



VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS
AND INDEPENDENT FINANCIAL ADVISORS

VIA ELECTRONIC MAIL

July 18, 2016

Brent J. Fields
Secretary, Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Joint Industry Plan; Notice of Filing of the National Market System Plan Governing the Consolidated Audit Trail

Dear Secretary Fields:

On May 17, 2016, the Securities and Exchange Commission (SEC) published a request for public comment on a proposed national market system (NMS) plan to create a consolidated audit trail (CAT) (CAT NMS Plan).¹ The proposed CAT is a single, comprehensive database that would enable regulators to efficiently track all trading activity in the U.S. equity and options markets. The CAT NMS Plan was submitted jointly by the self-regulatory organizations (SROs) as required by Rule 613 of Regulation NMS (Rule 613).²

The Financial Services Institute³ (FSI) appreciates the opportunity to comment on this important proposal. FSI supports leveraging technology to protect investors. However, we are concerned that the current proposal may have unintended consequences, particularly with regard to data security and access. FSI seeks clarification as to who bears liability to investors in the event of a breach of the central data repository. FSI also requests a thorough cost-benefit analysis in order to ensure that overly burdensome implementation costs do not restrict consumer access to objective financial guidance.

Background on FSI Members

The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the U.S., there are approximately 167,000 independent financial advisors, which account for approximately 64.5% percent of all producing registered representatives. These financial advisors are self-employed independent contractors, rather than employees of Independent Broker-Dealers (IBD).

¹ Notice of Filing and Immediate Effectiveness of Amendment No. 3 to the National Market System Plan Governing the Process of Selecting a Plan Processor and Developing a Plan for the Consolidated Audit Trail, 81 Fed. Reg. 35072 (June 1, 2016).

² SEC Rule 613: Consolidated Audit Trail (CAT), www.catnmsplan.com (last visited July 13, 2016).

³ The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has more than 100 Broker-Dealer member firms that have approximately 138,000 affiliated registered representatives serving more than 14 million American households. FSI also has more than 35,000 Financial Advisor members.

FSI member firms provide business support to financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions. Independent financial advisors are small-business owners who typically have strong ties to their communities and know their clients personally. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations and retirement plans with financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI member firms and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their investment goals.

Comments

FSI and its members have a great appreciation for the immense value data and technology can bring to the industry, regulators, and investors. New technologies continue to play an enormously important and transformative role in nearly every industry. The effective use of new technologies is particularly essential in the financial services industry and the IBD community in particular. FSI members have been effectively using technology to enhance their ability to conduct remote supervision, build robust compliance efforts, and provide innovative services to investors.

Technology has also changed the way that clients and financial advisors communicate about investing, whether by reviewing performance metrics and portfolio composition on a tablet or conducting meetings through videoconferences. The adoption of social media platforms and the emergence of “robo-advisors”⁴ will continue to change the way that clients receive financial advice and how advisors deliver value to their existing clients as well as the next generation of investors. As the industry and investors change, regulators must adapt as well and adopt new tools and technologies to better protect investors and conduct more targeted and efficient examinations and industry surveillance.

The SEC has proposed the CAT as one tool that will allow them to leverage the power of technology to be a more effective and efficient regulator. FSI members are interested in providing essential input and suggestions for the SEC to create a system that will allow it to achieve its important investor protection goals. We provide our comments and suggestions in the sections below.

OVERSIGHT

1. Overview

Rule 613 outlines a broad framework for the creation, implementation, and maintenance of the CAT, including the minimum elements the Commission believes are necessary for an effective consolidated audit trail. The CAT must collect and accurately identify every order, cancellation, modification, and trade execution for all exchange-listed equities and equity options across all U.S. markets. The proposed CAT NMS Plan would create a jointly owned LLC whose Operating Committee would be comprised of one representative from each national securities exchange and national securities association. The Operating Committee would select a Plan Processor to create

⁴ See Eric Rasmussen, The Rise of the Robo Advisors, Financial Advisor Magazine, available at <http://www.famag.com/news/the-rise-of-the-robo-advisors-17370.html>.

and operate the CAT. Following a Request for Proposals, the Selection Committee has narrowed the list to six Shortlisted Bidders and will select the Plan Processor via two rounds of voting as specified in the Plan.

The proposed CAT NMS Plan outlines the requirements for recording and reporting of CAT data by SROs and broker-dealers, and sets forth a plan to ensure the accuracy, integrity and security of the data in the CAT. The Plan Processor will provide the Operating Committee regular reports on the CAT System's operation and maintenance. The Plan Processor will be required to appoint, at a minimum the CCO, the CISO, and the Independent Auditor, to be approved by supermajority vote of the Operating Committee. The Operating Committee may remove the Plan Processor by a Supermajority vote at any time, or by a majority vote if it determines the Plan Processor "has failed to perform its functions in a reasonable acceptable manner in accordance with the provisions of the plan, or that its expenses have become excessive and are not justified."⁵ The Plan Processor may resign upon two year's prior written notice.

2. Conflict of Interest

FSI believes the Plan Processor's enumerated responsibilities are appropriate and reasonable, and the Operating Committee is given sufficient authority to maintain oversight over the Plan Processor. However, the CAT NMS Plan requires the Plan Processor to appoint a CCO and CISO, who would be officers of the LLC as well as employees of the Processor. FSI is concerned that this arrangement creates a potential conflict of interest that would undermine the ability of these officers to effectively carry out their responsibilities under the CAT NMS Plan because they would owe a fiduciary duty to the Plan Processor rather than to the LLC. Because they will be officers of the LLC, the CCO and CISO should be required to act in the best interest of the LLC in order to avoid conflicts of interest in carrying out their oversight activities. The CAT NMS Plan should impose a fiduciary duty on the CCO and CISO, or at a minimum, should require the Plan Processor to select individuals who do not have a fiduciary duty to the Plan Processor to serve in these roles.

3. Access to Data and Regulatory Oversight

The CAT NMS Plan provides that the Plan Processor will provide participants and the SEC with access to all CAT Data stored in the Central Repository through both an online targeted query tool, and user-defined direct queries and bulk extracts. The method in which the CAT Data is stored in the Central Repository will allow the ability to return results of queries that are complex in nature, including market reconstruction and the status of order books, at varying time intervals. While the Plan Processor will be required to certify annually or upon request from the Operating Committee that only Participants and the SEC have access to the Central Repository, FSI is concerned that absent reasonable safeguards, someone other than the intended user could obtain the extracts or query results. Once the data has been generated, it could potentially be removed from the Central Repository. Thus, an unauthorized user could obtain the data without accessing the CAT NMS System. While FSI does not believe that the CAT NMS Plan should mandate a particular data storage method, our members support requiring PII to be stored separately, given its sensitive nature and the potential for identity theft or fraud. Consequently, FSI supports the requirement that personally identifiable information (PII) be excluded from direct query tools, reports or bulk data extraction.

⁵ CAT NMS Plan Section 6.1(r).

DATA SECURITY

1. Overview

The Plan Processor is required to develop and maintain a comprehensive information security program for the Central Repository to ensure the security and confidentiality of all information reported to and maintained by the CAT. The information security program must be approved and reviewed at least annually by the Operating Committee. The program must include an overview of network security controls and document the process for responding to and reporting security incidents. The plan also instructs the Plan Processor to develop policies and procedures governing its responses to systems or data breaches, including a formal cyber incident response plan and documentation. The plan takes a principles-based approach rather than a prescriptive one with regard to these issues, providing the Plan Processor with a list of items such a response plan *may* include.

2. Data Breach Protocols

FSI supports requiring an annual review of the Plan Provider's information security plan by the Operating Committee. However, in light of FSI's belief that the CAT would be an attractive target for hackers, we recommend that the Plan Provider also be required to release a protocol document describing the specific procedures it will take upon a breach of CAT, including the procedure for notifying participants and allowing them to suspend CAT submissions temporarily in the event of an ongoing breach. Further, the CAT NMS Plan should specify that the Plan Provider will also notify investors of a breach of the CAT,. Regardless of whether the hacked data would be useful, any breach of the system where customer data is revealed should be disclosed to investors.

While the data security plan must include an explanation of the process by which the Plan Processor will assess the system for vulnerabilities, FSI requests that the data security plan also include a process for reviewing data incidents to determine what corrective actions are required to reduce the likelihood of reoccurrence. FSI believes that a breach review and corrective action plan are essential components of a comprehensive security program. Hopefully, the CAT will not be hacked in the near term, but it is possibility likelihood that the system will be breached in some manner in the long-term. It is important for investors and firms to know that the Plan Processor has a process in place to address any exploited vulnerabilities, ensure that personal investor data will be secured, and that breaches will be addressed and remedied swiftly. As such, FSI would appreciate the Plan Processor developing a process to review data incidents and sharing that protocol with the public so that all stakeholders can understand the full extent of the CAT NMS Plan's comprehensive security program.

3. Liability

FSI members request clarification from the Plan Processor regarding their liability to investors in the event of a CAT breach. In its current form, the Plan does not address the issue of who bears liability for a breach of the CAT or its Central Repository. The Plan Processor is responsible for constructing and operating the CAT, with the oversight of the Operating Committee, and will be solely in control of the system's information security. FSI suggests that the Plan Processor should bear responsibility in the event of a data breach and the CAT NMS Plan contain language to that

effect. Furthermore, as the Plan Processor will be solely responsible for the system's information security controls, it should expressly indemnify Participants for any costs or damages incurred as a result of a data breach occurring after they have provided data to the CAT.

4. Supervision

An April 2016 GAO report observed that the SEC has not addressed many of the cybersecurity weaknesses previously identified by GAO. The report found that despite issuing policies and implementing controls based on those policies, the SEC did not consistently protect access to its systems.⁶ The GAO asserted that weaknesses limiting the effectiveness of security controls exist in part because the SEC has not fully implemented an organization-wide information security program. FSI suggests that Participants require the Plan Processor to implement the safeguards outlined in the report to improve cybersecurity. At a minimum, the Plan Processor should be required to address the previously identified deficiencies in order to bolster the CAT's security. In particular, the GAO suggested the Commission: consistently review and update its information security policies in a timely manner; completely document plans of action to address weaknesses; document a physical inventory of its systems and applications; and fully implement a program to continuously monitor the security of its systems and networks. Eliminating potential weaknesses from the beginning will facilitate the smooth operation of the CAT and enhance the confidentiality, integrity, and availability of financial information. As a result, we urge the SEC to require the Plan Processor to adopt these practices prior to accepting data.

5. Business Continuity Plan

The Plan Processor would be required to develop and implement disaster recovery and business continuity plans (BCP) for the CAT, which must be approved and regularly reviewed by the Operating Committee. The BCP must address the protection of data and determine how business activities will continue in the event of a widespread disruption according to certain standards put forth by the National Institute of Standards and Technology. FSI members recognize the importance of business continuity planning for both investors and advisors. In order to support business operations, the CAT NMS Plan requires the Plan Processor to have a secondary site to house critical staff and operations. In addition, a bi-annual test of CAT operations at this secondary facility is required. Bi-annual is commonly understood to indicate twice in a year, but can be defined as every two years.⁷ Due to the sensitive nature of the CAT data, FSI requests clarification that this test is required to be conducted twice yearly, rather than once every two years. In order for the BCP to be the most effective, frequent testing of secondary equipment and critical personnel should be tested no less than once per year.

COST BENEFIT ANALYSIS

While it is not possible to conduct an accurate cost benefit analysis before a Plan Processor has been approved, the SEC must underscore the importance of the analysis to ensure that overly burdensome implementation costs do not restrict consumer access to objective financial guidance.

⁶ U.S. Gov't Accountability Office, GAO 16-493, Information Security: Opportunities Exist for SEC to Improve its Controls over Financial Systems and Data (2016).

⁷ The Merriam-Webster dictionary defines biannual as "happening twice a year; or happening every two years." Biannual Definition, Merriam-Webster.com, www.merriam-webster.com/dictionary/biannual (last visited July 14, 2016). The Oxford English Dictionary defines biannual as "occurring twice a year." Biannual Definition, Oxford Dictionaries.com, www.oxforddictionaries.com/definition/english/biannual (last visited July 14, 2016).

1. Funding

The Operating Committee has the discretion to establish funding for the LLC on an annual basis. The Plan provides that any net profit or net loss will be allocated equally among Participants and the Operating Committee will approve an annual operating budget for the LLC. To the extent that fees will be assessed on Participants, FSI requests transparency in the process of calculating such fees to ensure they are reasonably related to the anticipated costs to build, operate, and administer the CAT.

2. Implementation Costs

Because each shortlisted bidder has proposed a different approach to various issues, the specific approach taken in implementing aspects of the CAT NMS Plan will depend on which bidder is selected as the Plan Processor. Once the Plan Processor is selected, firms will have the ability to provide more definitive cost estimates and other projections related to CAT implementation. In determining fees related to implementation costs, the CAT NMS Plan provides that such costs "shall be fairly and reasonably shared among the Participants and Industry Members."⁸ We look forward to providing further feedback on information related to the specific costs, benefits and challenges related to CAT implementation once a Plan Processor is selected.

Conclusion

FSI supports leveraging innovative technologies to inform the regulatory process. We believe CAT is an important step toward leveraging technologies and request that our comments and concerns be considered in its implementation. We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with the SEC on this and other important regulatory efforts.

Thank you for considering FSI's comments. Should you have any questions, please contact me at (202) 803-6061.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "D. T. Bellaire". The signature is fluid and cursive, with a large initial "D" and "T" and a stylized "Bellaire".

David T. Bellaire, Esq.
Executive Vice President & General Counsel

⁸ CAT NMS Plan, Article XI.