CITADEL | Securities

February 5, 2024

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)

Nearly a year ago, the Securities and Exchange Commission (the "Commission") issued a misguided proposal to expand Regulation Systems Compliance and Integrity ("Reg SCI") to an extremely small and arbitrary subset of broker-dealers (the "Proposal").[1] While we appreciate the dialogue we have had with the Commission and staff, we are left with more questions than answers regarding the purpose and scope of the Proposal. Thus, we remain extremely concerned that the Commission intends to proceed with this ill-conceived Proposal without – as required by law – addressing the serious flaws extensively detailed in the record.

The Commission has not provided a coherent justification for extending a regulatory regime specifically designed for exchanges to broker-dealers. Indeed, the Commission has not cited in the Proposal a *single example* of a broker-dealer systems disruption that had a significant market-wide impact, and we have been left to grapple with conflicting feedback from the Commission and staff regarding *why* the Proposal is necessary. Likewise, there has been inadequate explanation as to why the Proposal only targets 17 firms, thereby subjecting similarly situated competitors to vastly different regulatory requirements. As proposed, Reg SCI would likely capture *thousands* of internal systems per firm, leading to annual costs in the *hundreds of millions of dollars*, with no discernible benefit.

Make no mistake, we wholeheartedly support efforts to increase the resiliency of our capital markets and we have a longstanding track record of developing recommendations and promoting commonsense reforms.[2] In addition, we devote substantial resources to ensuring that we remain a reliable and dependable liquidity provider across all market conditions. Unfortunately, the Proposal threatens to undermine market resiliency by imposing costly and unworkable requirements on a small and arbitrary subset of broker-dealers.

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[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").

[2] *See, e.g.,* Market Lens: Exchange Best Practices for Reducing Operational Risk at Broker-Dealers (Sept. 2021), available at: https://www.citadelsecurities.com/wp-content/uploads/sites/2/2021/09/Citadel_Securities_Market-Lens_Sept_2021_Exchange-Best-Practices-for-Reducing-Operational-Risk.pdf; Enhancing Competition, Transparency and Resiliency in U.S. Financial Markets (May 2021), available at: https://s3.amazonaws.com/citadel-wordpress-prd102/wp-content/uploads/sites/2/2021/05/03130457/EnhancingCompetitionTransparencyandResiliencyinUSFinancialMarkets.pdf; RFI on the Evolution of U.S. Treasury Market Structure (April 2016), available at: https://www.citadel.com/wp-content/uploads/2016/09/26121850/Citadel-Response-to-the-Treasury-RFI-April-22-2016.pdf; Completing the Commission's Security-Based Swap Rules (Feb. 2016), available at: https://www.sec.gov/comments/s7-06-11/s70611-172.pdf.

As detailed below, in light of recent technological disruptions at various stock exchanges, the Commission has not established that Reg SCI has been successful in improving the resiliency of exchanges and other critical market infrastructure. Thus, the Commission should carefully consider whether Reg SCI actually achieves the cited regulatory objectives, and in no event should the Commission expand this regulatory regime specifically designed for exchanges to an entirely new set of entities.[3] At a minimum, the Commission cannot finalize this Proposal without re-issuing the rule for public comment given the prevailing lack of clarity regarding its purpose and scope, and the completely unworkable nature of the proposed regime. Below, we reiterate key concerns with the Proposal.

I. The Commission Does Not Have A Consistent Or Rational Basis For The Proposal

There remains a complete lack of clarity regarding what the Commission is attempting to address by applying Reg SCI to broker-dealers. Our dialogue with the Commission and staff to date has yielded conflicting feedback on this fundamental question. For example, with respect to the equities and options markets, the following alternative explanations have been provided:

- One purported rationale is that the Proposal is designed to capture the largest on-exchange market markers in order to enhance the resiliency of on-exchange liquidity provision.

  However, the Proposal does not capture the vast majority of on-exchange market makers (including some of the largest firms), given that many firms focus on this single, highly competitive market segment where it is extremely challenging to exceed the proposed 10% trading volume threshold. The Commission has not provided any data on either (a) the percentage of on-exchange market makers or (b) the percentage of on-exchange displayed quotations that would be captured by the Proposal, even though such data is readily accessible to the Commission.[4] In addition, market makers on anonymous order books in the equities and options markets are fully substitutable, with market participants able to seamlessly interact with all available quotes, further calling into question why the Commission is specifically targeting a limited number of firms with extremely onerous regulatory requirements instead of applying equivalent regulation to all on-exchange market makers in order to maintain a level playing field.

- Another purported rationale is that the Proposal is designed to capture NYSE DMMs, given their role in facilitating price discovery and maintaining fair and orderly markets during the opening and closing auctions in the equities market.

  However, once again, the Proposal does not capture all of the NYSE DMMs, subjecting similarly situated competitors to vastly different regulatory requirements. In addition, NYSE already has rules designed to provide "customers and the investing public with

[3] See our prior comment letter for why the Commission also lacks the statutory authority to do so. Citadel Securities Letter (June 13, 2023), available at: https://www.sec.gov/comments/s7-07-23/s70723-204179-410982.pdf.

[4] For example, the Commission could readily access and analyze exchange data on the number of on-exchange market makers and CAT data regarding market-wide quoting activity.

the certainty of an open in circumstances where business continuity disruptions or other emergencies would prevent the assigned DMMs from opening a security."[5] These rules have been successfully employed to open and close NYSE-listed stocks[6] and the Commission has failed to identify any market resiliency-related issue.

- Yet another purported rationale is that the Proposal is designed to capture wholesale broker-dealers in order to safeguard retail investor access to the equities and options markets.

  However, once again, the Proposal does not capture all of the wholesale broker-dealers, subjecting similarly situated competitors to vastly different regulatory requirements. In addition, retail broker-dealers are able to switch instantaneously to other wholesale broker-dealers in the event one firm experiences a disruption, and are also equipped to directly route retail investor orders to other market centers, including exchanges, thereby bypassing wholesale broker-dealers entirely. As a result, the Commission fails to explain why – if the objective is to ensure retail investor access to the equities and options markets – the Proposal solely targets the most substitutable leg of the workflow, and completely ignores other broker-dealers performing far less replaceable functions (such as order-entry and clearing).

None of these divergent – and unfounded – explanations justify targeting only 17 broker-dealers (and fewer than 10 in the equities and options markets) with costly and burdensome regulatory requirements based on arbitrary thresholds that reference total trading volumes or total assets. More fundamentally, none of these explanations are even discussed in the Proposal; indeed, the Commission makes no attempt to explain (i) the trading activities that purportedly create market-wide resiliency concerns that could justify extending Reg SCI to broker-dealers or (ii) how the proposed thresholds capture the appropriate set of firms in light of any such regulatory concerns. At a minimum, the Commission must provide clear answers to these questions and re-propose the rule in order to provide market participants with an opportunity to meaningfully comment.

The Proposal's focus on aggregate trading volumes – instead of specific trading activities that purportedly create market-wide resiliency concerns – is particularly nonsensical for equities and options, as the arbitrary threshold will only capture the most diversified broker-dealers that operate across multiple market segments (e.g. as an on-exchange market maker, a wholesale broker-dealer, etc.). In particular, a diversified broker-dealer may account for *less* trading volume in any given market segment than a firm that specializes in one line of business. For example, a diversified broker-dealer may account for 5% of aggregate equities trading volume in each of (i) on-exchange market making and (ii) retail wholesaling, while a firm that specializes in on-exchange market making may alone account for 9% of aggregate equities trading volume. Under the Proposal, in the example above, the diversified broker-dealer would be subject to Reg SCI while the on-

[5] *See* NYSE Rule 7.35C; Exch. Act Rel. No. 34-76290 (Oct. 28, 2015) at 9, available at: https://www.sec.gov/files/rules/sro/nyse/2015/34-76290.pdf.

[6] *See, e.g.,* NYSE Trading Floor Closure FAQ, available at: https://www.nyse.com/publicdocs/nyse/NYSE_Floor_Closure_FAQ_20200320.pdf.

exchange market maker would not, even though a systems disruption affecting on-exchange market making would impact far more trading volume at the on-exchange market maker compared to the diversified broker-dealer. The Commission has failed to set forth a rational basis for this outcome, which clearly demonstrates that the proposed aggregate trading volume threshold is an unlawful and arbitrary approach to determining which broker-dealers are subject to Reg SCI.[7]

The end result of this arbitrary approach is to subject similarly situated competitors to vastly different regulatory requirements, creating material negative consequences for market liquidity, efficiency, and competition that the Commission has failed to consider.

II. The Proposal's Economic Analysis Is Woefully Deficient

In our prior comment letter,[8] we explained how the Proposal's economic analysis failed to consider the enormous costs that result from applying Reg SCI to broker-dealers. In stark contrast to current SCI entities – which are able to establish a clear perimeter regarding the scope of impacted systems – broker-dealers manage an expansive network of technological systems that support a range of different businesses, even in a given asset class. The Commission made no attempt to identify specific broker-dealer businesses or systems that merit focus, meaning that, under the Proposal, each broker-dealer would likely have *thousands* of internal systems that would be considered in-scope for Reg SCI (even if only subject to Reg SCI in a particular asset class, such as equities). Each such system would be subject to myriad regulatory requirements, such as business continuity, quarterly reporting of material system changes, additional reporting requirements to the Commission and customers, recordkeeping requirements, an annual SCI review, and Commission examinations.[9] We estimated that the business continuity requirements alone would cost *hundreds of millions of dollars per firm per year*.

In addition, in light of the Commission's approval of a CAT funding model that will allocate at least 77% – and up to 100% – of total CAT costs to market participants,[10] the Commission must assess whether this Proposal will increase the overall CAT budget, thereby increasing the total costs borne by market participants as a result of this Proposal. In particular, CAT LLC has stated that the Proposal "would likely double the cost of the CAT,"[11] meaning that *hundreds of millions of dollars in additional costs per year* would be passed-on to all broker-dealers – not just the 17 directly impacted by the Proposal. None of these costs are considered in the Proposal.

The Proposal's economic analysis also fails to substantiate any tangible benefit of applying Reg SCI to broker-dealers. While baselessly asserting that targeting only 17 broker-dealers (and

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[7] This is true across asset classes covered by the Proposal. For example, the Proposal does not appear to have covered the recent cyber incident in the Treasury market (https://www.bloomberg.com/news/articles/2023-11-10/treasury-settlement-delays-continue-in-wake-of-icbc-cyberattack?sref=BNAbdgOy).

[8] *Supra* note 3.

[9] *See* Proposal at 23156.

[10] This takes into account FINRA passing-on its portion to market participants and the potential for exchanges to do the same. CAT Funding Approval Order at 62684.

[11] Letter from CAT LLC (June 21, 2023), available at: https://www.sec.gov/comments/s7-07-23/s70723-208299-421042.pdf.

fewer than 10 in the equities and options markets) will improve market resiliency, the Commission has not provided in the Proposal a *single example* of a broker-dealer systems disruption that had a significant market-wide impact. Furthermore, even if the Commission could find such an example, it is unable to demonstrate that Reg SCI would have prevented such disruption from occurring. In this regard, we note the exchanges continue to suffer from significant technological disruptions despite being subject to Reg SCI for nearly a decade. In only the past twelve months, (a) a NYSE "glitch" led to "widespread trading halts, confusion over whether orders were being filled at correct prices, and trades in more than 250 securities being busted,"[12] (b) the Options Price Reporting Authority's post-trade data feed went down multiple times,[13] and (c) a NASDAQ "system error" impacted "thousands of stock orders, leading some to be canceled and incorrect clearing information to be submitted."[14] In contrast, the high degree of broker-dealer competition and substitutability, and the lack of a single point of failure, allowed market makers to make countless adjustments to their systems – including increasing and decreasing liquidity provision at their discretion – while retail broker-dealers regularly adjusted routing logic (including entirely routing away from certain wholesalers at particular times), all without any market-wide issues or concerns. Given the recent history with current SCI entities, we urge the Commission to focus on ensuring Reg SCI is accomplishing its stated regulatory objectives instead of expanding the regime to an entirely new set of entities.[15]

III. The APA Requires A Re-Proposal

To the extent the Commission materially revises the Proposal, such as by modifying (a) the thresholds for determining in-scope broker-dealers, (b) the types of systems covered by Reg SCI for in-scope broker-dealers (whether under the total assets or trading volume thresholds), or (c) the requirements applicable to in-scope broker-dealers (e.g. creating an "SCI-lite" regime), the rule must be re-proposed. Such a fundamental pivot requires a new period of notice and comment to allow all affected entities the opportunity to assess the costs associated with the scope of systems subject to Reg SCI and the specific SCI requirements selected by the Commission to apply to those in-scope broker-dealer systems.

Neither a stray question included in the Proposal nor initial suggestions from market participants regarding potential revisions to the Proposal provide "fair notice"[16] regarding a final rule that significantly deviates from what was initially proposed. For example, in our prior comment letter, we provided initial ideas regarding how the existing SCI regime designed for

[12] *John Mccrank et. al*, "NYSE Glitch Leads to Busted Trades, Prompts Investigation," Reuters (Jan. 24, 2023) available at: https://www.reuters.com/markets/us/some-nyse-listed-stocks-briefly-halted-trading-after-market-open-2023-01-24/.

[13] *Bernard Goyder*, "Opra outages cause consternation in options markets," Risk (Nov. 3, 2023) available at: https://www.risk.net/derivatives/7958170/opra-outages-causes-consternation-in-options-markets.

[14] *Katherine Doherty*, "Nasdaq Reverses Some Stock Orders After Glitch Hits Trades," Bloomberg (Dec. 13, 2023), available at: https://www.bloomberg.com/news/articles/2023-12-14/nasdaq-hit-by-error-affecting-thousands-of-trades-nixing-some

[15] As noted above, the Commission does not have statutory authority to extend Regulation SCI to broker-dealers in the proposed manner anyway. *See supra* note 3.

[16] *Tex. Ass'n of Mfrs. v. CPSC*, 989 F.3d 368, 381 (5th Cir. 2021).

exchanges could potentially be more tailored to reflect broker-dealer business models, such as by (i) excluding principal trading activities, (ii) limiting the scope of SCI systems, and (iii) removing "geographically diverse" backup requirements.[17] Importantly, these initial suggestions were not intended to be a "menu" of options from which the Commission could pick and choose; rather, they all must be addressed (e.g. it is not clear how to more reasonably limit the scope of SCI systems if principal trading activities remain in-scope). In addition, even if the Commission incorporates all of these initial suggestions, it does not remove the need to closely assess *how* the Commission has done so and to determine the costs associated with the revised SCI regime. This is clearly an instance where the Proposal was "so unworkable" that it "need[s] to be replaced,"[18] given that, as proposed, Reg SCI would likely capture *thousands* of internal systems per firm, leading to annual costs in the *hundreds of millions of dollars*, and would subject similarly situated competitors to vastly different regulatory requirements. To the extent the Commission materially revises the Proposal, it must conduct a new analysis that is exposed to public comment. In particular, continuing to apply different regulatory requirements to similarly situated competitors (even if those requirements are pared-back compared to the Proposal) could significantly impact market competition, liquidity, and efficiency.

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We thank the Commission for considering our comments.

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

Respectfully,

/s/ Stephen John Berger

Managing Director

Global Head of Government & Regulatory Policy

[17] *See supra* note 3 at 18.

[18] When "comments indicate" that a proposed requirement is "so unworkable" that it "need[s] to be replaced" with a different requirement, "the proper process [is] to start the notice-and-comment process again." *Mock v. Garland*, 75 F.4th 563, 583, 586 (5th Cir. 2023).