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July 26, 2013

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-1090  
Via Email (rule-comments@sec.gov)

**Re: Comment Letter on Proposed Regulation Systems Compliance and Integrity (File No. S7-01-13)**

Dear Ms. Murphy:

UBS Securities LLC ("UBS") respectfully submits this letter in response to the proposal made by the U.S. Securities and Exchange Commission ("Commission" or "SEC") to adopt Regulation Systems Compliance and Integrity ("Regulation SCI" or "Proposal"). The Proposal would require "SCI Entities"<sup>1</sup> to comply with new requirements with respect to their automated systems and would replace the voluntary Automation Review Policy program.<sup>2</sup>

**The UBS View**

UBS commends the Commission's important and timely efforts to "ensure the capacity, integrity, resiliency, availability, and security, and enhance compliance with federal securities laws and regulations, of automated systems relating to the U.S. securities markets."<sup>3</sup> UBS

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<sup>1</sup> Proposed Regulation SCI would apply to certain self-regulatory organizations, alternative trading systems ("ATs"), plan processors, and exempt clearing agencies (collectively, "SCI Entities").

<sup>2</sup> See, Securities Exchange Act Release Nos. 27445 (November 16, 1989) (ARP I Release) and 29185 (May 9, 1991) (ARP II Release).

<sup>3</sup> Securities Exchange Act Release No. 69077 (Mar. 8, 2013), 78 Fed. Reg. 18084 (Mar. 25, 2013)  
<http://www.sec.gov/rules/proposed/2013/34-69077.pdf>

supports the creation of a set of standards to which certain participants' automated systems are held, and a regulatory framework that provides for effective Commission oversight of compliance with such standards.

The fundamental challenge to creating such a framework, however, resides with the standards of conduct that must be developed. Standards that are too cumbersome, expensive, disruptive, or that dampen market efficiency and innovation will not further the well-intended goals of the Proposal.

Based upon a careful review of the Proposal with our internal subject matter experts, and in light of feedback received from our investor clients, UBS believes that the standards set forth in proposed Rule 1000(a) *require significant revision*. When viewed in combination with the obligations set forth in proposed Rule 1000(b) and the recordkeeping and electronic filing requirements in proposed Rules 1000(c)–(f), some components of the Proposal may actually increase instability and introduce systemic risk to the U.S. marketplace.

### **Areas of Concern and Recommendations**

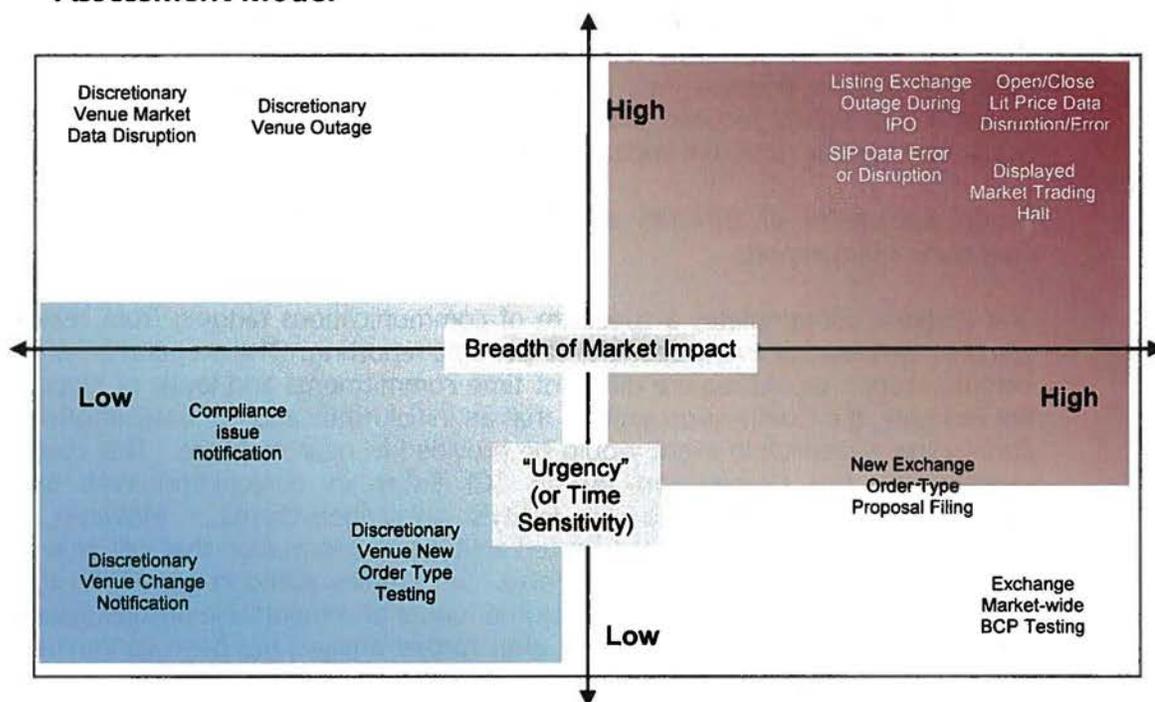
1) **SCI standards should establish controls for specific types of activities based upon criticality (impact on the market).**

Establishing effective standards for critical SCI activities should be the key priority of the Commission. Imposing regulation based solely on entity type or market share thresholds is overly formulaic and not appropriately targeted to the critical functions that warrant additional oversight. Moreover, regulation cast too broadly introduces burdensome costs and invites misapplication that is counterproductive to the goals of efficiency, consistency and fairness.

Certain activities are critical to the functioning of the National Market System and carry higher degrees of urgency and risk. These "public utility" type activities should be subject to greater levels of oversight, surveillance and reporting/disclosure. In contrast, some activities are routine or relate to discretionary systems that can be "routed around" and thus do not carry potential market-wide impact (irrespective of the platform's relative market share).

A "one-size-fits-all" approach does not work well for the many activities that fall within the scope of the Proposal. Rather, SCI activities should be assessed individually on the relative basis of their **potential market impact** and the **urgency** with which regulators and market participants must take action. In our view, SCI activities should be assessed for "criticality" along the axes of urgency and breadth of potential impact (see Figure 1).

**(Figure 1)  
SCI Activity Criticality  
Assessment Model**



Interruptions of activities that hold significant implications for the National Market System, such as those functions noted in the upper-right quadrant of the above table (e.g., Disruption at Primary Exchange during Open/Close, Problem with Protected Quote Data, Outage at Listing Exchange during IPO, SIP Data Disruptions) have a much higher degree of criticality than activities falling in the lower-left quadrant (e.g., Discretionary, Non-Displayed Venue Data Disruption; Discretionary Venue Change Notification, etc.). The high criticality activities pose unavoidable market-wide implications and widespread disruptions in the case of a problem, whereas the low criticality activities are much more manageable and localized in impact, in many instances because market participants are not directly touched or are equipped to quickly route around the problem.

*A. SCI Standards must set the right timeliness/reporting requirements based on activity criticality.*

The Commission understandably seeks notice of certain events that are targeted in the Proposal. It is important, however, to take into account the administrative implications for all such notifications, both for SCI Entities and the Commission. Poorly designed notification requirements have the potential to create intra-day efficiency issues, delay system remediation, create substantial resource demands, and create instability. This counterproductive result would diminish an SCI entity's ability to be responsive to investors and end up damaging market efficiency.

In addition, it is our view that complex and resource-intensive notification requirements across a broad scope of systems change activities could lead to an increase in the use of "big bang" product release cycles versus more streamlined "iterative" releases currently favored by the IT industry and many electronic trading platforms. "Big bang" product releases deliberately bunch numerous fixes, upgrades and changes for one large version release. Big bang releases have been shown to be more disruptive and prone to bugs and transitional instability. In contrast, iterative releases (i.e., small incremental release cycles) establish more frequent and tightly focused fixes that address a smaller number of changes to better manage the potential impact on clients and the risk of major disruptions.

*B. An assessment of criticality should drive the timing and nature of required communications/reports.*

The Proposal contemplates a spectrum of communications ranging from real-time alerts to detailed SCI Event debriefs, to periodic reporting. The preparation of each communication would require different time commitments and levels of resources. For example, the Commission expects that an initial notification of basic information concerning a reportable event would be provided in near real-time. This could be provided to the Commission by an SCI Entity in conjunction with similar communications provided to an Entity's subscribers/clients. However, the Commission should recognize the limited amount of information that will be known with certainty when an issue first surfaces. SCI Entities acting in good faith should not be held accountable if details about the nature of a reportable problem/event or the scope of impact vary substantially after further analysis has been conducted. A more detailed analysis pertaining to the causes, impact and the necessary remediation will naturally take more time and effort to formally prepare. Importantly, the Commission should establish rules that encourage the right kind of communication and transparency within workable and realistic timeframes, so that participants are not motivated by the threat of repercussions to delay notifications out of caution that would otherwise be informative to the Commission and helpful to the efficient functioning of the markets.

**2) Regulation SCI should set standards for industry-wide testing of business continuity and back-up/redundancy systems.**

One of the most important steps in validating and maintaining system integrity is an effective Business Continuity Plan ("BCP") model. We believe that industry-wide testing standards developed as part of Regulation SCI should replace the concept of individual firm testing that is proposed in Rule 1000(b).

BCP testing should be broadly implemented across the industry using scenario-based methods. The critical task of BCP testing should not be undertaken in isolated silos by individual firms. Individual BCP testing that does not involve realistic scenarios with connected participants may mask gaps and/or be insufficient from a systems integrity standpoint. Insufficient standards for rigorous BCP testing, could actually lead to an unintended increase in systemic risks.

We believe there exists today widespread support for enhanced BCP testing of the type we describe above. We would urge the Commission to promptly advance (whether through its own action or indirectly through SRO initiatives) a program to

introduce a new and more comprehensive BCP testing paradigm. The benefits to the marketplace would be broad and considerable. This is one area where the Commission can quickly strengthen market infrastructure – improved BCP testing should not be made to wait pending the final resolution of the Proposal.

**3) Any access to SCI Entity systems must be balanced with robust controls to address IT security risks.**

Under the Proposal, the Commission requests ongoing direct access to production systems for SCI Entities. This level of offsite production access poses significant risks to IT security and information protection protocols. Within individual SCI Entities themselves, production access is highly restricted to team members on a very selective, monitored and temporary basis, to help ensure system security, integrity and data protection. After considering the potential benefits if the Commission were to receive such access, we question whether any improvement in transparency would actually be gained, and whether it would outweigh the systemic risks associated with enabling this type of third party access.

**4) The Commission's cost-benefit analysis understates the Proposal's costs.**

Another challenge in creating a comprehensive framework such as Regulation SCI is ensuring that its costs strike a reasonable balance with the benefits that are likely to be realized. We agree with Chairman White's confirmation testimony:<sup>4</sup>

*“With respect to rulemaking, rigorous economic analysis is important and should inform and guide the decisions that are made. Although challenging – particularly in the quantification of benefits – in my view, the SEC should seek to assess, from the outset, the economic impacts of its contemplated rulemaking. Such transparent and robust analysis, including consideration of the costs and benefits, will help ensure that effective and optimal solutions are achieved without unnecessary burdens or competitive harm.”*

We appreciate the extensive series of questions on costs and benefits posed by the Commission in the proposal. It is vital that the Commission consider responses to these questions to avoid imposing a new and far-reaching regulatory regime without a proper appreciation of the related burdens thrust on market participants.

An initial review of the cost/benefit projections in the current Regulation SCI proposal reveals the estimates are not consistent with the historical experience of large broker-dealers. Based on experience with comparable past initiatives and the considerable scope of the proposal, the Commission's cost projections significantly underestimate the expense that will be incurred by market participants. For example, the Adopting Release for the SEC's Large Trader ID Rule estimated<sup>5</sup> that

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<sup>4</sup> See, Testimony of Mary Jo White, Nominee for Chair of the U.S. Securities and Exchange Commission Before the United States Senate Committee on Banking, Housing, and Urban Affairs; March 12, 2013.

<sup>5</sup> See Securities Exchange Act Release No. 64976 (July 27, 2011).

each broker-dealer would devote 715 hours in the first year and 215 hours per year thereafter to the new rule. The rule is only partially in place; but, as of the date of this letter, a reasonable accounting of the time UBS staff has expended on the rule is conservatively 5,000 hours. That tally will certainly increase as we move closer to full implementation.

The Commission should not underestimate the rigorous analysis and review that SCI Entities would undertake with respect to formal notifications and reporting. When, for example, we evaluate the potential impact of proposed notification requirements in proposed Rules 1000(b)(4)-(6), we look to our experience preparing written Regulation ATS filings, and responding to SEC and SRO regulatory inquiries that often follow regulatory interactions. Notifications made to the Commission in connection with SCI Events and Material Systems Changes would be considered a serious matter; therefore, a diligent and properly considered notification would require the time and effort of numerous staff in different departments. The estimates provided by the Commission in many instances do not reflect the broad range of personnel that would need to be involved and consulted, or the amount of time necessary to develop and provide a notification that is accurate, actionable and complete.

As a specific example, the Commission estimates that written notifications provided under proposed Rule 1000(b)(4)(i) would require 30 minutes from an in-house counsel, and requirements in Rule 1000(b)(4)(ii) would require an average of 20 hours (10 hours each from a compliance manager and in-house legal counsel). Based on our experience in assessing similar events on a real-time basis and preparing for regulatory interactions, we believe these types of notices would require substantive input from personnel outside of the legal and compliance departments, including IT analysts and managers as well as impacted business analysts and managers. We believe the true cost of these notifications will be many times what the Commission suggests<sup>6</sup>. For instance, rather than taking 30 minutes, we estimate the collective time spent preparing a written notification under Rule 1000(b)(4)(i) would be closer to 12 hours in the aggregate. Moreover, the Commission appears to assume that verbal notifications made under Rule 1000(b)(4)(i) would not consume the time of any employee. The Commission's estimate of the time and effort required in providing notification of Material Systems Changes likewise contains an extremely narrow scope, accounting only for 20 minutes of attorney time and 1.67 hours for a senior systems analyst. Such a notification also would require substantial review by IT management, relevant business supervisors, as well as compliance staff, which would increase that estimate at least three-fold.

We would urge the Commission to carefully reconsider the costs imposed by the Proposal and reformulate more accurate cost estimates by taking into account the

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<sup>6</sup> The requirement to provide extensive amounts of detailed information to the Commission within 24 hours of an SCI Event, including an assessment of the root cause of a problem, remediation plans, and analysis of the parties that experienced losses and estimates of such losses, significantly increases the level of resourcing that would be involved in assessing an SCI Event.

time spent by all broker-dealer personnel who would be involved in performing a required task.

5) **The Commission should convene an SCI Standards Working Group.**

To address the concerns we've outlined above, UBS suggests that the Commission promptly convene a **cross-industry, multi-disciplinary Working Group** to develop comprehensive recommendations for appropriate Regulation SCI standards. The Working Group should be tasked with identifying for the Commission's consideration those standards necessary to effectively mitigate the material systemic risks in our marketplace. The Working Group also should be asked to develop criticality assessments and a practical reporting/notification model designed to achieve the Proposal's core objectives.

By initiating an inclusive effort to create rational standards for systems compliance and integrity, the Commission would be well positioned to thoughtfully address the risks of market-wide disruptions, at the same time reinforcing and continuing to facilitate the improvements in market efficiency that have been experienced since the advent of electronic trading platforms. Further, the Working Group would be able to deliver useful input regarding the real-world costs reasonably expected to be incurred. We believe that a healthy level of industry participation would encourage ownership over the process and help ensure that developed goals are viable and fair to all participant types.

## **Conclusion**

UBS supports the underlying goals of the Proposal to enhance the efficiency and stability of the US equity securities markets. However, efforts to strengthen our markets must focus on the root causes of instability and disruption – rather than the symptoms.

Based on regulatory filings<sup>7</sup> and other industry research, ATSS serve an important function in the US equity markets, and their advent was driven by client demand for execution alternatives and options. ATSS offer meaningful price improvement and reduced market impact costs to investors, and often allow interaction with more natural order flow. Furthermore, certain ATSS provide additional liquidity opportunities, particularly for those institutional clients that prefer to work their orders away from lit markets. Without these ATSS, some investors would likely keep their orders on their blotter (as often occurred in the pre-ATS marketplace), which would suppress liquidity and price improvement opportunities.

Onerous reporting requirements and regulatory restrictions imposed on certain types of ATSS could stifle innovation on those platforms, or more significantly, create sufficient operational burdens or barriers to entry that will cause them to cease performing their regulated ATS function. The ultimate result of this contraction would be to limit or suppress the execution choices of buy-side investors, meaning investors will have less ability to effectively manage their trading strategies, and will have diminished opportunities to seek better execution, lower transaction costs and achieve price improvement and

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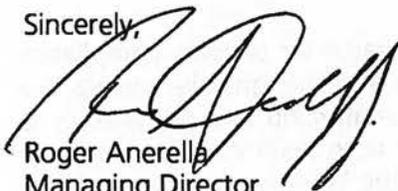
<sup>7</sup> For example, Rule 605 Reporting and other industry-wide reviews of overall U.S. market efficiency.

investment performance. As a result, the end clients of institutional investors -- which include retail investors, individual retirement account and fund holders -- will be impacted.

We respectfully request that the Commission work closely with the industry to further refine the Regulation SCI standards to create a framework that is best designed to achieve the goals of the regulation as well as preserve the execution choices of investors and enable broker-dealers to serve the evolving needs of clients with innovative execution offerings. Only in this way can we ensure that the new rules enhance the overall goals of market efficiency and regulatory oversight without doing damage to the fundamental benefits of competition, innovation and a fair and level playing field.

Thank you for the opportunity to comment on the Proposal. Should you have questions regarding the views of UBS, please do not hesitate to contact me.

Sincerely,



Roger Anerella  
Managing Director  
Global Head of Securities Execution Services

- cc: Honorable Mary Jo White, Chairman  
Honorable Luis A. Aguilar, Commissioner  
Honorable Daniel J. Gallagher, Commissioner  
Honorable Troy A. Paredes, Commissioner  
Honorable Elisse B. Walter, Commissioner  
John Ramsay, Acting Director, Division of Trading and Markets  
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