

# Client Update

## The SEC Proposes the CAT Plan, but at What Cost?

### NEW YORK

Lee A. Schneider  
lschneider@debevoise.com

Max Shaul  
mshaul@debevoise.com

Lilya Tessler  
ltessler@debevoise.com

As technology becomes the predominant means for delivering financial services and interacting with markets, industry regulators have focused more keenly on the development of their own tools to effectively monitor activity. The Securities and Exchange Commission (the “SEC”) took a significant step in that direction on April 27, 2016, by proposing for comment the latest version of the consolidated audit trail (“CAT”) plan (the “CAT Plan”), which will create a database accumulating all data relating to equity and options markets activity.<sup>1</sup>

The CAT Plan represents a further move by the SEC into the technology sphere. For example, Regulation Systems Compliance and Integrity,<sup>2</sup> which came into effect this past November, imposed requirements on major market participants such as self-regulatory organizations (“SROs”) with respect to the development, implementation and monitoring of their technology systems. Cybersecurity also has been a focus of various divisions within the SEC.<sup>3</sup>

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<sup>1</sup> Joint Industry Plan; Notice of Filing of the National Market System Plan Governing the Consolidated Audit Trail, Securities and Exchange Commission Release No. 34-77724; File No. 4-698 (Apr. 27, 2016) (the “Proposal”), available at <https://www.sec.gov/rules/sro/nms/2016/34-77724.pdf>.

<sup>2</sup> Regulation Systems Compliance and Integrity, Exchange Act Release No. 34-73639 (Nov. 19, 2014), 79 FR 72252 (December 5, 2014), available at <http://www.gpo.gov/fdsys/pkg/FR-2014-12-05/pdf/2014-27767.pdf>.

<sup>3</sup> See Jeremy Feigelson, Lee A. Schneider & Max Shaul, Law360, *SEC Regulation of Cybersecurity and Tech Risk Converges* (Oct. 23, 2015), <http://www.law360.com/articles/718238/sec-regulation-of-cybersecurity-and-tech-risk-converges>; see also the SEC’s Division of Investment Management Guidance Update No. 2015-02, *Cybersecurity Guidance* (Apr. 2015), available at <https://www.sec.gov/investment/im-guidance-2015-02.pdf>. The SEC has also focused on cybersecurity in enforcement actions (see, e.g., SEC Investment Advisers Act of 1940 Release No. 4204, *In the Matter of R.T. Jones Capital Equities Management, Inc.* (Sept. 22, 2015), available at <https://www.sec.gov/litigation/admin/2015/ia-4204.pdf>).

With these preparations in place and after four years of collaboration amongst the SROs, including all equities and options exchanges (the “Participants”), the SEC seeks comment on the CAT Plan pursuant to Rule 613 of Regulation NMS.<sup>4</sup> The data repository to be created will enable the SEC and the Participants to more efficiently conduct investigations, examinations and market analyses, and to provide better information for purposes of their rulemaking function. This update provides a summary of key aspects of the CAT Plan as well as certain concerns that it raises.

### CAT GOVERNANCE

The CAT Plan would create a new legal entity called CAT NMS, LLC to oversee operations of the repository and the use of its data as well as to formulate its compliance rules. The entity would be owned by the Participants (all SROs, including stock and options exchanges and the Financial Industry Regulatory Authority, or “FINRA”), who would delegate management to an Operating Committee. The Participants would, through a series of compliance rules, implement the CAT Plan with respect to Industry Members (the broker-dealer community).<sup>5</sup> In essence, CAT NMS, LLC has the governance and operations responsibility for the CAT Plan and the data repository.

Industry Members have a limited voice in the operations of the CAT through an independent Advisory Committee overseen by the SEC’s Chief Technology Officer. The Advisory Committee will consist of representatives of twelve categories of broker-dealers varying by size and type of firm, with no fewer than three broker-dealers in the options business and three broker-dealers in the equities business. The Advisory Committee would not have any governance powers, but would provide Industry Members with a voice in the implementation of the CAT Plan and use of the repository. At first blush, it appears that CAT NMS, LLC will function like a super-SRO in certain respects, but without the full complement of governance participation from all the entities it regulates.

The final member of the CAT Plan community would be the Plan Processor, who would administer the CAT system and maintain the Central Repository.<sup>6</sup>

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<sup>4</sup> 17 C.F.R. 242.613.

<sup>5</sup> “Industry Member” is defined as a member of a national security exchange or a member of a national securities association, which essentially covers all broker-dealers.

<sup>6</sup> “Central Repository” is defined as the repository responsible for the receipt, consolidation and retention of all information reported to the CAT pursuant to SEC Rule 613 and the Limited Liability Company Agreement of CAT NMS, LLC.

The Plan Processor's role would include responsibility for the day-to-day functionality of the CAT system in accordance with the technical specifications outlined in Appendix D of the CAT Plan, including recordkeeping and compliance responsibilities. At a minimum, the Plan Processor will hire a chief compliance officer ("CCO") and a chief information security officer ("CISO") as employees. The Plan Processor will report directly to the Operating Committee of CAT NMS, LLC, which will oversee its activities. The Plan Processor will be selected through a two-part bidding process, the first portion of which has narrowed the field to three finalists: FINRA, SunGard and Thesys Technologies. We note that FINRA also is one of the Participants.

### COVERED SECURITIES AND EXEMPTIONS

The proposed CAT Plan applies to all NMS and OTC securities, which includes most equities and listed options trading in secondary markets. Industry Members should note that the plan includes a provision requiring the Participants to jointly provide to the SEC, within six months from the effective date, a proposal for expanding the Central Repository to include debt securities and primary market transactions. The CAT Plan includes a number of exemptions approved by the SEC in response to industry concerns related to: (i) Options Market Makers, (ii) Customer IDs, (iii) CAT-Reporter-IDs, (iv) execution linkage and (v) time-stamp granularity. We do not discuss these exemptions in this update.

### CAT PLAN REPORTING REQUIREMENTS

The CAT Plan provides uniform data synchronization and reporting requirements across all Participants and Industry Members, with the view of providing expanded ability for regulators to conduct surveillance and reconstruct market events, as well as the possibility of replacing existing systems such as FINRA's Order Audit Trail System ("OATS"), the Electronic Blue Sheet system, and the Large Trader reporting requirements, among others. In order to construct the repository, Industry Members must record numerous data points contemporaneously with each "Reportable Event," defined to include, among other things, "the original receipt or origination, modification, cancellation, routing, execution (in whole or in part) and allocation of an order, and receipt of a routed order." The Operating Committee will have the power to expand that definition.

Participants and Industry Members must report the data associated with each Reportable Event to the Central Repository by 8:00 a.m. Eastern Time on T+1.

The plan provides a list of the data points<sup>7</sup> that need to be reported for each Reportable Event, including customer identification information, which may include Personally Identifiable Information (“PII”).<sup>8</sup> Currently, PII is collected by Industry Members, but is not reported to Participants, except during an inquiry or examination or pursuant to a subpoena; this will be a big change for the industry and raises significant data security and privacy concerns. Upon commencement of reporting, Industry Members must submit an initial set of customer information and update that information on a daily basis thereafter, including PII.

Participants and Industry Members will be required to synchronize business clocks, except those used solely for manual orders, to within 50 milliseconds of the time maintained by the National Institute of Standards and Technology. The SEC proposed this increment based on industry feedback and balancing cost versus accuracy. Manual orders will be synchronized to within one second and some firms may use a finer increment than the minimum. Industry Members must certify periodically that they meet such standards and report any violations. Regulators have acknowledged that 50-millisecond time increments may be too long and will not provide a completely accurate picture of the speed of trading, particularly with respect to high-frequency trading firms. Chair White remarked, “This element of the proposal is also a significant cost driver that must be carefully considered. Opinions on the rigor and practicality of various clock synchronization standards and their impacts on our regulatory objectives are of keen interest.”<sup>9</sup>

One stated purpose of the CAT is to enable regulators to more easily identify sources of market disruptions during events like the 2010 “flash crash.” However, not only does the 50-millisecond time differential cause potential uncertainty in any attempted recreation, but the CAT Plan also permits an initial error rate of 5% for reporting. This high number of errors has caused some to question the potential accuracy of the Central Repository. Based on industry experience with

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<sup>7</sup> Some examples of data that will be reported include: Firm Designated IDs for each Customer, SRO-Assigned Market Participant Identifier of the Industry Member receiving or originating the order, the date of order receipt or origination, the time of order receipt or origination, the material terms of the order, the CAT-Order-ID and other similar information.

<sup>8</sup> Exhibit A p.47-49 to the CAT Plan includes a list of all data to be provided based on each Reportable Event.

<sup>9</sup> SEC Chair Mary Joe White, Statement at an Open Meeting on a Notice of the Consolidated Audit Trail Market System Plan (Apr. 27, 2016), available at <https://www.sec.gov/news/statement/chair-white-open-meeting-042716.html>.

FINRA's OATS implementation and reporting, the initial maximum error rate of 5% will be phased down to 1% over a four-year period. In the proposal, the SEC specifically asked for comment from Industry Members on whether this 5% threshold seems "materially unreliable."

In addition to the data from Industry Members, the Central Repository will receive, consolidate and retain all SIP data, including NBBO, trading halts, and limits. As the Central Repository will be handling massive amounts of data, the SEC intends for it to use sophisticated technologies in order to support three aims: (i) scalability to increase the capacity to handle a significant increase in the volume of reported data, (ii) adaptability to support future technology developments and new requirements, and (iii) maintenance and upgrades to ensure technology is kept current and operational. The repository will maintain all data in a convenient and usable standard electronic data format that is directly available and searchable electronically for at least six years.

#### CAT DATA ACCESS AND SECURITY

In light of the huge amount of sensitive data that will be housed in the Central Repository, the Plan Processor will have a lot of work to provide access to regulators on a timely basis and, most importantly, appropriate data security. Under the proposal, the Plan Processor must provide the SEC and the Participants access to corrected and linked order and customer data by 8:00 a.m. Eastern Time on T+5, through both an online targeted query tool and through user-defined direct queries. The SEC is currently considering two data submission options: (i) the Industry Member's choice of messaging transmission or (ii) a format defined and specified by the Plan Processor. The submission method will depend upon which Plan Processor wins the bid.

The CAT Plan currently includes provisions for hiring standards and secure data access controls, particularly as it pertains to access by the Plan Processor, its staff and third-party service providers. The Plan Processor must certify to the Operating Committee at least annually that only Participants and the SEC have access to the Central Repository, other than access provided to Industry Members for correcting data. All data in the repository will be encrypted while at rest, and PII data will be encrypted both at rest and in-flight, as well as masked unless users have permission, granted on a "need-to-know" basis. While the proposed security measures vary by bidder and will be a major factor in considering an appropriate candidate for Plan Processor, all bidders suggested segregating PII from non-PII data with separate access controls.

The Plan Processor's CISO will be responsible for creating and enforcing policies to address data security issues, including connectivity, encryption, breach management, data storage, PII data requirements and penetration testing. Specific policies will be developed related to data loss prevention, business continuity plans and cyber incident response plans. The Plan Processor is required to report all noncompliance to the CCO within 24 hours.

To comply with the CAT Plan, the Participants will need to consider their compliance obligations under Reg SCI, as the SEC believes that CAT will be an SCI system of each Participant. Industry Members should consider whether implementation of the CAT Plan will require changes to their own cybersecurity policies and contractual relationships with clients and vendors.

### **COST TO THE INDUSTRY**

The CAT Plan reflects an unprecedented technology change for the industry at a cost estimated to be in excess of \$3 billion, likely to be borne by investors through new fees. The Proposal provides detailed estimates of implementation and maintenance costs of the CAT Plan by the Plan Processor, as provided by each bidder, along with additional cost estimates related to technology changes required by each Participant, Industry Member and third-party service provider to comply with the CAT Plan. To cover the cost of implementation and operation of the CAT NMS, LLC, along with the Central Repository by the Plan Processor, the Operating Committee will establish fee tiers based on market share for Participants and message traffic for Industry Members, along with ancillary fees for late or inaccurate reporting, correction of submitted information or access for regulatory purposes. The proposal includes a summary of the estimated cost by market participant.<sup>10</sup>

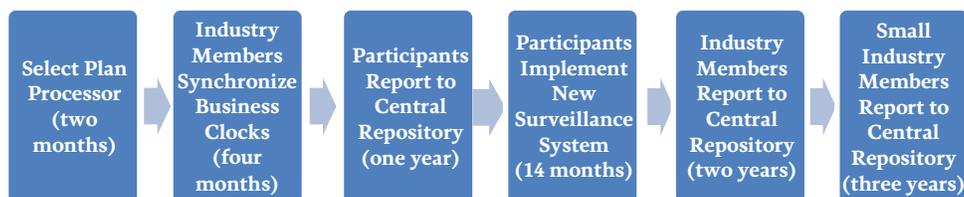
The CAT Plan as proposed does not make clear what fines or penalties might ensue for submissions of faulty or inaccurate data, or persistently late submissions. If such fines will be one manner by which CAT NMS, LLC funds its activities, Industry Members will be interested to understand these fines in more detail. Moreover, if CAT NMS, LLC will only be one of multiple regulators that will administer penalties, the potential costs associated with the CAT Plan might become quite significant.

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<sup>10</sup> See CAT Plan, supra note 1 at p. 470.

### IMPLEMENTATION SCHEDULE

The CAT Plan provides a detailed implementation schedule, all of which will happen within three years of the effective date. Industry Members may want to comment on the practicality of the implementation timeline, given the required changes to market structure, technology and data security.



### CONCLUSION

The CAT Plan may become the most robust and complicated financial database in the world and we recommend that firms carefully review and consider its implications. It is important to understand the benefits of the plan, along with the technology burdens it will impose upon industry and privacy concerns to the ultimate investors. The sixty-day comment period provides the opportunity for the industry to raise concerns and we suggest that Industry Members consider the issues raised by the Proposal and their impacts on each member’s business.

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Please do not hesitate to contact us with any questions.