

FINRA Settles First Significant CAT Reporting Enforcement Action

September 7, 2023

On August 16, Instinet, LLC (Instinet or the Firm) agreed to pay a \$3.8 million fine to settle an enforcement action with the Financial Industry Regulatory Authority (FINRA) regarding its alleged failure to comply with certain of its Consolidated Audit Trail (CAT) reporting obligations.¹ This case is FINRA's first significant enforcement action in the CAT space and should prompt member firms to revisit the efficacy of their CAT compliance programs.

Background

The CAT is a central repository created by the Securities and Exchange Commission (SEC) to allow regulators to track the activity of broker-dealers throughout US markets in national market system securities. FINRA utilizes CAT data as a part of its automated market surveillance program to detect manipulative activity and other potential violations. Pursuant to FINRA Rule 6830(a), FINRA members are required to record and electronically report certain details for each order and each reportable event to the CAT Central Repository. Reportable events include the original receipt or origination, modification, cancellation, routing, execution, allocation of an order, and receipt of a routed order.

Instinet's Alleged CAT Reporting Deficiencies

Instinet, as a large industry member, was required to begin reporting its order event data to the CAT Central Repository on June 22, 2020.² To assist with its CAT reporting obligations, Instinet hired a third-party vendor to act as its CAT reporting agent. However, FINRA alleged that the Firm failed to develop adequate technical specifications, as noted below, to allow the CAT reporting agent to convert the Firm's data to a format that it could use for CAT reporting.

Prior to the June 2020 CAT reporting launch, Instinet notified FINRA that it anticipated reporting difficulties, and indeed it did experience problems from the very beginning of its reporting obligations. Instinet determined it was not timely reporting all CAT-reportable events because its reporting agent could not fully translate the Firm's data into CAT-reportable format. As a result, from June 22, 2020, through November 6, 2020, Instinet failed to timely report over 5.2 billion equities and options order events to the CAT Central Repository, representing approximately 17 percent of its CAT reporting obligations for this period. The Firm reported 2.7 billion of the late order events by October 2020, and reported the remaining 2.5 billion by March 2021. FINRA alleged other reporting issues, with respect to at least 26 billion events from November 2020 through December 2022, which represented approximately 8 percent of the Firm's reporting obligations for this period. The Firm also identified approximately 180 different types of CAT reporting errors, such as inaccurate share quantity, customer display instruction flags and event timestamps.³

¹ https://www.finra.org/sites/default/files/fda_documents/2020067139101%20Instinet%2C%20LLC%2C%20CRD%207897%20AWC%20gg.pdf.

² As of December 2021, all FINRA members, regardless of size, were required to comply with CAT reporting requirements. All proprietary trading activity, including market-making activity, is also subject to CAT reporting.

³ In light of these reporting issues, FINRA found that Instinet violated FINRA Rules 6830, 6893, and 2010.

Instinet's Alleged Failure to Supervise

FINRA also detailed certain deficiencies related to Instinet's supervision of its CAT reporting. Specifically, FINRA alleged that Instinet did not conduct a supervisory review of the accuracy of the data it reported to the CAT Central Repository until the third quarter of 2021. Further, FINRA asserted that the frequency of the review, which was conducted only once per quarter, was not reasonable due to the billions of CAT events Instinet reported each quarter. Additionally, FINRA alleged that Instinet did not reasonably respond to red flags related to the accuracy of its CAT reports. As a part of its settlement with FINRA, Instinet agreed to hire an independent consultant to conduct a comprehensive review of the adequacy of the Firm's compliance with its CAT reporting obligations.

Why This Matters

The substantial fine imposed by FINRA signals its intent to scrutinize FINRA members' compliance with CAT reporting obligations. As emphasized by FINRA in its 2023 Report on FINRA's Examination and Risk Monitoring Program, and on a CAT panel at FINRA's 2023 Annual Conference, CAT reporting and related supervision is a regulatory priority in light of regulators' increased reliance on CAT data for market reconstruction and surveillance purposes. Several of the violations alleged in the Instinet action also were FINRA exam findings noted in the 2023 Report, including a reminder that when firms hire a CAT reporting agent, the reporting member remains responsible for complying with all CAT reporting rules. FINRA members subject to CAT reporting obligations should ensure their order event data is timely reported to the CAT Central Repository. Further, FINRA members should assess whether the frequency of their supervisory reviews of the accuracy of the data submitted to the CAT Central Repository is reasonable in light of the volume of data reported.

⁵ Due to these supervision issues, FINRA found that Instinet violated FINRA Rules 3110 and 2010.

⁶ <https://www.finra.org/sites/default/files/2023-01/2023-report-finras-examination-risk-monitoring-program.pdf>.

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9/6/23