



July 17, 2013

**Via Electronic Mail:**

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

**Re: Regulation Systems Compliance and Integrity; File No. S7-01-13**

Dear Ms. Murphy:

Managed Funds Association<sup>1</sup> (“MFA”) and the Alternative Investment Management Association<sup>2</sup> (“AIMA”) (together, the “Associations”) appreciate the opportunity to submit comments to the Securities and Exchange Commission (“SEC” or “Commission”) on its proposed Regulation Systems Compliance and Integrity (“**Proposed Reg SCI**”).<sup>3</sup> We support and commend the Commission’s efforts to review the security of our market infrastructure and to address issues arising from operational risks, such as technological failures, natural disasters, and cyber-attacks; and for proposing a formal regulatory framework to enhance the safety and soundness of our markets. In general, we believe that as a result of the Commission’s market regulations, today’s equity markets are more competitive and fairer than in the past. The Commission’s regulations, including implementation of the Order Handling Rules, Regulation ATS, decimalization and Regulation NMS, have removed anticompetitive barriers; promoted fair access to markets and market information; and have fostered innovations in technology. These advances have promoted greater competition among marketplaces, to the benefit of investors.

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<sup>1</sup> The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry’s contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

<sup>2</sup> Founded in 1990, AIMA is the global representative of the hedge fund industry. We represent all practitioners in the alternative investment management industry – including hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors. Our membership is corporate and comprises over 1,300 firms (with over 6,000 individual contacts) in more than 50 countries.

<sup>3</sup> 78 Fed. Reg. 18084 (Mar. 25, 2013), hereinafter “Proposing Release”.

Such efforts are consistent with, and in furtherance of, Congress’s objectives in enacting Section 11A(a)(2) of the Securities Exchange Act of 1934 (“**Exchange Act**”) to foster the development of the National Market System.<sup>4</sup> Accordingly, we support this effort to update current requirements with the goal of strengthening the equity markets’ technological infrastructure.

The electronic equity markets of the twenty-first century bring the benefits of greater competition, liquidity, transparency and innovation, fostered in large measure by remarkable technological advances. We believe that the Commission has wisely fostered an environment that has allowed such technological developments to flourish, encouraging U.S. markets to innovate and be competitive with other global markets. Such innovations benefit investors, including hedge funds and their investors, by allowing them to pursue different investment strategies.

But of course, such innovations also entail risks—namely operational, infrastructure and security risks (referred to herein as “Marketplace Risks”). We believe regulatory measures implemented after the May 6, 2010 flash crash, such as rules on the risk management controls for brokers or dealers with market access, circuit breakers, the process for breaking erroneous trades, and the limit up-limit down plan, have been effective in reducing risks.<sup>5</sup> We believe that the Commission could take additional steps to further reduce Marketplace Risks, and that it could do so in a manner that continues to foster competition and innovation with respect to our markets.

## **I. Background: Proposed Reg SCI**

Proposed Reg SCI codifies the Commission’s automation review program (“**ARP**”) inspection program, includes additional requirements, and broadens its application to more entities.<sup>6</sup> Proposed Reg SCI would require self-regulatory organizations (including registered clearing agencies), alternative trading systems, plan processors and exempt clearing agencies (“**SCI Entity**” or “**SCI Entities**”) to establish written policies and procedures reasonably designed to ensure that their systems have levels of capacity, integrity, resiliency, availability,

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<sup>4</sup> As the Commission notes in the Proposing Release at 18085, Congress enacted that provision as part of the Securities Acts Amendments of 1975, Public Law 94-29, 89 Stat. 97 (1975).

<sup>5</sup> See, e.g., Risk Management Controls for Brokers or Dealers with Market Access, 75 Fed. Reg. 69792 (Nov. 15, 2010), available at: <http://www.sec.gov/rules/final/2010/34-63241fr.pdf>; Order Approving Proposed Rule Change Relating to Expanding the Pilot Rule for Trading Pauses Due to Extraordinary Market Volatility to the Russell 1000 Index and Specified Exchange Traded Products, SEC Release No. 34-62883 (Sept. 10, 2010), available at: <http://www.sec.gov/rules/sro/finra/2010/34-62883.pdf>; Order Granting Approval of Proposed Rule Change Relating to Clearly Erroneous Transactions, SEC Release No. 34-62885 (Sept. 10, 2010), available at: <http://www.sec.gov/rules/sro/finra/2010/34-62885.pdf>; SEC Approves Rules Expanding Stock-by-Stock Circuit Breakers and Clarifying Process for Breaking Erroneous Trades, Sept. 10, 2010, available at: <http://www.sec.gov/news/press/2010/2010-167.htm>; and Notice of Filing of Amendments No. 1 and Order Granting Accelerated Approval of Proposed Rule Changes as Modified by Amendments No. 1, Relating to Trading Halts Due to Extraordinary Market Volatility, SEC Release No. 34-67090 (May 31, 2012), available at: <http://www.sec.gov/rules/sro/bats/2012/34-67090.pdf>.

<sup>6</sup> Proposing Release *supra* n. 2. The Commission’s ARP inspection program is a voluntary information technology review program for self-regulatory organizations, created in response to the October 1987 market break.

and security adequate to maintain their operational capability and promote the maintenance of fair and orderly markets, and that they operate in the manner intended.<sup>7</sup> It also would require an SCI Entity to engage in systems testing, including at least annually with designated members or participants; and to submit written notifications to the Commission in advance of systems changes and or systems disruptions, among other requirements.<sup>8</sup>

## II. Comments & Recommendations

### A. General Comments

In general, the Associations believe that Marketplace Risks should be addressed in two ways. First, by safeguarding market utilities and ensuring that they operate as intended. Second, by requiring brokers-dealers, as the gateways to the markets, to have financial and regulatory risk management controls to reduce risks associated with market access, as required by Rule 15c3-5.<sup>9</sup> We strongly believe that such a framework optimizes investor protection, the maintenance of fair and orderly markets and the economically efficient execution of securities transactions.<sup>10</sup> We also believe from a practical and regulatory standpoint that such a framework would be both consistent with the Commission's prior rulemaking and more manageable to implement and enforce.

We support requiring an SCI Entity to have policies, procedures and controls with respect to ensuring that their systems have levels of capacity, integrity, resiliency, availability, and security to maintain their operational capacity. As investors, we believe it is important to ensure that market utilities are able to maintain their operational capacity and function as they are intended.<sup>11</sup> We agree with the Commission's statement in 1987 in ARP I that market movements should be "the result of market participants' changing expectations about the direction of the market for a particular security, or group of securities, and not the result of investor confusion or

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<sup>7</sup> *See id.*

<sup>8</sup> *See id.*

<sup>9</sup> *See* Risk Management Controls for Brokers or Dealers with Market Access, 75 Fed. Reg. 69792 (Nov. 15, 2010), available at: <http://www.sec.gov/rules/final/2010/34-63241fr.pdf> (hereinafter "Adopting Release for Rule 15c3-5"); 17 C.F.R. 240.15c3-5 ("Rule 15c3-5").

<sup>10</sup> *See, e.g.*, Section 11A(a)(1) of Exchange Act.

<sup>11</sup> *See, e.g., In the Matter of the Nasdaq Stock Market, LLC and Nasdaq Execution Services, LLC*, Exchange Act Release No. 69655, May 29, 2013, available at: <http://www.sec.gov/litigation/admin/2013/34-69655.pdf> (finding that Nasdaq violated several securities law and rule provisions in connection with its initial public offering of Facebook, Inc.); *In the Matter of New York Stock Exchange LLC, and NYSE Euronext*, Exchange Act Release No. 67857, September 14, 2012, available at: <http://www.sec.gov/litigation/admin/2012/34-67857.pdf> (finding that the NYSE experienced software issues and systems delays for processing quotes and trades on May 6, 2010 during the "Flash Crash."). We believe many investors stopped trading during the Flash Crash over concerns with data integrity. *See generally* REPORT OF THE STAFFS OF THE CFTC AND THE SEC TO THE JOINT ADVISORY COMMITTEE ON EMERGING REGULATORY ISSUES, FINDINGS REGARDING THE MARKET EVENTS OF MAY 6, 2010, at Part III.3 (Sept. 30, 2010) available at: <http://www.sec.gov/news/studies/2010/marketevents-report.pdf>.

panic resulting from operational failures or delays in SRO automated trading or market information systems.”<sup>12</sup> We provide a few comments below on aspects of Proposed Reg SCI, which we believe may not optimize the security of U.S. markets. In general, we concur with comments by the Securities Industry and Financial Markets Association (“SIFMA”) on tailoring obligations based on the criticality of the entity and its systems, and simplifying the framework by adopting a more general requirement related to the security of SCI Systems.<sup>13</sup>

## **B. Application of Proposed Reg SCI to Other Entities**

The Commission requests comment on whether Proposed Reg SCI should apply to other entities.<sup>14</sup> While the requirements under Proposed Reg SCI may be appropriate for market utilities given the role they play in the U.S. securities markets, we believe an important distinction needs to be made between market utilities and general market participants. The requirements under Proposed Reg SCI demand extensive resources and would not be feasible for investors who have an algorithmic or quantitative component to their investing. Moreover, we believe the Commission’s regulations already address risks from customer orders. We supported the Commission’s proposal and now final Rule 15c3-5<sup>15</sup> and believe it is the best construct for enhancing market integrity and investor protection with respect to trade orders. Pursuant to Rule 15c3-5 broker-dealers should have appropriate systematic risk management controls and supervisory procedures to prevent trading errors and to ensure compliance with applicable regulatory requirements with respect to both proprietary and customer business.<sup>16</sup> Specifically, such risk management controls and supervisory procedures need to be reasonably designed to manage legal and operational risks and to “prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds in the aggregate for each customer and the broker or dealer . . .”<sup>17</sup>

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<sup>12</sup> See Proposing Release at 18085; Exchange Act Release No. 27445 (Nov. 16, 1989), 54 *Fed Reg.* 48703 (Nov. 24, 1989).

<sup>13</sup> See letter from Theodore R. Lazo, Managing Director and Associate General Counsel, SIFMA, to Elizabeth M. Murphy, Secretary, SEC, dated July 8, 2013, on “Proposed Regulation Systems Compliance and Integrity,” available at: <http://www.sec.gov/comments/s7-01-13/s70113-50.pdf>.

<sup>14</sup> Proposing Release at 18139 (stating that while the Commission is not proposing to apply Regulation SCI to broker-dealers other than SCI ATSS at this time, it is soliciting comments generally on whether the requirements of Regulation SCI should apply in whole or in part to other entities).

<sup>15</sup> See letter from Stuart J. Kaswell, Executive Vice President and General Counsel, MFA to Elizabeth M. Murphy, Secretary, SEC, on March 29, 2010 on “Risk Management Controls for Brokers or Dealers with Market Access” available at: <https://www.managedfunds.org/wp-content/uploads/2010/03/MFA-Comments-on-BD-Risk-Mgmt.3.29.10.pdf>. See Rule 15c3-5.

<sup>16</sup> Rule 15c3-5.

<sup>17</sup> Rule 15c3-5(b) and (c)(1)(i). See also Adopting Release for Rule 15c3-5 at 69795 (providing that a broker-dealer must establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks, such as legal and operational risks, related to market access).

We believe practices under Rule 15c3-5 may need some fine-tuning, however, in light of the SEC staff's findings with respect to the general causes of spikes in stock prices—namely, manual human errors.<sup>18</sup> Nevertheless, we believe the rule is the appropriate regulatory framework to ensure market integrity. The Commission more specifically asks whether Proposed Reg SCI should apply in full or in part to certain broker-dealers.<sup>19</sup> We believe Proposed Reg SCI should only apply to market utilities as generally proposed. As Rule 15c3-5 requires a broker-dealer to apply risk management controls to both customer and proprietary trades alike, we believe that a broker-dealer's risk management controls should be designed to stop orders, including erroneous orders (even if generated by a faulty system), which exceed its capital thresholds in order to limit financial exposure.<sup>20</sup>

### C. Scope of Proposed Reg SCI

We have some concerns with the scope of Proposed Reg SCI. We believe some of the definitions are overly broad and will, as a result, make Proposed Reg SCI very burdensome for SCI Entities, and in turn, impair competition and innovation in our markets (discussed further below).<sup>21</sup> In particular, we are concerned with the definition of “material systems change” and “SCI security systems.”<sup>22</sup>

The proposal would require SCI Entities to file notices and reports with the Commission on a new proposed Form SCI regarding, among other things, material systems changes. Proposed Reg SCI defines “material systems change” to mean a change to one or more:

- (1) SCI systems of an SCI entity that:
  - i. Materially affects the existing capacity, integrity, resiliency, availability, or security of such systems;
  - ii. Relies upon materially new or different technology;
  - iii. Provides a new material service or material function; or
  - iv. Otherwise materially affects the operations of the SCI entity; or

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<sup>18</sup> See Gregg E. Berman, Transformational Technologies, Market Structure, and the SEC, Address at the SIFMA TECH Conference (June 18, 2013) (stating that generally the SEC staff has found that spikes in stock prices or mini-flash crashes tend to be triggered by old-fashioned manual human mistakes) available at: <http://www.sec.gov/news/speech/2013/spch061813geb.htm>.

<sup>19</sup> Proposing Release at 18139.

<sup>20</sup> We are not familiar with the details of the Knight Capital Group, Inc. technology issues of August 1, 2012, but were surprised that its risk management controls did not catch the erroneous orders. See letter from Stuart J. Kaswell, Executive Vice President and General Counsel, MFA, to the Honorable Mary L. Schapiro, Chairman, SEC, on August 14, 2012 on “Computer Trading & Risk Management Issues” (suggesting that the Commission consider whether a broker-dealer's pre-trade risk management controls should include checking credit or capital thresholds on an order-by-order basis or during a very short period of time) available at: <https://www.managedfunds.org/wp-content/uploads/2012/08/Risk-Management-8-14-12-final.pdf>.

<sup>21</sup> See Section 3(f) of the Securities Exchange Act of 1934.

<sup>22</sup> See *id.* at 18177; Proposed Reg SCI Rule 1000(a).

- (2) SCI security systems of an SCI entity that materially affects the existing security of such systems.<sup>23</sup>

While standards of materiality are well-established in other securities law contexts, we believe that it is more difficult to establish a standard of materiality with respect to technology and software programming. Because it is possible for simple coding changes to have a material impact on SCI systems<sup>24</sup> due to software errors, in effect, any systems change could be interpreted to be a “material systems change.” As a result, we believe Proposed Reg SCI may be overly broad as it could be interpreted to apply to routine tasks and systems work. In this sense, Proposed Reg SCI provides an SCI Entity with little flexibility in their ability to take a more risk-based approach; and does not recognize or distinguish between different levels or kinds of systems risk or disruption. We believe an SCI Entity in complying with Proposed Reg SCI should be allowed to assess its systems risks and expend resources accordingly; and that such process is likely to lead to greater security in the market systems.

Proposed Reg SCI defines “SCI security systems” to mean “any systems that share network resources with SCI systems that, if breached, would be reasonably likely to pose a security threat to SCI systems.”<sup>25</sup> We believe that SCI security systems could be interpreted to extend to broker-dealers or other third parties as the definition is fairly broad in scope.<sup>26</sup> We would be highly concerned if it extended indirectly to customers of broker-dealers, as we believe the requirements under Proposed Reg SCI would be extremely burdensome and unmanageable for customers. Further to our comment above that an SCI Entity should have discretion to take a more risk-based approach in assessing and addressing systems risks, we believe that Proposed Reg SCI does not need to distinguish between SCI systems and SCI security systems, but should instead require an SCI Entity to take appropriate measures to ensure the security of SCI systems. Put generally, we believe that Proposed Reg SCI should be limited to those systems of, or operated by or on behalf of, an SCI Entity. With respect to broker-dealer systems, we believe Rule 15c3-5 is the appropriate framework.

#### **D. Commission Notifications**

Proposed Reg SCI requires an SCI Entity to “notify the Commission in writing at least 30 calendar days before implementation of any planned material systems change . . . .”<sup>27</sup> We are concerned that such requirement may delay the implementation of important systems upgrades

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<sup>23</sup> *Id.*

<sup>24</sup> “SCI systems” is defined as “all computer, network, electronic, technical, automated, or similar systems of, or operated by or on behalf of, an SCI entity, whether in production, development, or testing, that directly support trading, clearance and settlement, order routing, market data, regulation, or surveillance.” Proposed Reg SCI Rule 1000(a).

<sup>25</sup> Proposed Reg SCI Rule 1000(a).

<sup>26</sup> See Proposing Release discussion at 18099 (noting that the proposed definition of SCI security systems includes systems that give issuers, market participants and clients of an SCI Entity a “point of access” to SCI systems).

<sup>27</sup> Proposed Reg SCI Rule 1000(b)(6).

and enhancements, and even simple coding adjustments and improvements; and serve as a constraint on market innovation and development. We believe it would be a better use of the Commission's resources to conduct periodic inspections to review an SCI Entity's overall compliance with Proposed Reg SCI rather than to have Commission staff review filings of all material SCI Entity systems changes prior to implementation. Accordingly, we recommend that the Commission eliminate the requirement in Proposed Reg SCI for an SCI Entity to notify the Commission prior to material systems changes. If the Commission feels strongly that it should be kept abreast of planned material systems changes, then we respectfully recommend that the Commission require such details only as part of the semi-annual Form SCI reports that SCI Entities are supposed to file pursuant to Proposed Reg SCI Rule 1000(b)(8)(ii).

#### **E. Dissemination of Information**

We support Proposed Reg SCI's requirement for an SCI Entity to disseminate information about SCI events to members or participants.<sup>28</sup> Specifically, Proposed Reg SCI requires an SCI Entity to: (1) promptly after becoming aware of a "dissemination SCI event"<sup>29</sup> other than a systems intrusion, disseminate information on an SCI event to members/participants;<sup>30</sup> (2) when known, disseminate detailed information regarding an SCI event to members/participants;<sup>31</sup> and (3) provide regular updates to members/participants on developments relating to the SCI event.<sup>32</sup>

We also believe that there would be great value in requiring an SCI Entity to make such information on a "dissemination SCI event" publicly available on the SCI Entity's website. In other words, Proposed Reg SCI should require an SCI Entity to reveal this information to the public at large, and not just to its members or participants. First, we believe it would help enhance investor confidence by presenting the facts of the SCI event, preventing speculation and misinformation, and informing the public of corrective action being taken. Second, we believe it would serve as an important collective learning opportunity for the industry. In this way, other SCI Entities and market participants could learn from each dissemination SCI event other than a systems intrusion and build upon their policies and controls as appropriate. We believe such industry protocol would help strengthen and enhance the integrity and security of our markets.

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<sup>28</sup> Proposed Reg SCI Rule 1000(b)(5).

<sup>29</sup> "Dissemination SCI event" is defined as a: (1) Systems compliance issue; (2) Systems intrusion; or (3) Systems disruption that results, or the SCI entity reasonably estimates would result, in significant harm or loss to market participants. Proposed Reg SCI Rule 1000(a).

<sup>30</sup> Promptly, upon becoming aware of a dissemination SCI event, an SCI Entity must disseminate information on: (1) the systems affected by the SCI event; and (2) a summary description of the SCI event. Proposed Reg SCI Rule 1000(b)(5)(i)(A).

<sup>31</sup> When known, an SCI Entity must disseminate to members/participants: (1) A detailed description of the SCI event; (2) The SCI entity's current assessment of the types and number of market participants potentially affected by the SCI event; and (3) A description of the progress of its corrective action for the SCI event and when the SCI event has been or is expected to be resolved. Proposed Reg SCI Rule 1000(b)(5)(i)(B).

<sup>32</sup> An SCI Entity must provide regular updates to members/participants on information required to be disseminated pursuant to Proposed Reg SCI Rule 1000(b)(5)(i)(A) and (B).

### III. Conclusion

The Associations applaud the Commission's efforts to address the security of our market infrastructure from operational risks. We support requiring an SCI Entity to adopt policies and procedures to ensure that its systems have levels of capacity, integrity, resiliency, availability, and security, adequate to maintain operational capability and promote fair and orderly markets. We would welcome the opportunity to discuss our comments in greater detail. Please do not hesitate to contact the undersigned or Jennifer Han, Associate General Counsel, of MFA, at (202) 730-2600, or Adam Jacobs, Director, Head of Markets Regulations, of AIMA, at 44 20 7822 8380.

Respectfully submitted,

/s/ Stuart J. Kaswell

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/s/ Jiří Król

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cc: The Hon. Mary Jo White, Chair  
The Hon. Elisse B. Walter, Commissioner  
The Hon. Luis A. Aguilar, Commissioner  
The Hon. Troy A. Paredes, Commissioner  
The Hon. Daniel M. Gallagher, Commissioner

John Ramsay, Acting Director, Division of Trading and Markets  
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