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KCG

July 25, 2013

Elizabeth Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

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

Dear Ms. Murphy:

As an active participant in our global financial markets, KCG Holdings, Inc. ("KCG") appreciates the opportunity to provide its views on proposed Regulation Systems Compliance and Integrity ("Proposed Regulation SCI").[1]

Over the last three years, the Commission has led efforts to bring greater stability to securities markets that are heavily reliant on technology. Following the events of May 6, 2010, the Commission led the exchanges and FINRA in implementing single stock circuit breakers, eliminating stub quotes, and establishing clearer rules for breaking trades that are clearly erroneous. These efforts brought greater stability and restored confidence in the markets. As a further refinement of these efforts, the Commission approved the securities exchanges' and FINRA's Volatility Plan -- a market-wide limit up-limit down mechanism to address extraordinary market volatility. This Plan is being implemented now and will eventually replace the single-stock circuit breakers.

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1 Securities Exchange Act Release No. 69077 (Mar. 8, 2013) 78 FR 18084 (Mar. 25, 2013) (Regulation Systems Compliance and Integrity).

In addition, in November 2011, the Commission adopted a ban on naked sponsored access and required broker-dealers that provide access to trading on an exchange or alternative trading system to implement prudent risk management controls. These pre-trade risk management requirements were an important enhancement to the other supervisory controls to which broker-dealers are subject.

The measures described above are designed to reduce the likelihood and minimize the impact of failures on firms and the market. This dual approach is important because, as discussed by participants at the Commission's October 2, 2012 Roundtable on Technology and the Markets, it is not possible to build systems and software that never fail.[2] By using multiple, overlapping measures the magnitude and impact of failure is minimized.

KCG strongly supports the Commission's goals in Proposed Regulation SCI. We agree that entities important to the functioning of the US securities markets should carefully design, develop, test, maintain and monitor systems integral to their operations. The central role of technology in today's market means that it is critical that all market participants establish robust controls and use practices that are designed to reduce the likelihood, and minimize the impact of, errors and trading disruptions. In this letter, we offer our comments and suggestions on how the Commission could achieve its goals in Proposed Regulation SCI more efficiently and effectively.

Summary of Key Points:

1. Scope of Proposed Regulation SCI is too broad
    - KCG recommends that the Commission focus regulatory requirements under Proposed Regulation SCI on those entities that are sole providers of a service in the securities market. For example, the opening and closing auctions, coordination of the markets during trading halts, IPO auctions, trading of

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[2] Securities and Exchange Commission, "Roundtable on Technology and Trading: Promoting Stability in Today's Markets" (October 2, 2012).

exclusively-listed options, market data consolidators, and settlement and central clearing are effectively industry utilities on which all participants rely and for which there is no commercial alternative. These "single points of failure" should be subject to heightened regulatory requirements, including a regulatory mandate for redundancy.

- Much of today's equity market is highly competitive, with multiple vendors for the same or similar services. After the market opens, alternative trading systems ("ATSs") and exchanges compete vigorously to provide trading services until the closing auction. This competition provides a market-based redundancy that limits the additional benefits that can be expected from regulatory measures for these highly competitive services with multiple providers.
- The Commission should be cautious in including within Regulation SCI fixed income ATSs, which have a very low proportion of the total notional value of trading volume. Proposed Regulation SCI would substantially increase costs to automated platforms and discourage the shift from traditional fixed income OTC market makers to more transparent, automated trading venues.
- KCG recommends that the Commission narrow the systems of an SCI entity that would be subject to Regulation SCI to include only those systems that are highly critical to functioning as an SCI entity. In addition, KCG recommends that the Commission eliminate the definition of SCI security system.

2. <u>Costs on SCI entity participants who will have to be fully redundant</u>
    - Trading from a back-up facility is not the same as trading from a primary site and, therefore, market participants do not use back-up facilities. Instead, when a trading venue's primary site is unavailable, participants re-route orders to another of the many alternative venues available in today's highly competitive securities market. The availability of robust back-up facilities will not change this dynamic, but will materially increase costs to market participants.

- KCG estimates that the costs to a market making firm, such as KCG, to support fully redundant exchange and ATS back-up facilities would be approximately $7 to $10 million in initial capital, with annual costs of between $5 and $9 million. This substantial per firm cost is not justified by the minimal benefits because such back-up facilities would not be used in the event of an outage at the primary site.

3. Proposed Regulation SCI should not be extended to market makers handling customer orders
    - Broker-dealers are already subject to extensive FINRA, exchange, and Commission rules that are designed to achieve the same goals as Proposed Regulation SCI.
    - Broker-dealers are accountable to their customers through best execution obligations. In addition, broker-dealers have contractual obligations to their customers, which are not limited by absolute legal immunity.
    - KCG believes that there is little basis to impose an additional layer of regulatory requirements on broker-dealers that are subject to comparable systems and control requirements under current rules.

I. Background:

KCG is a global financial services firm offering investors a range of services designed to address trading needs across asset classes, product types and time zones. As an independent market maker, KCG combines advanced technology with exceptional client service to deliver greater liquidity, lower transaction costs, improve pricing, and provide execution choices.

KCG is a registered market maker on numerous US cash equity and options exchanges, including a Designated Market Maker and Supplemental Liquidity Provider on the New York Stock Exchange ("NYSE"), and a Lead Market Maker on NYSE Arca. As a market

maker, KCG commits its capital to facilitate trades by buyers and sellers on exchanges, ATSs, and directly to our clients.

KCG offer clients multiple opportunities to interact with our market making operations. In addition, KCG's institutional clients have access to algorithms and experienced trading desks to access liquidity, maintain anonymity and minimize market impact. KCG also operates three Commission-registered ATSs.

KCG employs more than 1400 people worldwide, including in offices in New York, New Jersey, Chicago, London, Palo Alto, and Singapore.

II. Discussion

KCG begins with the premise that all regulated entities should have comprehensive controls over, as well as testing protocols and contingency plans for, their operations. As described in more detail in Section C below, broker-dealers are currently subject to numerous regulatory requirements under Commission and self-regulatory organization ("SRO") rules that are designed to achieve the same goals as Proposed Regulation SCI. In addition, as registered broker-dealers, ATSs are also subject to these requirements.

All exchanges, clearing agencies, FINRA, the MSRB, and plan processors should similarly be subject to rules that require robust controls to reduce the likelihood, and minimize the magnitude, of errors and trading disruptions.

In addition, when critical services are provided, additional heightened regulatory requirements, as proposed in Regulation SCI, may be appropriate. These requirements should be tailored to the service provided.

A. **Scope of SCI Entity: Commission's regulatory requirements and resources should focus only on entities whose failure would have market-wide or systemic consequences**

The Commission requests comment on its proposed definition of SCI entity. As proposed, SCI entities would include the following:

- All exchanges, FINRA, clearing agencies, and the Municipal Securities Rulemaking Board;
- ATSs with an average daily dollar volume over four of the last six months that is: (1) 5% or more in any NMS stock and ¼% or more of all NMS stocks; or (2) 1% or more in all NMS stocks;
- ATSs with 5% or more of the average daily dollar volume or average daily transaction volume in municipal or corporate debt securities; and
- Plan processors for NMS plans, such as the CAT processor and market data processors.

The Commission asks whether these SCI entities play a significant role in the US securities markets such that they should be subject to Proposed Regulation SCI.

KCG does not believe that all the entities that fall within the scope of the proposed definition of SCI entity play a significant enough role in the securities markets to be included within the rule. For this reason, we support the approach outlined in SIFMA's comment letter on Proposed Regulation SCI that would replace the "one-size-fits-all" approach in the proposal with a tiered approach that considers the criticality of the function. We believe that such an approach would better align the benefits to the public markets and investors with the costs of complying with Regulation SCI.

Because the requirements the Commission proposes to apply to SCI entities are significant and costly, it is critical that the Commission ensure that the benefits of applying such requirements to a particular entity are justified. Accordingly, KCG recommends that Regulation SCI be targeted to services offered by only one or a few entities, such as the opening and closing auctions, exclusively listed options, clearing agencies, plan processors, or represent a significant proportion of trading volume such

that market participants would not be expected to be able to easily re-route to alternative venues.

KCG is concerned that the expansive scope of the Proposed Regulation SCI and the substantial and costly requirements that would apply to entities within its scope would raise barriers to entry and make it difficult for many current service providers to continue to compete. The current competitive equity market structure – while complex – is also highly redundant. There are a few noteworthy exceptions to this redundancy and KCG believes the Commission's regulatory focus should be on ensuring that systems on which services dependent on a single or dominant provider have appropriate levels of capacity, integrity, resiliency, availability, and security. Further, market participants that use these services should be required to participate in systems testing of business continuity and disaster recovery plans for these services.

However, when services are provided by many competing firms, competition provides redundancy without duplication or back-up facilities. With the exception of the critical services noted above, trading of securities takes place on multiple venues. While there are many costs imposed on the industry by the proliferation of trading venues, one of the benefits is that venues provide an alternative facility for the trading of securities when technical problems occur on a particular market. This redundancy is a positive byproduct of the multiple, competing markets facilitated and encouraged by the Commission's regulatory policy over the last 40 years and reduces the need for – and relative benefits of – individual exchange or ATS redundancy.

Market-based redundancy is also significantly more reliable than a separate disaster recovery site because it is based on systems that are in use every day. For example, excluding auctions, no exchange had more than 17% of trading volume on average in any month in 2013. There are 13 exchanges that trade NMS stocks and 11 exchanges that trade listed-equity options. Unless an exchange or ATS routinely has a substantial amount of the trading volume in a particular security – which we believe is at least 20% – it is unlikely that market participants will be so reliant upon the trading venue that its unavailability would have an impact on the marketplace as a whole.

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For this reason, KCG believes the definition of SCI entity is too broad. Proposed Regulation SCI would impose a high cost on those activities by exchanges and ATSs, which we do not believe are justified by the relatively few benefits of such requirements when there are many alternatives to the services offered by a trading platform.

In particular, while there may be valid commercial reasons, we do not believe there is a regulatory basis for requiring exchanges and ATSs that do not have exclusive or dominant trading in a security to have a geographically remote back-up facility. A regulatory mandate for separate backup and recovery capabilities is important for systems that support regulated services performed by only one or a few dominant providers. However, for systems that support services that are highly competitive, KCG does not believe there is a public policy basis to mandate separate backup and recovery capabilities. In addition, we do not believe that there would be any benefit to requiring such entities to comply with the extensive notice requirements proposed in Regulation SCI. It is unclear what benefits the Commission anticipates from receiving notices of SCI events from ATSs or exchanges with very little trading volume.

1. <u>It is unclear the basis for lowering from 20% the threshold for ATS compliance with systems' capacity, integrity, and security requirements</u>

In Regulation ATS, the Commission established the threshold for compliance with ARP guidelines at 20%. ATSs trading 20% of more of the volume in any equity security or in certain categories of debt securities are required to comply with standards regarding the capacity, integrity, and security of their automated systems. The volume threshold of 20% of volume was considered by the Commission in 1998 as one at which an ATS played a significant role in the national market system and could disrupt the securities markets due to failures of their automated systems.

In Proposed Regulation SCI, the Commission states that it is lowering the threshold for ATSs to "ensure that proposed Regulation SCI is applied to an ATS that could have a significant impact on the NMS market as a whole, as well as an ATS that could have a significant impact on a single NMS stock and some impact on the NMS stock market as a

whole at the same time." In 1998, when it adopted Regulation ATS, the Commission determined that an ATS was not significant unless it had 20% of the total market and on this basis applied the Automation Review Policy requirements only to ATSs that exceeded this 20% threshold.[3] KCG respectfully requests that the Commission more fully explain why it believes, in proposing the threshold for ATSs subject to Regulation SCI, that an ATS with 5% of total volume in an NMS stock or 1% in any single NMS stock has a significant impact on the market.

KCG understands and the Commission notes that the proposed threshold for ATSs would include ATSs having NMS stock dollar volume comparable to the NMS stock dollar volume of the equity exchanges that are SCI SROs and therefore covered by Proposed Regulations SCI.[4] However, as discussed above, we would appreciate a further exploration by the Commission of whether all services of all exchanges, regardless of the trading volume on an exchange, should be subject to Proposed Regulation SCI. In light of this, we also ask that the Commission reconsider whether its reasons for including ATSs of comparably low trading volume as some exchanges should be included within the scope of Regulation SCI.

After the opening auction, trading services are highly competitive with many venues offering comparable, competing services. Accordingly, market participants have many alternative venues on which they trade and the temporary unavailability of one venue is unlikely to be a systemic disruption. Market participants routinely re-route orders from a venue that is temporarily unavailable to other venues. In fact, the privatization and decentralization of market linkages was an intended consequence of Regulation NMS. The routine re-routing of orders in today's markets should be a basis to limit the application of Proposed Regulation SCI for both exchanges and ATSs.

Finally, ATSs are registered broker-dealers and, thus, are already subject to SRO and Commission rules that are designed to achieve many of the same goals as Regulation SCI.

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3 Securities Exchange Act Release No. 40760 (Dec. 8, 1998),

4 Proposed Regulation SCI, text accompanying note 105.

KCG believes these already applicable requirements are appropriate for ATSs that do not perform a critical role in the market by being a substantial (at least 20%) provider of trading services for a particular NMS stock.

2. The Commission should consider the impact of Regulation SCI on fixed income ATSs' ability to compete with traditional, manual fixed income trading desks

Today's fixed income markets remain a largely manual, over-the-counter market. However, a few ATSs for fixed income securities have emerged and, like in equity markets, make trading in the fixed income markets more transparent and efficient and, ultimately, lower costs for investors.

While the majority of fixed income trading continues to be done in the OTC markets, ATSs have been successful in providing services to various types of investors. For example, KCG BondPoint is an ATS that provides a trading venue for fixed income odd lot orders. Specifically, depending on the specific asset class, the average size transaction ranges from $30,000 to $100,000 in notional value. KCG BondPoint executes on average 3500 trades each day across all fixed income asset classes.

Proposed Regulation SCI would define as an SCI entity, ATSs with 5% or more of the average daily transaction volume in municipal or corporate debt securities. In secondary market TRACE reportable corporate bonds, BondPoint's daily trade executions represent just over 5% of all reportable transactions. However, the relatively small size of its transactions means that trades on BondPoint on average represent less than 1% of the notional value of daily secondary TRACE reportable corporate bond notional volume. As discussed above, KCG does not believe that an ATS with less than 1% of the notional value of any security is so significant a part of the securities market that the requirements of Proposed Regulation SCI are necessary.

Moreover, because the vast majority of fixed income trades continue to be executed off exchanges and ATSs, market participants are not reliant on automated systems for the execution of their orders. Broker-dealers that use ATSs, such as KCG BondPoint, also execute much of their order flow via traditional OTC market mechanisms including

Bloomberg messages, the telephone and through internal principal based trading. Therefore, to the extent that a fixed income ATS were temporarily unavailable, broker-dealers are able to access the liquidity of traditional voice brokerage, other ATSs, as well as their own internal trading desks. For this reason, KCG believes the benefits to investors and the market of the additional regulatory requirements in Proposed Regulation SCI are very limited. Moreover, the burdensome requirements proposed would increase costs to ATSs, thereby increasing transactions fees charged to dealers, which would slow the move to more transparent and efficient trading venues.

Further, as noted above, fixed income ATSs, like other ATSs, are registered as broker-dealers and therefore subject to FINRA and Commission rules applicable to broker-dealers.

B. The indirect costs on SCI entity members and participants of supporting the requirement that Regulation SCI entities have back-up facilities are substantial

The Commission proposes that all SCI entities have business continuity and disaster recovery plans that include maintaining backup and recovery capabilities sufficiently resilient and geographically diverse to ensure next business day resumption of trading and 2-hour resumption of clearance and settlement services following a wide-scale disruption.[5] Depending on what level of trading resumption by SCI entities the Commission would consider sufficient, the costs to exchange and ATS members, as well as other participants, could be substantial.

More importantly, KCG is concerned that the Commission's expectations are unrealistically high in suggesting that trading from a back-up facility would be comparable to trading from a primary site. If trading from a back-up facility is different than from the primary site, which KCG believes it would be, market participants will not

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[5] Backup sites could not rely on the same infrastructures components (e.g., transportation, telecommunications, water supply, and electric power) used by the primary site.

use the back-up facility, but instead trade on the many other venues available in today's market. The high likelihood that back-up facilities would not be used substantially reduces the value of such back-up facilities.

The costs, however, to exchange members and ATS participants to support a back-up facility are substantial and may not be needed to meet their trading objectives. For example, if the Commission expects that trading on an SCI entity's back-up facility would provide the same liquidity as trading on the primary site, market participants would need to fully replicate their infrastructure and connectivity to each SCI entity. To electronically stream high quality and competitive quotes, market makers must be in close proximity to the exchange or ATS. Specifically, it is a market maker's ability to co-locate their computer systems at the exchange's or ATS's datacenter that underpins its ability to respond rapidly to changing market conditions and manage the risks associated with posting two-sided markets. Mere network connectivity to an exchange or ATS would be insufficient for a market maker to provide meaningful liquidity on such SCI entity. Accordingly, if the Commission's expectation is that an SCI entity's back-up facility would be identical to such entity's primary site, SCI entities would have to require market makers to fully replicate their footprint at back-up sites, which would double the costs associated with being a market maker. These substantial costs would lead firms to reconsider their ability to make markets on as many trading platforms and potentially reduce price competition during normal trading.

While difficult to predict without further information about the implementation of Proposed Regulation SCI, the costs for a market maker, such as KCG, to support the back-up facilities of all SCI entities on which it currently trades could reasonably be $7 to $10 million in initial capital, with ongoing costs of between $5 and $9 million annually. We note that the cost of supporting a back-up facility of an SCI entity would be reduced, if the backup facility of an SCI entity were the primary site of another SCI entity on which a market maker traded.

More importantly, however, KCG does not believe it would be able to quote competitively on an SCI entity's back-up facility because of the risks associated with its

posted quotes being swept by other participants' removal strategies as market prices move. The geographic differences between a primary site and a back-up facility would mean different latencies between correlated markets, creating uncertainty for market makers. This uncertainty would limit the ability of market makers to quote normally from a back-up facility and thus provide little reason for other market participants to access the liquidity on that market. For this reason, trading from back-up facilities of exchanges is, and would be, very low. A high cost, fully redundant back-up facility will not change this dynamic.

If, on the other hand, the Commission does not intend for SCI entities to be able to trade in the same way from a back-up facility as it trades from the primary site, then, rather than duplicating their computer system infrastructure at the disaster recovery site, market makers could maintain a more limited remote connectivity to an SCI entity's backup site. Remote connectivity, rather than full co-locations, would reduce the cost burden to market makers, but it would not facilitate posting of competitive quotes. Because it is proximity of the computer systems to an SCI entity's datacenter that underpins the quality of the markets made by the market maker, simply maintaining remote connectivity to the disaster recovery site would force market makers to post unusually wide markets. Accordingly, though the costs of this, more limited, redundant connectivity would be lower, we do not believe there would be any benefits.

Finally, the Commission states that the basis for its proposed requirement that all SCI entities be subject to a next business day resumption of trading standard is its preliminary view that an SCI entity, being part of the critical infrastructure of the US securities markets, should have plans to limit downtime caused by a wide-scale disruption to less than one business day.[6] As discussed above, however, KCG believes that the scope of truly critical securities market services is much more limited than the 13 exchanges and approximately 10 ATSs that the Commission estimates would be SCI entities. These markets do not offer unique services and no one of them is critical. For

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[6] Proposed Reg SCI, text accompanying note 182.

this reason, KCG reiterates its views that the scope of SCI entity should be substantially narrowed to cover those services that are truly critical.

C. Regulation SCI should not be extended to other broker-dealers

In Proposed Regulation SCI, the Commission states that many orders are internalized by OTC market makers and refers to Rule 606 data that eight broker-dealers with significant retail customer accounts route nearly 100% of their customer market orders to OTC market makers. KCG does not believe that the longstanding practice of retail brokers routing their customers' orders to market makers for execution makes any one of those market makers critical.

Retail broker-dealers route their customers' orders to OTC market makers because these market makers provide cost savings, superior execution quality and high levels of client service. However, retail broker-dealers are not dependent on any one market maker or even on market makers as a group. Over the years, many retail customers' brokers have improved their infrastructure and connectivity, which allows them to route orders to multiple trading centers, including multiple market makers. These routing alternatives help retail brokers to fulfill their best execution obligations by allowing direct comparisons of execution quality among market centers. The routing infrastructure of many retail brokers is also resilient and sophisticated enough for brokers to quickly re-route orders away from a market maker that is not providing the expected execution quality or level of service to that may be experiencing a systems issue. To the extent weaknesses were revealed in broker-dealers' business continuity plans by recent events, such as Superstorm Sandy, FINRA could issue additional guidance under its existing rules. FINRA's rules are designed to apply to the business of operating a broker-dealer and are a more appropriate tool than Regulation SCI to require broker-dealers to establish controls and practices to reduce the likelihood, and minimize the impact of, errors and trading disruptions.

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Moreover, OTC market makers are registered broker-dealers and, thus, subject to comprehensive regulatory requirements of the Commission and SROs, including FINRA. Unlike the regulatory framework for exchanges, the framework that applies to broker-dealers does not include absolute legal immunity, which shields exchanges from liability for even the most egregious conduct. The absence of legal immunity makes broker-dealers more accountable than exchanges to their clients.

Below is a summary of key regulatory requirements applicable to broker-dealers, which together are designed to achieve the same goals as Proposed Regulation SCI.

- Written supervisory procedures. FINRA, pursuant to NASD Rule 3010(b)(1), requires a member to establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives, registered principals, and other associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations.

  This rule already requires broker-dealers to have policies and procedures similar to those the Commission proposes to require of SCI entities under Proposed Rules 1000(b)(1)-(b)(3).

- Best execution obligation. Broker-dealers have a duty to seek to obtain for customers' orders the most favorable terms reasonably available under the circumstances. Market makers that route and execute orders they receive from clients also have a duty of best execution. To fulfill this duty, market makers not only execute orders at competitive prices, but also consider the speed of execution and the reliability of any routing or execution systems used.

- Reporting of systems failures and regulatory violations. FINRA Rule 4530 requires a member to promptly report to FINRA certain occurrences in which the member or the member itself has violated any securities, insurance, commodities, financial or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body or self-regulatory organization.

This rule is designed to require reporting of similar events that the Commission proposes to require SCI entities to report in proposed Rule 1000(b)(4). Specifically, FINRA interprets this rule to require members to report conduct that has widespread or potential widespread impact to the member, its customers or the markets, or conduct that arises from a material failure of the member's systems, policies or practices involving numerous customers, multiple errors or significant dollar amounts.[7] KCG does not believe that there would be any additional benefit to broker-dealers making reports to the Commission of such compliance events.

- Business continuity plans. FINRA Rule 4370 requires a member to create and maintain a written business continuity plan identifying procedures relating to an emergency or significant business disruption that are reasonably designed to enable members to meet their existing obligations to customers, other broker-dealers and counter-parties. A member must also update its plan in the event of any material change to the member's operations, structure, business or location and must conduct an annual review of its business continuity plan to determine whether any modifications are necessary in light of changes to the member's operations, structure, business, or location. This rule is very specific about the elements that a broker-dealer's BCP must, at a minimum include and substantially overlaps with requirements the Commission proposes in Regulation SCI Rule 1000(b)(8).[8]
- Report of the Chief Compliance Officer ("CCO"). FINRA Rule 3130 requires a member's CCO to prepare a report that outlines the member's processes for:

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7 FINRA Regulatory Notice 11-32 (July 2011).

8 For firms like KCG that have many retail broker-dealer and institutional clients, robust back-up facilities may be necessary to help meet client trading needs and these firms should tailor their back-up facilities to meet business objectives.

- establishing, maintaining and reviewing policies and procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules and federal securities laws and regulations,
- modifying such policies and procedures as business, regulatory and legislative changes and events dictate; and
- testing the effectiveness of such policies and procedures on a periodic basis.

In addition, this rule requires the CCO to meet with Senior Management to discuss these processes, the member's compliance efforts as of the date the meeting, significant compliance problems and plans for emerging business areas. Senior Management must certify that these processes are in fact in place.

- Commission Rule 15c3-5, which requires broker-dealers to establish and maintain a system of risk management controls and supervisory procedures that control the access they provide to markets. These controls and procedures must be reasonably designed to systematically limit the financial exposure of the broker-dealer that could arise as a result of market access, and to ensure compliance with all regulatory requirements that apply to providing market access.
- Capital requirements. Unlike exchanges, broker-dealers are subject to capital requirements under Commission and FINRA rules, which mitigate the impact on customers and other market participants of a broker-dealer's systems errors.

D. Other Technical Comments

1. Scope of SCI systems should be narrowed and definition of SCI security system should be eliminated

The Commission's proposed definition of "SCI systems" is very broad, including 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. In addition, if an SCI entity contracts with a 3rd party to operate its systems (such as those that use execution algorithms) on behalf of the SCI entity, such systems would also be covered by the proposed definition of SCI systems if they directly support trading, clearance and settlement, order routing, market data, regulation or surveillance.[9]

KCG agrees with SIFMA that this definition should be better tailored to identify those SCI systems that are highly critical to an SCI entity's proper functioning as an SCI entity. KCG believes that the current definition, which includes systems used in development and testing is needlessly broad. Systems used by SCI entities in development or testing do not directly impact other market participants and it is unclear the benefit that would be derived from additional regulatory requirements on such systems. Instead, KCG recommends that the Commission include a materiality standard that would permit SCI entities to determine which systems are most critical and would have the most impact on other market participants if they failed.

In addition, KCG recommends that the definition of SCI security system be eliminated. The proposed definition of SCI security system is "any systems that share network resources with SCI systems that, if breached, would be reasonably likely to pose a security threat to SCI systems." Thus, SCI security systems would subject systems in addition to SCI systems to Regulation SCI, though only a subset of Regulation SCI requirements would apply to SCI security systems. KCG believes that the Commission's goals can be achieved more effectively by requiring SCI entities to establish policies and procedures designed to ensure the security of their systems. This approach would be more effective than the Commission attempting to define the systems that implicate security issues. KCG believes market participants are better placed to identify their own points of vulnerability to security breaches.

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[9] Proposed Regulation SCI Rule 1000(a); Exchange Act Release No. 69077, at notes 139-144 and accompanying text (March 8, 2013), 78 FR at 18099 (March 25, 2013).

2. Calculation of SCI ATS thresholds should be calculated on the basis of trading volume over a 12 month period

The Commission proposes that proposed SCI ATS thresholds be calculated by reference to executions during at least four of the preceding six calendar months. This is the method and measurement period currently used in Regulation ATS.

As the operator of three ATSs, KCG has found this method and measurement period cumbersome to apply in practice. We recommend that that the Commission instead use a reference to executions over a twelve month period. This approach would require a sustained trading level at the threshold. In addition, KCG recommends that once an ATS meets the threshold for a twelve month period, the ATS be provided at least six months to come into compliance with Regulation SCI.

3. Proposal to require SCI entities to notify the Commission of material systems changes before implementation is of unclear benefit

Proposed Regulation SCI would require an SCI entity to notify the Commission at least 30 calendar days before implementation of any planned material change. It is unclear to KCG the benefit of providing the Commission with this information. The Commission does not have authority to stop implementation of systems changes by ATSs or system changes that exchanges are not required to submit under Section 19(b) of the Exchange Act. Systems changes that must be submitted by exchanges under Section 19(b) of the Exchange Act are already subject to a regulatory process before they may be implemented. It is, therefore, unclear whether the Commission is expanding its process for approval of systems changes beyond what is already required under Section 19(b) or proposing a parallel and redundant process.

In addition, KCG is concerned that this 30-day notification requirement would enshrine within Commission rules the assumption that the best practice for software deployments involve large, periodic releases. Much of the current thinking in software development

circles tend to rely on iterative approaches to software changes relying on frequent small releases.[10] Such models have been shown to lead to more stable systems. However, it is unclear how an SCI entity using such a model would comply with a 30-day notification requirement. While each iterative change on its own would be immaterial, together the changes may be material. Yet, the progression of such changes would not be knowable at the outset. Because the proposed notification requirement seems to assume that there would be infrequent, large changes to software, rather than smaller, iterative changes, KCG is concerned that the Commission would unintentionally favor some deployment styles over others.

Moreover, in KCG's experience, all systems changes carry a risk of causing systems disruptions. For this reason, all systems changes must be subject to robust procedures to reduce the likelihood and minimize the magnitude of errors and trading disruptions. There is a risk that a systems error or disruption will be considered by regulators to have been a material systems change and the absence of a prior notification a violation of Regulation SCI. To avoid this potential result, SCI entities would have an incentive to report all systems changes. Thus, if the Commission determines to retain this requirement in a final rule, it is critical that a clear safe harbor be established that defines the types of systems changes that – even if a problem subsequently occurs – is not subject to the prior notification requirement.

4. Proposal that Commission staff have remote access to SCI systems would create security risks

The Commission proposes that SCI entities would be required to provide Commission staff with remote or on-site access to SCI systems. KCG has significant concerns about Commission staff having remote access to industry automated systems. Such access

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[10] There are many models of software development life cycle and these models are constantly evolving and new ones emerging. http://en.wikipedia.org/wiki/Software_development_process

creates unnecessary security risks – precisely the type of security risk that Proposed Regulation SCI is designed, in part, to address.

III. Conclusion

KCG appreciates the opportunity to submit these comments. Please do not hesitate to contact me at (312) 931-2498 if you have questions regarding any of the comments provided in this letter.

Sincerely,

Elizabeth K. King
Global Head of Regulatory Affairs

cc: Chair Mary Jo White
Commissioner Luis A. Aguilar
Commissioner Daniel M. Gallagher
Commissioner Troy A. Paredes
Commissioner Elisse B. Walter
John Ramsey, Acting Director, Division of Trading & Markets
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