

SEC PROPOSES REGULATION SYSTEMS COMPLIANCE AND INTEGRITY

On March 7, 2013, the Securities and Exchange Commission's (the "SEC") commissioners unanimously approved issuing a new rule proposal, called Regulation Systems Compliance and Integrity ("Regulation SCI" or "the Regulation") under the Securities Exchange Act of 1934 (the "Exchange Act").¹ Regulation SCI will impose technology and control standards on the automated systems of entities such as self-regulatory organizations ("SROs") and alternative trading systems ("ATs"), including dark pools and electronic communications networks that meet certain volume thresholds (collectively, "SCI entities"). In addition, the proposal requests comment on whether the Regulation should include broker-dealers that execute client orders internally.

Since the May 2010 Flash Crash, the SEC has approved various initiatives to address technological issues, such as revised market-wide circuit breakers, the limit up/limit down mechanism, and Exchange Act Rule 15c3-5 (the "Market Access Rule"), which requires risk management controls and supervisory procedures for brokers and dealers with market access. Now, the SEC is seeking to further prevent technical issues from affecting securities markets by imposing standards on the automated systems of certain market participants through the proposed Regulation SCI. If adopted, Regulation SCI will replace the current voluntary compliance program governing the SEC's Automation Review Policy ("ARP") and certain system-related requirements under Regulation ATS.² The SEC estimates that there are currently 44 entities that would meet the definition of SCI entities (26 SROs, 15 ATs, two plan processors and one clearing agency).³ There is a 60-day public comment period, which ends on May 24, 2013.

¹ Regulation Systems Compliance and Integrity, Exchange Act Release No. 69077, 78 Fed. Reg. 18083 (Mar. 25, 2013), available at <http://www.sec.gov/rules/proposed/2013/34-69077.pdf>. For additional information, see our memorandum on SEC market structure initiatives, including the adoption of Exchange Act Rule 15c3-5 at http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3574/Recent-SEC-Market-Structure-Initiatives.pdf and our memorandum on the final rule regarding the large trader reporting system at http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3849/SEC-Adopts-Large-Trader-Reporting-System.pdf.

² Currently, all SROs and one ATS participate in ARP.

³ If adopted, Regulation SCI will apply to national securities exchanges registered under Section 6(b) of the Exchange Act, registered securities associations, registered clearing agencies and the Municipal Securities Rulemaking Board. There is currently one clearing agency exempt from registration under Section 17A of the Exchange Act. "Plan processor" would be defined in the same manner as it is under Regulation NMS, which includes SROs and securities information processors.

Summary of Proposed Regulation SCI

Regulation SCI will require, among other things, that an SCI entity:

- Implement policies and procedures concerning its technology systems' capacity, integrity, resiliency, availability and security;
- Institute policies and procedures ensuring that the technology systems operate in the manner intended, including complying with the federal securities laws, and with the entity's own relevant rules and governing documents;
- Respond to and take corrective action regarding systems disruptions, systems compliance issues and systems intrusions ("SCI events") in a timely manner;
- Notify and update the SEC about SCI events and the progress of any corrective actions;
- Inform the SEC about material systems changes;
- Disseminate information about certain types of SCI events to its members or participants;
- Conduct an annual compliance review pursuant to Regulation SCI, and submit a report of the review to the SEC and the entity's senior management;
- Test the operation of business continuity and disaster recovery plans (and backup systems) at least once every 12 months, and coordinate the testing on an industry- or sector-wide basis with other SCI entities;
- Assign certain individuals or firms to participate in the testing of business continuity and disaster recovery plans;
- Provide SEC staff with access to its systems;
- Create and maintain books and records relating to compliance with Regulation SCI; and
- Utilize a new Form SCI to file any notices and reports that are required to be filed with the SEC under the Regulation.

Volume Thresholds

Notably, the SEC is seeking to lower the current systems capacity and integrity volume thresholds for ATSS currently included in Regulation ATS, and move the thresholds to Regulation SCI. The SEC notes that no ATSS currently meet the significant volume thresholds specified in Regulation ATS and, therefore, at the present time no ATSS are required to comply with the ARP inspection program. The proposed definition would (1) replace the current average daily share volume threshold with average daily dollar volume thresholds for ATSS that

trade national market system (“NMS”) stocks or non-NMS equity securities; (2) use alternative tests based on either the average daily dollar volume or average daily transaction volume trade in the United States for ATSs that trade municipal or corporate debt securities; and (3) lower the volume thresholds for ATSs for each category of asset class (i.e., generally lower thresholds for NMS stocks than other asset classes). Any ATS meeting the significant-volume thresholds would fall under the definition of “SCI entity” and would have to meet the requirements of Regulation SCI.

The current volume threshold for NMS stocks is 20 percent of average daily volume in any NMS stock. Regulation SCI would apply to any ATS that trades NMS stocks and meets one of the following criteria for average daily dollar volume reported by an effective transaction reporting plan: (i) five percent or more in any NMS stock, and 0.25 percent or more in all NMS stocks, or (ii) one percent or more in all NMS stocks. Regarding non-NMS equity securities, as well as municipal and corporate debt securities, the SEC is proposing to reduce the respective standards from 20 percent to five percent. Non-NMS equity securities volumes will be calculated by the SRO to which the transactions are reported.

Consolidated Market Data

The SEC is also proposing that SCI entities’ systems contribute to the collection and distribution of consolidated market data. Specifically, Regulation SCI would require that the SCI entities include standards in their policies and procedures that result in their “systems being designed, developed, tested, maintained, operated, and surveilled in a manner that facilitates the successful collection, processing, and dissemination of market data.” The SEC indicates that this is a new requirement, not currently found in any securities laws or SEC policy statements.

Safe Harbor

Proposed Regulation SCI requires entities to institute policies and procedures ensuring that the technology systems operate in the manner intended. The SEC has proposed a safe harbor from liability applicable to SCI entities and their employees. An SCI entity would qualify for the safe harbor if the entity established and maintained certain policies and procedures relating to testing of SCI systems and changes (pre- and post-implementation), internal controls over changes, ongoing monitoring of system functionality, compliance assessments and regulatory personnel review of SCI systems and system changes, and testing and controls to prevent, detect and address actions that are not in compliance with the federal securities laws and with the entity’s rules and/or governing documents.⁴ The proposed “safe harbor,” however, is so extensive in its requirements that it might appear to impose a separate regime of regulatory requirements by itself.

⁴ In addition, the SCI entity’s system for applying the policies and procedures must be reasonably designed and maintained in a manner to prevent and detect violations of the policies and procedures, to the extent practicable. The SCI entity: (1) must reasonably discharge its duties and obligations in the policies and procedures, and (2) be without reasonable cause to believe that such policies and procedures are not being complied with in any material respect. An SCI employee will also receive safe harbor protection if the employee reasonably discharges his/her duties and obligations in the policies and procedures and is without reasonable cause to believe the policies and procedures are not being complied with in any material respect.

Consequences of Regulation SCI

Regulation SCI is more than 350 pages long. The release poses 235 questions for comment. By any measure, this is a gargantuan rule proposal that seeks to regulate operational systems of every market venue of any consequence. While some of its proposals are such that any significant market participant should already be implementing them, market participants may regard the broad scope and the vast array of the proposed regulation of their IT systems to be unwieldy and to necessitate a burdensome compliance commitment.

Perhaps most significantly, if Regulation SCI is adopted as proposed, its volume thresholds will cause certain broker-dealer ATSS, and their automated systems, to be subject to a wide array of unprecedented regulation, including governmental access to their systems, broad notification requirements, the establishment of systems to collect and disseminate consolidated data and extensive recordkeeping requirements. The SEC states that the volume thresholds were not derived from any mathematical or econometric models, but rather, are based on preliminary best estimates of when a market execution venue is sufficiently significant to affect the trading of a particular asset class. The SEC is soliciting comments on the appropriateness of the proposed threshold levels that will be due on May 24, 2013.

If enacted in its current form, SCI entities, especially those not currently subject to ARP, will likely raise substantial questions regarding the implementation of Regulation SCI. For example, SCI entities will be required to report “system disruptions,” which include, among other things, (1) loss of use of an SCI system, (2) significant processing back ups or delays in processing, and (3) a significant reduction in the ability to disseminate accurate and timely market data. SCI entities will have to enact controls and processes to discern whether an event meeting this broad definition has occurred.

Further, the Commission is asking whether certain other market participants, such as over-the-counter market makers, exchange market makers, order entry/routing broker-dealers, clearing broker-dealers, or large multi-service broker-dealers and transfer agents, should be subject to some or all of the additional safeguard rules being proposed for SCI entities. The SEC notes that the Market Access Rule, which requires brokers or dealers with market access to implement risk management controls and supervisory procedures, currently seeks to address market risks posed by the automated systems of broker-dealers. The SEC, however, is now considering whether certain categories of broker-dealers should be subject to any (or all) of the system safeguard rules the SEC formerly applied only to exchanges and clearinghouses (and ATSS with 20 percent or more volume in an NMS stock). The SEC indicated that it would issue a separate proposal if it decided to propose to apply the requirements of Regulation SCI to broker-dealers other than those that meet the definition of an SCI entity in the release.

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