

CLIENT MEMORANDUM

SEC Adopts Regulation Systems Compliance and Integrity

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Regulation Systems Compliance and Integrity (“Regulation SCI”)¹ marks a significant addition to the recent initiatives undertaken by the Securities and Exchange Commission (“SEC” or “Commission”) to address concerns about the reliability and resilience of U.S. securities market infrastructure.² Described as the codification of the Securities and Exchange Commission’s long-standing Automation Review Policy (“ARP”) inspection program,³ the new rule in fact

¹ On November 19, 2014, the SEC unanimously adopted Regulation SCI under the Securities Exchange Act of 1934 (“Exchange Act”). See Regulation Systems Compliance and Integrity, Exchange Act Release No. 73639 (Nov. 19, 2014), available [here](#). For additional information, please see our memorandum on proposed Regulation SCI [here](#).

² Since the May 2010 Flash Crash, the SEC has approved various initiatives to address technological issues, including revised market-wide circuit breakers, the limit up/limit down mechanism, and Exchange Act Rule 15c3-5 (the Market Access Rule). For additional information, please see our memoranda on SEC market structure initiatives, including the adoption of Exchange Act Rule 15c3-5 [here](#), our memorandum on the proposed tick pilot program [here](#), and our memorandum on the final rule regarding the large trader reporting system [here](#).

³ ARP served as a voluntary regime under which the trading and related systems of national securities exchanges and associations, alternative trading systems (“ATs”), clearing agencies, and plan processors were evaluated on a periodic basis by SEC staff for conformance with policy statements, including Exchange Act Release Nos. 34-27445 (Nov. 16, 1989), and 34-29185 (May 9, 1991), subsequent staff letters and evolving

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imposes sweeping new obligations on entities already participating in the program and, as a practical matter, draws others into the regime for the first time, including ATs engaged in substantial equities trading. Regulation SCI also establishes obligations that will affect other market participants designated for participation in mandatory testing established by the rule.

SCI entities,⁴ including most SROs, ATs that meet equity trading thresholds, national market system plan processors, and exempt clearing agencies already subject to ARP, must now meet substantial new responsibilities, including that they (1) implement written policies and procedures to help ensure the adequacy of their technology systems and the operation of such systems in compliance with the Exchange Act, Exchange Act rules, and their own rules; (2) mandate participation by designated members or participants in coordinated periodic business continuity and disaster recovery plan and backup systems testing; (3) take corrective action in response to systems disruptions, systems compliance issues and systems intrusions (“SCI events”) and notify and update the Commission and, in more major cases, other entities; and (4) make periodic reports on systems changes and file with the SEC the results of an annual review of their compliance with the regulation.

Regulation SCI will require considerable attention by senior management and the boards of SCI entities as they review annual reports filed with the Commission under the rule’s mandate. Given that many of the new requirements will come into force nine months after the rule goes into effect, Regulation SCI will demand immediate sustained attention by SCI entities and their personnel. As further discussed below, it will also set significant de facto obligations for other market participants in the years ahead.

Finally, SEC staff issued guidance on “current SCI industry standards” at the same time the Commission approved Regulation SCI to assist SCI entities in creating and evaluating policies and procedures to address the standards

best practices. Regulation SCI supersedes the compliance program governing ARP and certain system-related requirements established under Regulation ATS.

⁴ The release estimates that, as of the date of adoption, 44 entities meet the definition of an SCI entity – 27 self-regulatory organizations (“SROs”) (of which there are 18 registered national securities exchanges, seven registered clearing agencies, the Financial Industry Regulatory Authority (“FINRA”) and the Municipal Securities Rulemaking Board (MSRB)), 14 ATs that satisfy equity volume thresholds, two plan processors, and one exempt clearing agency (Omgeo Matching Services – US, LLC). Exchanges that list or trade security futures products and are notice-registered with the Commission are excluded from Regulation SCI in order to avoid regulatory overlap with the CFTC. “Plan processor” is defined in the same manner as under Rule 600(b)(55) 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.” See also Exchange Act Section 3(a)(22)(B) (defining “exclusive processor”). Plan processors currently include the Securities Industry Automation Corporation (SIAC), which is owned by NYSE Euronext and is the plan processor for the Consolidated Tape Association System (CTA), Consolidated Quotation System (CQS) and Options Price Reporting Authority (OPRA) plans, and Nasdaq, which is the plan processor for the Nasdaq UTP plan. Both plan processors are registered with the SEC as securities information processors (“SIPs”).

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requirements under the rule. The guidance will be updated periodically as those standards evolve. As a result, SCI entities will need to be vigilant to ensure that they are keeping abreast of evolving systems best practices across a host of domains.

Regulation SCI Overview

Regulation SCI requires SCI entities to have comprehensive policies and procedures for their technological systems; take corrective action when systems issues occur; provide notifications and reports to the SEC on certain systems issues or changes; inform members and participants about certain systems issues; conduct business continuity and disaster recovery testing with mandatory participation by certain members and participants; and conduct and file reports on annual reviews of their automated systems.

In particular, the rule will require, among other things, that an SCI entity:

- Establish, maintain, and enforce reasonably designed policies and procedures relating to capacity, integrity, resiliency, availability and security of certain systems in accordance with a set of minimum standards and consistent with current SCI industry standards;
- Institute policies and procedures reasonably designed to ensure that its technology systems operate in a manner that complies with the Exchange Act and the rules and regulations thereunder, and with the entity's own rules and governing documents, in keeping with a set of minimum standards;
- Institute policies and procedures for identifying, designating and documenting responsible SCI personnel and escalation procedures related to the responsibility of those personnel;
- Respond to and take appropriate corrective action, including mitigating harm and devoting adequate resources, to address SCI events as soon as reasonably practicable;
- Immediately notify the SEC about non de minimis SCI events and subsequently provide updates to the SEC about these SCI events and the progress of any corrective actions;
- Disseminate information about non de minimis SCI events to members or participants who may have been affected or, in the case of a major SCI event, to all members or participants;
- Report to the SEC any completed, ongoing and planned material changes to SCI systems and the security of indirect SCI systems on a quarterly basis, and submit supplemental reports to notify the SEC of any material errors or omissions in the quarterly reports;
- 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 and board of directors;

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- Assign designated members or participants to participate in the testing of, and 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;
- Create and maintain books and records relating to compliance with the regulation; and
- Utilize a new Form SCI to file notices and reports required under the rule.

Entities subject to Regulation SCI will generally have until nine months after the effective date to comply with the regulation's substantive requirements.⁵ Affected entities will have 21 months from the effective date to comply with the industry- or sector-wide coordinated testing requirements under the rule. Although the release did not discuss penalties for non-compliance, failure to properly comply with the requirements could result in fines and/or imposition of forced enhancements to an SCI entity's technology and IT supervisory structure, such as through the appointment of an independent overseer or consultant (i.e., as part of a settlement order).

ATS Volume Thresholds

Regulation SCI treats an ATS as an SCI entity if it trades NMS stocks and meets one of the following criteria for average daily dollar volume reported by an effective transaction reporting plan: (i) 5 percent or more in any NMS stock, and 0.25 percent or more in all NMS stocks, or (ii) 1 percent or more in all NMS stocks. For ATSs transacting in non-NMS equity securities, the SEC has reduced the threshold for inclusion from 20 percent of average daily volume to 5 percent of average daily dollar volume. If an ATS meets one of the above thresholds for at least four of the six previous calendar months, it becomes subject to Regulation SCI. The final rule excludes fixed-income ATSs that only trade municipal or corporate debt securities.

Systems Covered by the Rules

Regulation SCI establishes obligations and requirements related to "SCI systems," and introduces the concepts of "critical SCI systems" and "indirect SCI systems." As described below, "SCI systems" are the production systems of SCI entities that directly support six key functions. "Critical SCI systems," a new phrase in the adopting release, represent single points of failure within SCI entities and therefore warrant heightened resilience and information dissemination requirements.

⁵ The effective date is 60 days after publication in the Federal Register. ATSs meeting the volume thresholds in the rules for the first time will be provided an additional six months from the time that the ATS first meets the applicable thresholds to comply.

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SCI Systems

Obligations relating to the policies and procedures of SCI entities, as well as key reporting and recordkeeping requirements, focus on “SCI systems,” defined as “all computer, network, electronic, technical, automated, or similar systems of, or operated by or on behalf of, an SCI entity that, with respect to securities, directly support trading, clearance and settlement, order routing, market data, market regulation, or market surveillance.” This definition departs from the proposal by excluding systems that are still in development or testing. The release makes clear, however, that SCI entities should still expect SEC staff reviews of their SCI systems’ development and testing programs. In addition, SCI entities are still required to conduct reviews of testing and development systems when examining the design and effectiveness of internal controls during annual reviews. The SEC further noted that test systems that are not completely walled off from production systems may be captured in the definition of SCI systems.

Critical SCI Systems and Indirect SCI Systems

“Critical SCI systems,” a subset of SCI systems essential to the operations and infrastructure of the markets, are subject to heightened scrutiny, such as shorter recovery periods in business continuity and disaster recovery plans,⁶ and a wider dissemination audience for related SCI events, as explained in more detail below. Critical SCI systems are those that directly support functionalities such as the opening or closing of trading on a primary listing market, initial public offerings, the imposition or lifting of trading halts, the provision of consolidated market data, and clearance and settlement systems of clearing agencies or exclusively listed securities. The definition also captures SCI systems that “provide functionality to the securities markets for which the availability of alternatives is significantly limited or nonexistent and without which there would be a material impact on fair and orderly markets.” This catch-all provision is meant to capture systems that currently pose the greatest level of risk to the markets and to accommodate those that may develop in the future. We expect keen attention by SEC examiners to these “critical SCI systems” as they encompass the same set of functions Chair White drew attention to in launching her critical market infrastructure review among the SROs in the wake of last year’s SIP outage.⁷

The final release renames the proposed term “SCI security systems” as “indirect SCI systems,” defined to mean “any systems of, or operated by or on behalf of, an SCI entity that, if breached, would be reasonably likely to pose a security threat to SCI systems.” The compliance requirements of indirect SCI systems are limited to disclosures related to security standards, security changes, systems intrusions, and certain recordkeeping requirements. In order to properly tailor the new policies and procedures, SCI entities should consider defining and mapping out in some detail those operating

⁶ There is a two-hour resumption target for recovery of all critical SCI systems, which the SEC highlighted as a “goal” against which the design of business continuity and disaster recovery plans will be measured, rather than a strict requirement.

⁷ See SEC Chair White Statement on Meeting With Leaders of Exchanges (Sept. 12, 2013), available [here](#). See also SIFMA response letter regarding SIPs and Operational Resiliency (Dec. 5, 2013), available [here](#).

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systems, hardware, software, data and processes that they would include as “SCI systems” and “critical SCI systems” for their particular business and operations.

Obligations of SCI Entities

SCI Policies and Procedures

Regulation SCI requires that SCI entities establish, maintain, and enforce written SCI-related policies and procedures reasonably designed to give effect to the requirements under Rules 1001(a), (b), and (c) and that these policies and procedures be periodically reviewed as to their effectiveness and remedied to address identified deficiencies.

Rule 1001(a)(1) requires policies and procedures reasonably designed to ensure that SCI entities have levels of capacity, integrity, resiliency, availability and security for their SCI systems and (for purposes of security standards) indirect SCI systems that are “adequate to maintain the SCI entity’s operational capability and promote the maintenance of fair and orderly markets.” Rule 1001(a)(2) outlines the minimum baseline elements for the design and upkeep of these systems.⁸

The policies and procedures required under Rule 1001(a) must be reviewed periodically and will be deemed to be reasonably designed if they are “consistent with current SCI industry standards.” To assist SCI entities in this assessment, staff in the Division of Trading and Markets issued guidance on the same day the rule was approved.⁹ The publication covers nine inspection areas, or “domains” deemed by the staff to be relevant to an SCI entity’s development of reasonable policies and procedures: application controls; capacity planning; computer operations and production environment controls; contingency planning; information security and networking; audit; outsourcing; physical security; and systems development methodology. The publications are issued by a range of entities, including the National Institute of Standards and Technology (NIST); Federal Financial Institutions Examination Council (FFIEC); financial regulatory agencies, including the SEC; the Institute of Internal Auditors, and the Security Benchmarks division of the Center for Internet Security.

Since the Commission did not adopt the guidance as part of Regulation SCI, it does not represent a set of “rules, regulations or statements” by the agency. Nevertheless, there are indications in the Regulation SCI adopting release, the guidance itself, and from inspection staff that suggest examinations of SCI entities for compliance with Regulation SCI will

⁸ The minimum standards will be used by examination staff in tandem with staff guidance on industry standards as prescribed in Rule 1001(a)(4). See *infra* note 9. The baseline elements include reasonable current and future technological infrastructure capacity planning estimates; periodic capacity stress testing for transaction processing; a program for reviewing and keeping current systems development and testing methodology; review and testing of the systems (and backup systems) to identify vulnerabilities (including internal and external threats, physical hazards, and natural or man-made disasters); business continuity and disaster recovery planning; collection, processing and dissemination standards for market data; and the monitoring of SCI systems for potential SCI events.

⁹ Staff Guidance on Current SCI Industry Standards (Nov. 19, 2014), available [here](#).

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look in the first instance to these domains and publications to provide a road map for evaluating whether SCI entities have created policies and procedures in keeping with the requirements of the rule.

Exchange Act Compliance

Rule 1001(b)(1) requires additional written policies and procedures reasonably designed to ensure that SCI systems operate in a manner that complies with the Exchange Act and the SCI entity's rules and governing documents. Rule 1001(b)(2) sets out minimum standards for such policies and procedures, including pre-implementation testing of SCI systems and changes to the systems; a system of internal controls over SCI system changes; a plan for the detection of systems compliance issues; and a plan of coordination and communication between personnel of the SCI entity designed to detect and prevent systems compliance issues.

As adopted, Rule 1001(b) includes a safe harbor for individuals.¹⁰ In general, personnel of an SCI entity will not be deemed to have aided and abetted or otherwise encouraged or caused the violation by an SCI entity of its obligation to establish and maintain policies and procedures if (i) such person has reasonably discharged its duties and obligations in accordance with the applicable policies and procedures and (ii) had no reasonable cause to believe that the policies and procedures were not established or maintained as required.¹¹ The final rule eliminates the proposed safe harbor for SCI entities.

Responsible SCI Personnel

Under Rule 1001(c), SCI entities must implement policies and procedures for identifying, designating and documenting "responsible SCI personnel" who will play key roles in connection with SCI events. In the final rule, the SEC staff narrowed the definition of "responsible SCI personnel" to include only senior managers and their designees that have responsibility for an SCI system or indirect SCI system affected by an SCI event. By allowing SCI entities the ability to identify the senior manager(s) (and their designee(s)) that have responsibility for each SCI system or indirect SCI system, the SEC is allowing SCI entities some flexibility in determining who will be considered "responsible SCI personnel" for the purposes of Regulation SCI. The SEC noted in the adopting release that it "believes that SCI entities are best suited to establish the appropriate criteria for such a designation but notes that such criteria could include, for example, consideration of the level of knowledge, skills and authority necessary to take the required action under the rules." The release notes that the rule "does not permit the senior manager having responsibility for an applicable system to disclaim

¹⁰ The term "individuals" as used in the rule could refer not only to employees, but also to any contractors, consultants and other non-employees acting in a similar capacity to an SCI entity's employees.

¹¹ The Commission noted that an individual could be subject to liability if it aided or otherwise participated in the SCI entity's violation.

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responsibility under the rule by delegating it fully to one or more designees.” In addition, the procedures should include escalation procedures for “quickly” informing these personnel about potential SCI events.¹²

Periodic Review of Policies and Procedures

Regulation SCI does not specify a precise time interval for the periodic review of policies and procedures established under Rule 1001(a), 1001(b), or 1001(c), but the adopting release states that the Commission expects “diligence in maintaining a reasonable set of policies and procedures that keeps pace with changing technology and circumstances.” The SEC notes that an SCI entity will not be found to be in violation of this requirement “solely because it failed to identify a deficiency in its policies and procedures immediately after the deficiency occurred if the SCI entity takes prompt action to remedy the deficiency once it is discovered, and the SCI entity ha[s] otherwise reviewed the effectiveness of its policies and procedures and t[aken] prompt action to remedy those deficiencies that were discovered.” SCI entities should consider how they can capture efficiencies in their policies and procedures review by incorporating it in the broader annual compliance review process described in Rule 1003(b).

Obligations Related to SCI Events

Under Rule 1002, SCI entities are required to take appropriate corrective action, provide notification to the SEC and disseminate information to certain of their members or participants in connection with an “SCI event,” which includes a “systems disruption,”¹³ “systems intrusion”¹⁴ or “systems compliance issue.”¹⁵ Importantly, an SCI entity will be required to begin to take corrective action and immediately notify the SEC once responsible SCI personnel have a “reasonable basis to conclude” that an SCI event has occurred, and to submit written notification about the event and any steps taken or planned in connection with the event to the SEC within 24 hours of that determination. The SCI entity will also be required to provide information to the SEC, such as regular updates (written or oral) and final (and in some cases interim) written reports about the SCI event and corrective action.¹⁶ Any corrective action should, “include at a minimum, mitigating potential harm to investors and market integrity resulting from the SCI event and devoting adequate resources to remedy

¹² The SEC did not specify a time requirement in the rule, but allowed SCI entities flexibility in promptly notifying responsible SCI personnel about SCI events so they can determine whether an SCI event has occurred and which obligations have been triggered under the regulation.

¹³ “Systems disruption” means “an event in an SCI entity’s SCI systems that disrupts, or significantly degrades, the normal operation of an SCI system.”

¹⁴ “Systems intrusion” means “any unauthorized entry into the SCI systems or indirect SCI systems of an SCI entity.”

¹⁵ A “systems compliance issue” is “an event at an SCI entity that has caused any SCI system of such entity to operate in a manner that does not comply with the Act and the rules and regulations thereunder or the entity’s rules or governing documents, as applicable.”

¹⁶ Interim written reports are required if the SCI event is not resolved or the entity’s investigation of the event is not closed within 30 calendar days of the event occurrence.

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the event as soon as reasonably practicable.” The SCI entity will also be required to disseminate certain information about the SCI event to affected members or participants of the entity. For “major SCI events,”¹⁷ the information will be required to be disseminated to all members or participants of the SCI entity.

The SEC declined to adopt a materiality threshold for SCI events. Instead, it determined to apply a “tiered” or “risk-based” approach, allowing that an SCI entity will not have to provide immediate notification or submit written notifications to the SEC, or disseminate information to members or participants, about de minimis SCI systems disruptions or intrusions.¹⁸ Rather, the SCI entity will be able to make records and submit quarterly reports to the SEC in connection with these types of events.

Notifications of System Changes

Under Rule 1003(a), SCI entities are required to provide periodic notice of systems changes. Specifically, SCI entities will be required within 30 calendar days after the end of each calendar quarter to submit to the Commission reports that describe completed, ongoing and planned “material changes” to SCI systems, as well as the security of indirect SCI systems. The reports should cover systems changes during the prior, current and subsequent calendar quarters.¹⁹ Although the SEC allowed SCI entities flexibility in establishing “reasonable written criteria” for identifying changes as material, the release also states that the SEC may review the criteria during an examination to determine whether or not it agrees with the SCI entity’s decision. The rule also requires SCI entities to “promptly” submit a supplemental report notifying the Commission of a material error in or omission from a previously submitted quarterly report.

SCI Review and Annual Report

Rule 1003(b) requires each SCI entity to (i) conduct an annual “SCI review”²⁰ of its compliance with Regulation SCI not less than once each calendar year (though certain reviews may be conducted less frequently),²¹ (ii) submit a report of the

¹⁷ A “major SCI event” means “an SCI event that has had, or the SCI entity reasonably estimates would have: (a) Any impact on a critical SCI system; or (b) A significant impact on the SCI entity’s operations or on market participants.”

¹⁸ A de minimis SCI event is any “SCI event that has had, or the SCI entity reasonably estimates would have, no or de minimis impact on the SCI entity’s operations or on market participants.”

¹⁹ The reporting notification is a notable change from the proposed rule, which generally required 30 day advance notification of material systems changes.

²⁰ An “SCI review” is defined as “a review, following established procedures and standards, that is performed by objective personnel having appropriate experience to conduct reviews of SCI systems and indirect SCI systems.”

²¹ Penetration test reviews of a firm’s network, firewalls, and production systems may be conducted not less than once every three years and assessments of SCI systems directly supporting market regulation or market surveillance must be conducted based upon the risk assessment conducted as part of the SCI review, but in no case less than once every three years.

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SCI review to senior management²² for their review within no more than 30 calendar days after completion of such SCI review; and (iii) submit to the SEC and the SCI entity's board of directors a copy of the report and any response by senior management within 60 days after its submission to senior management. An "SCI review" contains (i) a risk assessment of the SCI systems and indirect SCI systems of an SCI entity and (ii) an assessment of internal control design and effectiveness of those systems to include logical and physical security controls, development processes, and information technology governance, consistent with industry standards.

The release emphasizes the importance of senior management carefully reviewing reports of SCI reviews and being engaged in promptly establishing plans for resolving issues raised. The reports and any responses by senior management are required to be filed using Form SCI and, as such, are subject to Exchange Act Section 32(a) liability. The release provides little additional detail regarding the extent of the reviews that must be conducted by senior management.²³

Business Continuity and Disaster Recovery Testing

In addition to requiring SCI entities to establish and maintain business continuity and disaster recovery ("BC/DR") plans under the policies and procedures provisions of Rule 1001(a), Regulation SCI mandates that SCI entities establish standards for designating certain members or participants as the minimum necessary for the maintenance of fair and orderly markets in the event of the activation of such plans. Designated members or participants are required to take part in functional and performance testing of the operation of the SCI entity's BC/DR plans at least once every 12 months.²⁴

The requirement that SCI entities designate members or participants for BC/DR testing exercises is a significant modification to current voluntary testing practices and one likely to result in outlays of time and resources not just for SCI entities, but for larger or more active market participants not otherwise subject to Regulation SCI. In response to

²² "Senior management," for the purposes of Rule 1003(b), is defined to specifically include an SCI entity's chief executive officer, chief technology officer, chief information officer, general counsel and chief compliance officer, or the equivalent of such employees or officers of an SCI entity. The SEC stated in the adopting release that its definition of senior management encompasses the "executive, technology, legal, and compliance functions that are necessary to effectively review the reports of SCI reviews."

²³ The release indicated that senior management should note any material inaccuracies or omissions in the report that they are aware of, in addition to any other responses that they make. The SEC, however, recognized the different levels of knowledge that senior managers may have about SCI systems and indirect SCI systems, due to their positions and experience.

²⁴ The SEC explained that functional testing examines whether a system operates in accordance with its specifications, whereas performance testing examines whether a system is able to perform under a particular workload. The SEC noted that performance testing is not synonymous with "stress testing," in which capacity limits are tested. Rule 1004(b) requires testing not only of connectivity, but also of systems such as order entry, execution, clearance and settlement or routing, and the transmission and/or receipt of market data, as applicable, to determine if these systems operate as contemplated by the BC/DR plan.

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concerns about the discretion that SCI entities will have in designating members and participants for participation in BC/DR testing, the rule as adopted requires that each SCI entity establish standards for the designation of those members or participants that the SCI entity “reasonably” determines are, taken as a whole, the minimum necessary for the maintenance of fair and orderly markets in the event of the activation of its BC/DR plans.²⁵ The rule requires SCI entities to coordinate the testing of their BC/DR plans on an industry- or sector-wide basis, but the SEC declined to provide guidance on how such coordination should occur.²⁶

Recordkeeping and Filing Requirements

Rules 1005-1007 establish requirements relating to recordkeeping and electronic filing and submission of Form SCI. Notably, Regulation SCI as adopted no longer contains the proposed requirement that SCI entities provide Commission representatives reasonable access to their systems. Instead, the Commission will be relying on its existing authority under Sections 17(a) and 17(b) of the Exchange Act as well as Rule 1005 requirements to acquire records.

A new form, Form SCI, was promulgated as part of the rule for all notifications, reviews, descriptions, analyses or reports to the SEC required by the regulation, including 24-hour notifications of SCI events; final or interim status reports about SCI events; quarterly reports regarding de minimis systems disruptions and intrusions; quarterly material system change reports (and any supplemental reports); and submissions of SCI review reports and any responses by senior management. SCI event immediate notifications and updates are not required in this format, but Form SCI may be used for these submissions as well. SCI entities may also request confidential treatment of information submitted on Form SCI.²⁷

Future Implications for SCI Entities and Other Market Participants

Regulation SCI launches a broad and extensive overlay of rules and guidance to address systems capacity and integrity issues that have increasingly affected the securities markets. SCI entities themselves already have a tremendous commercial and reputational incentive to prevent such issues. The new obligations add a regulatory mandate to the

²⁵ Given the discretion that SCI entities are provided in determining which members or participants they will designate for testing, it remains to be seen how many market participants will be affected by the testing requirements. In the economic analysis accompanying the rule, the SEC estimated that SCI entities will designate between 10 and 20 percent of their members or participants for testing.

²⁶ The SEC explained that SCI entities with rulemaking authority, such as national securities exchanges, could enforce their testing requirements through rulemaking, whereas SCI entities without rulemaking authority, such as ATSS, could enforce their testing requirements through contractual arrangements with their participants.

²⁷ The SEC also adopted an amendment to Exchange Act Rule 24b-2, which currently allows confidential portions of electronic filings and confidential treatment requests to be submitted in paper format only. The rule change will allow Form SCI filers to fill out Section IV of Form SCI in order to request confidential treatment of all information contained in the electronic Form SCI submissions.

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technology focus that has long been a part of daily life for operations and business professionals at SCI entities and at member and participant firms. Affected entities will now be confronted with multiple requirements that, depending on the facts and circumstances that arise, may more readily empower the SEC to institute enforcement actions when the entities experience systems problems or otherwise fail to meet the rule's various new demands. Moreover, Regulation SCI will create challenges for the SEC as the agency digests notices of systems issues from affected entities. In some circumstances, these notices may lead to considerable immediate follow-up diligence. But, without a large staff experienced in firm-specific technology to analyze the notices submitted in response to every SCI event, the SEC may also compile notices for further examination or investigation rather than handling specific instances as they occur. Thus, there could be considerable scrutiny applied after the fact by the SEC to an entity's systems preparedness. For these reasons, SCI entities will need to devote considerable attention and resources not just to prevent incidents where possible, but also to establish systems for ensuring thorough compliance and well-documented and reasonable follow-up actions where necessary.

Of note for other securities market participants, SEC Chair White, at the SEC's open meeting to adopt Regulation SCI, stated that she has directed the SEC staff to prepare recommendations for the Commission's consideration as to whether similar rules should be developed for additional market participants, such as broker-dealers and transfer agents. The release itself notes that Regulation SCI has adopted an incremental approach to expanding requirements to registrants, but adds that this will enable the agency "to monitor and evaluate the implementation of Regulation SCI, the risks posed by the systems of other market participants, and the continued evolution of the securities markets, such that it may later consider extending the types of requirements in Regulation SCI to additional categories of market participants, such as non-ATS broker-dealers, security-based swap dealers, investment advisers, investment companies, transfer agents, and other key market participants."

In the interim, as noted above, Regulation SCI will create obligations for market participants – whether those are direct or indirect costs for SCI entities or for those entities designated to participate in mandatory testing under Rule 1004, or costs to other service providers and participants otherwise affected by the rule. The adoption of Regulation SCI suggests that there will continue to be increased scrutiny by the SEC, FINRA and other regulators of the automated systems and related policies and procedures of all market participants, even those not directly covered by the new rules. Regulators' actions to date show a continuing emphasis on the uses of technology and cyber security in the marketplace. Even those market participants not directly covered by Regulation SCI should remain vigilant in ensuring that their technological systems and related policies and procedures can withstand regulatory scrutiny. Our expectation is that there will be more and expanded review and regulation of the technology used by securities market participants in the years to come and increasing coordination by the SEC with its fellow regulators in the United States and abroad. As a result, we urge all market professionals – including broker-dealers, investment advisers, pension funds and investment companies – to study the new regulation and consider adopting appropriate policies and procedures to address operating as well as cyber security issues with respect to their own critical operating technology.

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