– FACT SHEET –

The Consolidated Audit Trail is a long overdue transparency and accountability measure to protect investors and the integrity of the U.S. securities markets

Updated: February 16, 2021

What is the Consolidated Audit Trail?

In 2016, the Securities and Exchange Commission approved a rule (Rule 613) that requires stock exchanges and the Financial Industry Regulatory Authority (FINRA) to establish a consolidated audit trail (CAT) for much of order and trade information generated in the capital markets. The CAT is meant to address the SEC's and self-regulatory organizations' (SROs) challenges effectively overseeing today's complex, dispersed, and highly automated securities markets, which generate disparate data from information systems lacking in completeness, accuracy, accessibility, and timeliness. The implementation of the CAT has suffered from years-long delays and is still not fully operational.

The GameStop and "Reddit Rebellion" perhaps best illustrates the need for the CAT. If the regulators had access to a fully operational CAT, they would be able to monitor the trading of these "meme" stocks much more quickly and effectively, and detect manipulative and predatory behavior. Without a CAT, the regulators must rely on decades old information systems that are slow and contain incomplete information. While the SEC and regulators lack the adequate technology and databases to effectively regulate the markets, the hedge funds, high-frequency traders, and other sophisticated market participants use cutting-edge technology to gain advantage over competitors, and often, at the expense of retail investors and market integrity. This disparity is harmful to investors, and risks damaging investors' confidence both in the markets and the regulators charged to police these markets—as evidenced by the recent GameStop saga.

A similar investor-confidence shattering episode took place more than a decade ago called the "Flash Crash." After the Flash Crash, the SEC required months and thousands of staff hours to reconstruct events that occurred over less than 18 minutes, largely because the SEC had neither the tools nor the data to understand how and why securities markets experienced a record, precipitous drop in value and subsequent recovery. Ten years or so later, the U.S. securities markets still do not have a CAT, leaving investors vulnerable not only to another Flash Crash but also to predatory trading activities and other types of misconduct—which likely occurred in recent weeks.

The CAT—properly implemented—would provide the SEC diagnostic and enforcement tools to prevent, detect, and correct such misconduct and market events that can erode investor confidence and participation in the capital markets, increase costs for investors, and increase market fragility. Without a

CAT, it will be near impossible for the regulators to gain a deep understanding of the players and the predatory practices related to the “meme” stocks.

The SEC must have access to timely, accurate, and complete information on trading activities to effectively police markets and consider policy improvements in light of trading anomalies. Once fully operationalized, the CAT will collect granular order, cancellation, modification, and trade execution information and enable the SEC and other regulators to reduce, manage, and better understand market disruptions, distortions, and crashes—including anomalous trading events like the GameStop frenzy—and identify, deter, and punish manipulative, disruptive, or other illegal trading activities.

The CAT will aggregate data on tens of billions of trades each day, collected from more than 2,000 sources. This massive database, coupled with a supercomputer which will consolidate the data, would potentially allow the SEC, FINRA and exchanges that have surveillance responsibilities, to sift through trading records to detect market manipulation or fraud, and will help the agency reconstruct market activity in the event of a disruption.

Policymakers must now hold the industry-led consortium called CAT NMS accountable for its years-long failure to fully operationalize the CAT. In this regard, policymaker must examine:

- Whether conflicts-of-interest embedded in the CAT’s governance structure have impeded implementation and thereby denied the SEC a valuable tool needed to assess recent GameStop trading and related market activities, and whether those conflicts of interest will continue to plague the CAT once it is operational;
- Whether the SEC should continue to outsource construction and operation of the CAT to the industry or the industry’s representatives in light of the many crippling conflicts of interest and repeated failures to meet deadlines and operationalize the long overdue project;
- Whether transparent CAT-planning milestones and significant penalties can be adopted near-term to increase accountability and the rapid construction, deployment, and operation of the CAT;
- Whether recent changes to the CAT NMS Rule would make it more difficult for regulators to detect manipulative trading activities and identify manipulators—and make CAT less user-friendly—by (1) reducing or eliminating key information to be reported into CAT and (2) increasing hurdles (such as download and access limits) for users;
- Whether accelerated phased implementation of certain order and trade execution information would better facilitate near-term completion of the CAT; and
- Whether the SEC should upgrade CAT with an eye towards real-time reporting as originally envisioned by the SEC in 2010.

The SEC has recently proposed a series of amendments to Rule 613 to increase transparency and accountability of CAT implementation. But it has also approved changes—such as limiting the amount of information CAT could gather and placed limits on its use—that risk turning CAT into a user-unfriendly, bulky and a slow database and information system. In light of GameStop, policymaker should revisit these changes. Additional key concerns about CAT include:

- ✓ **<u>Industry Control</u>:** The CAT suffers from serious governance deficiencies, the most apparent of which is that it is owned, controlled, and operated by the financial industry. That presents a conflict of interest, because the CAT is a critical enforcement tool that could increase regulatory risks for the very firms overseeing implementation.

- ✓ **<u>SEC and FINRA Should Jointly Operate the CAT:</u>** CAT—a mission critical tool—should be a governmental regulatory tool operated by the SEC and used to protect investors, make the capital markets fairer, and facilitate investments in companies. SEC and FINRA should control regulatory access (including user-accounts) and should limit the access to CAT of SROs (i.e., exchange) that also have affiliated broker-dealers or otherwise engage in commercial activities that utilize trading data.

- ✓ **<u>CAT Governance Must Be Reformed:</u>** Given the failure to implement CAT, the governing structure of CAT NMS must be reformed to increase accountability and transparency. The charter of CAT NMS must be turned into a not-for-profit entity, the SEC must designate a permanent Chair of the CAT NMS Operating Committee, and, the SEC must appoint independent members to Operating Committee who are not representatives of the industry. Absent these critical governance reforms, the SEC must begin enforcement proceedings against CAT NMS group, as expressly permitted under Rule 613, should CAT NMS miss any further deadlines. These enforcement actions must include significant penalties to compel CAT NMS to complete the implementation.

- ✓ **<u>CAT 2.0 Should Be Real-Time, Include Data on All Products:</u>** CAT NMS plan should be amended to mandate regular and meaningful upgrades to CAT system. CAT 2.0 should strive to enable regulators to surveil the markets in real-time (as proposed in the initial SEC Rule 613). CAT 2.0 should also include futures data, clearing data, and be integrated in the derivatives reporting and repository systems.

For more on CAT—and to access Better Markets' years-long advocacy on CAT—please visit https://bettermarkets.com/Where-Is-The-CAT.

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