CITADEL | Securities

June 13, 2023

Ms. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549–1090

Re: Regulation Systems Compliance and Integrity (File No. S7-07-23)

We appreciate the opportunity to provide comments to the Securities and Exchange Commission (the "Commission") on the proposed amendments to Regulation Systems Compliance and Integrity ("SCI") (the "Proposal").[1] The Proposal should be withdrawn. The Commission is a markets regulator and does not have the authority or expertise to micromanage the technology operations of the nation's largest securities firms. Yet, that is exactly what it proposes here, at a cumulative cost of *billions of dollars* without any tangible benefit.

Since it was implemented nearly a decade ago, Regulation SCI has focused on ensuring that critical components of our market infrastructure – mainly, the stock exchanges – have reasonable policies in place to ensure that they can open for business and facilitate trading by market participants. The Commission now, for the first time, proposes to impose these same requirements on certain broker-dealers that *trade as principal* on the venues that are currently subject to Regulation SCI. This results in a number of costly and impractical consequences, including due to the new and prescriptive business continuity requirements that appear to affirmatively compel broker-dealers to provide principal liquidity and that require the building of a complete backup system that serves little practical benefit – at a cost that can reach hundreds of millions of dollars per firm. In addition, the breadth of broker-dealer systems that could be considered subject to Regulation SCI raises fundamental concerns around the disclosure of highly sensitive intellectual property (including source code).

The Commission makes no attempt to justify targeting a small group of broker-dealers with these costly and impractical requirements, apart from merely noting that they have a large market share. In particular, the Commission does not identify a *single example* of a meaningful market disruption caused by any of the 17 broker-dealers that would be covered by this Proposal. Nor does the Commission explain why it is rational to solely focus on trading volumes to determine the application of Regulation SCI to broker-dealers. This approach fails to consider other important factors, such as substitutability, that are relevant when considering the potential implications of a temporary withdrawal of a large broker-dealer from specific trading activities. In addition, the Commission ignores the strong commercial incentives that lead broker-dealers to voluntarily invest significant resources in the operational resiliency of client trading businesses in order to serve as a dependable and resilient counterparty, as well as the fact that other broker-dealers perform far less replaceable functions in the securities markets (such as clearing).

[1] 88 FR 23146 (Apr. 14, 2023), available at: https://www.govinfo.gov/content/pkg/FR-2023-04-14/pdf/2023-05775.pdf (the "Proposal").

Fundamentally, the Commission does not appropriately consider the practical implications of applying the existing Regulation SCI framework to an entirely new set of entities. By imposing massive costs on a limited set of firms, but not their competitors, the Commission is significantly, unfairly, and irrationally altering current competitive dynamics. One possible effect of such differential treatment would be for certain of the targeted broker-dealers to reduce trading activity so as to stay below the 10% trading volume threshold, thereby leading to the precise harm – a material reduction in market liquidity – that the Proposal is purportedly intended to avoid.

It is therefore striking that the Commission admits in its economic analysis that it cannot substantiate *any* tangible benefit that would result from applying Regulation SCI in this manner. And the Commission fails to assess the extent to which these new requirements are *already addressed* by the robust regulatory framework applicable to broker-dealers, including rules issued by the Commission, FINRA, and specific trading venues, such as requirements for broker-dealers to implement extensive market access controls.

Statutory authority is an indispensable prerequisite to any legitimate agency action. Yet, the Commission makes no effort to explain how its amendments to Regulation SCI are authorized by any specific grant of statutory authority. Instead it simply asserts – with no elaboration – that the Proposal is authorized by 11 different sections of the Exchange Act. As detailed below, those sections do not say anything of the sort.

Given the Commission's lack of legal authority to extend Regulation SCI to broker-dealers and the absence of any adequate justification for imposing onerous, costly, and impractical requirements on a small group of those firms, we urge the Commission to withdraw this Proposal. Rather than take this unauthorized and unnecessary step, the Commission should continue to rely on existing Commission and FINRA requirements, which establish a robust broker-dealer regulatory framework that has enhanced the operational resilience of U.S. securities markets.

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I. The Proposed Extension of Regulation SCI to Certain Broker-Dealers Is Arbitrary and Unfairly Discriminatory

When the Commission finalized Regulation SCI in 2014,[2] it detailed numerous system disruptions that had recently occurred in Commission-regulated securities markets that Regulation SCI was intended to address. Those system disruptions included (a) exchange systems disruptions during the Facebook and BATS Global Markets IPOs, (b) repeated delays, halts, and systems errors experienced by options exchanges, (c) exchange systems disruptions caused by Superstorm Sandy, and (d) various other systems intrusions, connectivity issues, and trading halts reported by exchanges and ATSs.[3] Based on this list of identified issues, and their significant market-wide impacts, the Commission determined to apply Regulation SCI to certain self-regulatory organizations (including national securities exchanges and clearing agencies) as well as certain alternative trading systems, and designed the regulatory framework accordingly.[4]

The Commission now proposes to dramatically depart from this prior position and apply the existing Regulation SCI framework to an entirely new set of entities – broker-dealers that exceed one or more arbitrary thresholds based on total trading volumes or total assets.[5] These Commission-invented thresholds result in 17 broker-dealers being subject to Regulation SCI out of the approximately 3,500 broker-dealers registered with the Commission.[6] As detailed below, the Commission does not provide a rational basis for targeting these firms with extremely onerous, costly, and impractical requirements. Importantly, unlike when Regulation SCI was first adopted, the Commission is unable to concretely articulate the market failure that it is seeking to address; indeed, the Proposal *does not provide a single example* of a broker-dealer systems disruption that had a significant market-wide impact in the securities markets (nor demonstrate that any such market-wide disruption would have been prevented by capturing the specific firms targeted by the Proposal).[7]

Given the lack of an identified market failure attributable to *any* broker-dealer – let alone the 17 targeted firms – the Proposal fails to draw a "rational connection" between the problem the

[2] 79 FR 72252 (Dec. 5, 2023) ("Regulation SCI").

[3] *See generally* Regulation SCI at 72254-55.

[4] The scope of covered entities was also consistent with the Commission's Automation Review Policy inspection program that was in place for over two decades prior to the implementation of Regulation SCI. *See* Regulation SCI at 72253.

[5] The Proposal applies Regulation SCI to broker-dealers that (a) in at least two of the four preceding calendar quarters, reported to the Commission total assets in an amount that equals five percent (5%) or more of the total assets of all security brokers and dealers, or (b) during at least four of the preceding six calendar months, transacted average daily dollar volume in an amount that equals ten percent (10%) or more of the average daily dollar volume reported by a transaction reporting plan or made available by the relevant self-regulatory organization for NMS stocks, exchange-listed options, U.S. Treasury securities, or Agency securities. Proposal at 23161.

[6] Proposal at 23157 and 23205.

[7] The Commission's failure to provide such examples is notable because there have been instances in which large broker-dealers have had to temporarily withdraw from the market. The Commission could have, but did not, analyze such instances to determine whether these caused market-wide disruptions of the type the Commission otherwise hypothesizes might occur.

Commission has identified and the solution it has chosen.[8] The Commission's proposed 10% trading volume threshold simply represents an arbitrary and unjustifiable attempt to increase the regulatory burdens of larger, diversified broker-dealers.[9]

First, by focusing solely on trading volumes, the Proposal fails to consider other important factors, such as substitutability, that are relevant when considering the potential implications of a temporary withdrawal of a large broker-dealer from specific trading activities. At the same time, the Proposal completely ignores other broker-dealers that are performing far less replaceable functions in the securities markets (as detailed further below).

Second, by counting *all* trading activities of a broker-dealer towards the threshold for a given asset class, the Proposal unfairly discriminates against broker-dealers with diversified businesses and makes no attempt to identify specific trading activities that could lead to the type of market-wide concern Regulation SCI was intended to address.

Third, the Commission fails to provide a rational basis for setting the proposed trading volume threshold at 10% (versus another level) for the asset classes covered by the Proposal. The Commission's "explanation for its decision . . . runs counter to the evidence before [it]," and therefore fails the most basic test of the rulemaking process.[10]

A. The Proposal Illogically Focuses on Trading Volumes

By inventing a threshold that solely focuses on trading volumes, the Proposal fails to consider other important factors, such as substitutability and switching costs, that are relevant when considering the potential implications of a temporary withdrawal of a large broker-dealer from one or more market segments.[11] For example, in the equities and options asset classes, there are a plethora of liquidity providers who display quotations on exchanges and ATSs, providing ample capacity (and substitutability) in the event a liquidity provider temporarily withdraws from the market. In turn, to the extent the Commission were focused on ensuring investor access to securities markets, recent market events have clearly demonstrated that retail broker-dealers are able to effectively manage the temporary withdrawal of a wholesale broker-dealer by routing retail orders either to the remaining wholesale broker-dealers or directly to exchanges and ATSs (again demonstrating high substitutability and low switching costs).[12] The Proposal "entirely fails to consider an important aspect of the problem" by not accounting for the level of competition and substitutability that exists with respect to a specific type of trading activity in a given asset class

[8] *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

[9] The Commission notes that all 17 targeted broker-dealers exceed the 10% trading volume threshold in at least one asset class. Proposal at FN 190.

[10] *State Farm*, 463 U.S. at 43.

[11] We note that, in the asset classes covered by the Proposal, specific market developments, such as the growth of sub-dollar equities trading, can have a significant influence on which firms are captured by a threshold that solely focuses on trading volumes, further underscoring its arbitrary nature.

[12] *See, e.g.,* "Staff Report on Equity and Options Market Structure Conditions in Early 2021," (Oct. 14, 2021) at 35, available at: https://www.sec.gov/files/staff-report-equity-options-market-struction-conditions-early-2021.pdf (finding that an increasing percentage of volume executed on exchange when volatility spiked).

before making unsubstantiated claims regarding potential "capacity constraints" if one of the 17 targeted broker-dealers were to temporarily withdraw from the market.[13]

In focusing on trading volume, the Commission also completely ignores other broker-dealers performing far less replaceable functions in the securities markets. When considering the appropriate scope of Regulation SCI in 2013, the Commission requested comment regarding a variety of broker-dealers, including (i) order-entry firms that handle and route order flow for execution, and (ii) clearing broker-dealers.[14] Recent market events have further underscored the importance of these types of broker-dealers in ensuring the efficient functioning of securities markets,[15] yet the Proposal does not consider them at all. In addition, the Proposal does not consider other types of broker-dealers that play an important role in maintaining orderly trading in securities markets, such as broker-dealers offering (a) prime brokerage services, (b) institutional agency routing, (c) institutional execution algorithms, and (d) order management systems.[16] These important functions may have much less substitutability and higher switching costs than the trading activities currently captured by the Proposal. For example, establishing a new clearing relationship typically involves a lengthy, heavily-negotiated process, and there are often only a limited number of firms who offer clearing services in a particular asset class. In light of the stated regulatory objectives in the Proposal, failing to consider the impact of one of these broker-dealers suddenly withdrawing from the market would be arbitrary and capricious.

The Commission also does not explain why the Proposal only targets broker-dealers in certain asset classes. For example, the proposed trading volume threshold does not apply to corporate bonds, municipal bonds, or security-based swaps, even though there is less competition and substitutability among liquidity providers in those asset classes.

B. The Proposal Unfairly Discriminates Against Diversified Broker-Dealers

The Proposal counts all trading activities of a broker-dealer in a given asset class towards the 10% trading volume threshold and, once the threshold is surpassed, all such trading activities are equally subject to Regulation SCI. In making no attempt to identify specific trading activities that could lead to the type of market-wide concern Regulation SCI was intended to address, the Proposal adopts a deeply flawed approach that unfairly discriminates against diversified broker-dealers. For example, in the equities asset class, the following distinct trading activities would all be aggregated and counted towards the 10% threshold: (i) on-exchange principal trading, (ii) customer order handling, and (iii) other off-exchange trading, such as on single-dealer platforms.

Depending on the purported market failure that the Commission is attempting to address, some of these trading activities will be more relevant than others. For example, if the Commission were

[13] *State Farm*, 463 U.S. at 43; Proposal at FN 197.

[14] Proposal at 23157-8.

[15] *Supra* note 12 at 31.

[16] We note there appears to be very little focus on how institutional investors access the market. In addition, the Proposal also does not clarify how broker-dealers using direct market access or sponsored access via another broker-dealer are treated for purposes of the trading volume threshold.

focused on ensuring investor access to securities markets, then trading activities where a broker-dealer is handling customer orders would be more relevant than trading activities where a broker-dealer is providing principal liquidity on a trading venue.[17] In addition, the Proposal appears to inaccurately assume that a systems disruption should be expected to impact *all* of a broker-dealer's trading activities, thereby making it more likely that a large, diversified broker-dealer could negatively impact the functioning of the overall securities market.[18] In reality, the disparate trading activities of a diversified broker-dealer are typically supported by *different* internal systems. For example, the systems supporting a customer order handling business are very different than the systems supporting on-venue principal trading. Thus, the larger aggregate trading volumes of a diversified broker-dealer are irrelevant to assessing the probability that a specific system will experience a disruption and the impact of such a disruption were it to occur.

As a result, the Commission must identify specific activities that could lead to the type of market-wide concern Regulation SCI was intended to address, and then assess the universe of broker-dealers engaged *in such activities*. Furthermore, any such assessment must take into account the level of competition and substitutability that exists with respect to a specific type of trading activity. In contrast, solely focusing on aggregate trading volumes can lead to outcomes that appear directly contrary to apparent regulatory objectives. For example, if the Commission were concerned about ensuring retail investor access to securities markets, it would appear nonsensical to apply Regulation SCI to a firm that exceeds the 10% trading volume threshold but only has a 1% market share in retail wholesaling, while failing to capture a firm that accounts for 9% of total market volume solely due to its retail wholesaling business. And yet, that is exactly what the Proposal would do. Such arbitrary and discriminatory requirements violate the Commission's statutory obligation to assure "fair competition among brokers and dealers."[19]

C. The 10% Trading Volume Threshold Is Completely Arbitrary

The Commission provides no explanation as to why the trading volume threshold was set at 10%, other than to acknowledge that "the proposed numeric thresholds ultimately represent a matter of judgment by the Commission" and to assert, without further explanation, that 15% was too high and 5% was too low.[20] The complete lack of any objective rationale for the 10% threshold

[17] In this context, the Commission should also consider the implications of its recent U.S. equity market structure proposals, which seek to reduce the role of wholesale broker-dealers and off-exchange retail trading.

[18] *See, e.g.,* Proposal at FN 197 ("For example, capacity constraints [. . .] could limit how much one broker-dealer could handle a sudden increase in order flow from a large broker-dealer.").

[19] 15 U.S.C. § 78k-1(a)(1)(C)(ii); *see Bus. Roundtable v. SEC*, 905 F.2d 406, 416 (D.C. Cir. 1990) (holding that the statutory objectives in Section 11A(a)(1) "necessarily constrain[ ]" the Commission's regulatory authority).

[20] Proposal at 23168 and 23264 ("Similarly, the Commission has also considered whether all broker-dealers with transaction activity thresholds above 5% should be included as SCI broker-dealers, but determined that this would scope within Regulation SCI several broker-dealers that are not among the most significant broker-dealers that pose technological vulnerabilities and risks to the maintenance of fair and orderly markets.").

suggests that the threshold was arbitrarily set in order to engineer a specific outcome and ensure that certain broker-dealers would be captured.[21] This is unlawful arbitrary rulemaking.

As further evidence of the arbitrary nature of the threshold, the Commission makes no attempt to calibrate by asset class, instead adopting the same threshold across equities, options, Treasuries, and agencies, even though these are very different markets.[22] This approach represents another departure from precedent, as the Commission has previously attempted to tailor trading volume thresholds by asset class when applying Regulation SCI to ATSs. In particular, ATSs listing NMS stocks are subject to Regulation SCI if they exceed 1% of average daily volume, while the Commission has adopted a 5% threshold for ATSs listing non-NMS stocks and proposed a 5% threshold for ATSs listing Treasuries.[23] In setting these various thresholds for ATSs, the Commission evaluated the market-wide risk associated with an ATS systems disruption given the characteristics of the relevant asset class, including the number of trading venues and the observed degree of interconnectedness.[24] No such analysis was performed by the Commission in this Proposal; nor did the Commission explain why the trading volume threshold for broker-dealers was set at a significantly higher level than the existing trading volume thresholds for ATSs. These unexplained inconsistencies are incompatible with the reasoned decisionmaking the APA requires.

[21] The Proposal also acknowledges that the method for computing trading volume over-estimates a firm's market share, as both parties to a single trade would be considered to have 100% market share. Proposal at FN 218.

[22] For example, according to the Proposal, the average daily volume in the options market is approximately 5% of the average daily volume in the equities market. Proposal at FN 171 and 172. In addition, the Treasury and agency markets are principal markets with very different characteristics, such as less central clearing and minimal retail participation.

[23] *See* Proposal at FN 262 ("As stated in the SCI Adopting Release, the higher threshold for equity securities that are not NMS stocks versus NMS stocks was selected taking into account the lower degree of automation, electronic trading, and interconnectedness in the market for equity securities that are not NMS stocks and assessment that those ATSs would present lower risk to the market in the event of a systems issue, but not necessarily no risk.").

[24] *Id.*

II. The Proposal's Economic Analysis Is Fatally Flawed

The economic analysis of the Proposal is extremely limited and vague, and fails to adequately consider the practical implications of applying the existing Regulation SCI framework to an entirely new set of entities – broker-dealers.

First, attempting to apply Regulation SCI to principal trading activities results in extremely burdensome and seemingly unmanageable outcomes, such as the broad scope of covered systems and the related intellectual property concerns that arise if source code is required to be made available for summary inspection by the Commission. In addition, the new and prescriptive business continuity and disaster recovery requirements[25] appear to lack any rational basis given that they appear to affirmatively compel broker-dealers to provide principal liquidity and require the building of a backup system in a "geographically diverse" location that is of little practical benefit.

Second, the Proposal inappropriately burdens market competition by subjecting similarly situated competitors to very different regulatory requirements. One possible effect of such differential treatment would be for certain of the targeted broker-dealers to reduce trading activity so as to stay below the 10% trading volume threshold, thereby leading to the precise harm – a material reduction in market liquidity – that the Proposal is purportedly intended to avoid.

Third, in light of these significant negative impacts, it is striking that the Commission is unable to substantiate *any* tangible benefit that would result from the Proposal. The lack of any tangible benefit associated with the Proposal is all the more clear considering the comprehensive regulatory requirements to which broker-dealers are already subject, including from the Commission, FINRA, and trading venues. These include requirements that advance the same objectives as Regulation SCI and are not applicable to current SCI entities, such as market access requirements.

A. Regulation SCI Is Not Designed to Apply to Principal Trading Activities

Regulation SCI currently applies to trading centers (exchanges and ATSs),[26] and is designed to enhance the operational resilience of these key venues where buyers and sellers of securities transact. In particular, requirements regarding systems management and controls are designed to reduce the likelihood of a systems disruption, while business continuity and disaster recovery requirements are designed to ensure there is a resumption of trading by the next business day in the event a disruption occurs.[27] The Proposal fails to adequately consider the implications of attempting to apply this existing regulatory framework to broker-dealers that *trade as principal on these venues* that are currently subject to Regulation SCI.

First, there is no recognition of the immense scope of broker-dealer systems that could be considered subject to Regulation SCI. The current definition of an "SCI system" includes "all

[25] We note that, in contrast, FINRA Rule 4370 permits broker-dealers to tailor business continuity plans based on the size and needs of the firm.

[26] Regulation SCI also applies to plan processors and clearing agencies, which are critical to facilitating trading on exchanges and ATSs.

[27] *See generally* Regulation SCI.

computer, network, electronic, technical, automated, or similar systems" that directly support trading or order routing, among others.[28] When applied to a broker-dealer engaging in various different principal trading businesses within a given asset class, this vague and expansive definition could result in *thousands* of internal systems being considered in-scope, dramatically increasing compliance costs and slowing the pace of innovation. In using the estimated compliance costs for trading venues currently subject to Regulation SCI as the baseline for broker-dealers,[29] the Commission demonstrates a fundamental lack of understanding regarding the scope of what it has proposed, as a broker-dealer's compliance costs would be *multiples* of an exchange's given the scope of impacted systems.

The breadth of broker-dealer systems that could be considered subject to Regulation SCI, and the associated disclosure and examination requirements, also raise concerns around the disclosure of highly sensitive intellectual property (including source code). The source code utilized by a broker-dealer is often its most valuable intellectual property and critical to its overall commercial success. If this were required to be made available for summary inspection by the Commission, the risks of unauthorized disclosure significantly increase. Risks include accidental disclosure by Commission staff, disclosure and/or use by Commission staff following an employment move to the private sector, and security breaches due to cyberattacks, which could be expected to increase in frequency if the Commission was known to possess source code that could unlock the trading strategies of the world's most successful broker-dealers. Similar to other types of highly confidential intellectual property, such as recipes or formulas for consumer products, it is difficult to overstate the commercial impact that the unauthorized disclosure of source code would have on a broker-dealer.[30] The Proposal does not consider these implications at all.

Second, the new and prescriptive business continuity and disaster recovery requirements in particular appear to lack any rational basis when applied to a broker-dealer trading as principal. Broker-dealers are not subject to a regulatory obligation to commit capital and provide principal liquidity to the market. In contrast, exchanges typically have Commission-approved rules that require continuous operation.[31] Imposing similar requirements on broker-dealers that are designed to ensure a resumption of trading by the next business day appears to suggest the Commission is seeking to affirmatively compel broker-dealers to provide principal liquidity.

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[28] Regulation SCI §242.100.

[29] *See, e.g.,* Proposal at 23250 ("the Commission believes that the estimates from 2014 are still appropriate estimates for the non-PRA costs associated with Rule 1001(a) and (b) of Regulation SCI without the proposed amendments for the new SCI entities."). We note the Commission should also obtain accurate data regarding actual implementation costs from those entities currently subject to Regulation SCI instead of continuing to rely on out-of-date and inaccurate estimates.

[30] We reference the feedback provided to the Commodity Futures Trading Commission regarding its 2016 proposal "Regulation Automated Trading," available at: https://comments.cftc.gov/PublicComments/CommentList.aspx?id=1646 (which included a requirement for market participants to maintain a source code repository that was available for summary inspection by the CFTC and other government agencies, which the CFTC subsequently withdrew).

[31] *See, e.g.,* NYSE Rule 7.1 (*Hours of Business*) ("Except as may be otherwise determined by the Board of Directors as to particular days, the Exchange shall be open for the transaction of business on every business day").

In addition, Regulation SCI requires backup and recovery capabilities to be "geographically diverse."[32] This makes little sense in the context of a broker-dealer's trading activities, particularly in the equities and options markets. In these markets, broker-dealer systems are co-located with exchanges' systems in order to effectively provide liquidity. Given that the exchanges are concentrated geographically, a backup system in a *different* location would be of little practical benefit. Yet the Proposal would require broker-dealers to build one anyway. That project alone would cost *hundreds of millions of dollars per firm*, taking into account the costs associated with replicating a broker-dealer's technology platform, including servers, networks, connectivity, and storage. Requiring firms to spend hundreds of millions of dollars to build a backup technology setup that serves little practical benefit is not reasoned decisionmaking.

Given these considerations, and prevailing levels of competition and substitutability, we recommend that, at a minimum, the Commission exclude a broker-dealer's principal trading activities in the equities and options asset classes from Regulation SCI (see Section IV below for more detail).

B. The Proposal Inappropriately Burdens Market Competition

By focusing on aggregate trading volumes, instead of broker-dealers active in specific trading activities that could lead to the type of market-wide concern Regulation SCI was intended to address, the Proposal inappropriately burdens market competition.

As detailed above, the Proposal aggregates distinct trading activities when determining whether a broker-dealer is subject to Regulation SCI, such as (i) on-exchange principal trading, (ii) customer order handling, and (iii) other off-exchange trading, such as on single-dealer platforms. As a result, a diversified broker-dealer with 4% market share in each trading activity above would be subject to Regulation SCI, while a broker-dealer with a 9% market share in principal trading and without other business lines, would not. This means that, with respect to a specific trading activity, competitor firms will be subject to very different regulatory requirements.

As a result, the Proposal may significantly, unfairly, and irrationally alter current competitive dynamics. Imposing hundreds of millions of dollars in costs on one firm but not another can radically impact profitability and overall liquidity provision. One possible effect of such differential treatment would be for certain of the targeted broker-dealers to reduce trading activity so as to stay below the 10% trading volume threshold, thereby leading to the precise harm – a material reduction in market liquidity – that the Proposal is purportedly intended to avoid.[33] While the Commission is aware that ATSs actively manage trading volumes to remain below the relevant threshold for Regulation SCI,[34] these trading venues do not provide principal liquidity to the market. In the context of principal trading, a similarly managed reduction of trading volume would

[32] Regulation SCI §242.1001(a)(2)(v).

[33] We note that this harm is another example of the unique implications associated with applying Regulation SCI to broker-dealers, given that SROs focus on providing matching services and do not add liquidity to the market.

[34] Many ATS rules specify that the ATS can suspend trading in individual NMS stocks for, among other reasons, approaching Regulation SCI volume thresholds.

have a material negative impact on market activity and liquidity, which appears contrary to the stated objectives of the Proposal.

We also note that the Commission is considering significant amendments to the rules governing the U.S. equity and options markets that could also impose new costs on broker-dealers and negatively impact overall trading volumes and competition.[35] The Commission fails to consider the cumulative impact of these competitive considerations in the Proposal.

C. The Proposal Cannot Substantiate Any Tangible Benefit

The Proposal's economic analysis does not substantiate *any* tangible benefit that would result from applying Regulation SCI to certain broker-dealers. Notably, the Commission admits that it "finds it impracticable to quantify many of the benefits associated with amended Regulation SCI."[36] Thus, the Commission exclusively relies on vague and unsubstantiated assertions around "reducing the likelihood, severity, and duration of market disruptions arising from systems issues" even though the Proposal is unable to provide *a single example* of a broker-dealer systems disruption that had a significant market-wide impact in the securities markets (nor demonstrate that any such market-wide disruption would have been prevented by capturing the specific 17 firms targeted by the Proposal). Such conclusory statements cannot support such an onerous and expansive Proposal.

The Commission is also incorrect to suggest that there is a "principal-agent conflict" that may lead broker-dealers to underinvest in operational resilience since customers and counterparties may not directly observe those investments.[37] In contrast, customers and counterparties *are* able to directly observe when broker-dealers have systems disruptions, and demonstrating operational resilience across all market conditions is typically an important component of an ongoing customer or counterparty relationship. The SEC has not adequately considered the strong commercial incentives that lead broker-dealers to voluntarily invest significant resources in the operational resiliency of client trading businesses in order to serve as a dependable and resilient counterparty. The operational resiliency that has been achieved as a result is clearly evident, as the Commission is unable to identify a meaningful market-wide disruption caused by any of the broker-dealers covered by this Proposal.

The lack of any tangible benefit associated with the Proposal is all the more striking considering the comprehensive regulatory framework to which broker-dealers are already subject, including rules issued by the Commission, FINRA, and trading venues. These include requirements to which current SCI entities are not subject, such as market access requirements that ensure broker-dealers "appropriately control the risks associated with market access so as not to jeopardize their own financial condition, that of other market participants, the integrity of trading on the securities markets, and the stability of the financial system" and that include an annual CEO

[35] *See* 88 FR 128 (January 3, 2023) (*Order Competition Rule*); 87 FR 80266 (December 29, 2022) (*Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders*); and 88 FR 5440 (January 27, 2023) (*Best Execution*).

[36] Proposal at 23236. We note the Proposal does not conduct any serious analysis of the effectiveness of Regulation SCI as currently implemented, taking into account recent exchange outages.

[37] Proposal at 23240.

certification attesting to the efficacy of the firm's systems and controls.[38] Other requirements include preparing an annual report that details the firm's system of supervisory controls,[39] business continuity planning,[40] and an annual review.[41] Many of these requirements significantly overlap with aspects of Regulation SCI, with the Commission even *admitting* that "some" of its new requirements "may be consistent" with existing requirements.[42] However, there is little effort to quantify or seriously analyze the extent of overlap. The Commission "cannot accurately assess" the impact of its Proposal without first understanding the requirements under *existing* law.[43]

[38] Commission Rule 15c3-5.

[39] FINRA Rule 3120.

[40] FINRA Rule 4370.

[41] FINRA Rule 4370.

[42] Proposal at 23256.

[43] *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 178 (D.C. Cir. 2010).

III. The Commission Lacks Legal Authority to Extend Regulation SCI to Broker-Dealers

It is axiomatic that an agency "'literally has no power to act' . . . unless and until Congress authorizes it to do so by statute."[44] Yet despite spanning 129 pages in the Federal Register, the Proposal devotes no analysis whatsoever to the essential preliminary question of whether the agency has statutory authority to extend Regulation SCI to broker-dealers in the proposed manner. Instead, as if its legal authority to adopt the proposed changes were an afterthought, the agency simply lists 11 sections of the Exchange Act as the legal basis for the Proposal without attempting to explain how any of the sections justify the changes outlined by the Proposal.[45] At a minimum, the agency must explain why it believes these provisions authorize the Proposal so that commenters can have the opportunity to address those rationales.

When the Commission originally adopted Regulation SCI in 2014, it identified four provisions as sources of legal authority for its action: Section 11A(a)(2), 6(b), 15A, and 17A(b)(3) of the Exchange Act.[46] None of those provisions support this Proposal. The first is not an independent source of authority, while the latter three are inapplicable to broker-dealers by their terms.

A. Section 11A(a)(2) Provides No Authority for the Extension of Regulation SCI to Broker-Dealers

When the Commission originally adopted Regulation SCI in 2014, it relied on Section 11A(a)(2) of the Exchange Act as its primary source of legal authority.[47] Section 11A(a)(2), which was adopted as part of the Securities Act Amendments of 1975, provides that "[t]he Commission is directed, therefore, having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets, to use its authority under this chapter to facilitate the establishment of a national market system for securities . . . in accordance with the findings and to carry out the objectives set forth in paragraph (1) of this subsection."[48]

The Commission explained that "[a]mong the findings and objectives in Section 11A(a)(1) of the Exchange Act is that '[n]ew data processing and communications techniques create the opportunity for more efficient and effective market operations' and '[i]t is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure . . . the economically efficient execution of securities transactions.'"[49] The Commission took the position that Section 11A(a)(2) authorized it to adopt Regulation SCI because its requirements would "further the goals of the national market system" by "ensur[ing] the capacity,

[44] *FEC v. Cruz*, 142 S. Ct. 1638, 1649 (2022) (citation omitted).

[45] Proposal at 23267–68 (listing sections 2, 3, 5, 6, 11A, 13, 15, 15A, 17, 17A, and 23(a) of the Exchange Act).

[46] 79 FR 72252, 72322 (Dec. 5, 2014) ("Regulation SCI").

[47] Regulation SCI at 72322.

[48] 15 U.S.C. § 78k-1(a)(2); *see* Pub. L. 94-29, 89 Stat. 97.

[49] Regulation SCI at 72322 (quoting 15 U.S.C. § 78k-1(a)(1)).

integrity, resiliency, availability, and security of the automated systems of entities important to the functioning of the U.S. securities markets."[50]

Boiled down, the Commission's position in 2014 – and apparently its unexplained view today – is that Section 11A(a)(2) is a capacious grant of authority to take whatever measures it believes "will further the goals of the national market system."[51] But that is not what the provision says or how it works. Section 11A(a)(2) is a directive to the Commission about how "to use its authority *under this chapter*" – i.e., how to employ the specific grants of statutory authority provided elsewhere in the Exchange Act (Chapter 2B of Title 15). Reading Section 11A(a)(2) as an all-encompassing *grant* of authority rather than a directive about the *use* of authority granted elsewhere fails to respect the words of the provision.

The Commission's reading also makes a hash of Congress's careful delineation of the specific powers that the Commission wields with respect to the national market system. For example, if Section 11A(a)(2) were a general grant of authority to take any actions that "further the goals of the national market system," why would Congress have included a separate provision in Section 11A stating that "[t]he Commission is authorized in furtherance of the directive in [(a)(2)]" to take specific actions such as "creat[ing] one or more advisory committees," and "conduct[ing] studies and mak[ing] recommendations to Congress"?[52] Congress could have simply promulgated Section 11A(a)(2) and dispensed with the rest of the Securities Act Amendments of 1975 altogether.[53] Courts are loathe "to adopt an interpretation of a congressional enactment which renders superfluous another portion of that same law"[54]—much less one that would make pointless everything but a single paragraph in a 74-page act.

The Commission argued in 2014 that Section 11A(a)(2) is a blanket authorization to pursue the "findings and objectives set forth in Section 11A(a)(1),"[55] but it is blackletter law that agency action cannot "rest merely on the 'policy objectives of the Act.'"[56] Statements of statutory purpose are "in reality as well as in name *not* part of the congressionally legislated or privately created set of rights and duties."[57] A "purpose in the preamble"—no matter how expansively worded—"cannot add to the specific dispositions of the operative text."[58] The text of Section 11A(a)(2) requires the Commission to rely on the authority it is specifically granted "in this

[50] Regulation SCI at 72322–23.

[51] Regulation SCI at 72322.

[52] 15 U.S.C. § 78k-1(a)(3).

[53] Pub. L. 94-29, 89 Stat. 97.

[54] *Maine Cmty. Health Options v. United States*, 140 S. Ct. 1308, 1323 (2020).

[55] Regulation at 72322.

[56] *Georgia v. President of the United States*, 46 F.4th 1283, 1298 (11th Cir. 2022); *accord Comcast Corp. v. FCC*, 600 F.3d 642, 654 (D.C. Cir. 2010).

[57] Antonin Scalia & Bryan A. Garner, *Reading Law: The Interpretation of Legal Texts* 217 (2012).

[58] *Id.* at 219.

chapter" to pursue Congress's stated findings and objectives, so the Commission must depend on those specific grants of authority rather than Section 11A(a)(2) when undertaking rulemakings.

The Commission, however, does not identify any specific grant of rulemaking authority that would authorize the proposed expansion of Regulation SCI to broker-dealers. In the grab-bag of provisions the Commission cites, some merely supply definitions or the authority to define trade terms,[59] which cannot support the Commission's substantive proposals. Others simply state congressional findings.[60] Some provisions concern stock exchanges,[61] which are not at issue in the proposed expansion to broker-dealers, or address only large-trader reporting,[62] an entirely different regulatory regime. And while some provisions discuss "operational capability"[63] and "reports,"[64] those provisions, read in context, concern specific issues. "Reports" concern matters the Commission regulates, such as financial solvency or customer complaints, not literally any matter the Commission is curious about. "Operational capability," which is closely linked to employees' "training" and "experience,"[65] likewise concerns a broker-dealer's ability to perform certain operations at all; it does not authorize the Commission to second guess and micromanage the broker-dealer's technological systems to "maintain the[ ] operational capability" in whatever way the Commission demands.[66] Finally, the Commission also cites a provision granting it general authority to issue regulations in the public interest.[67] But it is well established that "[a]n agency's general rulemaking authority does not mean that the specific rule the agency promulgates is a valid exercise of that authority."[68]

B. Sections 6(b), 15A, and 17A(b)(3) Are Inapplicable to Broker-Dealers by Their Terms

In addition to relying on Section 11A(a)(2), the Commission in adopting Regulation SCI in 2014 also relied on Sections 6(b), 15A, and 17A(b)(3) of the Exchange Act.[69] Section 6(b) prohibits a national securities exchange from being registered unless it "is so organized and has the capacity to be able to carry out the purposes of" the Exchange Act.[70] Section 15A applies the

[59] 15 U.S.C. § 78c(b).

[60] *Id.* § 78b.

[61] *Id.* § 78e.

[62] *Id.* § 78m(h).

[63] *Id.* § 78o(b)(7).

[64] *Id.* § 78q(a).

[65] *Id.* § 78o(b)(7).

[66] Proposal at 23188.

[67] 15 U.S.C. § 78w(a).

[68] *Colo. River Indian Tribes v. Nat'l Indian Gaming Comm'n*, 466 F.3d 134, 139 (D.C. Cir. 2006); *see, e.g.*, *MCI Telecomms. Corp. v. Am. Tel. & Tel. Co.*, 512 U.S. 218, 231 n.4 (1994) (agencies "are bound, not only by the ultimate purposes Congress has selected, but by the means it has deemed appropriate, and prescribed, for the pursuit of those purposes")

[69] Regulation SCI at 72322.

[70] 15 U.S.C. § 78f(b)(1).

same requirement to national securities associations.[71] And Section 17A(b)(3) does the same for clearing agencies.[72]

Those provisions speak directly to the organization and capacity of national securities exchanges, national securities associations, and clearing agencies. But they give the Commission no authority over the organization and capacity of broker-dealers. Indeed, the absence of a corresponding provision applicable to broker-dealers indicates that the Commission lacks the authority to manage the organization and capacity of broker-dealers in the same manner that it does for national securities exchanges, national securities associations, and clearing agencies. Courts must "assume that Congress 'acts intentionally and purposely' when it 'includes particular language in one section of a statute but omits it in another section of the same Act.'"[73]

The Commission offers no explanation of the basis of its statutory authority to adopt the Proposal, and the explanations it offered in 2014 are unavailing. The Commission must explain its statutory authority or withdraw the Proposal.

[71] 15 U.S.C. § 78o-3(a).

[72] 15 U.S.C. § 78q-1(b)(3).

[73] *Polselli v. Internal Revenue Serv.*, 143 S. Ct. 1231, 1237 (2023) (citation omitted).

IV. The Commission Must Adequately Consider Reasonable, Less Burdensome Alternatives

Given the lack of an identified market failure attributable to the targeted broker-dealers, we urge the Commission to withdraw this Proposal. Existing Commission and FINRA requirements establish a robust broker-dealer regulatory framework that has increased the operational resilience of U.S. securities markets. In addition, the Commission has recently proposed to establish minimum cybersecurity rules for *all* broker-dealers,[74] an approach that is far more appropriate than attempting to arbitrarily apply onerous rules designed for exchanges and ATSs to a small group of 17 broker-dealers.

To the extent the Commission determines to apply Regulation SCI to broker-dealers, the Commission must appropriately tailor the regime such that it can be applied to broker-dealer business models in a practical manner. We provide the following recommendations:

- **Covered firms and activities**. The Commission must identify specific *activities* that could lead to the type of market-wide concern Regulation SCI was intended to address, and then assess the universe of broker-dealers engaged *in such activities* so as to avoid subjecting similarly situated competitors to very different regulatory requirements. In doing so, the Commission should consider other broker-dealers performing far less replaceable functions in the securities markets.

- **Exclude Principal Trading**. The Commission should, at a minimum, exclude a broker-dealer's principal trading activities in the equities and options asset classes.

- **Limit the Scope of SCI Systems**. As noted above, when applied to a broker-dealer engaging in various different trading businesses within a given asset class, the vague and expansive definition of "SCI system" could result in *thousands* of internal systems being considered in-scope. The Commission should, at a minimum, limit the definition of "SCI systems" to core order-entry infrastructure (e.g. order placement systems and associated pre-trade controls).

- **Remove "Geographically Diverse" Backup Requirements**. The Commission should remove the requirement for broker-dealer backup and recovery capabilities to be "geographically diverse" for the reasons detailed in Section II above.

- **Streamline Required Notifications**. Immediate notification requirements should be limited to major incidents that require a broker-dealer to manually terminate trading within the entity. In turn, the Commission should clarify that quarterly notification of material system changes is limited to system changes that trigger an internal "material business change" process or similar. Any required notifications to customers should be permitted to be made via a firm website.

Finally, we note that an implementation period of at least 18 months would be necessary.

[74] *See* Proposal at FN 145.

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We thank the Commission for considering our comments.

Please feel free to call the undersigned with any questions regarding these comments.

Respectfully,

/s/ Stephen John Berger

Managing Director

Global Head of Government & Regulatory Policy