

Clients & Friends Memo

SEC Issues Proposed Regulation SCI to Enhance its Regulatory Oversight of Exchanges, Plan Processors, ATs, and other Key Market Participants

March 18, 2013

I. Overview of SEC Proposal

The SEC has issued a release (the “**Release**”)¹ proposing Regulation Systems Compliance and Integrity (“**Regulation SCI**”). The Release would impose a variety of requirements upon key market participants, e.g., exchanges and certain alternate trading systems (“**ATs**”), clearing agencies, FINRA, the MSRB, and “plan participants,” with respect to automated systems that directly support trading, clearance and settlement, order routing, market data, regulation or surveillance.

Requirements under Regulation SCI applicable to “SCI Entities” (as defined below) include:

- establishing, maintaining and enforcing written policies and procedures designed to ensure that SCI Entities
 - have levels of capacity, integrity, resiliency, availability, and security adequate to maintain operational capability and promote fair and orderly markets, and
 - operate in compliance with the federal securities laws and rules and with the entity's own rules and governing documents;
- taking corrective action upon becoming aware of a system disruption, compliance issue or intrusion (an “**SCI Event**”);
- notifying the SEC of certain material system disruptions or any system compliance issue or system intrusion;

¹ SEC Release No. 34-69077 (March 8, 2013).

- disseminating to SRO members or participants in an ATS notice of system any compliance issue or material system disruption;
- providing thirty days advance notice to the SEC of material system changes;
- reviewing, at least annually, compliance with Regulation SCI and submitting a report on compliance to senior management and both the report and the response of management to the SEC; and
- testing, at least annually, business continuity and disaster recovery plans, including:
 - requiring participation in the test of SRO members and ATS participants; and
 - coordinating testing on an industry or sector-wide basis.

The remainder of this memorandum includes a brief background section (Section II), an overview of the entities covered by Regulation SCI (Section III) and concludes with a short discussion of some of the policy issues raised by Regulation SCI (Section IV), including considerations relating to enforcement risk and whether Regulation SCI may color the SEC's view of Exchange Act Rule 15c3-5 (Risk Management Controls for Brokers or Dealers with Market Access).

II. Background

Regulation SCI is meant to replace, and expand, two Automation Review Policy statements issued by the SEC in 1989 and 1991, respectively, as well as the SEC's "voluntary" ARP inspection program (collectively, "ARP"). Regulation SCI would cover the same types of entities as are currently covered by ARP, but it would significantly lower the applicable thresholds that govern whether an ATS would be subject to Regulation SCI. Indeed, the Release states that no ATS currently exceeds the ARP applicable volume threshold. By contrast, the SEC estimates that fifteen ATSS would exceed the thresholds for becoming subject to Regulation SCI.²

III. Covered Entities

Entities covered by Regulation SCI ("SCI Entities") would include the national securities exchanges,³ FINRA, the Municipal Securities Rulemaking Board, and the registered clearing agencies (collectively, "SCI Self-Regulatory Organizations" or "SCI SROs"). Also subject to

² See the Release at 226.

³ The term SCI Entities does not include securities futures exchanges that are noticed registered under Section 6(g) of the Exchange Act.

Regulation SCI would be plan processors that process and disseminate quotations and transactions data under the various national market system plans.⁴ As discussed further below, SCI Entities would also include ATSS that meet certain volume thresholds in (i) NMS stocks,⁵ (ii) equity securities that are not NMS stocks but for which transactions are reported to FINRA,⁶ (iii) municipal securities or corporate debt securities (such covered ATSS, “**SCI ATSS**”). In addition, Global Joint Venture Matching Services – US, LLC (“**Omgeo**”), an exempt clearing agency that is nonetheless subject to ARP, would be an SCI Entity.

Broker-Dealers and Regulation SCI. While Regulation SCI, as proposed, would not cover broker-dealers that are not ATSS, the Release discusses whether some broker-dealers should be subject to the Regulation. The Release also includes a discussion of the scope of Rule 15c3-5, which the Release characterizes as designed to address in a more limited manner some of the same concerns as Regulation SCI. The Release requests comment on 17 separate questions relevant to broker-dealers and Regulation SCI while also stating that should the SEC decide to regulate broker-dealers under Regulation SCI, it would issue a separate release discussing such proposal.

SCI ATSS. Currently, Rule 301(b)(6) of Regulation ATS generally provides that ATSS that exceed 20% of the U.S. average daily trading volume in covered securities must comply with ARP-like provision.

Regulation SCI would apply to ATSS that, during four of the preceding six calendar months, satisfied any of the following volume thresholds:

- With respect to NMS stocks:
 - Five percent or more of the average daily dollar volume of any single NMS stock and one-quarter of one percent or more of the average daily dollar volume in all NMS stocks; or

⁴ The term “plan processors” is defined at (a)(55) of Rule 600 of Regulation NMS as “any self-regulatory organization or securities information processor acting as an “exclusive processor” in connection with the development, implementation and/or operation of any facility contemplated by an effective national market system plan.” Section 3(a)(22)(B) of the Exchange Act, defines “exclusive processor” to mean “any securities information processor or self-regulatory organization which, directly or indirectly, engages on an exclusive basis on behalf of any national securities exchange or registered securities association, or any national securities exchange or registered securities association which engages on an exclusive basis on its own behalf, in collecting, processing, or preparing for distribution or publication any information with respect to (i) transactions or quotations on or effected or made by means of any facility of such exchange or (ii) quotations distributed or published by means of any electronic system operated or controlled by such association.”

⁵ An “NMS stock” is a security, other than an option, for which transaction reports are made available pursuant to an effective “transaction reporting plan” that meets the requirements of Rule 601 of Regulation NMS. See Regulation NMS Rule 600(b)(46), (47) and (82). Practically speaking, the term “NMS stock” is synonymous with the term “listed equity.”

⁶ As a general matter, this means “OTC Equity Securities” and “Restricted Equity Securities” as defined at FINRA Rule 6420.

- One percent or more of the average daily dollar volume in all NMS stocks.
- With respect to non-NMS stocks for which transactions are reported to an SRO:
 - Five percent or more of the average daily dollar volume.
- With respect to municipal securities and corporate debt securities, five percent or more, respectively, of either:
 - the average daily dollar volume traded in the U.S. or
 - the average daily transaction volume traded in the US.

IV. Policy Considerations

Market Solutions. While the Release discusses the potential for market driven solutions to the technology compliance problems to be addressed by Regulation SCI, it does so largely for the purpose of asserting their short comings. The Release fails to acknowledge however the negative impact that the structure of the national market system, as created by Regulation NMS, has on market driven solutions. Specifically, the order protection rule, which makes it impossible for market participants to avoid any one exchange, also serves to undermine the market discipline that true competition between the exchanges might bring.⁷ It could be productive to at least begin a discussion of ways the national market system itself contributes to the very problems the SEC is trying to solve.

Business Continuity. The Release identifies a business continuity standard that is focused on rapid recovery and timely resumption of critical operations, *i.e.*, no later than the next business day. While this sounds all for the good, in the case of exchanges, however, it might be more economically efficient to develop processes and systems to take advantage of the redundancies offered by the fact that there are thirteen separate exchanges that trade NMS stocks. Assuming an exchange is able to process all open transactions along a normal settlement cycle and transition or cancel all existing orders, how important is it that the exchange be prepared to open no later than the next business day notwithstanding earthquake, hurricane or other natural disaster? While listing exchanges have unique responsibilities, *e.g.*, opening auctions, how difficult would it be to transition those responsibilities to a backup exchange? Indeed, it appears that the NYSE is prepared to adopt such an approach by announcing a new disaster recovery plan that, effectively, shifts trading to its electronic Arca system.⁸

⁷ Rule 611 of Regulation NMS.

⁸ See Wall Street Journal "NYSE Disaster Recovery Plan Focuses on Electronic Trading," March 8, 2013, available at <http://mobile.blogs.wsj.com/cio/2013/03/08/nyse-disaster-recovery-plan-focuses-on-electronic-trading/>.

Focus on Risk and on Structures to Reduce Risk. The Release also does not appear to recognize that not all system disruptions are equally significant or even significant at all. For the reasons set forth above under “Business Continuity,” so long as system issues do not affect the ability to process open transactions and transition or cancel existing orders, it seems likely that the system “problem” will be of little or no harm – except perhaps to the reputation of the applicable exchange. Accordingly, rather than forcing exchanges to focus broadly and indiscriminately across all “SCI systems,” exchanges might be better directed to begin their efforts by developing a risk matrix based upon possible harm to market participants and then focusing their efforts on steps to mitigate any significant sources of harm. Similarly, the SEC might find it productive to focus on the development of structures that serve to reduce or eliminate risk.

Narrow Conduits. Regulation SCI fails to focus significantly or even identify “narrow conduits” in the national market system. By “narrow conduits”, we mean single source providers that are crucial to the functioning of the national market system. While the national market system might function just fine with one less exchange, that same is not true if there is one less clearing agency or one less plan processor since they function as monopolies within their areas of coverage. Might it be useful to consider means of encouraging redundancies and competition in these areas?

Enforcement. Given the comprehensive nature of Regulation SCI and the numerous obligations it imposes on SCI entities, it seems likely that one result of Regulation SCI will be to create an easier path for enforcement actions by the SEC wherever a firm has had technology problems. Moreover, and regardless of whether the SEC ultimately decides to impose Regulation SCI on broker-dealers, it seems likely that Regulation SCI, and the standards that it seeks to impose, will color their view of appropriate policies and procedures for purposes of Rule 15c3-5.

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