4</sup> 17 CFR 242.608.

<sup>5</sup> See Letter from the Participants to Brent J. Fields, Secretary, Commission, dated September 30, 2014; and Letter from Participants to Brent J. Fields, Secretary, Commission, dated February 27, 2015. On December 24, 2015, the Participants

comply with Rule 613 of Regulation NMS under the Exchange Act.<sup>6</sup> The Plan was published for comment in the Federal Register on May 17, 2016,<sup>7</sup> and approved by the Commission, as modified, on November 15, 2016.<sup>8</sup> On March 15, 2017, the Commission approved the new FINRA Rule 6800 Series to implement provisions of the CAT NMS Plan that are applicable to FINRA members.<sup>9</sup>

The CAT NMS Plan is designed to create, implement, and maintain a consolidated audit trail that will capture in a single consolidated data source customer and order event information for orders in NMS Securities and OTC Equity Securities, across all markets, from the time of order inception through routing, cancellation, modification, or execution. Among other things, Section C.9. of Appendix C to the Plan, as modified by the Commission, requires each Participant to “file with the SEC the relevant rule change filing to eliminate or modify its duplicative rules within six (6) months of the SEC’s approval of the CAT NMS Plan.”<sup>10</sup> The Plan notes that “the elimination of such rules and the retirement of such systems [will] be effective at such time as CAT Data meets minimum standards of accuracy and reliability.”<sup>11</sup> Finally, the Plan requires the rule filing to discuss the following:

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submitted an amendment to the CAT NMS Plan. See Letter from Participants to Brent J. Fields, Secretary, Commission, dated December 23, 2015. Unless otherwise specified, capitalized terms used in this rule filing are defined as set forth herein, or in the CAT Compliance Rule Series or in the CAT NMS Plan.

<sup>6</sup> 17 CFR 242.613.

<sup>7</sup> Securities Exchange Act Rel. No. 77724 (April 27, 2016), 81 FR 30614 (May 17, 2016).

<sup>8</sup> Securities Exchange Act Rel. No. 79318 (November 15, 2016), 81 FR 84696 (November 23, 2016) (“Approval Order”).

<sup>9</sup> Securities Exchange Act Rel. No. 80255 (March 15, 2017), 82 FR 14563 (March 21, 2017).

<sup>10</sup> CAT NMS Plan, Appendix C, Section C.9.

<sup>11</sup> See id.

(i) specific accuracy and reliability standards that will determine when duplicative systems will be retired, including, but not limited to, whether the attainment of a certain Error Rate should determine when a system duplicative of the CAT can be retired;

(ii) whether the availability of certain data from Small Industry Members two years after the Effective Date would facilitate a more expeditious retirement of duplicative systems; and

(iii) whether individual Industry Members can be exempted from reporting to duplicative systems once their CAT reporting meets specified accuracy and reliability standards, including, but not limited to, ways in which establishing cross-system regulatory functionality or integrating data from existing systems and the CAT would facilitate such Individual Industry Member exemptions.<sup>12</sup>

In response to these requirements, the proposed rule change deletes the Rule 7400 Series (the “OATS Rules”)<sup>13</sup> and Rule 4554 from the FINRA rulebook and adds new Supplementary Material to FINRA’s EBS rules, Rules 8211 and 8213, once the CAT achieves the specific accuracy and reliability standards described below and FINRA has determined that its usage of the CAT Data has not revealed material issues that have not been corrected, confirmed that the CAT includes all data necessary to allow FINRA to continue to meet its surveillance obligations,<sup>14</sup> and confirmed that the Plan Processor is sufficiently meeting all of its obligations under the CAT NMS Plan.<sup>15</sup>

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<sup>12</sup> See id.

<sup>13</sup> FINRA notes that there are multiple rules throughout the FINRA Rulebook that cross-reference or otherwise incorporate some or all of the OATS Rules. If the Commission approves the proposed rule change, FINRA will file a subsequent proposed rule change to eliminate or amend, as applicable, the references to the OATS Rules before the amendments in the current proposed rule change are implemented.

<sup>14</sup> As noted in the Participants’ September 23, 2016 response to comment letters on the Plan, the Participants “worked to keep [the CAT] gap analyses up-to-date by including newly-added data fields in these duplicative systems, such as the new OATS data fields

(2) Specific Accuracy and Reliability Standards

The first issue the Plan requires the proposed rule change to discuss is “specific accuracy and reliability standards that will determine when duplicative systems will be retired, including, but not limited to, whether the attainment of a certain Error Rate should determine when a system duplicative of the CAT can be retired.”<sup>16</sup> FINRA believes that relevant error rates are the primary, but not the sole, metric by which to determine the CAT’s accuracy and reliability and will serve as the baseline requirement needed before OATS can be retired and requests for trading information pursuant to Rule 8211 or 8213 can be amended to account for information being available in the CAT.

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related to the tick size pilot and ATS order book changes, in the gap analyses.” Letter from Participants to Brent J. Fields, Secretary, Commission, dated September 23, 2016, at 21. The Participants noted that they “will work with the Plan Processor and the industry to develop detailed Technical Specifications to ensure that by the time Industry Members are required to report to the CAT, the CAT will include all data elements necessary to facilitate the rapid retirement of duplicative systems.” Id.

<sup>15</sup> FINRA notes that the OATS Rules were originally proposed to fulfill one of the undertakings contained in an order issued by the Commission relating to the settlement of an enforcement action against the NASD for failure to adequately enforce its rules. See Securities Exchange Act Release No. 39729 (March 6, 1998), 63 FR 12559 (March 13, 1998) (“OATS Approval Order”); see also Securities Exchange Act Release No. 37538 (August 8, 1996); Administrative Proceeding File No. 3-9056 (“SEC Order”). In approving the OATS Rules, the Commission concluded that OATS satisfied the conditions of the SEC Order and was consistent with the Exchange Act. See OATS Approval Order, supra, at 12566-67. As noted, the Plan is designed to create, implement, and maintain a CAT that would capture customer and order event information for orders in NMS Securities and OTC Equity Securities, across all markets, from the time of order inception through routing, cancellation, modification, or execution in a single consolidated data source. FINRA has already adopted rules to enforce compliance by its Industry Members, as applicable, with the provisions of the Plan. See Rule 6800 Series. Once the CAT can replace the OATS Rules, FINRA believes it will be appropriate to delete the OATS Rules that were implemented to comply with the SEC Order. Accordingly, FINRA believes that it would continue to be in compliance with the requirements of the SEC Order once the OATS Rules are deleted.

<sup>16</sup> See CAT NMS Plan, Appendix C, Section C.9.

As discussed in Section A.3.(b) of Appendix C to the CAT NMS Plan, the Participants established an initial Error Rate, as defined in the Plan, of 5% on initially submitted data (i.e., data as submitted by a CAT Reporter before any required corrections are performed). The Participants noted in the Plan that their expectation was that “error rates after reprocessing of error corrections will be de minimis.”<sup>17</sup> The Participants based this Error Rate on their consideration of “current and historical OATS Error Rates, the magnitude of new reporting requirements on the CAT Reporters and the fact that many CAT Reporters may have never been obligated to report data to an audit trail.”<sup>18</sup>

FINRA agrees with the Participants’ conclusion that a 5% pre-correction threshold “strikes the balance of adapting to a new reporting regime, while ensuring that the data provided to regulators will be capable of being used to conduct surveillance and market reconstruction, as well as having a sufficient level of accuracy to facilitate the retirement of existing regulatory reports and systems where possible.”<sup>19</sup> However, FINRA believes that, when assessing the accuracy and reliability of the data for the purposes of retiring OATS, the error thresholds should be measured in more granular ways and should also include minimum error rates of post-correction data, which represents the data most likely to be used by FINRA to conduct surveillance. Although FINRA is proposing to measure the appropriate error rates in the aggregate, rather than firm-by-firm, FINRA believes that the error rates for equity securities should be measured separately from options since options orders are not currently reported regularly or included in OATS.

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<sup>17</sup> See CAT NMS Plan, Appendix C, Section A.3(b), at n.102.

<sup>18</sup> See CAT NMS Plan, Appendix C, Section A.3(b).

<sup>19</sup> Id.

To ensure the CAT's accuracy and reliability, FINRA is proposing that, before OATS could be retired, the CAT would generally need to achieve a sustained error rate for Industry Member reporting in each of the categories below for a period of at least 180 days of 5% or lower, measured on a pre-correction or as-submitted basis and 2% or lower on a post-correction basis (measured at T+5).<sup>20</sup> FINRA is proposing to measure the 5% pre-correction and 2% post-correction thresholds by averaging the error rate across the period, not require a 5% pre-correction and 2% post-correction maximum each day for 180 consecutive days. FINRA believes that measuring each of the thresholds over the course of 180 days will ensure that the CAT consistently meets minimum accuracy and reliability thresholds for Industry Member reporting while also ensuring that single-day measurements do not unduly affect the overall measurements.

FINRA is proposing to use error rates in each the following categories, measured separately for options and for equities, to assess whether the threshold pre- and post-correction error rates are being met:

- Rejection Rates and Data Validations. Data validations for the CAT, while not expected to be designed the same as OATS, must be functionally equivalent to OATS in accordance with the CAT NMS Plan (i.e., the same types of basic data validations must be performed by the Plan Processor to comply with the CAT NMS Plan requirements). Appendix D of the Plan, for example, requires that certain file validations<sup>21</sup> and syntax

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<sup>20</sup> The Plan requires that the Plan Processor must ensure that regulators have access to corrected and linked order and Customer data by 8:00 a.m. Eastern Time on T+5. See CAT NMS Plan, Appendix C, Section A.2(a).

<sup>21</sup> See CAT NMS Plan, Appendix D, Section 7.2. The Plan requires the Plan Processor to confirm that file transmission and receipt are in the correct formats, including validation of header and trailers on the submitted report, confirmation of a valid SRO-Assigned Market Participant Identifier, and verification of the number of records in the file. Id.

and context checks be performed on all submitted records.<sup>22</sup> If a record does not pass these basic data validations, it must be rejected and returned to the CAT Reporter to be corrected and resubmitted.<sup>23</sup> The specific validations can be determined only after the Plan Processor has finalized the Industry Member Technical Specifications; however, the Plan also requires the Plan Processor to provide daily statistics on rejection rates after the data has been processed, including the number of files rejected and accepted, the number of order events accepted and rejected, and the number of each type of report rejected.<sup>24</sup> FINRA is proposing that, over the 180-day period, aggregate rejection rates (measured separately for equities and options) must be no more than 5% pre-correction or 2% post-correction across all CAT Reporters.

- Intra-Firm Linkages. The Plan requires that “the Plan Processor must be able to link all related order events from all CAT Reporters involved in the lifecycle of an order.”<sup>25</sup> At a minimum, this requirement includes the creation of an order lifecycle between “[a]ll order events handled within an individual CAT Reporter, including orders routed to internal desks or departments with different functions (e.g., an internal ATS).”<sup>26</sup> FINRA

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<sup>22</sup> See id. The Plan notes that syntax and context checks would include format checks (i.e., that data is entered in the specified format); data type checks (i.e., that the data type of each attribute conforms to the specifications); consistency checks (i.e., that all attributes for a record of a specified type are consistent); range/logic checks (i.e., that each attribute for every record has a value within specified limits and the values provided are associated with the event type they represent); data validity checks (i.e., that each attribute for every record has an acceptable value); completeness checks (i.e., that each mandatory attribute for every record is not null); and timeliness checks (i.e., that the records were submitted within the submission timelines). Id.

<sup>23</sup> See id.

<sup>24</sup> See id.

<sup>25</sup> CAT NMS Plan, Appendix D, Section 3.

<sup>26</sup> Id.

is proposing that aggregate intra-firm linkage rates across all Industry Member Reporters must be at least 95% pre-correction and 98% post-correction.

- Inter-Firm Linkages. The order linkage requirements in the Plan also require that the Plan Processor be able to create the lifecycle between orders routed between broker-dealers.<sup>27</sup> FINRA is proposing that at least a 95% pre-correction and 98% post-correction aggregate match rate be achieved for orders routed between two Industry Member Reporters.<sup>28</sup>
- Order Linkage Rates. In addition to creating linkages within and between broker-dealers, the Plan also includes requirements that the Plan Processor be able to create lifecycles to link various pieces of related orders.<sup>29</sup> For example, the Plan requires linkages between customer orders and “representative” orders created in firm accounts for the purpose of facilitating a customer order, various legs of option/equity complex orders, riskless principal orders, and orders worked through average price accounts.<sup>30</sup> FINRA is proposing that there be at least a 95% pre-correction and 98% post-correction linkage rate for multi-legged orders (e.g., related equity/options orders, VWAP orders, riskless principal transactions).
- Exchange and TRF/ORF Match Rates. The Plan requires that an order lifecycle be created to link “[o]rders routed from broker-dealers to exchanges” and “[e]xecuted orders and trade reports.”<sup>31</sup> FINRA is proposing at least a 95% pre-correction and 98% post-

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Id.

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This assumes linkage statistics will include both unlinked route reports and new orders where no related route report could be found.

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See CAT NMS Plan, Appendix D, Section 3.

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See id.

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Id.

correction aggregate match rate to each equity exchange for orders routed from Industry Members to an exchange and, for over-the-counter executions, the same match rate for orders linked to trade reports.

In addition to these minimum error rates and matching thresholds that generally must be met before OATS can be retired, FINRA believes that during the minimum 180-day period during which the thresholds are calculated, FINRA's use of the data in the CAT must confirm that (i) usage over that time period has not revealed material issues that have not been corrected, (ii) the CAT includes all data necessary to allow FINRA to continue to meet its surveillance obligations, and (iii) the Plan Processor is sufficiently meeting all of its obligations under the CAT NMS Plan. FINRA believes this time period to use the CAT Data is necessary to reveal any errors that may manifest themselves only after surveillance patterns and other queries have been run and to confirm that the Plan Processor is meeting its obligations and performing its functions adequately.

### (3) Small Industry Member Data Availability

The second issue the Plan requires the proposed rule change to address is “whether the availability of certain data from Small Industry Members two years after the Effective Date would facilitate a more expeditious retirement of duplicative systems.”

FINRA believes that there is no effective way to retire OATS until all current OATS reporters are reporting to the CAT. Although Technical Specifications for Industry Members are not yet available, FINRA believes it would be inefficient, less reliable, and more costly to attempt to marry the OATS and CAT databases for a temporary period to allow some FINRA members to report to CAT while others continue to report to OATS. Consequently, FINRA has concluded at this time that having data from those Small Industry Members currently reporting to

OATS available two years after the Effective Date would substantially facilitate a more expeditious retirement of OATS. For this reason, FINRA supports an amendment to the Plan that would require current OATS Reporters that are “Small Industry Members” to report two years after the Effective Date (instead of three). FINRA intends to work with the other Participants to submit a proposed amendment to the Plan to require Small Industry Members that are OATS Reporters to report two years after the Effective Date.<sup>32</sup>

FINRA has identified approximately 300 member firms that currently report to OATS and meet the definition of “Small Industry Member;” however, only ten of these firms submit information to OATS on their own behalf, and eight of the ten firms report very few orders to OATS.<sup>33</sup> The vast majority of these 300 firms use third parties to fulfill their reporting obligations, and many of these third parties will begin reporting to CAT in November 2018. Consequently, FINRA believes that the burden on current OATS Reporters that are “Small Industry Members” would not be significant if those firms are required to report to CAT beginning in November 2018 rather than November 2019. The burdens, however, are significantly greater for those firms that are not reporting to OATS currently; therefore, FINRA does not believe it would be necessary or appropriate to accelerate CAT reporting for “Small Industry Members” that are not currently reporting to OATS, and FINRA would not support an amendment to the Plan to accelerate CAT reporting for “Small Industry Members” that are not currently OATS Reporters.

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<sup>32</sup> The 180-day timeframes discussed above with respect to usage of the data and calculation of error rates would apply to data reported to the CAT by Small Industry Members that are reporting to OATS. If an amendment to the Plan to accelerate the reporting requirement for those firms is not approved, the retirement of OATS could not be accomplished until at least 180 days after Small Industry Members begin reporting, which is scheduled to begin in November 2019.

<sup>33</sup> For example, in one recent month, eight of the ten firms submitted fewer than 100 reports during the month, with four firms submitting fewer than 50.

#### (4) Individual Industry Member Exemptions

The final issue the Plan requires the proposed rule change to address is “whether individual Industry Members can be exempted from reporting to duplicative systems once their CAT reporting meets specified accuracy and reliability standards, including, but not limited to, ways in which establishing cross-system regulatory functionality or integrating data from existing systems and the CAT would facilitate such Individual Industry Member exemptions.”

As described above, FINRA believes that a single cut-over from OATS to CAT is highly preferable to a firm-by-firm approach and is not proposing to exempt members from the OATS requirements on a firm-by-firm basis. The primary benefit to a firm-by-firm exemptive approach would be to reduce the amount of time an individual firm is required to report to a legacy system (e.g., OATS) if it is also accurately and reliably reporting to the CAT. FINRA believes that the overall accuracy and reliability thresholds for the CAT described above would need to be met under any conditions before firms could stop reporting to OATS. Moreover, as discussed above, FINRA supports amending the Plan to accelerate the reporting requirements for Small Industry Members that are OATS Reporters to report on the same timeframe as all other OATS Reporters. If such an amendment were approved by the Commission, there would be no need to exempt members from OATS requirements on a firm-by-firm basis.

#### (5) Automated Submission of Trading Data

In addition to the OATS rules, Rules 8211 and 8213 (the “EBS Rules”) will also be affected by the implementation of the CAT. The EBS Rules are FINRA’s rules regarding the automated submission of specific trading data to FINRA upon request using the EBS system.

Once broker-dealer reporting to the CAT has begun, the CAT will contain much of the data the Participants would otherwise have requested via the EBS system for purposes of NMS

Securities and OTC Equity Securities. Consequently, FINRA will not need to use the EBS system or request information pursuant to the EBS Rules for NMS Securities and OTC Equity Securities for time periods after CAT reporting has begun if the appropriate accuracy and reliability thresholds are achieved, including an acceptable accuracy rate for customer and account information. However, the EBS Rules cannot be completely removed from the FINRA Rulebook immediately upon the CAT achieving the appropriate thresholds because FINRA may still need to request information pursuant to these rules for trading activity occurring before a member was reporting to the CAT.<sup>34</sup> In addition, the EBS Rules apply to information regarding transactions involving securities that will not be reportable to the CAT initially, such as fixed-income securities; thus, the rules must remain in effect with respect to those transactions indefinitely or until those transactions are captured in the CAT.

The proposed rule change adds new Supplementary Material to the EBS Rules to clarify how FINRA will request data under these rules after members are reporting to the CAT. Specifically, the proposed Supplementary Material to each rule will note that FINRA will request information under the rules only if the information is not available in the CAT because, for example, the transactions in question occurred before the firm was reporting information to the CAT or involved securities that are not reportable to the CAT. In essence, under the new Supplementary Material, FINRA will make requests under these rules if and only if the information is not otherwise available through the CAT.

However, as noted above, FINRA believes that the CAT must meet certain minimum accuracy and reliability standards before FINRA could rely on the CAT Data to replace existing

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<sup>34</sup> Firms are required to maintain the trade information for pre-CAT transactions in equities and options pursuant to applicable rules, such as books and records retention requirements, for the relevant time period, which is generally three or six years, depending upon the record. See 17 CFR 240.17a-3(a), 240.17a-4.

regulatory tools, including EBS. Consequently, the proposed Supplementary Material will be implemented only after the CAT achieves the thresholds set forth above with respect to OATS and an accuracy rate for customer and account information of 95% for pre-corrected data and 98% for post-correction data. In addition, as discussed above, FINRA can rely on CAT Data to replace EBS requests only after FINRA has determined that its usage of the CAT Data over a 180-day period has not revealed material issues that have not been corrected, confirmed that the CAT includes all data necessary to allow FINRA to continue to meet its surveillance obligations, and confirmed that the CAT Plan Processor is fulfilling its obligations under the CAT NMS Plan.

If the Commission approves the proposed rule change, the rule text will be effective; however, the amendments will not be implemented until FINRA has determined the accuracy and reliability standards set forth in the proposed rule change have been met. FINRA will announce the implementation date of the proposed rule change in a Regulatory Notice that will be published once FINRA concludes the thresholds for accuracy and reliability described herein have been met and that the CAT Plan Processor is sufficiently meeting all of its obligations.

## 2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>35</sup> which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed rule change fulfills the obligation in the CAT NMS Plan for FINRA to submit a proposed rule change to eliminate or modify duplicative rules. FINRA believes that the

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<sup>35</sup> 15 U.S.C. 78o-3(b)(6).

approach set forth in the proposed rule change strikes the appropriate balance between ensuring that FINRA is able to continue to fulfill its statutory obligation to protect investors and the public interest by ensuring its surveillance of market activity remains accurate and effective while also establishing a reasonable timeframe for elimination or modification of its rules that will be rendered duplicative after implementation of the CAT.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

(a) Economic Impact Assessment - Retirement of OATS and Amendments to the EBS Rules Following the Implementation of CAT

Currently all FINRA members that do business in equity securities are required to report equity audit trail information to OATS and make transaction information available through the EBS system. As stated in the CAT NMS Plan, all large broker-dealers that are also FINRA members will be required to report order information in NMS Securities and OTC Equity Securities to both OATS and CAT beginning in November 2018 and Small Industry Members beginning in November 2019 as part of the broader CAT NMS Plan to implement the CAT and retire other systems. Further, clearing firms will be required to continue to make equity and option transaction data available through EBS requests until the proposed Supplementary Material is implemented. The proposed rule change lays out a plan by which FINRA will retire OATS and amend its rules for EBS to eventually eliminate the need for duplicative reporting and records maintenance.

Costs and benefits associated with establishing the CAT, including the economic impacts associated with retiring existing systems, have been established as a part of the Plan approved by

the SEC. Significant economic impacts of OATS retirement as described in this proposed rule change include amending the Plan to require that Small Industry Members who currently report to OATS would be required to begin reporting to the CAT in 2018 rather than 2019 and a single cut-over from OATS to CAT for all firms provided that (1) average error rate thresholds over a 180-day period are met, (2) no material issues related to market surveillance needs have been identified but are uncorrected, (3) the CAT not [sic] contain material issues that would negatively impact market surveillance, and (4) the plan processor is sufficiently meeting all of its obligations under the CAT NMS Plan. The key aspect to the proposed amendments to FINRA's rules for EBS include a provision that FINRA would no longer request data that is available in CAT through EBS, once the accuracy and reliability thresholds are achieved. The EBS Rules would continue to apply for securities that are not included within the CAT and for transactions that occurred before the CAT's accuracy and reliability are confirmed.

(b) Economic Impact

In creating the proposal to retire OATS and amend the EBS Rules, FINRA is seeking to carefully balance the additional costs incurred by member firms associated with continuing to maintain duplicate systems and records created by the CAT NMS Plan and existing rules with the risks to effective and efficient surveillance that could arise from eliminating access to existing data systems before a high-quality alternative has been tested and verified. The costs of maintaining duplicate systems and records include, among other things, system maintenance, quality control oversight, and staff to maintain the systems and records. Because the CAT NMS Plan created the need to have duplicate systems and required a plan for the retirement of duplicate systems and processes, the Economic Impact Assessment will focus on the proposed choices made by FINRA in implementing the retirement plan.

(1) OATS Retirement

The proposed rule change will impact all OATS-reporting firms. Currently all but 299 medium and large broker-dealers and 300 of 630 small broker-dealers report to OATS. Of the 300 Small Industry Members that report to OATS, all but 10 of them currently report through other firms or service providers.<sup>36</sup> Of the 10 that self-report, eight of them report very few orders to OATS as described above in Footnote 33. The approximately 629 broker dealers that are currently exempt or excluded from OATS reporting are not impacted by this proposed rule change. The EIA focuses on the impact of the proposed plan for retiring OATS on all OATS-reporting firms.

First, FINRA's proposed plan recommends a requirement that there be a single cut-over from OATS to CAT rather than a firm-by-firm cut-over. The primary beneficiary of this proposal will be the investing public. This approach eliminates the need to merge OATS and CAT data in order to execute surveillance in accordance with SEC rules and SRO obligations. The integration process would be technologically costly and difficult and could introduce errors into the data being surveilled that did not exist prior to integration. Conducting market surveillance from a single audit trail system increases the efficiency and effectiveness of the process and improves the integrity of the markets. In addition, there are direct benefits of this approach to firms. Specifically, other than during the time period during which the accuracy and reliability of CAT data is validated, a single cut-over approach would eliminate the need for firms that report on other firms' behalf to create a technological solution for receiving and

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<sup>36</sup> All of the clearing firms that report to OATS on behalf of Small Industry Members are required to begin reporting to CAT in 2018. In addition, the service providers that report to OATS on behalf of Small Industry Members have a mix of small and large clients for whom they provide this service and, therefore, would be prepared to begin CAT reporting on behalf of their clients in 2018.

reporting on data structured for both OATS and CAT simultaneously. Such a practice would increase costs to ensure compliance with the proper reporting mechanism. These costs would likely be incorporated into the fees for the service charged to introducing firms and could eventually be borne by customers through higher fees based on the price elasticity for brokerage services.

The potential costs associated with the single cut-over approach will be borne by firms that could meet the maximum error thresholds for reporting to CAT earlier than the single cut-over approach would allow. These firms would bear the technology and compliance costs associated with dual reporting for a longer period than they might otherwise.

Another potential cost of the single cut-over method is that there will likely be firms reporting to CAT that do not meet the maximum error rate thresholds, leading to lower quality data available for surveillance. If firms were individually permitted to end OATS reporting only when meeting a maximum error rate, every firm's reporting would meet the minimum criterion. Requiring an aggregate error rate may permit individual firms to end OATS reporting even while their CAT reporting does not meet the specified error rate as long as the error rate is low enough for the industry. Thus, surveillance of market activity for those firms may not be as efficient or effective due to the higher error rates. Taken further, it is possible that a single cut-over may reduce the incentives for any one firm to put significant effort and costs into meeting or beating the threshold error rates because the benefits are shared among all firms while greater cost is borne by the firms whose compliance rates satisfy the minimum error rate thresholds. This disincentive is likely to be small for firms with significant reporting obligations, who would seek to end duplicative reporting as quickly as possible and who represent the vast majority of OATS reports, but may, at the margin, extend the time necessary to meet the error reporting threshold.

However, significant error rates could constitute a rule violation and subject firms to possible disciplinary action.<sup>37</sup> Thus, firms that delay reducing error rates to threshold levels would over time incur higher costs through enforcement actions and be incentivized to improve their compliance rates.

FINRA supports an amendment to the Plan to require that all firms that report to OATS begin CAT reporting in November 2018. This requirement would accelerate by one year the CAT reporting obligations for 300 Small Industry Members. The primary benefit of this approach is that it allows the OATS system to be retired up to a year earlier, saving firms the costs of maintaining duplicate reporting systems. Of the estimated 300 firms who would be impacted by this proposal, 290 report to OATS through clearing firms or other third party providers, all of whom will begin CAT reporting in 2018 either by the requirement in the Plan or on behalf of clients who are required to in the Plan. Thus, there should be limited additional technical requirements or costs to facilitate accelerated reporting for these firms. In fact, the accelerated reporting will likely allow the introducing and clearing firms to avoid the costs associated with maintaining two systems for reporting during the additional transition year. The other 10 small firms will be required to incur costs associated with the changeover to CAT a year earlier. The magnitude of these costs is dependent on several factors, including the volume of trades expected to be reported to CAT as well as the technological differences between the OATS system specifications and the as yet unknown CAT system specifications.

Third, FINRA proposes that the official retirement of OATS occurs only once CAT has met minimum accuracy and reliability standards defined as (1) a maximum of a 5% pre-correction error rate and 2% post-correction error for all CAT submissions averaged over a 180-

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<sup>37</sup> See CAT NMS Plan, Appendix C, Section 3(b) (discussing firm-specific compliance thresholds).

day period in applicable categories, (2) no material data issues not captured in the error rates that would negatively impact FINRA's ability to conduct effective market surveillance, (3) the CAT including all data necessary to allow FINRA to continue to meet its surveillance obligations, and (4) the plan processor is sufficiently meeting all of its obligations under the CAT NMS Plan.

FINRA believes that a minimum of 180 days is required to provide sufficient time to ensure that future error rates below the maximum thresholds are able to be maintained and that the CAT data can otherwise be relied upon for conducting effective market surveillance. The trade-offs of lengthening or shortening the phase-in period and raising or lowering error rate thresholds are increased costs to member firms for maintaining duplicate reporting systems and records versus increased assurance for FINRA that the data will continue to meet maximum error thresholds and not contain material issues that would negatively impact market surveillance. Note that the current OATS error rates are significantly lower than 2%; however, OATS reporting errors have decreased over time with additional experience by firms, and CAT reporting is anticipated to be more complex and new to some firms and therefore more likely to contain errors when initially reported.

#### (2) Electronic Blue Sheet System Rule Amendments

Once broker-dealer reporting to the CAT has begun, the CAT will contain much of the data that otherwise would have been requested via the EBS system for purposes of equities and options. Consequently, FINRA will no longer need to rely on the EBS system or request new information pursuant to the EBS Rules for equities or options for time periods after CAT has met the minimum accuracy and reliability standards defined above. Supplementary Material to the EBS Rules detailing the changes in how FINRA requests equity and options data will be implemented once the appropriate accuracy and reliability thresholds are achieved. The EBS

Rules will remain applicable for historical equity and options data prior to CAT implementation and for record keeping purposes, three to seven years depending on the record. The EBS Rules will also remain in effect for reporting data for securities not reported in CAT.

The proposed changes to the EBS Rules will impact clearing firms differently depending on the amount of automation already built into each firm's EBS system. As described in the Economic Impact Assessment for OATS retirement, there are economic trade-offs for loosening or tightening the requirements under which the new Supplementary Material outlined in the EBS Rule amendments would become effective. Loosening the requirements would hasten the effective date but could increase the risk that the quality of the data received would hamper FINRA's efforts to conduct market surveillance and investigate trading violations, potentially increasing risks to investors. Alternatively, tightening the requirements could decrease the risk that the data will be low quality but will increase the costs to member firms for maintaining duplicate reporting and data delivery systems. These costs to continue using the EBS system will have a differential impact on clearing firms, depending on the level of automation in each firm's EBS response process. Firms that have a fully automated EBS response system incur lower variable costs to responding to any individual request, but have higher fixed costs stemming from maintenance of a more complex system. Alternatively firms where more of the response process is manual incur higher variable costs to EBS requests due to data collection and validation but do not have the more sophisticated systems to maintain and therefore incur low fixed costs. So, when the Supplementary Material is implemented and clearing firms begin receiving fewer Blue Sheet requests, firms with highly manual processes will incur lower variable and therefore lower overall costs while firms with highly automated systems will likely see more modest cost decline. Firms with semi- or fully-automated EBS response systems may

decide to phase out their automated systems and gradually replace them with more manual processes as the number of requests declines. Because clearing firms use different processes and systems to collect and submit EBS requests, there is ambiguity as to whether any individual firm's costs will be affected by the transition to CAT for transaction data requests and at what point firms may choose to move toward manual processes.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Although written comments on the proposed rule change were not solicited, two commenters, the Financial Information Forum ("FIF") and the Securities Industry and Financial Markets Association ("SIFMA"), submitted letters to the Participants regarding the retirement of systems related to the CAT.<sup>38</sup> In its comment letter, with regard to the retirement of duplicative systems more generally, FIF recommends that the Participants continue the effort to incorporate current reporting obligations into the CAT in order to replace existing reportable systems with the CAT. In addition, FIF further recommends that, once a CAT Reporter achieves satisfactory reporting data quality, the CAT Reporter should be exempt from reporting to any duplicative reporting systems. FIF believes that these recommendations "would serve both an underlying regulatory objective of more immediate and accurate access to data as well as an industry objective of reduced costs and burdens of regulatory oversight."<sup>39</sup> In its comments about EBS specifically, FIF states that the retirement of the EBS requirements should be a high priority, and that the CAT should be designed to include the requisite data elements to permit the rapid

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<sup>38</sup> Letter from William H. Hebert, FIF, to Participants re: Milestone for Participants' rule change filings to eliminate/modify duplicative rules, dated April 12, 2017 ("FIF Letter"); Letter from Kenneth E. Bentsen, Jr., SIFMA, to Participants re: Selection of Thesys as CAT Processor, dated April 4, 2017, at 2 ("SIFMA Letter").

<sup>39</sup> FIF Letter at 2.

retirement of the EBS system.<sup>40</sup> Similarly, SIFMA states that “the establishment of the CAT must be accompanied by the prompt elimination of duplicative systems,” and “recommend[ed] that the initial technical specifications be designed to facilitate the immediate retirement of . . . duplicative reporting systems.”<sup>41</sup>

As discussed above, FINRA agrees with the commenters that the OATS reporting requirements should be replaced by the CAT reporting requirements as soon as accurate and reliable CAT Data is available. To this end, FINRA anticipates that the CAT will be designed to collect the data necessary to permit the retirement of OATS. As discussed above, FINRA disagrees with the recommendation to provide individual exemptions to those CAT Reporters who obtain satisfactory data reporting quality; however, FINRA supports amendments to the CAT NMS Plan that would accelerate reporting for Small Industry Members that are currently reporting to OATS to facilitate the retirement of OATS.

### III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

### IV. Solicitation of Comments

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<sup>40</sup> Id.

<sup>41</sup> SIFMA Letter at 2.

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2017-013 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2017-013. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the

Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2017-013 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>42</sup>

Eduardo A. Aleman  
Assistant Secretary

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<sup>42</sup> 17 CFR 200.30-3(a)(12).