The Marketplace Awaits Regulation SCI

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The SEC may soon adopt Regulation Systems Compliance and Integrity ("**Regulation SCI**"), which it proposed in March 2013 in the wake of several high-profile systems problems in the securities markets. As proposed, Regulation SCI would impose a series of new technology, control and security requirements on certain self-regulatory organizations, alternative trading systems ("**ATSs**"), plan processors and exempt clearing agencies.

The rulemaking may have broad implications. It could impact the balance of regulatory requirements imposed on exchanges and competing market centers – i.e., ATSs and over-the-counter ("**OTC**") market makers. The rulemaking also likely will be the SEC's first major action in the market structure area following two important speeches this summer by SEC Chair Mary Jo White, in which she articulated an ambitious agenda of regulatory initiatives focused on a number of complex market structure issues. The contours of Regulation SCI and the Commissioner statements at the open meeting may also provide clues about the SEC's potential next steps in this area.

The Proposal

Proposed Regulation SCI would supersede, and in several ways expand upon, the SEC's Automation Review Policy ("**ARP**"), a "voluntary" set of standards and inspection program focused on the automated systems of self-regulatory organizations. In general, proposed Regulation SCI would require SCI Entities (described below) to establish written policies and procedures to ensure that their systems meet certain enumerated standards and have levels of capacity, integrity, resiliency, availability and security adequate to maintain their operational capability. SCI Entities would also be required, among other things, to provide 30-day written notice to the SEC before making any material systems changes and submit written notice to the SEC within 24 hours of becoming aware of any systems compliance issue, systems intrusion or "systems disruption" (collectively, "**SCI Events**"). The proposal also includes requirements regarding corrective action and the dissemination of information concerning certain SCI Events to members or participants. The proposal includes a highly controversial requirement that SCI Entities provide SEC representatives "reasonable access" to their core systems, which according to the SEC would facilitate remote or on-site access by SEC representatives to the SCI Entity's systems.

Proposed Regulation SCI would apply to any "SCI Entity," which would include:

- each national securities exchange,
- each registered clearing agency and any exempt clearing agency subject to ARP (i.e., Omgeo),
- ATSs that meet certain trading volume thresholds,
- the Regulation NMS plan processors and
- FINRA and the MSRB.

[1] http://www.tradersmagazine.com/news/regulation/the-marketplace-awaits-regulation-sci-112924-1.html.

Significantly, the SEC has not proposed to apply Regulation SCI to OTC market makers, perhaps in view of the existence of the SEC's market access rule, which requires broker-dealers with market access (or that provide customers with market access) to establish risk management controls and supervisory procedures to manage the risk of such activities. The SEC proposing release notes that the SEC is considering the appropriateness of extending Regulation SCI obligations to OTC market makers and certain other categories of broker-dealers, although the SEC would issue a separate release if it decides to pursue further regulation. It is also notable that the proposal does not calibrate or tier the attendant regulatory obligations based on an entity's function or risk profile.

As the SEC moves closer to adopting the final regulation—potentially within the next few weeks—we look forward to learning how the SEC will approach certain other key issues.

Scope of Reporting Requirements

The proposed definition of an "SCI Event" is quite broad. For example, the SEC proposes to include among the events that would be considered reportable "systems disruptions," an SCI Entity's failure to maintain service level agreements and the queuing of data between systems components. The breadth of the reporting obligations may impose a significant burden and resource strain on the SEC staff responsible for reviewing notifications and tracking the reported issues, not to mention SCI Entities themselves. The NYSE has suggested that the SEC's proposal may trigger between 200 to 500 annual notification events *per exchange*. It will be interesting to see whether the SEC adopts a more narrowly tailored definition of an SCI Event, one which more closely reflects systems issues that have a material impact on the delivery of core services to market participants.

Direct SEC Staff Access to the Systems of SCI Entities

Ironically, the proposed requirement that SCI Entities provide SEC representatives with remote or on-site access to their systems could introduce new risks to SCI Entities and undermine system security and integrity. It is unclear why the SEC staff would need remote access to the systems of, for example, the NASDAQ Stock Market, the Options Clearing Corporation or the MSRB. The SEC could instead rely on the current approach under ARP, where an entity's staff demonstrates systems testing and capabilities in the presence of SEC staff on the entity's premises during an inspection. Given recent information security lapses by the government, including the SEC, potentially covered entities are eager to learn whether this aspect of the proposal will be eliminated, and if not, what protections, training and limitations the SEC would put in place to safeguard SCI Entities' systems and data.

Confidentiality Concerns

Proposed Regulation SCI's reporting and information requirements also raise significant concerns regarding the confidentiality and safe handling of mission critical information reported to the SEC. FINRA and the exchanges, for example, have requested that any information provided to the SEC pursuant to Regulation SCI be done on a confidential, nonpublic basis and be explicitly protected from Freedom of Information Act disclosure requests. This uneasiness brings to mind the broader trend of concern among market participants regarding the protection of the reams of highly confidential information provided to regulators (e.g., the Volcker Rule risk metric submissions).

Application to CFTC-Regulated Entities

The SEC's recognition of CFTC regulation is also an issue. Proposed Regulation SCI would apply to all registered clearing agencies, including those, such as CME and ICE Clear Credit, whose clearing agency registrations are limited solely to the clearing of security-based swaps and which are registered with, and under the primary supervision of, the CFTC. As CFTC-registered derivatives clearing organizations ("**DCOs**"), CME and ICE Clear Credit are already subject to extensive requirements regarding the

safeguarding of their systems. Moreover, due to their designation by FSOC as systemically important, CME and ICE Clear Credit also recently became subject to certain enhanced systems requirements that the CFTC adopted in November 2013. Given the limited scope of their registrations with the SEC and the potential for overlapping requirements, it would not be surprising if the SEC excludes CME and ICE Clear Credit from Regulation SCI. In its May 2014 proposal to impose heightened regulatory requirements on systemically important clearing agencies, the SEC recognized that systemically important DCOs for which the CFTC acts as the supervisory agency are subject to analogous CFTC requirements and appropriately excluded them from the scope of the proposed rules.

Costs and Burdens

The initial SEC estimates of the impacts and compliance costs of the proposed requirements may be unrealistically low. For example, the SEC estimates that there would be 65 annual reportable events per SCI Entity. By contrast, as noted, the NYSE initially estimates that each exchange would experience anywhere from 200 to 500 annual reportable events. Several of the SEC's estimates concerning the amount of time it would take to meet aspects of the proposed regulation also appear unrealistic. For instance, the SEC estimates that it would take only two total man hours for an entity to prepare and submit to the SEC a notice of a material systems change. In several cases, the SEC failed to fully account for the various departments (e.g., legal, compliance, technology, operations) within an organization that would need to provide input and play a role in satisfying the proposed requirements. Given the number of comments relating to compliance costs, it will be interesting to see whether the SEC increases its estimates of the impacts and costs in the final release.

Conclusion

The final version of Regulation SCI may look quite different from the proposal, particularly since three of the five current SEC Commissioners, including the Chair, are new to the Commission and did not vote on the proposal. The rulemaking may be an interesting window into the SEC's future steps in the area of market structure under Mary Jo White's leadership.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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