

A Strategy for Creating an Effective CAT Compliance Program

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A man who carries a cat by the tail learns something he can learn in no other way.
– Mark Twain¹

Twain was definitely not referring to the Consolidated Audit Trail (CAT). However, like many of his observations, there is a good deal of truth here: experience is useful in helping a compliance officer craft an effective CAT compliance program.² This article presents an overview of FINRA’s recent guidance for CAT compliance programs and tips for crafting a compliance program reasonably designed to meet these expectations.

FINRA’s Recent Guidance

CAT is taking a leading role in regulatory reporting. It already led to the retirement of the Order Audit Trail System (OATS) in Fall 2021.³ Upon the successful implementation of Phase 2e reporting, which CAT will start implementing this summer, CAT will ultimately lead to the demise of the current Blue Sheet reporting regime.⁴ Soon it will be the only reporting requirement for NMS securities.

A firm can contract with a service to help it report data to the CAT, but it cannot contract its supervisory and compliance activities away from its direct control.⁵ As such, FINRA expects a firm to have policies and procedures that are reasonably designed to ensure that the data it reports is complete and accurate, whether it is self-reporting or using a reporting service.⁶ A firm remains responsible for all supervisory activities associated with CAT reporting, including compliance with the duty to report timely, accurate and complete data in accordance with FINRA Rule 6893.⁷ This is, of course, part and parcel with FINRA’s overall guidance concerning firms’ use of vendors, which FINRA reiterated in Regulatory Notice 21-29. In that Notice, FINRA reminded its firms that its “supervisory obligation extends to member firms’ outsourcing of certain “covered activities” – activities or functions that, if performed directly by a member firm, would be required to be the subject of a supervisory system and WSPs pursuant to FINRA Rule 3110.2.”⁸

Putting that guidance into practice with respect to the CAT, FINRA noted in its recent 2022 Report on FINRA’s Examination and Risk Monitoring Program (the “2022 Report”) that certain firms did not establish and maintain supervisory controls regarding CAT reporting and clock synchronization performed by their third-party vendors.⁹ FINRA also outlined its expectations of a firm in crafting its CAT compliance program. A firm should keep in mind, among other considerations:

- “How does your firm confirm that the data your firm reports, or that is reported on your firm’s behalf, is transmitted in a timely fashion and is complete and accurate?”;
- “Does your firm conduct periodic comparative reviews of accepted CAT data against order and trade records and the CAT Reporting Technical Specifications?”;
- “Does your firm communicate regularly with your CAT reporting agent, review relevant CAT guidance and announcements and report CAT reporting issues to the FINRA CAT Help Desk?”; and

1. See https://www.brainyquote.com/quotes/mark_twain_105031 (last visited on Apr. 12, 2022).

2. Under FINRA Rules 6830 and 6810(u), only an “Industry Member” - defined as “a member of a national securities exchange or a member of a national securities association” – is required to report to the CAT. This means a broker-dealer. However, it is worth noting that this includes entities that are registered as a broker-dealer and a registered investment adviser, even if that entity effectively functions only as an RIA. See CAT FAQ B14 (available at <https://www.catnmsplan.com/faq#B14> (last visited on Apr. 13, 2022)).

3. See FINRA Regulatory Notice 21-21 (available at <https://www.finra.org/sites/default/files/2021-06/Regulatory-Notice-21-21.pdf> (last visited on Apr. 11, 2022)); see also <https://www.finra.org/filing-reporting/market-transparency-reporting/order-audit-trail-system-oats> (last visited on Apr. 11, 2022).

4. See the Limited Liability Company Agreement of Consolidated Audit Trail, LLC (current) (the “Plan”) at C-60 (available at <https://catnmsplan.com/sites/default/files/2020-07/LLC-Agreement-of-Consolidated-Audit-Trail-LLC-as-of-7.24.20.pdf> (last visited on Apr. 8, 2022)) (“For example, after the implementation of CAT, regulators seeking to identify activity for NMS Securities at the customer account level, would access that information from the Central Repository, rather than making a Blue Sheet request.”)

5. See Regulatory Notice 20-31 at 4 (available at <https://www.finra.org/sites/default/files/2020-08/Regulatory-Notice-20-31.pdf> (last visited on Apr. 11, 2022)).

6. *Id.*

7. *Id.*

8. See Regulatory Notice 21-29 at 3 (available at <https://www.finra.org/sites/default/files/2021-08/Regulatory-Notice-21-29.pdf> (last visited on Apr. 8, 2022)).

9. See the 2022 Report on FINRA’s Examination and Risk Monitoring Program (the “2022 Report”) at 43 (available at <https://www.finra.org/sites/default/files/2022-02/2022-report-finras-examination-risk-monitoring-program.pdf> (last visited on Apr. 11, 2022)).

- “How does your firm work with its clearing firm and third-party vendors to maintain CAT compliance?” (emphasis in the original).¹⁰

FINRA also recommended that a firm’s written supervisory procedures (WSPs) must identify the person(s) or title(s) who are responsible for reviewing CAT reporting and “describe specifically” the what, when and how of the reviews.¹¹

Meeting the Standard: Crafting an Effective CAT Compliance Program

Meeting FINRA’s standard is unlike almost any other compliance obligation. This is not like assessing whether a particular trade is suitable for a client or whether an associate’s conduct is consistent with the firm’s WSPs. CAT reporting is a very technical, engineering-led task, which can be daunting for any compliance officer. As I see it, reporting to the CAT is comparable to blockchain (or, more specifically, distributed ledger technology) in that various actors (in this case, firms) add elements (here, events) to a central repository to inform third parties (the CAT) of certain events (in a securities transaction).¹² Below are several tips that a compliance officer can use to help his or her firm to craft an effective CAT compliance program – regardless of whether the firm self-reports or has another firm or vendor report on its behalf.¹³

1. Understand that CAT is not just CAT.

The industry pays considerable attention to the transaction data it reports to the CAT. And rightfully so. It is a considerable undertaking to report substantially all events associated with a securities transaction in the form requested and the time needed. However, it is sometimes overlooked that CAT reporting involves more than just transaction data – it also requires reporting customer account information to the Customer and Account Information System (CAIS). These are different reports with different requirements and different cadences. For example, generally speaking a firm must report transaction data to the CAT by 8:00 a.m. on the next business day. By comparison, a firm is only obligated to report account information to the CAIS upon commencement of the account and any changes.¹⁴ As such, CAT has published different guidance for reporting to CAT and CAIS.

2. Know where to find guidance.

FINRA publishes two resources – the Industry Member Reporting Scenarios (“Reporting Scenarios”) and Industry Member Technical Specifications (“Tech Specs”) – for both the CAT and the CAIS data to help firms meet their reporting obligations.¹⁵ The Reporting Scenarios supply guidance on what an industry member should report; the Technical Specifications instruct industry members on how to report it. The CAT updates these references often, and when it does so, posts a redlined version. Bookmark these sites. The redlined version is especially useful to keep current on any changes to the reporting.

3. Understand that most actions in a transaction are reported as separate events that have separate elements.

The Reporting Scenarios include over 800 pages illustrating the specific reporting requirements for a variety of order handling execution scenarios.¹⁶ Recounting every event is beyond the scope of this primer. However, it is worth noting two general propositions. First, an industry member is only responsible for reporting (or have reported on its behalf) its actions, not those of other industry members (unless, of course, it agreed to do so).

10. *Id.* at 42.

11. *Id.*

12. The analogy is not perfect. The blockchain is decentralized, which ensures that the information in it is transparent. By comparison, the regulators are the only entities that can view the entire securities transaction “blockchain”. Nonetheless, I find it a helpful tool to understand the relationship between the events and CAT reporters in each transaction.

13. This article does not purport to cover all obligations for reporting to the CAT. As noted below, the CAT has published hundreds of pages of guidance, which it updates regularly. Rather, this article intends to give a compliance officer a starting point.

14. Note that Phase 2e will also usher in periodic full account refreshes. See CAT FAQ Q19 (available at <https://www.catnmsplan.com/faq#Q19> (last visited on Apr. 13, 2022)).

15. These are available at <https://www.catnmsplan.com/specifications/imreportingscenarios> and <https://www.catnmsplan.com/specifications/im>, respectively.

16. See CAT Reporting Scenarios, Version 4.9 dated March 9, 2022 (available at https://catnmsplan.com/sites/default/files/2022-03/03.11.22_Industry_Member_Tech_Specs_Reporting_Scenarios_v4.9_CLEAN_0.pdf (last visited on Apr. 12, 2022)).

Second, if an industry member acts in a given transaction, then with few exceptions it will have to report (or have reported on its behalf) a certain event. As an example, the Reporting Scenarios instruct an industry member to report a MENO (New Order) when it originates an order or receives a customer order for an equity security.¹⁷ If the order is for an option, then it reports a MONO.¹⁸ If it routes the equity transaction to an internal desk, then it reports a MEIR. If it sends that transaction out to another firm or an exchange, then it must report a MEOR. The other firm or exchange must report (or have reported on its behalf) the actions it takes. Trades, order fulfillments and order allocations call for separate events. And so forth.

As noted, the Tech Specs then inform the industry member of the elements that it needs to report for any given event. Fortunately, the CAT structured analogous events for equities and options flow similarly. MENOs and MONOs, for example, differ in certain elements – for example, the eighth element is a symbol if the event is a MENO, but an optionID if the event is a MONO – but otherwise remain consistent with one another.¹⁹

4. Understand the firm's trade flow.

It is important to have a working knowledge of how the firm processes client orders. Does the firm only accept orders through a website, or can a registered representative accept an order directly from a client? Does it trade options or equities? Both or neither? These answers determine whether the firm needs to report the event at all, and if so, the elements reported on the event (a MENO or MONO, more on that below).²⁰

Similarly, it is important to know what the firm does with the order. Does it pool the order with others? Does the firm send the order to a principal desk or out to another firm or an exchange? Will the firm allow a client to change their order? When are these orders generally filled? Answers to these questions inform the sequence of events that the firm must report after the order's acceptance. Know these and the compliance officer will have a good understanding of what the firm needs to report.

5. Have a working knowledge of how the firm's trade flow translates to those events and elements.

Twain would tell the compliance officer that understanding how the firm's trade flow translates into events is where he or she starts carrying the CAT by the tail. Having an encyclopedic knowledge of hundreds of pages of reporting scenarios is beyond most compliance officers' ability, especially if CAT reporting is only one of his or her many duties. But it is possible to pare that universe down to those events that the firm's trade flow requires. For example, if the firm's practice is to send client orders to a market maker, then the compliance officer will be well served knowing that the reporting will include a MENO for the customer's order and a MEOR for the route. If the firm does business via telephone with its clients, then the compliance officer will pay attention to MENO sequence No. 10 (manualFlag) to ensure that the event correctly captures how the firm took the order. Have a punch list of events based upon the firm's typical flow ready.

6. Know the firm's data structure for account information.

As noted above, CAT will implement Phase 2e in July 2022. This will require firms to report a host of information about its active clients in its CAIS reporting.²¹ It is a substantial undertaking.

17. See, e.g., *id.* at Section 2.1.1.

18. *Id.*

19. See CAT Reporting Tech Specs, Version 4.0.0 r15 dated May 16, 2022 (available at https://catnmsplan.com/sites/default/files/2022-05/05.16.2022_CAT_Reporting_Technical_Specifications_for_Industry_Members_v4.0.0r15_CLEAN.pdf) (last visited on May 25, 2022) at Table 15 and Table 57.

20. Of course, firms only need to report information concerning NMS Securities and OTC Equity Securities, as the Plan defines those terms. See, e.g., FAQ B4 (available at <https://www.catnmsplan.com/faq#B4>) (last visited on Apr. 19, 2022)). As such, transactions in securities such as fixed income securities, open-end mutual funds and variable annuities are out of scope for reporting.

21. Firms only must report on its "Active Accounts", as that term is defined in the Plan. Broadly speaking, this is an account that has had CAT-eligible activity within the last six months (or January 11, 2022). See CAT FAQs Q40 and Q59 (available at <https://www.catnmsplan.com/faq#Q40> and <https://www.catnmsplan.com/faq#Q59>, respectively) (last visited on Apr. 13, 2022)). This does not prevent a firm from reporting information on all of its active and inactive accounts, but if it does so, then the information must complete and accurate. See CAT FAQ Q8 (available at <https://www.catnmsplan.com/faq#Q8>) (last visited on Apr. 13, 2022)).

Unlike reporting transaction data – which is, of course, determined by the actual events in a transaction – reporting account information is more straightforward. The firm must map its account information into the form and format that the CAT requires. Understanding the firm’s data structure for account information is a key to helping the firm meet this requirement.

7. Devise a strategy to check the quality of the firm’s CAT and CAIS reporting.

After processing a submission, the CAT gives feedback on errors it detects and reporting statistics to the firm’s portal in the “Feedback and Corrections” process.²² While a regular review of the portal is a key component of timely detection and repair for reporting errors, surveilling a firm’s reporting is more than just checking error codes and compliance rates.²³ The CAT can only inform an industry member whether its data was submitted timely and structured appropriately, not necessarily whether it was accurate. FINRA highlighted in its 2022 Report several data points – including department type code, handling instructions and representative indicator – for which it found errors only upon examination.²⁴ Periodically sampling the CAT data reported against the firm’s blotter and/or the CAIS data reported against the firm’s client records – coupled with the information compiled in the steps above – can help a firm detect, and control for, data errors. And it is likely that data errors will occur from time to time as unique fact patterns reveal programming bugs. This leads to . . .

8. Know how to correct and report errors.

A firm must repair any errors that CAT identifies by 8:00 a.m. Eastern Time on the third trading day after the event.²⁵ For example, if a firm erroneously reports an event that occurred on a Monday afternoon, then it has until Thursday morning to make the repair.²⁶ As noted above, a firm’s regular review of the reporter portal is a key component for making timely repairs. However, as also noted above, a firm’s reporting may have a systemic issue that the Feedback and Corrections process cannot detect. An example of this could be not incorporating a field that enables the firm to report an order as manually accepted. A firm must be familiar with the guidance and considerations for self-reporting errors to the CAT found in CAT Alert 2020-04 and the related Self-Reporting Erroneous Events Form.²⁷ It is important to note that there is no requirement to self-report errors.²⁸ In addition, even if a firm self-reports to the CAT in accordance with the Alert, it does not relieve it from the obligation to submit corrected data and is not a defense against liability under the FINRA rules.²⁹ If a firm decides to do so, then it simply completes the Form and e-mails it to the CAT Help Desk.³⁰

No, A Compliance Officer Does Not Need a Computer Science Degree

There is little question that reporting to the CAT requires a considerable amount of engineering skill. However, a compliance officer does not need to have or obtain a computer science degree to help their firm craft an effective CAT compliance program. Rather, it starts with less technical tasks – understanding the CAT’s different reporting requirements, knowing where to find guidance, understanding the firm’s flow and how these translate to CAT events, and devising an effective sampling strategy. Deploying these in a thoughtful manner are the foundations of an effective CAT compliance program. ■

22. See Sections 6 and 7 of the Tech Specs for CAIS and CAT, respectively.

23. The CAT Reporter Portal provides firms, among other things, a dashboard to view any errors that the CAT detects in the reporting and to track their reporting compliance rates. Compliance officers can get access to the portal from the firm’s Super Account Administrator (SAA).

24. 2022 Report at 42-43.

25. CAT Tech Specs, *supra* Note 19, at Section 6.4.2.

26. *Id.*

27. See CAT Alert 2020-04 dated March 23, 2022 (available at <https://www.catnmsplan.com/sites/default/files/2022-03/03.23.22-CAT-Alert-2020-04.pdf> (last visited Apr. 12, 2022)). Version 1.3 of the Self-Reporting Erroneous Events form is available at <https://catnmsplan.com/sites/default/files/2022-05/05.03.22-Erroneous-Events-Self-Report-Form-v1.3.pdf>.

28. *Id.* at 2.

29. *Id.*; *Id.* at 1, fn. 1.

30. *Id.* at 4.