Consolidated Audit Trail (CAT): the saga continues

RegEdge

Regulatory Technology Transformation

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Background

Just when it seemed that things had finally settled down with Consolidated Audit Trail (CAT) requirements and preparations, industry members woke up to a flurry of text messages, tweets and emails earlier this year (January 31, 2019) informing them that Thesys – the CAT processor selected by the operating committee – had been fired, and that the responsibility to build and operate CAT would be transitioned to a new entity. This was later confirmed to be FINRA. Despite murmurs about Thesys's ability to deliver on the project, the news came as a shock, fanning uncertainty around the latest regulatory plans.

Thesys, a small technology firm (which had successfully developed the MIDAS surveillance solution for the US Securities & Exchange Commission), had been selected back in 2017 as the winning bidder from among several large established players (FIS, FINRA, Google etc). The selection of Thesys, although unexpected (FINRA, which currently operates the OATS reporting system, was the expected choice), was welcomed by many in the industry. They saw this is an opportunity for a disruptive technology firm to harness emerging technologies and build a solution without the issues that continue to plague legacy trade reporting solutions such as OATS and Bluesheets. On the flipside, there were concerns about soaring expenses associated with this new route (had FINRA been selected, OATS might have been extended to support additional CAT requirements, proving a faster and less expensive - albeit potentially less effective - option for the industry).

Figure I: CAT - a brief history

Date	Event
July 2012	SEC adopts Regulation NMS Rule 613
February 2013	CAT RFP published
November 2015	3 bidders shortlisted (Thesys, FIS, FINRA) from a crowded pool of more than 15
January 2017	Thesys selected as the winning bidder to build and operate the CAT
November 2017	Participants file for exemptive relief proposing updated timelines, pushing the go-live date by more than a year for an implementation completion date of April 2021
May 2018	Participants submit a 'Master Plan' to the SEC with a phased implementation approach and updated timelines with all phases being implemented by November 2022
October 2018	Final technical specifications for phase 2A and 2B published with several unresolved issues
November 2018	SROs start reporting to the CAT (after significant delays). Several issues reported
January 2019	Thesys replaced as the CAT processor by an unnamed potential successor
February 2019	Participants publish an updated elongated roll-out plan for phase 2a and 2b for large broker-dealer reporting which further breaks down the project into sub-phases
March 2019	FINRA (FINRA CAT) officially named as the CAT processor

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So how has this changed the picture and what happens next?

Following the news in March 2019 that FINRA (or more specifically FINRA CAT) will now fulfil the role of CAT processor, a series of clarifications and updates have emerged from industry events, which are summarized below.

- No changes to industry member technical specifications

The successor plan processor will continue to use the final industry member technical specifications published in October 2018 (version 1.0). No material changes to the specifications are expected outside of resolution of outstanding issues.

- Error feedback and correction mechanism to be included

The need for a mechanism to facilitate error feedback and correction has been acknowledged.

- Updated roll-out plan

A revised roll-out plan for phase 2A and 2B for large broker-dealers has been scheduled, which further breaks down the implementation for these two phases into 4 sub-phases, as follows:

Figure II: Updated phasing for large broker-dealers

Phase	Sub-phase	Testing Start Date	Go-live date
2A Equity	File Submission & Data Integrity	December 16, 2019	**April 2020**
	Intra-Firm Linkage	April 2020	**July 2020**
	Inter-Firm Linkage	July 2020	**October 2020**
	Exchange and TRF Linkage	September 2020	**October 2020**
2B Options	File Submission & Data Integrity	December 16, 2019	**May 2020**
	Intra-Firm Linkage	April 2020	**August 2020**
	Inter-Firm Linkage	July 2020	**October 2020**
	Exchange and TRF Linkage	September 2020	**December 2020**

More details on the above phases and dates can be found on the CAT NMS Plan website (https://www.catnmsplan.com/wpcontent/uploads/2019/02/CAT_Industry_Webcast_02.20.2019_vF.pdf)

Given these changes, a ‘regulatory conformance period’ is no longer deemed necessary. Details pertaining to Phase 2C and 2D, and updated timelines for small broker-dealers, have not yet been communicated.

The prospect of further delays

The plan participants have made it clear that there won't be any further changes to the timeline, yet, given the complexity involved, past experience, and the number of outstanding issues, a 6-9 month delay is likely:

- The transition to FINRA CAT will be complex

It is highly likely that, although market participants and FINRA CAT will have been discussing the transition details and associated complexities for some time already, several critical questions remain unanswered. For instance:

  - Will FINRA CAT take over and use the technology infrastructure, architecture and software (technology assets) developed by Thesys, as is?
    - I suspect FINRA CAT will leverage some elements of the technology assets and build others based on its preferred standards and protocols.
    - Even if FINRA CAT decides to leverage all of the technology assets, it will not do so without a detailed and thorough review and assessment of their functionality, stability, scalability and security.
    - Irrespective of which option is chosen, the transition to FINRA CAT will be reasonably time-consuming and complex.

- A large number of outstanding issues remain

Although technical specifications have been finalized, several issues have been raised by industry members that have yet to be resolved. Expedited resolution of key issues will be critical in enabling the development effort to be completed in a timely fashion.

- An error correction & feedback mechanism could be complex to build

The request for the new processor to provide a mechanism for error correction and feedback is understandable and accepted, but fulfilling this could be complex if it is done properly. Building a robust functionality within the specified timeframe seems aggressive and possibly unrealistic.

A 4-point plan of action

The Capital Markets industry has faced uncertainty associated with CAT from day one, and recent events have not helped. Yet, these indisputable facts remain:

- Delay or no delay, CAT is not going away
- OATS will not be enhanced in lieu of CAT
- CAT reporting requirements will be unavoidably complex.
  No amount of preparatory time will be sufficient to develop a robust reporting solution (firms still get OATS reporting wrong, 15 years down the line)

All of this being the case, the industry should consider the following 4-point action plan to alleviate pain later:

1 Continue development as planned for Phase 2A with increased focus on 2B

Although proposals to make the roll-out more gradual help to relieve some pressure, the CAT go-live dates remain aggressive. Firms should therefore continue development as planned for Phase 2A and 2B. In addition, although simple options order flow is not very complex, it is still a new asset class for which firms historically have not engaged in order lifecycle reporting.

2 Focus on building a strong control framework

The concept of a mature control framework for regulatory trade reporting was unheard of in the past. This explains the numerous issues and breaks firms face daily with existing reports (OATS, LOPR etc). Given the increased volumes and complex requirements for CAT, such issues will be magnified in the absence of a robust control framework. Firms should use the extra time to build a strong and robust control framework which will greatly reduce breaks and errors, and will also speed up testing.

3 Focus on simple flows first

Broker-dealers should focus on simple order and trade flows first. Irrespective of the type of firm, most of the order volume at large and small broker-dealers consists of simple order flows (eg where an order is routed away without any splitting or bunching, or is crossed internally etc). Given that these simple flows contribute most of the volume, handling them successfully will be a big win. Complex order flows (eg multiple entity / desk / system hops, splitting / bunching etc) which typically account for 10-20% of overall volumes should be handled separately. In my experience, firms tend to focus too much on complex order flows and in the process create a complex code base for handling all order flows, leading to issues and delays. I am not proposing that complex order flows should be ignored, but rather that they should be handled separately once the reporting for simple order flows has been completed successfully.

4 Be engaged, proactive & forceful in voicing concerns

Finally, I am firmly of the belief that every change brings about an opportunity. In this case, industry members should aim to use the latest CAT developments as an opportunity to address key concerns. FINRA CAT appears to be more accommodating of industry requests than the original designated processor. We have already seen the intention to include error feedback and correction functionality, which is a step in the right direction. Industry members should seize this chance to participate proactively and with intent in industry forums (FIF, SIFMA etc), and be prepared to deliberately and forcefully voice any concerns and requests relating to outstanding issues and desired functionality, while there is still an opportunity to do so.

For further information

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About RegEdge
RegEdge was formed with one key goal in mind: to assist financial services firms in solving their most complex regulatory challenges through innovative solutions delivered in a lean and efficient manner. We provide specialized strategy and technology consulting services aimed at broker-dealers and investment management firms; specifically within the first and second line of defense functions.

About Harshad Pitkar
Harshad is a seasoned leader with more than 16 years' experience of helping firms define, identify and implement technology strategy and solutions within the financial services industry. Throughout his career, he has assisted multiple clients to transform their risk and regulatory technology capabilities based on industry insights, emerging technologies, trends and regulatory expectations.

Prior to founding RegEdge, Harshad spent several years working for Big 4 consulting firms, most recently as a risk and regulatory practice Partner. Before moving into consulting, he worked at a large high-frequency trading firm in roles spanning front-, middle- and back-office functions.
Today, in addition to his profile as an independent CAT expert, Harshad is a board member of Inforalgo, the Capital Markets data integration & smart automation solutions provider.

Read about a CAT solution