

Cost Estimate for Adding Primary Market Transactions into CAT

February 17, 2015

Background:

Rule 613(a)(1)(vi) requires the CAT NMS Plan submitted by the SROs to discuss “[t]he feasibility, benefits, and costs of broker-dealers reporting to the consolidated audit trail in a timely manner: (A) The identity of all market participants (including broker-dealers and customers) that are allocated NMS securities, directly or indirectly, in a primary market transaction¹; (B) The number of such securities each such market participant is allocated; and (C) The identity of the broker-dealer making each such allocation.”

The SROs have requested cost estimates from the industry on reporting allocations of primary market transactions into CAT to be used in the CAT NMS Plan they intend to submit at the end of this month (Feb 2015).

Due to uncertainty around the scope of this requirement, industry DAG has evaluated two options:

- Option 1 – supply the initial allocation (e.g., Fidelity gets 10,000 shares) as well as sub-account allocations²
- Option 2 – supply only sub-account allocations resulting from primary transactions to CAT

Key Considerations

Without more specifics on how the inclusion on of primary markets would be implemented, it is difficult to assess the costs of implementation. Several factors will influence costs including:

- Role of broker dealer in primary market transaction process (lead underwriter, member of selling group, institutional broker-dealer receiving a primary market allocation, retail broker dealer receiving a primary market allocation)
- Scope of activities covered by Rule 613 (e.g., registered and/or unregistered transactions)
- Structure of IPO (lead underwriter versus joint book)
- Impacted systems. Not all IPOs follow the same process depending on the structure of the deal
- Data elements required in CAT including granularity of time stamps. Firms will need to perform a gap analysis between what is currently captured in book building systems and what is required by CAT.
- Impacted accounts – allocations to foreign customers may be handled in different systems.
- Timing of CAT submissions. Estimates assume that existing business processes would be supported which would include a timing of Pricing plus 1 for initial allocations and settlement plus one for sub-account allocations. Allocations are subject to modification prior to settlement. CAT reporting prior to settlement would be cumbersome and require frequent allocation modifications.
- Responsibility for CAT Reporting. Estimate assumes that each broker dealer will be responsible for the allocations that they make to their customers.

Cost Estimate Methodology

¹ The SEC defines a primary market transaction as “any transaction other than a secondary market transaction and refers to any transaction where a person purchases securities in an offering.”

² The term “initial allocation” may also be commonly referred to as “top account” or “block.”

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To establish an average cost of implementation that may be used to provide the basis for an initial cost estimate in the CAT NMS Plan, the industry undertook a high level cost estimate approach. This high level estimate is subject to the many considerations outlined above.

The basis for the cost estimate analysis is a key finding of a prior FIF study which industry has validated on additional projects that is as follows: On average, over 1/3 of implementation effort is spent on business analysis. In order to develop a cost number for implementing primary market allocations in CAT, the following exercise was completed:

- Make assumptions/highlight considerations based on information available in order to establish a common understanding of what will need to be implemented
- Discuss average amount of person months required to complete business analysis
- Use FIF study assumption that business analysis accounts for a third of project time, multiply business analysis time by 3 to get total person months
- Convert total person months to total person days using 21.741 days per month
- Multiply Total person days by \$1200 (Assuming average FTE staff cost of \$1200/day. This is a number used in other CAT cost estimates)
- Multiply by 250 to obtain an estimated industry cost

Option 1 – Initial and Sub-account Allocations

Based on the methodology outlined above, the industry estimated that 12 person months of business analysis would result in a total implementation time of 36 person months at a cost of just over \$939,000 per broker-dealer.

Given FINRA's role in managing the IPO Distribution Manager reporting system, they may be in a better position to provide the number of firms involved in primary transactions. It is worth noting that even firms with a small volume of primary transactions, will need to establish the same reporting mechanisms into CAT. Additionally, if both the distributor and recipient of a primary market allocation are required to report, the number of CAT reporters will increase. If we assume at least 250 firms are involved in primary market transactions, the industry cost would be \$234.8 million.

Option 2 – Sub-Account Allocations Only

Firms expect the cost of implementation associated with sub-account allocation reporting would be significantly less than reporting both the initial and sub-account allocations due to the following implementation considerations:

- The same middle and back office systems that are used for secondary market sub-account allocation processing are used for the primary market transactions. These systems could report the sub-account allocations to CAT.
- Sub-account allocations are in an electronic format that could be converted into a CAT reportable format.
- The same level of details is captured for sub-account allocation processing of secondary and primary market transactions.
- Initial allocations are stored in book building systems. The sophistication of book-building systems differs across the industry and includes the use of applications provided by third-parties, in-house systems as well as spreadsheets which may be used by smaller firms.

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Based on the cost methodology outlined above, the industry estimated that 3 person months of business analysis would result in a total implementation time of 12 person months at a cost of just over \$234,800 per broker-dealer. If we assume at least 250 firms are involved in sub-account allocation processing, the industry cost would be \$58.7 million.

Additional Comments:

Given the significantly higher costs associated with reporting initial allocations, it is recommended that CAT only include the reporting of final sub-account allocations.