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[redacted]

May 12, 2021

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Via Email to rule-comments@sec.gov

Re: Notice of Filing of Amendment to the Consolidated Audit Trail ("CAT") NMS Plan to Implement a Revised Funding Model (File No. 4-698)

Dear Ms. Countryman:

This letter is submitted on behalf of the Financial Industry Regulatory Authority, Inc. ("FINRA")[1] with respect to the proposed amendment to the CAT NMS Plan to implement a revised funding model for the CAT ("Proposed Funding Model") and to establish a fee schedule for Participant CAT fees based on the Proposed Funding Model.[2]

FINRA supports the goal of adopting a transparent funding model that reasonably and fairly allocates CAT costs among Participants and Industry Members based on objective criteria aligned with the CAT's cost drivers. However, FINRA believes that the Proposed Funding Model—put forward without unanimous Participant consent and over FINRA's objections—fails to achieve this goal. Accordingly, FINRA believes the Proposed Funding Model is inconsistent with the Securities Exchange Act of 1934

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1 FINRA is submitting this letter solely in its capacity as a Participant of the National Market System Plan Governing the Consolidated Audit Trail (the "CAT NMS Plan" or "Plan"). This letter does not reflect or represent the views of FINRA CAT, LLC, which is a distinct corporate subsidiary of FINRA that acts as the CAT Plan Processor pursuant to an agreement with the Plan Participants. Unless otherwise defined, capitalized terms are defined as set forth in the CAT NMS Plan.

2 *See* Securities Exchange Act Release No. 91555 (April 14, 2021), 86 FR 21050 (April 21, 2021) (Notice of Filing of Proposed Funding Model).

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("Exchange Act") and should not be approved by the Securities and Exchange Commission ("SEC" or "Commission") in its current form.

Ultimately, FINRA agrees that the continued funding of the CAT solely by the Participants was and is not contemplated by the CAT NMS Plan, nor is it a financially sustainable approach.[3] As discussed below, FINRA would support more objective and transparent alternatives to allocating CAT costs among Participants and Industry Members that are aligned with the CAT's cost drivers, and FINRA stands ready to engage further with the Participants, SEC, and market participants on the development of a fair, reasonable, and equitable model for sustainable CAT funding.

I. The Proposed Changes to the Existing, Approved Funding Principles Negatively Impact the Operation of the Entire Funding Model

As discussed below, the Proposed Funding Model would make several significant changes to the CAT's funding principles. These changes result in dramatically different outcomes for some CAT reporters and negatively impact the operation of the entire funding model, as they deviate from objective cost alignment principles for several key allocation criteria without sufficient justification grounded in any other funding principles.

The current CAT NMS Plan, as approved by the Commission, establishes a governing framework for funding the CAT. Specifically, the current CAT NMS Plan provides six principles that a CAT funding model will seek to achieve on behalf of the Operating Committee for Consolidated Audit Trail, LLC ("CAT LLC" or "Company" under the CAT NMS Plan):

(a) to create transparent, predictable revenue streams for CAT LLC that are aligned with the anticipated costs to build, operate and administer the CAT and the other costs of CAT LLC;

(b) to establish an allocation of the Company's related costs among Participants and Industry Members that is consistent with the Exchange Act, taking into account the timeline for implementation of the CAT and distinctions in the securities trading operations of Participants and Industry Members and their relative impact upon Company resources and operations;

(c) to establish a tiered fee structure in which the fees charged to: (i) CAT Reporters that are Execution Venues, including ATSs, are based upon the level of market share; (ii) Industry Members' non-ATS activities are based upon message traffic; and (iii) the CAT Reporters with the most CAT-related activity (measured by market share and/or message traffic, as applicable) are generally comparable (where, for these comparability purposes, the tiered fee structure takes into consideration affiliations

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[3] *See id.* at 21052.

between or among CAT Reporters, whether Execution Venues and/or Industry Members);

(d) to provide for ease of billing and other administrative functions;

(e) to avoid any disincentives such as placing an inappropriate burden on competition and a reduction in market quality; and

(f) to build financial stability to support CAT LLC as a going concern.[4]

Notably, the "comparability" principle, expressed in paragraph (c) above, played a critical role in prior funding discussions. For example, when the Participants previously proposed CAT fees in 2017 based on the original funding model, comparability was a key basis for the then-proposed 75%/25% split in costs allocated to Industry Members and Execution Venues.[5] Similarly, comparability was a core justification for a bifurcated approach, where execution venue fees were based on market share and industry member fees were based on message traffic.[6] In the context of the original funding model, FINRA supported the stated goal of the comparability principle, which incorporated cost alignment considerations and sought "to mitigate competitive impacts by aligning the cost allocation

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4 *See* CAT NMS Plan, Section 11.2(a) through (f).

5 *See, e.g.*, Letter from CAT NMS Plan Participants to Brent J. Fields, Secretary, SEC (November 2, 2017), available at www.sec.gov/comments/sr-batsbyx-2017-11/batsbyx201711-2674608-161412.pdf, at pg. 10 ("The Operating Committee determined that the 75%/25% allocation between Execution Venues and Industry Members (other than Execution Venue ATSs) provided the greatest level of fee comparability at the individual entity level for the largest CAT Reporters, while still providing for appropriate fee levels across all tiers for all CAT Reporters.").

6 *See, e.g.*, Letter from CAT NMS Plan Participants to Brent J. Fields, Secretary, SEC (June 29, 2017), available at www.sec.gov/comments/sr-batsbyx-2017-11/batsbyx201711-1832632-154584.pdf, at pg. 6 ("[T]he Participants believe that equity exchanges produce similar volumes of message traffic regardless of their size, and similarly, that options exchanges produce similar volumes of message traffic regardless of their size. Therefore, if exchange Execution Venues were charged based on message traffic, large and small exchanges would pay comparable fees, thus making the fee structure inequitable."); Securities Exchange Act Release No. 79318 (November 15, 2016), 81 FR 84696, 84796 (November 23, 2016) (Order Approving CAT NMS Plan) (discussing the same comparability rationale offered by Participants).

in a manner that seeks comparability among the largest CAT Reporters regardless of their regulatory status."[7]

Under the Proposed Funding Model, the CAT NMS Plan would be amended to eliminate comparability as a funding principle. The Operating Committee[8] explains that comparability "is no longer relevant" because the Proposed Funding Model does not assess fees on tiers, as contemplated by the original funding model.[9] FINRA recognizes the reasons the Proposed Funding Model would eliminate the tiered approach to fee assessments. However, if the principle driving the change to a no-tier approach is to assess fees more transparently on CAT Reporters in direct relation to the costs that each creates for the CAT with its reporting activity,[10] the Proposed Funding Model fails to apply this principle consistently.

II. The Proposed Funding Model Lacks Consistent Principles and Justification

During development of the Proposed Funding Model, FINRA advocated for more transparent and objective allocation criteria tied to the CAT's cost drivers, consistent with the CAT NMS Plan funding principles and Exchange Act requirements. FINRA reiterates its concerns here about the insufficient basis for several key elements of the Proposed Funding Model.

A. Allocation between Participants and Industry Members

Under the Proposed Funding Model, 75% of total CAT costs would be allocated to Industry Members and 25% of total CAT costs would be allocated to Participants. The Operating Committee offers several reasons for this proposed split: the Participants would pay more than previously proposed, as the Participants would no longer share their 25% allocation with ATSs; there are far more Industry Members than there are Participants; and Industry Members collectively represent significantly greater "available CAT Reporter revenue."[11]

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7 *See* CAT NMS Plan, Appendix C-91.

8 The Proposed Funding Model was authorized by the affirmative vote of not less than two thirds of the Participants in accordance with the voting provisions set forth in the CAT NMS Plan. *See* Notice of Filing of Proposed Funding Model, *supra* note 2, at 21072. FINRA did not vote to approve the Proposed Funding Model.

9 *See* Notice of Filing of Proposed Funding Model, *supra* note 2, at 21056.

10 *See id.* at 21056.

11 *See id.* at 21054-55.

FINRA does not believe this proposed allocation split between Participants and Industry Members is sufficiently justified. Two of the CAT's funding principles—which would not change under the Proposed Funding Model—relate to the alignment of revenues with costs.[12] Cost alignment is also a relevant factor when assessing fee reasonableness under the Exchange Act. However, the Proposed Funding Model does not discuss or analyze how the proposed 75% allocation to Industry Members relates to the overall CAT costs associated with Industry Member reporting. While FINRA recognizes that other funding principles may appropriately be considered in addition to cost alignment, it is not clear which funding principles, if any, support the Proposed Funding Model's allocation split between Industry Members and Participants. FINRA believes further objective analysis should be conducted and would more successfully justify a funding model that different stakeholders would accept.

B. Allocation among Industry Members

Under the Proposed Funding Model, there would be both minimum and maximum Industry Member fees. In effect, the minimum and maximum fees serve to shift cost allocation from firms with more message traffic to those with less. There may be reasons to allow cross-subsidization among Industry Members consistent with the CAT's funding principles; for example, market maker discounts may be grounded in the CAT funding principle that seeks to avoid reductions in market quality. But the Proposed Funding Model does not sufficiently analyze or justify the cross-subsidization that results from the proposed minimum and maximum Industry Member fees.

The need for a maximum Industry Member fee is driven by other choices embedded in the Proposed Funding Model. The Operating Committee states that the maximum fee "serves as a method to institute a cap on fees in order to fairly allocate costs to Industry Members as using message traffic alone potentially may result in certain Industry Members paying a significant allocation of Total CAT Costs."[13] In other words, as a result of the 75% allocation to Industry Members, and the elimination of tiers and comparability, the Operating Committee concluded that certain Industry Members would pay fees large enough to warrant a cap. But the Operating Committee does not identify these underlying choices that prompted it to conclude a maximum Industry Member fee is necessary, nor does the Operating Committee articulate the reasoning for this or any other primarily

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[12] Specifically, the funding principle set forth in Section 11.2(a) of the CAT NMS Plan refers to aligning revenue streams with the anticipated costs to build, operate, and administer the CAT and the other costs of CAT LLC. In addition, the funding principle in Section 11.2(b) of the CAT NMS Plan says that CAT funding shall seek to take into account "distinctions in the securities trading operations of Participants and Industry Members *and their relative impact upon Company resources and operations"* (emphasis added).

[13] *See* Notice of Filing of Proposed Funding Model, *supra* note 2, at 21059.

redistributional decision. This lack of justification similarly calls into question the method for establishing a minimum fee applied to small firms under the Proposed Funding Model.

For example, under the Proposed Funding Model, the excess fees that the Industry Members with the most message traffic would otherwise be assessed absent a cap would be redistributed to all Industry Members, including the Industry Members subject to the minimum fee. As a result, the minimum fee amount could in fact increase for firms (including many small firms) that report very little message traffic, as they absorb a portion of fees reallocated from the largest Industry Members. This impact is not discussed, quantified, or analyzed by the Operating Committee, and the Proposed Funding Model does not explain how this impact is consistent with the CAT's funding principles.

C. Allocation among Participants

The Proposed Funding Model incorporates several criteria to allocate fees among Participants that are inconsistent with the CAT's cost alignment principles and not sufficiently justified by any other funding principles.

First, the Proposed Funding Model would allocate a greater portion of the Participants' share to equities Participants than options Participants. Specifically, under the Proposed Funding Model, equities Participants would be allocated 60% of the Participants' share and options Participants would be allocated 40% (after adjustment to account for Participant minimum fees). This split is not justified in relation to any data about the relative costs imposed by equities and options Participants. In fact, the Participants have previously explained that "message traffic is a key component of the costs of operating the CAT,"[14] yet the Proposed Funding Model would assess options Participants—which generate far more message traffic than equities Participants, in the order of multiples—a lesser share of costs. The Operating Committee does not explain how this result, which is inconsistent with cost alignment principles, is otherwise supported by the CAT's funding principles or consistent with the Exchange Act.

Second, the Proposed Funding Model would base the Participants' fee assessments on market share rather than message traffic. This allocation decision is again inconsistent with cost alignment principles—which would be difficult to argue, given that message traffic is the most significant driver of CAT costs—or otherwise justified based on the funding principles. Rather, the Operating Committee states that Participants' message traffic is "largely derivative of quotations and orders received from Industry Members that [the Participants] are required to display."[15] And because "[t]he business models for Participants . . . generally are focused on executions and/or trade reporting in their

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[14] *See* Letter from CAT NMS Plan Participants to Brent J. Fields, Secretary, SEC (June 29, 2017), *supra* note 6, at pg. 6.

[15] *See* Notice of Filing of Proposed Funding Model, *supra* note 2, at 21060.

marketplaces," the Operating Committee states its belief "that it is more equitable to charge Participants based on their market share rather than their message traffic."[16] The Operating Committee's justification here relies on unsupported qualitative conclusions, not quantitative analysis. And the only real effort to link this decision to a funding principle—ease of billing—cannot plausibly justify the inconsistency with other funding principles, including the cost alignment principles.[17]

Third, the Proposed Funding Model appears to acknowledge these distortions with its proposed special purpose "maximum equities participant fee" that would apply solely to FINRA. This maximum FINRA fee would assess FINRA the greater of 20% of the equities Participant allocation, or the highest CAT fee required to be paid by any other equities Participant, plus an additional 5%.[18] The Operating Committee reasons that this maximum fee helps limit what FINRA would otherwise owe based on its "market share." But the Operating Committee does not explain how its proposed measure of "market share" for FINRA—based simply on the trade reporting volume reported through FINRA facilities, which is all also separately reported by Industry Members—is consistent with its earlier statement that it would be inequitable to assess fees on Participants for message traffic that is simply derivative of Industry Member reporting activity. FINRA notes that under the current CAT NMS Plan, the Participants mitigated the potential for double counting by excluding from FINRA's market share the volume reported to FINRA by Execution Venue ATSs.[19] Moreover, the Operating Committee states that market share is a

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16 *See id.*

17 The Operating Committee further notes that the funding principles in the currently approved CAT NMS Plan contemplate allocation to the Participants based on market share. *See* Notice of Filing of Proposed Funding Model, *supra* note 2, at 21060. However, as discussed elsewhere in this letter, the Operating Committee now proposes to make fundamental changes to the funding principles—namely, eliminating tiers and the comparability principle—that impact the operation of the entire funding model. The Operating Committee fails to explain the impact of these changes, making its reliance on only some elements of the prior funding model selective at best. The same issues underlie the Operating Committee's statement that "the Participants have been voluntarily allocating CAT costs based on market share for the past eight years and are comfortable that allocating CAT cost based on market share is an appropriate way to allocate CAT costs, as it is consistent with the CAT NMS Plan." *See id.* Again, this statement fails to acknowledge that the Proposed Funding Model is significantly different in many respects than the original model previously agreed to by the Participants and reflected in the CAT NMS Plan.

18 *See* Notice of Filing of Proposed Funding Model, *supra* note 2, at 21061.

19 *See* CAT NMS Plan, Section 11.3(a)(i).

reasonable allocation methodology for Participants because their business models generally are focused on executions,[20] but it does not address the fact that, given FINRA's unique role, trade volume is reported through FINRA for regulatory purposes, not to serve FINRA's business purposes.

Based on these allocation criteria, the Proposed Funding Model would result in FINRA paying at least 20% of the equities Participants' share, the most of any equities Participant, despite producing less than 1% of equities message traffic reported to the CAT. Instead of directly addressing the misalignment between FINRA's proposed fees and the message traffic costs it imposes on the CAT, the Operating Committee interjects an entirely new rationale—without discussion of any CAT funding principles—that it applies solely to FINRA. Specifically, the Operating Committee claims that its market share-based methodology for FINRA is justified by FINRA's regulatory usage, given that FINRA is expected to be one of the largest regulatory users of the CAT.[21]

FINRA is not opposed to considering a fee based on regulatory usage. However, FINRA questions why regulatory usage is offered only to justify FINRA's allocation of the proposed fee that is based on unrelated criteria (market share), particularly when all Participants may use CAT data for regulatory purposes.[22] Moreover, the Operating Committee offers no analysis of the actual costs of regulatory usage, and it does not provide any mechanism to evaluate, calculate or adjust fee assessments based on any future changes in regulatory usage by the Participants. Notably, when the Participants last filed proposed CAT fees in 2017, they explicitly *excluded* regulatory usage from consideration, noting that data ingestion and processing is the primary cost driver.[23] And the Participants stated that regulatory usage fees might be considered as an "ancillary" fee authorized separately by the CAT NMS Plan.[24] To the extent the Operating Committee now believes

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20 It is noteworthy, however, that for purposes of market data revenue allocation under the SIP NMS plans, distributable revenue is allocated among all Participants based on a 50/50 split between trading share and quoting share. *See*, *e.g.*, www.ctaplan.com/publicdocs/ctaplan/notifications/trader-update/Revenue_Allocation_Formula_Summary.pdf.

21 *See* Notice of Filing of Proposed Funding Model, *supra* note 2, at 20162.

22 *See* Rule 613(f) of SEC Regulation NMS.

23 *See* Letter from CAT NMS Plan Participants to Brent J. Fields, Secretary, SEC (June 29, 2017), *supra* note 6, at pg. 8.

24 *See id.* (citing Section 11.3(c) of the CAT NMS Plan, which states that "[t]he Operating Committee may establish any *other* fees *ancillary* to the operation of the CAT . . . including fees . . . based on access and use of the CAT for regulatory and

a regulatory usage fee is appropriate, it should propose one on all Participants in an objective, transparent manner. Regulatory usage should not be invoked on an *ad hoc* basis solely to justify a fee assessment for FINRA that is otherwise inconsistent with the CAT's funding principles.

FINRA believes there are alternatives for fee allocation among Participants that have not been sufficiently evaluated. For example, using message traffic for the Participants' allocation would be the alternative most consistent with the proposed approach to Industry Member allocation, and the most directly aligned with costs. To the extent a pure message traffic approach would result in a FINRA fee that the Participants believe is too low, FINRA has expressed its willingness to determine a more appropriate amount, or to consider a hybrid Participation allocation based on both message traffic and market share. But the Operating Committee should not simply be afforded the "deference" it claims is appropriate for what it characterizes as "negotiations" of the Participant fees "among themselves",[25] particularly here for a Proposed Funding Model that was put forward without unanimous Participant consent and over FINRA's objections.

One effect of adopting these unsupported allocation criteria would be an unjustified increase in FINRA's fee assessments, notwithstanding FINRA's role among the Participants as the only not-for-profit self-regulatory organization and the only Participant not operating a national securities exchange. Given FINRA's unique status, FINRA necessarily relies on cost-based regulatory fees from its members to fund its regulatory mission.[26] As a result, the Proposed Funding Model's plan to increase FINRA's fee assessments would indirectly reallocate Participant costs to Industry Members, in addition to their allocated fee assessments.

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oversight purposes (and not including any reporting obligations)" (emphasis added)).

25 *See* Notice of Filing of Proposed Funding Model, *supra* note 2, at 21059-60.

26 In that regard, FINRA notes that FINRA does not retain any revenue for the market data provided to the SIPs via FINRA's NMS trade reporting facilities ("TRFs"). The TRFs are operated on FINRA's behalf by the "Business Members," Nasdaq, Inc. and NYSE Market (DE), Inc. While FINRA is entitled in the first instance to SIP data revenue for over-the-counter trading in NMS stocks under the SIP plans, pursuant to the contractual arrangements establishing the TRFs, FINRA has agreed not to retain the SIP revenues. The Business Members are entitled to the SIP revenues and share a percentage of those revenues with FINRA member TRF participants in the form of transaction credits. *See, e.g.*, FINRA Rules 7610A and 7610B.

As the Operating Committee acknowledges, Participant fees must still satisfy the requirements of the Exchange Act and the CAT NMS Plan,[27] and the Operating Committee has failed to demonstrate that the Proposed Funding Model meets those requirements.

III. Conclusion

FINRA thanks the Commission for its attention to FINRA's comments on the Proposed Funding Model and looks forward to continued engagement with the Participants, SEC, and market participants to achieve an equitable and sustainable solution to the CAT's funding needs.

Sincerely,

Marcia E. Asquith
Executive Vice President,
Board and External Relations

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27 *See* Notice of Filing of Proposed Funding Model, *supra* note 2, at 21060.