

SECURITIES AND EXCHANGE COMMISSION

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Unless otherwise noted, each of the following individual Members of the Commission voted affirmatively upon each action of the Commission shown in the file:

MARY JO WHITE, CHAIR

LUIS A. AGUILAR, COMMISSIONER

DANIEL M. GALLAGHER, COMMISSIONER

KARA M. STEIN, COMMISSIONER

MICHAEL S. PIWOWAR, COMMISSIONER

(80 Documents)

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73496 / November 3, 2014

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3594 / November 3, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16231

In the Matter of

**BIO-RAD LABORATORIES,
INC.,**

Respondent.

**ORDER INSTITUTING CEASE-AND-
DESIST PROCEEDINGS PURSUANT TO
SECTION 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, MAKING
FINDINGS, AND IMPOSING A
CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Bio-Rad Laboratories, Inc. ("Bio-Rad" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent admits the Commission's jurisdiction over the Respondent and the subject matter of these proceedings, and consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Summary

1. These proceedings arise from violations of the Foreign Corrupt Practices Act of 1977 (the "FCPA") [15 U.S.C. § 78dd] by Bio-Rad Laboratories, Inc. ("Bio-Rad") concerning medical diagnostic and life science equipment sales to government customers in Russia, Vietnam, and Thailand.

2. From approximately 2005 to 2010, subsidiaries of Bio-Rad made unlawful payments in Vietnam and Thailand to obtain or retain business. During the same period, Bio-Rad's subsidiary paid certain Russian third parties, disregarding the high probability that at least some of the money would be used to make unlawful payments to government officials in Russia. With respect to Russia, one of Bio-Rad's foreign subsidiaries paid three off-shore agents (the "Russian Agents") for alleged services in connection with sales of its medical diagnostic and life science equipment to government agencies. These agents were not legitimate businesses, and despite receiving large commissions, they did not provide the contracted-for services. In paying these agents, Bio-Rad's foreign subsidiary demonstrated a conscious disregard for the high probability that the Russian Agents were using at least a portion of the commissions to pay foreign officials to obtain profitable government contracts. The General Manager ("GM") of Bio-Rad's Emerging Markets sub-division and the Emerging Markets Controller, both employees of the parent company (collectively, "the Emerging Markets managers") ignored red flags, which permitted the scheme to continue for years. In Vietnam and Thailand, Bio-Rad's foreign subsidiaries used agents and distributors to funnel money to government officials. In total, Bio-Rad made \$35.1 million in illicit profits from these improper payments.

3. In violation of Bio-Rad's policies, Bio-Rad's foreign subsidiaries did not record the payments in their own books in a manner that would accurately or fairly reflect the transactions. Instead they booked them as commissions, advertising, and training fees. These subsidiaries' books were consolidated into the parent company's books and records. During the relevant period, Bio-Rad also failed to devise and maintain adequate internal accounting controls.

Respondent

4. **Bio-Rad Laboratories, Inc.** ("Bio-Rad") is a corporation organized under the laws of the state of Delaware. Bio-Rad's corporate headquarters is Hercules, California. Bio-Rad issues and maintains a class of publicly traded securities registered pursuant to Section 12(b) of the Securities Exchange Act of 1934, which are traded on the New York Stock Exchange.

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

Other Relevant Entities and Persons

5. **Bio-Rad SNC** is an indirect wholly-owned subsidiary of Bio-Rad headquartered in Marnes-La-Coquette, France. Bio-Rad SNC manufactures, sells, and distributes Bio-Rad products. During the relevant time period, Bio-Rad SNC manufactured the products sold to the Russian government, contracted with the off-shore agents in Russia, and paid their sales commissions. Bio-Rad SNC's books, records, and financial accounts are consolidated into Bio-Rad's books and records and reported by Bio-Rad in its financial statements.

6. **Bio-Rad Laboratorii OOO** ("Bio-Rad Russia") is a wholly-owned subsidiary of Bio-Rad located in Moscow, Russia. Bio-Rad Russia's books, records, and financial accounts are consolidated into Bio-Rad's books and records and reported by Bio-Rad in its financial statements.

7. **Agents A, B, and C** (collectively, the "Russian Agents") were incorporated in the United Kingdom, Belize, and Panama, respectively. They contracted with Bio-Rad SNC to assist Bio-Rad Russia in the sale of Bio-Rad products to the Russian government.

8. **Bio-Rad Laboratories** (Singapore) Pte. Limited ("Bio-Rad Singapore") is Bio-Rad's wholly-owned subsidiary, located in Singapore. Bio-Rad Singapore's books, records, and financial accounts are consolidated into Bio-Rad's books and records and reported by Bio-Rad in its financial statements.

9. **Diamed South East Asia Ltd.** ("Diamed Thailand") was a 49%-owned subsidiary of Diamed AG (Switzerland) that was acquired by Bio-Rad in October 2007. Local majority owners ran Diamed Thailand's operations until 2011, when Bio-Rad bought out their interest in the company. Diamed Thailand's financial statements are consolidated into those of Bio-Rad.

Background

10. Bio-Rad is a life science research and clinical diagnostics company that operates in two industry segments, Life Science and Clinical Diagnostics, in the United States and internationally. Bio-Rad's Clinical Diagnostics segment, which designs, manufactures and sells diagnostic testing kits and systems to clinical laboratories and hospitals, accounts for the majority of Bio-Rad's net sales, and almost the entirety of the unlawful payments at issue in this Order.

11. Bio-Rad's international sales organization ("ISO") oversees the company's international sales operations; this includes all locations outside the United States and Canada. In 2009, the ISO consisted of four sub-divisions: (1) Western Europe; (2) Asia Pacific; (3) Japan; and (4) Emerging Markets. Each sub-division had a general manager, reporting to the vice-president of ISO. The Asia Pacific sub-division included Vietnam and Thailand. The Emerging Markets sub-division included Russia and other eastern European countries. Some countries within the sub-divisions had a country manager who reported to the ISO sub-division general manager.

12. Bio-Rad's total consolidated net income for the year ended December 31, 2013 was \$77.8 million, with gross revenues of \$2.1 billion.

Unlawful Payments in Russia

13. From 2005 to the beginning of 2010, a substantial portion of Bio-Rad Russia's business consisted of sales of clinical diagnostic products to the Russian government. Those sales arose from government contracts awarded to Bio-Rad Russia through a public tender offer process that required approval from various government officials. Bio-Rad Russia's largest contracts with the Russian government were national contracts awarded by the Russian Ministry of Health for the sale of HIV testing equipment and blood bank equipment. The clinical diagnostic products sold to the Russian government were manufactured by Bio-Rad SNC, which in many instances also sold them directly to the Russian government due to certain complexities with Russian regulations and tax laws. Those sales were recorded on Bio-Rad SNC's financial records. Other sales made by Bio-Rad Russia were recorded in the first instance on Bio-Rad Russia's financial books.

14. During the relevant time period, Bio-Rad Russia had a country manager, who reported to the GM of Emerging Markets. From 2005 to 2006, the Emerging Markets GM, along with the Emerging Markets' Controller, worked out of Bio-Rad SNC's offices. After that, they worked out of Bio-Rad's corporate offices in the United States.

The Unlawful Payments Scheme

15. From at least 2005 to the beginning of 2010, Bio-Rad SNC paid the Russian Agents commissions of 15%-30% while demonstrating a conscious disregard for the high probability that the Russian Agents were passing along at least a portion of their commissions to Russian government officials to obtain profitable public contracts for the sale of medical diagnostic equipment. The scheme began prior to 2005, orchestrated by the then country manager, who used the Russian Agents, primarily for their influence in connection with the tenders for the government contracts. The Russian Agents were foreign entities with bank accounts in Latvia and Lithuania, all affiliated with the same individual. The Russian Agents entered into agreements to provide various services to Bio-Rad Russia including acquiring new business, creating and disseminating promotional materials to prospective customers, distributing and installing products and related equipment, and training customers. The Russian Agents, however, had no offices in Russia, no employees, and therefore, likely no capability to perform the services outlined in their contracts. One of the Russian Agents even used a phony office address in Moscow that was actually the office address for a Russian government building.

16. After the country manager died in or about 2007, his successor continued to make payments to the Russian Agents. He knew from discussions with colleagues in the Russian health care industry that the Russian Agents' principal had important contacts at the Russian Ministry of Health, and could influence the tender offer specifications and selection process. He performed no additional due diligence on the Russian Agents prior to signing subsequent agreements with them. Some documents suggest that the Russian Agents may have performed distribution services in connection with a few of the contracts. The new country manager estimated in an email to the Emerging Markets GM that Bio-Rad's distribution costs ranged

between 2%-2.5% in one instance. However, Bio-Rad SNC paid the Agents commissions of 15%-30%.

17. Both Russian country managers made extensive efforts to conceal matters relating to the Russian Agents. For example, no one other than the Russian country managers communicated with the Russian Agents and the country managers maintained no records of the Russian Agents. The new country manager used at least ten different personal email addresses with aliases when communicating about the Russian Agents with the Emerging Markets managers. He also used code words like "bad debts" when referring to the Russian Agents' commissions. The Russian country managers knew or disregarded the high probability that the Russian Agents were using at least a portion of the sales commission payments to bribe Russian government officials in exchange for awarding the company profitable government contracts.

18. The Russian Agents received a total of \$4.6 million on sales of \$38.6 million. These unlawful payments were made by Bio-Rad SNC and recorded as commission payments on its books. These payments continued unabated until the beginning of 2010 when Bio-Rad Russia terminated the services of the Russian Agents. Immediately after that, Bio-Rad Russia lost its first government contract in Russia.

The Red Flags

19. Throughout the relevant time period, the Emerging Markets managers, who were employees of Bio-Rad, ignored repeated red flags regarding the high probability that the Russian Agents were making improper payments to government officials to win public tender offers for government contracts on behalf of Bio-Rad Russia. Specifically, they knew that the Russian Agents were foreign companies and that the Agents did not have the resources to perform the contracted-for services. They also knew that their commissions were excessive and were paid to banks in Latvia and Lithuania. Additionally, they condoned the secrecy surrounding the Russian Agents, and even encouraged it. For example, the Emerging Markets Controller sent an email to a lower-level Bio-Rad SNC employee instructing her to "talk with codes" when communicating about the Russian Agents' invoices.

20. Furthermore, the Emerging Markets managers knew that the Russian country manager often requested approval for the Russian Agents' commissions in installments of less than \$200,000. These managers should have recognized that this was an attempt to bypass an additional approval tier by Bio-Rad's corporate controller, as required by Bio-Rad's internal controls. Additionally, the Russian country manager sometimes requested payments to the Russian Agents even before Bio-Rad Russia had collected on the underlying sales contracts. The Emerging Markets managers should have known that pre-paying the commission was not normal, and it suggested the possibility of a bribe payment. The practice also violated the express terms of the Russian Agents' contracts.

21. The Emerging Markets managers also knew that many of the contracted-for services were not necessary to Bio-Rad Russia's business with the Russian government. Many of the clinical diagnostic products required limited installation or training; additionally, Bio-Rad Russia used a separate distributor for several of the same government contracts during the relevant time period, thereby obviating the need for an additional distributor. Finally, the

Emerging Markets managers knew that some of the Russian Agents' invoices were generated internally at Bio-Rad Russia.

22. Despite the red flags, which surfaced repeatedly over five years, the Emerging Markets managers approved all of the payments to the Russian Agents. They also reviewed, negotiated, and approved the Russian Agents' contracts.

Other Internal Controls Deficiencies

23. In many instances where the corporate controller's approval was needed for payments of over \$200,000 to the Russian Agents, the Emerging Markets controller merely sent an email request for the payment to be approved, without supplying the underlying contracts and invoices. Nevertheless, the corporate controller approved payments to the Russian Agents, relying solely on the Emerging Markets controller's prior review of the supporting documents.

24. The Emerging Markets GM instructed Bio-Rad Russia's country manager to sign the consulting agreements with the Russian Agents on behalf of Bio-Rad SNC. He did this in direct violation of the internal policies and procedures that required Bio-Rad SNC's GM to sign such agreements or, alternatively, to grant a power of attorney to the Bio-Rad senior manager to sign them.

25. The same Emerging Markets GM failed to provide Bio-Rad SNC's legal and finance departments with translated copies of the agreements with the Russian Agents in violation of Bio-Rad's internal policies and procedures. Nevertheless, for five years Bio-Rad's finance department approved the Russian Agents' sales commission payments.

26. From 2005 to the beginning of 2010, the Emerging Markets managers signed and submitted sub-certifications to Bio-Rad's chief financial officer attesting that Bio-Rad Russia's balance sheets and income statements were fairly presented in conformity with U.S. GAAP. The sub-certifications also stated that these managers were responsible for establishing and maintaining Bio-Rad Russia's internal controls, which the documents described as "adequate" and "functioning as needed."

Facts in Vietnam

27. From at least 2005 to the end of 2009, Bio-Rad maintained a sales representative office in Vietnam. A country manager supervised the Vietnam Office's sales activities, and was authorized to approve contracts up to \$100,000 and sales commissions up to \$20,000. Vietnam's country manager reported to Bio-Rad Singapore's Southeast Asia regional sales manager ("RSM"), who in turn reported to the Asia Pacific GM.

28. From 2005 through 2009, the country manager of the Vietnam office authorized the payment of bribes to government officials to obtain their business. At the direction of the country manager, the sales representatives made cash payments to officials at government-owned hospitals and laboratories in exchange for their agreement to buy Bio-Rad's products.

29. In 2006, the RSM first learned of this practice from a finance employee. She raised concerns about it to the Vietnam Office's country manager, who informed her that paying

bribes was a customary practice in Vietnam. On or about May 18, 2006, the Vietnamese country manager wrote in an email to the RSM and the Bio-Rad Singapore finance employee that paying third party fees “[w]as outlawed in the Bio-Rad Business Ethics Policy,” but that Bio-Rad would lose 80% of its Vietnam sales without continuing the practice. In that same email, the country manager proposed a solution that entailed employing a middleman to pay the bribes to Vietnamese government officials as a means of insulating Bio-Rad from liability. Under the proposed scheme, Bio-Rad Singapore would sell Bio-Rad products to a Vietnamese distributor at a deep discount, which the distributor would then resell to government customers at full price, and pass through a portion of it as bribes.

30. The RSM and the Asia Pacific GM were aware of and allowed the payments to continue. Between 2005 and the end of 2009, the Vietnam office made improper payments of \$2.2 million to agents or distributors, which was funneled to Vietnamese government officials. These bribes, recorded as “commissions,” “advertising fees,” and “training fees,” generated gross sales revenues of \$23.7 million to Bio-Rad Singapore. The payment scheme did not involve the use of interstate commerce, and no United States national was involved in the misconduct.

Facts in Thailand

31. Bio-Rad acquired a 49% interest in Diamed Thailand as part of its acquisition of Diamed AG (Switzerland) in October 2007. Bio-Rad performed very little due diligence on Diamed Thailand prior to the acquisition.

32. Diamed Thailand’s local majority owners managed the subsidiary. Bio-Rad’s Asia Pacific GM was responsible for working and communicating with Diamed Thailand’s majority owners and distributors.

33. Prior to the October 2007 acquisition, Diamed Thailand had an established bribery scheme, whereby Diamed Thailand used a Thai agent to sell diagnostic products to government customers. The agent received an inflated 13% commission, of which it retained 4%, and paid 9% to Thai government officials in exchange for profitable business contracts.

34. The scheme continued even after Bio-Rad acquired Diamed Thailand. Diamed Thailand renewed the contract with the distributor in June 2008, but unbeknownst to Bio-Rad, the distributor was partially owned by one of Diamed Thailand’s local Thai owners.

35. Bio-Rad’s Asia Pacific GM learned of Diamed Thailand’s bribery scheme while attending a distributor’s conference in Bangkok in March 2008. At the conference, Diamed Thailand’s local manager informed him that some of Diamed Thailand’s customers received payments, which the Asia Pacific GM understood to mean kickbacks. The Asia Pacific GM instructed Bio-Rad Singapore’s controller to investigate the matter. The controller confirmed to the Asia Pacific GM that Diamed Thailand was bribing government officials through the distributor. Despite these findings, the Asia Pacific GM did not instruct Diamed Thailand to stop making the improper payments to the distributor.

36. From 2007 to early 2010, Diamed Thailand improperly paid a total of \$708,608 to the distributor, generating gross sales revenues of \$5.5 million to Diamed Thailand. These

payments were recorded as sales commissions. The payment scheme did not involve the use of interstate commerce, and no United States national was involved in the misconduct.

Legal Standards and Violations

A. Under Section 21C(a) of the Exchange Act, the Commission may impose a cease-and-desist order upon any person who is violating, has violated, or is about to violate any provision of the Exchange Act or any rule or regulation thereunder, and upon any other person that is, was, or would be a cause of the violation, due to an act of omission the person knew or should have known would contribute to such violation.

FCPA Violations

B. Under Section 30A(a) of the Exchange Act it is unlawful for any issuer, officer, director, employee, or agent of such issuer or any stockholder thereof acting on behalf of the issuer, to make use of the mails or any means or instrumentality of interstate commerce corruptly in furtherance of an offer, payment, promise to pay, or authorization of the payment of any money, or offer, gift, promise to give, or authorization of the giving of anything of value to any foreign official or any person, while knowing that all or a portion of such money or thing of value will be offered, given, or promised, directly or indirectly, to any foreign official for the purposes of (i) influencing any act or decision of such foreign official in his official capacity, (ii) inducing such foreign official to do or omit to do any act in violation of the lawful duty of such official, or (iii) securing any improper advantage in order to assist such issuer in obtaining or retaining business for or with, or directing business to, any person. [15 U.S.C. § 78dd-1].

C. Additionally, under Section 30A(f)(2), a "knowing" state of mind as to a circumstance may be established "if a person is aware of a high probability of the existence of such circumstance, unless the person actually believes that such circumstance does not exist."

D. As described above, Bio-Rad violated Section 30A of the Exchange Act because Bio-Rad's Emerging Markets managers demonstrated a conscious disregard for the high probability that the Russian Agents were using at least a portion of Bio-Rad Russia's sales commission payments to bribe Russian government officials in exchange for awarding the company profitable government contracts. These managers knew the Russian Agents operated as mere shell entities. They also knew that, among other things, the commissions were large, and that the Russian Agents did not have the resources to perform any of the contracted-for services set forth in their agreements. Nevertheless, the managers approved all of their agreements, and authorized \$4.6 million in payments to the Russian Agents' off-shore accounts even though many of the payment requests and invoices raised substantial questions as to their legitimacy. Finally, the same Emerging Markets managers communicated about the Russian Agents under cover of secrecy, which further calls in question their legitimacy. These red flags surfaced repeatedly over a five year period.

E. Under Section 13(b)(2)(A) of the Exchange Act issuers are required to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and disposition of the assets of the issuer. [15 U.S.C. § 78m(b)(2)(A)].

F. As described above, Bio-Rad violated Section 13(b)(2)(A) of the Exchange Act. Its subsidiaries falsely recorded the payments to the agents/distributors as payments for legitimate services or commissions, when the true purpose of these payments was to make corrupt payments to government officials to obtain business. The false entries were then consolidated and reported by Bio-Rad in its consolidated financial statements.

G. Under Section 13(b)(2)(B) of the Exchange Act issuers are required to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that (i) transactions are executed in accordance with management's general or specific authorization; (ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets; (iii) access to assets is permitted only in accordance with management's general or specific authorization; and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences. [15 U.S.C. § 78m(b)(2)(B)].

H. Bio-Rad violated Section 13(b)(2)(B) because although it had an ethics policy prohibiting the payment of bribes and various policies and procedures requiring accurate books and records, its systems of internal controls proved insufficient to provide reasonable assurances that such payments would be detected and prevented.

Bio-Rad's Self-Disclosure, Cooperation, and Remedial Efforts

I. Bio-Rad made an initial voluntary self-disclosure of potential FCPA violations to the Commission staff and the Department of Justice in May 2010, and immediately thereafter Bio-Rad's audit committee retained independent counsel to conduct an investigation of the alleged violations. The audit committee conducted a thorough internal investigation, and subsequently expanded it voluntarily to cover a large number of additional potentially high-risk countries. The investigation included over 100 in-person interviews, the collection of millions of documents, the production of tens of thousands of documents, and forensic auditing. Bio-Rad's cooperation was extensive, including voluntarily producing documents from overseas, summarizing its findings, translating numerous key documents, producing witnesses from foreign jurisdictions, providing timely reports on witness interviews, and making employees available to the Commission staff to interview.

J. Bio-Rad also undertook significant and extensive remedial actions including: terminating problematic practices; terminating Bio-Rad employees who were involved in the misconduct; comprehensively re-evaluating and supplementing its anti-corruption policies and procedures on a world-wide basis, including its relationship with intermediaries; enhancing its internal controls and compliance functions; developing and implementing FCPA compliance procedures, including the further development and implementation of policies and procedures such as the due diligence and contracting procedure for intermediaries and policies concerning hospitality, entertainment, travel, and other business courtesies; and conducting extensive anti-corruption training throughout the organization world-wide.

Criminal Disposition

K. Bio-Rad has agreed, with the United States Department of Justice, Criminal Division, Fraud Section, to enter into a Non-Prosecution Agreement to resolve potential criminal liability for conduct relating to certain of the findings in the Order.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Bio-Rad's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent Bio-Rad cease and desist from committing or causing any violations and any future violations of Sections 30A, 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act;

B. Respondent shall pay, within 10 days of the entry of this Order, disgorgement of \$35,100,000 and prejudgment interest of \$5,600,000 to the Securities and Exchange Commission. If timely payment of disgorgement is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Bio-Rad Laboratories, Inc. as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Alka N. Patel, Assistant Regional Director, Division of Enforcement, Securities and Exchange Commission, 5670 Wilshire Boulevard, Eleventh Floor, Los Angeles, CA 90036.

C. Respondent shall report to the Commission staff periodically, at no less than twelve-month intervals during a two-year term, the status of its remediation and implementation of compliance measures. Should Respondent discover credible evidence, not already reported to

the Commission staff, that questionable or corrupt payments or questionable or corrupt transfers of property or interests may have been offered, promised, paid, or authorized by Respondent entity or person, or any entity or person while working directly for Respondent, or that related false books and records have been maintained, Respondent shall promptly report such conduct to the Commission staff. During this two-year period, Respondent shall: (1) conduct an initial review and submit an initial report, and (2) conduct and prepare at least one (1) follow-up review and report, as described below:

- (1) Respondent shall submit to the Commission staff a written report within one (1) year of the entry of this Order setting forth a complete description of its Foreign Corrupt Practices Act ("FCPA") and anti-corruption related remediation efforts to date, its proposals reasonably designed to improve the policies and procedures of Respondent for ensuring compliance with the FCPA and other applicable anti-corruption laws, and the parameters of the subsequent reviews (the "Initial Report"). The Initial Report shall be transmitted to Alka N. Patel, Assistant Director, Division of Enforcement, United States Securities and Exchange Commission, 5670 Wilshire Blvd., 11th floor, Los Angeles, CA 90036. Respondent may extend the time period for issuance of the Initial Report with prior written approval of the Commission staff.
- (2) Respondent shall undertake at least one (1) follow-up review, incorporating any comments provided by the Commission staff on the previous report, to further monitor and assess whether the policies and procedures of Respondent are reasonably designed to detect and prevent violations of the FCPA and other applicable anti-corruption laws (the "Follow-up Report").
- (3) The Follow-up Report shall be completed by no later than one (1) year after the Initial Report. Respondent may extend the time period for issuance of the Follow-up Report with prior written approval of the Commission staff.
- (4) Respondent's reporting obligations pursuant to the Order, and its concurrent reporting obligations pursuant to the resolutions of certain of its subsidiaries with the U.S. Department of Justice, shall each be satisfied by the simultaneous submission of the same reports to both the Commission staff and the Department of Justice.
- (5) The periodic reviews and reports submitted by Respondent will likely include proprietary, financial, confidential, and competitive business information. Public disclosure of the reports could discourage cooperation, impede pending or potential government investigations or undermine the objectives of the reporting requirement. For these reasons, among others, the reports and the contents thereof are intended to remain and shall remain non-public, except (1) pursuant to court order, (2) as agreed by the parties in writing, (3) to the extent that the Commission staff

determines in its sole discretion that disclosure would be in furtherance of the Commission's discharge of its duties and responsibilities, or (4) is otherwise required by law.

By the Commission.

Brent J. Fields
Secretary

Kevin M. O'Neill
By: Kevin M. O'Neill
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73503 / November 3, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16237

In the Matter of

Stifel Nicolaus & Co., Inc.,

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, PURSUANT TO
SECTIONS 15(b), 15B(c)(2) AND 21C OF
THE SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS AND
A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Stifel Nicolaus & Co., Inc. ("Stifel" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

Summary

These proceedings involve the sale of non-investment grade or "junk" bonds issued by the Commonwealth of Puerto Rico ("Puerto Rico") by Stifel, a registered broker-dealer and municipal securities dealer, to a customer in an amount below the minimum denomination of the issue. Rule G-15(f) promulgated by the Municipal Securities Rulemaking Board ("MSRB") prohibits dealers from effecting customer transactions in municipal securities in amounts below the minimum denominations of the issues. Minimum denominations are generally intended to limit sales of municipal securities to retail customers for whom such bonds may not be suitable, but the proscriptions of Rule G-15(f) apply to all transactions with customers, regardless of whether the securities are suitable for the customer. In March 2014, Stifel violated MSRB Rule G-15(f) by executing one sales transaction in the Puerto Rico bonds with a customer in an amount below the \$100,000 minimum denomination of the issue.

Respondent

1. Stifel is a Missouri corporation that maintains principal offices in St. Louis, Missouri. It is a registered broker-dealer pursuant to Section 15(b) of the Exchange Act. It is also a municipal securities dealer and a municipal securities broker as defined in Sections 3(a)(30) and 3(a)(31) of the Exchange Act.

MSRB Rule G-15(f): Minimum Denomination Requirements for Bond Sales to Customers

2. Section 15B(b) of the Exchange Act established the MSRB and empowered it to propose and adopt rules for transactions in municipal securities by brokers, dealers, and municipal securities dealers. Section 15B(c)(1) of the Exchange Act prohibits a broker, dealer, or municipal securities dealer from using the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the MSRB. As a municipal securities dealer, Respondent is subject to Section 15B(c)(1) of the Exchange Act and MSRB rules.

3. MSRB Rule G-15(f)(i) prohibits a broker, dealer, or municipal securities dealer from effecting a customer transaction in municipal securities issued after June 1, 2002 in an amount lower than the minimum denomination of the issue except pursuant to two limited exceptions. First, under MSRB Rule G-15(f)(ii), a dealer may purchase municipal securities from a customer in an amount below the minimum denomination of the issue if the dealer determines that the customer's position in the issue is already below the minimum denomination and the customer's entire position in the issue would be liquidated by the transaction. Second, under MSRB Rule G-15(f)(iii), a dealer may sell municipal securities to a customer in an amount below the minimum denomination of the issue if the dealer determines that the position being sold resulted from the liquidation of another customer's entire position in the issue which was below the minimum denomination of the issue. Additionally, a dealer selling under MSRB Rule G-15(f)(iii) must, at or before the completion of the transaction, notify the customer that the amount of the transaction is

below the minimum denomination of the issue and that this may adversely affect the liquidity of the customer's position.

4. Under MSRB Rule G-15(f), brokers, dealers, and municipal securities dealers may not sell municipal securities in amounts below the minimum denomination of an issue to a customer regardless of whether the customer holds or would hold a position in the issue which is equal to or exceeds the minimum denomination of the issue. The rule also prohibits brokers, dealers, and municipal securities dealers from purchasing municipal securities in amounts below the minimum denomination of an issue from a customer whose position in the securities equals or exceeds the minimum denomination of the issue unless the customer's position is being liquidated in its entirety.

5. The purpose of MSRB Rule G-15(f) is to ensure municipal securities dealers observe the minimum denominations stated in the official documents of municipal securities issues.² Official documents for municipal securities issues may state a "minimum denomination" larger than the normal \$5,000 par due to issuers' concerns that the securities may not be appropriate for those retail investors who would be likely to purchase securities in relatively small amounts.³

The Puerto Rico General Obligation Bonds of 2014

6. On March 11, 2014, Puerto Rico issued \$3.5 billion in General Obligation Bonds of 2014, Series A (CUSIP 74514LE86) (the "2014 Bonds").

7. The 2014 Bonds are non-investment grade securities and are considered "junk" bonds. In March 2014, the 2014 Bonds had a credit rating of "Ba2" by Moody's Investors Service, "BB+" by Standard & Poor's Rating Services, and "BB" by Fitch Ratings.

8. Non-investment grade bonds present substantial risks to retail investors. Risks of investing in non-investment grade bonds include liquidity risk (*i.e.*, risk that an investor will not be able to sell a bond quickly and at an efficient price), credit risk (*i.e.*, risk of loss due to an actual or perceived deterioration in the financial health of the issuer) and interest rate risk (*i.e.*, risk that rising interest rates may cause bond prices to decline). In addition, the market for non-investment grade bonds is constricted by the fact that many municipal bond mutual funds are prohibited by their prospectuses from purchasing non-investment grade bonds.

9. The Official Statement of the Commonwealth of Puerto Rico (the "Official Statement") disseminated in connection with the issue of the 2014 Bonds specifies in pertinent part that the 2014 Bonds "are issuable as registered bonds without coupons in denominations of \$100,000 and any multiple of \$5,000 in excess thereof." During the relevant period, MSRB Rule G-15(f) permitted dealers to effect customer transactions in the 2014 Bonds in amounts equal to the

² Order Granting Approval of Proposed Rule Change Relating to Minimum Denominations, Exchange Act Release No. 45338, 67 Fed. Reg. 6960 (Feb. 14, 2002); Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 (Dec. 28, 2001).

³ Id.

\$100,000 minimum denomination of the issue or amounts greater than \$100,000 in increments of \$5,000. Dealers could therefore have effected customer transactions for \$105,000, \$110,000, and so forth. Dealers were prohibited from effecting transactions with customers in the 2014 Bonds in amounts below \$100,000, regardless of a customer's aggregate position in the 2014 Bonds.⁴

Sale in 2014 Bonds to a Customer
Below the \$100,000 Minimum Denomination of the Issue

10. In March 2014, Respondent received an unsolicited customer order to purchase \$130,000 of the 2014 Bonds. In order to fill the order, Respondent purchased \$130,000 of the 2014 Bonds on a riskless principal basis. After it purchased these bonds, Respondent's customer directed Respondent to allocate \$100,000 of the bonds to his account and \$30,000 to another customer's account. In response, Respondent executed two separate sales transactions with each customer, one for \$30,000 and another for \$100,000. The \$30,000 sales transaction in the 2014 Bonds was below the \$100,000 minimum denomination of the issue established by the issuer, Puerto Rico, and specified in the Official Statement. The limited exceptions provided under MSRB Rule G-15(f) for customer transactions in municipal securities below the minimum denomination of an issue did not apply to this transaction.

Violations

11. As a result of the conduct described above, Respondent willfully⁵ violated MSRB Rule G-15(f).

12. As a result of Respondent's willful violations of MSRB Rule G-15(f), Respondent willfully violated Section 15B(c)(1) of the Exchange Act.

Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent. After it became aware that it had effected a customer transaction in the 2014 Bonds below the minimum denomination of the issue, Respondent cancelled the transaction.

Undertakings

Respondent will undertake to review the adequacy of its existing policies and procedures relating to compliance with MSRB Rule G-15(f). After that review, Respondent will make such

⁴ For example, a dealer could not have effected a customer transaction for \$100,000, followed by a separate below-minimum-denomination transaction for \$5,000, for a total of \$105,000. The second transaction would have violated MSRB Rule G-15(f). See Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 at n.12 (Dec. 28, 2001).

⁵ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." Id. (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).

changes as are necessary to effect compliance with MSRB Rule G-15(f), including adopting new policies and procedures or supplementing existing policies and procedures. Respondent will implement these policies and procedures, and conduct training as to the policies and procedures and compliance with MSRB Rule G-15(f). Respondent will inform Commission staff no later than six (6) months after the entry of this Order that it has complied with the above undertakings and shall provide the Commission staff with a copy of its existing policies and procedures as to MSRB Rule G-15(f) at that time.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 15(b), 15B(c)(2) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent cease and desist from committing or causing any violations and any future violations of Section 15B(c)(1) of the Exchange Act and MSRB Rule G-15(f).

B. Respondent is censured.

C. Respondent shall, within seven (7) days of the entry of this Order, pay a civil money penalty in the amount of \$60,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Stifel as a Respondent in these proceedings, and the file number of these proceedings; a copy of the

cover letter and check or money order must be sent to LeeAnn G. Gaunt, Chief, Municipal Securities and Public Pensions Unit, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110.

By the Commission.

Brent J. Fields
Secretary


By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73498 / November 3, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16232

In the Matter of

Charles Schwab & Co., Inc.,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, PURSUANT TO
SECTIONS 15(b), 15B(c)(2) AND 21C OF
THE SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS AND
A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Charles Schwab & Co., Inc. ("Schwab" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Summary

These proceedings involve the sale of non-investment grade or "junk" bonds issued by the Commonwealth of Puerto Rico ("Puerto Rico") by Schwab, a registered broker-dealer and municipal securities dealer, to customers in amounts below the minimum denomination of the issue. Rule G-15(f) promulgated by the Municipal Securities Rulemaking Board ("MSRB") prohibits dealers from effecting customer transactions in municipal securities in amounts below the minimum denominations of the issues. Minimum denominations are generally intended to limit sales of municipal securities to retail customers for whom such bonds may not be suitable, but the proscriptions of Rule G-15(f) apply to all transactions with customers, regardless of whether the securities are suitable for the customer. In March 2014, Schwab violated MSRB Rule G-15(f) by executing four sales transactions in the Puerto Rico bonds with customers in amounts below the \$100,000 minimum denomination of the issue.

Respondent

1. Schwab is a California corporation that maintains principal offices in San Francisco, California. It is a registered broker-dealer pursuant to Section 15(b) of the Exchange Act. It is also a municipal securities dealer and a municipal securities broker as defined in Sections 3(a)(30) and 3(a)(31) of the Exchange Act.

MSRB Rule G-15(f): Minimum Denomination Requirements for Bond Sales to Customers

2. Section 15B(b) of the Exchange Act established the MSRB and empowered it to propose and adopt rules for transactions in municipal securities by brokers, dealers, and municipal securities dealers. Section 15B(c)(1) of the Exchange Act prohibits a broker, dealer, or municipal securities dealer from using the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the MSRB. As a municipal securities dealer, Respondent is subject to Section 15B(c)(1) of the Exchange Act and MSRB rules.

3. MSRB Rule G-15(f)(i) prohibits a broker, dealer, or municipal securities dealer from effecting a customer transaction in municipal securities issued after June 1, 2002 in an amount lower than the minimum denomination of the issue except pursuant to two limited exceptions. First, under MSRB Rule G-15(f)(ii), a dealer may purchase municipal securities from a customer in an amount below the minimum denomination of the issue if the dealer determines that the customer's position in the issue is already below the minimum denomination and the customer's

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

entire position in the issue would be liquidated by the transaction. Second, under MSRB Rule G-15(f)(iii), a dealer may sell municipal securities to a customer in an amount below the minimum denomination of the issue if the dealer determines that the position being sold resulted from the liquidation of another customer's entire position in the issue which was below the minimum denomination of the issue. Additionally, a dealer selling under MSRB Rule G-15(f)(iii) must, at or before the completion of the transaction, notify the customer that the amount of the transaction is below the minimum denomination of the issue and that this may adversely affect the liquidity of the customer's position.

4. Under MSRB Rule G-15(f), brokers, dealers, and municipal securities dealers may not sell municipal securities in amounts below the minimum denomination of an issue to a customer regardless of whether the customer holds or would hold a position in the issue which is equal to or exceeds the minimum denomination of the issue. The rule also prohibits brokers, dealers, and municipal securities dealers from purchasing municipal securities in amounts below the minimum denomination of an issue from a customer whose position in the securities equals or exceeds the minimum denomination of the issue unless the customer's position is being liquidated in its entirety.

5. The purpose of MSRB Rule G-15(f) is to ensure municipal securities dealers observe the minimum denominations stated in the official documents of municipal securities issues.² Official documents for municipal securities issues may state a "minimum denomination" larger than the normal \$5,000 par due to issuers' concerns that the securities may not be appropriate for those retail investors who would be likely to purchase securities in relatively small amounts.³

The Puerto Rico General Obligation Bonds of 2014

6. On March 11, 2014, Puerto Rico issued \$3.5 billion in General Obligation Bonds of 2014, Series A (CUSIP 74514LE86) (the "2014 Bonds").

7. The 2014 Bonds are non-investment grade securities and are considered "junk" bonds. In March 2014, the 2014 Bonds had a credit rating of "Ba2" by Moody's Investors Service, "BB+" by Standard & Poor's Rating Services, and "BB" by Fitch Ratings.

8. Non-investment grade bonds present substantial risks to retail investors. Risks of investing in non-investment grade bonds include liquidity risk (*i.e.*, risk that an investor will not be able to sell a bond quickly and at an efficient price), credit risk (*i.e.*, risk of loss due to an actual or perceived deterioration in the financial health of the issuer) and interest rate risk (*i.e.*, risk that rising interest rates may cause bond prices to decline). In addition, the market for non-investment

² Order Granting Approval of Proposed Rule Change Relating to Minimum Denominations, Exchange Act Release No. 45338, 67 Fed. Reg. 6960 (Feb. 14, 2002); Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 (Dec. 28, 2001).

³ Id.

grade bonds is constricted by the fact that many municipal bond mutual funds are prohibited by their prospectuses from purchasing non-investment grade bonds.

9. The Official Statement of the Commonwealth of Puerto Rico (the "Official Statement") disseminated in connection with the issue of the 2014 Bonds specifies in pertinent part that the 2014 Bonds "are issuable as registered bonds without coupons in denominations of \$100,000 and any multiple of \$5,000 in excess thereof." During the relevant period, MSRB Rule G-15(f) permitted dealers to effect customer transactions in the 2014 Bonds in amounts equal to the \$100,000 minimum denomination of the issue or amounts greater than \$100,000 in increments of \$5,000. Dealers could therefore have effected customer transactions for \$105,000, \$110,000, and so forth. Dealers were prohibited from effecting transactions with customers in the 2014 Bonds in amounts below \$100,000, regardless of a customer's aggregate position in the 2014 Bonds.⁴

**Sales in 2014 Bonds to Customers
Below the \$100,000 Minimum Denomination of the Issue**

10. In March 2014, Respondent executed four unsolicited sales transactions in the 2014 Bonds with customers in amounts below the \$100,000 minimum denomination of the issue established by the issuer, Puerto Rico, and specified in the Official Statement. The limited exceptions provided under MSRB Rule G-15(f) for customer transactions in municipal securities below the minimum denomination of an issue did not apply to these transactions.

11. Respondent did not have any policies or procedures concerning MSRB Rule G-15(f).

Violations

12. As a result of the conduct described above, Respondent willfully⁵ violated MSRB Rule G-15(f).

13. As a result of Respondent's willful violations of MSRB Rule G-15(f), Respondent willfully violated Section 15B(c)(1) of the Exchange Act.

Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent. After it was made aware by Commission staff that it had effected customer transactions in the 2014 Bonds below the minimum denomination of the issue,

⁴ For example, a dealer could not have effected a customer transaction for \$100,000, followed by a separate below-minimum-denomination transaction for \$5,000, for a total of \$105,000. The second transaction would have violated MSRB Rule G-15(f). See Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 at n.12 (Dec. 28, 2001).

⁵ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." Id. (quoting Gearhart & Otis, Inc. v. SEC, 348 F. 2d 798, 803 (D.C. Cir. 1965)).

Respondent cancelled the transactions. Respondent has also amended its policies and procedures to ensure compliance with MSRB Rule G-15(f).

Undertakings

Respondent will undertake to review the adequacy of its existing policies and procedures relating to compliance with MSRB Rule G-15(f). After that review, Respondent will make such changes as are necessary to effect compliance with MSRB Rule G-15(f), including adopting new policies and procedures or supplementing existing policies and procedures. Respondent will implement these policies and procedures, and conduct training as to the policies and procedures and compliance with MSRB Rule G-15(f). Respondent will inform Commission staff no later than six (6) months after the entry of this Order that it has complied with the above undertakings and shall provide the Commission staff with a copy of its existing policies and procedures as to MSRB Rule G-15(f) at that time.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 15(b), 15B(c)(2) and 21C of the Exchange Act, it is hereby ORDERED that:

- A. Respondent cease and desist from committing or causing any violations and any future violations of Section 15B(c)(1) of the Exchange Act and MSRB Rule G-15(f).
- B. Respondent is censured.
- C. Respondent shall, within seven (7) days of the entry of this Order, pay a civil money penalty in the amount of \$61,800 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341

6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Schwab as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to LeeAnn G. Gaunt, Chief, Municipal Securities and Public Pensions Unit, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110.

By the Commission.

Brent J. Fields
Secretary


By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73499 / November 3, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16233

In the Matter of

Hapoalim Securities USA, Inc.,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, PURSUANT TO
SECTIONS 15(b), 15B(c)(2) AND 21C OF
THE SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS AND
A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Hapoalim Securities USA, Inc. ("Hapoalim" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Summary

These proceedings involve the sale of non-investment grade or "junk" bonds issued by the Commonwealth of Puerto Rico ("Puerto Rico") by Hapoalim, a registered broker-dealer and municipal securities dealer, to customers in amounts below the minimum denomination of the issue. Rule G-15(f) promulgated by the Municipal Securities Rulemaking Board ("MSRB") prohibits dealers from effecting customer transactions in municipal securities in amounts below the minimum denominations of the issues. Minimum denominations are generally intended to limit sales of municipal securities to retail investors for whom such bonds may not be suitable, but the proscriptions of Rule G-15(f) apply to all transactions with customers, regardless of whether the securities are suitable for the customer. In March 2014, Hapoalim violated MSRB Rule G-15(f) by executing one sales transaction in the Puerto Rico bonds with a customer in an amount below the \$100,000 minimum denomination of the issue.

Respondent

1. Hapoalim is a Delaware corporation that maintains principal offices in New York, New York. It is a registered broker-dealer pursuant to Section 15(b) of the Exchange Act. It is also a municipal securities dealer and a municipal securities broker as defined in Sections 3(a)(30) and 3(a)(31) of the Exchange Act.

MSRB Rule G-15(f):

Minimum Denomination Requirements for Bond Sales to Customers

2. Section 15B(b) of the Exchange Act established the MSRB and empowered it to propose and adopt rules for transactions in municipal securities by brokers, dealers, and municipal securities dealers. Section 15B(c)(1) of the Exchange Act prohibits a broker, dealer, or municipal securities dealer from using the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the MSRB. As a municipal securities dealer, Respondent is subject to Section 15B(c)(1) of the Exchange Act and MSRB rules.

3. MSRB Rule G-15(f)(i) prohibits a broker, dealer, or municipal securities dealer from effecting a customer transaction in municipal securities issued after June 1, 2002 in an amount lower than the minimum denomination of the issue except pursuant to two limited exceptions. First, under MSRB Rule G-15(f)(ii), a dealer may purchase municipal securities from a customer in an amount below the minimum denomination of the issue if the dealer determines that the customer's position in the issue is already below the minimum denomination and the customer's

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

entire position in the issue would be liquidated by the transaction. Second, under MSRB Rule G-15(f)(iii), a dealer may sell municipal securities to a customer in an amount below the minimum denomination of the issue if the dealer determines that the position being sold resulted from the liquidation of another customer's entire position in the issue which was below the minimum denomination of the issue. Additionally, a dealer selling under MSRB Rule G-15(f)(iii) must, at or before the completion of the transaction, notify the customer that the amount of the transaction is below the minimum denomination of the issue and that this may adversely affect the liquidity of the customer's position.

4. Under MSRB Rule G-15(f), brokers, dealers, and municipal securities dealers may not sell municipal securities in amounts below the minimum denomination of an issue to a customer regardless of whether the customer holds or would hold a position in the issue which is equal to or exceeds the minimum denomination of the issue. The rule also prohibits brokers, dealers, and municipal securities dealers from purchasing municipal securities in amounts below the minimum denomination of an issue from a customer whose position in the securities equals or exceeds the minimum denomination of the issue unless the customer's position is being liquidated in its entirety.

5. The purpose of MSRB Rule G-15(f) is to ensure municipal securities dealers observe the minimum denominations stated in the official documents of municipal securities issues.² Official documents for municipal securities issues may state a "minimum denomination" larger than the normal \$5,000 par due to issuers' concerns that the securities may not be appropriate for those retail investors who would be likely to purchase securities in relatively small amounts.³

The Puerto Rico General Obligation Bonds of 2014

6. On March 11, 2014, Puerto Rico issued \$3.5 billion in General Obligation Bonds of 2014, Series A (CUSIP 74514LE86) (the "2014 Bonds").

7. The 2014 Bonds are non-investment grade securities and are considered "junk" bonds. In March 2014, the 2014 Bonds had a credit rating of "Ba2" by Moody's Investors Service, "BB+" by Standard & Poor's Rating Services, and "BB" by Fitch Ratings.

8. Non-investment grade bonds present substantial risks to retail investors. Risks of investing in non-investment grade bonds include liquidity risk (*i.e.*, risk that an investor will not be able to sell a bond quickly and at an efficient price), credit risk (*i.e.*, risk of loss due to an actual or perceived deterioration in the financial health of the issuer) and interest rate risk (*i.e.*, risk that rising interest rates may cause bond prices to decline). In addition, the market for non-investment

² Order Granting Approval of Proposed Rule Change Relating to Minimum Denominations, Exchange Act Release No. 45338, 67 Fed. Reg. 6960 (Feb. 14, 2002); Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 (Dec. 28, 2001).

³ Id.

grade bonds is constricted by the fact that many municipal bond mutual funds are prohibited by their prospectuses from purchasing non-investment grade bonds.

9. The Official Statement of the Commonwealth of Puerto Rico (the "Official Statement") disseminated in connection with the issue of the 2014 Bonds specifies in pertinent part that the 2014 Bonds "are issuable as registered bonds without coupons in denominations of \$100,000 and any multiple of \$5,000 in excess thereof." During the relevant period, MSRB Rule G-15(f) permitted dealers to effect customer transactions in the 2014 Bonds in amounts equal to the \$100,000 minimum denomination of the issue or amounts greater than \$100,000 in increments of \$5,000. Dealers could therefore have effected customer transactions for \$105,000, \$110,000, and so forth. Dealers were prohibited from effecting transactions with customers in the 2014 Bonds in amounts below \$100,000, regardless of a customer's aggregate position in the 2014 Bonds.⁴

**Sale in 2014 Bonds to a Customer
Below the \$100,000 Minimum Denomination of the Issue**

10. In March 2014, Respondent executed one unsolicited sales transaction in the 2014 Bonds with a customer in an amount below the \$100,000 minimum denomination of the issue established by the issuer, Puerto Rico, and specified in the Official Statement. The limited exceptions provided under MSRB Rule G-15(f) for customer transactions in municipal securities below the minimum denomination of an issue did not apply to this transaction. Respondent informed the customer of the risks of trading in the 2014 bonds before executing the trade.

Violations

11. As a result of the conduct described above, Respondent willfully⁵ violated MSRB Rule G-15(f).

12. As a result of Respondent's willful violations of MSRB Rule G-15(f), Respondent willfully violated Section 15B(c)(1) of the Exchange Act.

Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent. After it was made aware by Commission staff that it had effected a customer transaction in the 2014 Bonds below the minimum denomination of the issue, Respondent cancelled the transaction.

⁴ For example, a dealer could not have effected a customer transaction for \$100,000, followed by a separate below-minimum-denomination transaction for \$5,000, for a total of \$105,000. The second transaction would have violated MSRB Rule G-15(f). See Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 at n.12 (Dec. 28, 2001).

⁵ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." Id. (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).

Undertakings

Respondent will undertake to review the adequacy of its existing policies and procedures relating to compliance with MSRB Rule G-15(f). After that review, Respondent will make such changes as are necessary to effect compliance with MSRB Rule G-15(f), including adopting new policies and procedures or supplementing existing policies and procedures. Respondent will implement these policies and procedures, and conduct training as to the policies and procedures and compliance with MSRB Rule G-15(f). Respondent will inform Commission staff no later than six (6) months after the entry of this Order that it has complied with the above undertakings and shall provide the Commission staff with a copy of its existing policies and procedures as to MSRB Rule G-15(f) at that time.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 15(b), 15B(c)(2) and 21C of the Exchange Act, it is hereby ORDERED that:

- A. Respondent cease and desist from committing or causing any violations and any future violations of Section 15B(c)(1) of the Exchange Act and MSRB Rule G-15(f).
- B. Respondent is censured.
- C. Respondent shall, within seven (7) days of the entry of this Order, pay a civil money penalty in the amount of \$54,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. Payment must be made in one of the following ways:
 - (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
 - (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
 - (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341

6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Hapoalim as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to LeeAnn G. Gaunt, Chief, Municipal Securities and Public Pensions Unit, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110.

By the Commission.

Brent J. Fields
Secretary


By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73500 / November 3, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16234

In the Matter of

Interactive Brokers LLC,

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, PURSUANT TO
SECTIONS 15(b), 15B(c)(2) AND 21C OF
THE SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS AND
A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Interactive Brokers LLC ("Interactive" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Summary

These proceedings involve the sale of non-investment grade or "junk" bonds issued by the Commonwealth of Puerto Rico ("Puerto Rico") by Interactive, a registered broker-dealer and municipal securities dealer, to customers in amounts below the minimum denomination of the issue. Rule G-15(f) promulgated by the Municipal Securities Rulemaking Board ("MSRB") prohibits dealers from effecting customer transactions in municipal securities in amounts below the minimum denominations of the issues. Minimum denominations are generally intended to limit sales of municipal securities to retail investors for whom such bonds may not be suitable, but the proscriptions of Rule G-15(f) apply to all transactions, regardless of whether the securities are suitable for the customer. In March 2014, Interactive violated MSRB Rule G-15(f) by executing one sales transaction in the Puerto Rico bonds with a customer in an amount below the \$100,000 minimum denomination of the issue.

Respondent

1. Interactive is a Connecticut limited liability corporation that maintains principal offices in Greenwich, Connecticut. It is a registered broker-dealer pursuant to Section 15(b) of the Exchange Act. It is also a municipal securities dealer and a municipal securities broker as defined in Sections 3(a)(30) and 3(a)(31) of the Exchange Act.

MSRB Rule G-15(f):

Minimum Denomination Requirements for Bond Sales to Customers

2. Section 15B(b) of the Exchange Act established the MSRB and empowered it to propose and adopt rules for transactions in municipal securities by brokers, dealers, and municipal securities dealers. Section 15B(c)(1) of the Exchange Act prohibits a broker, dealer, or municipal securities dealer from using the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the MSRB. As a municipal securities dealer, Respondent is subject to Section 15B(c)(1) of the Exchange Act and MSRB rules.

3. MSRB Rule G-15(f)(i) prohibits a broker, dealer, or municipal securities dealer from effecting a customer transaction in municipal securities issued after June 1, 2002 in an amount lower than the minimum denomination of the issue except pursuant to two limited exceptions. First, under MSRB Rule G-15(f)(ii), a dealer may purchase municipal securities from a customer in an amount below the minimum denomination of the issue if the dealer determines that the customer's position in the issue is already below the minimum denomination and the customer's

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

entire position in the issue would be liquidated by the transaction. Second, under MSRB Rule G-15(f)(iii), a dealer may sell municipal securities to a customer in an amount below the minimum denomination of the issue if the dealer determines that the position being sold resulted from the liquidation of another customer's entire position in the issue which was below the minimum denomination of the issue. Additionally, a dealer selling under MSRB Rule G-15(f)(iii) must, at or before the completion of the transaction, notify the customer that the amount of the transaction is below the minimum denomination of the issue and that this may adversely affect the liquidity of the customer's position.

4. Under MSRB Rule G-15(f), brokers, dealers, and municipal securities dealers may not sell municipal securities in amounts below the minimum denomination of an issue to a customer regardless of whether the customer holds or would hold a position in the issue which is equal to or exceeds the minimum denomination of the issue. The rule also prohibits brokers, dealers, and municipal securities dealers from purchasing municipal securities in amounts below the minimum denomination of an issue from a customer whose position in the securities equals or exceeds the minimum denomination of the issue unless the customer's position is being liquidated in its entirety.

5. The purpose of MSRB Rule G-15(f) is to ensure municipal securities dealers observe the minimum denominations stated in the official documents of municipal securities issues.² Official documents for municipal securities issues may state a "minimum denomination" larger than the normal \$5,000 par due to issuers' concerns that the securities may not be appropriate for those retail investors who would be likely to purchase securities in relatively small amounts.³

The Puerto Rico General Obligation Bonds of 2014

6. On March 11, 2014, Puerto Rico issued \$3.5 billion in General Obligation Bonds of 2014, Series A (CUSIP 74514LE86) (the "2014 Bonds").

7. The 2014 Bonds are non-investment grade securities and are considered "junk" bonds. In March 2014, the 2014 Bonds had a credit rating of "Ba2" by Moody's Investors Service, "BB+" by Standard & Poor's Rating Services, and "BB" by Fitch Ratings.

8. Non-investment grade bonds present substantial risks to retail investors. Risks of investing in non-investment grade bonds include liquidity risk (*i.e.*, risk that an investor will not be able to sell a bond quickly and at an efficient price), credit risk (*i.e.*, risk of loss due to an actual or perceived deterioration in the financial health of the issuer) and interest rate risk (*i.e.*, risk that rising interest rates may cause bond prices to decline). In addition, the market for non-investment

² Order Granting Approval of Proposed Rule Change Relating to Minimum Denominations, Exchange Act Release No. 45338, 67 Fed. Reg. 6960 (Feb. 14, 2002); Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 (Dec. 28, 2001).

³ Id.

grade bonds is constricted by the fact that many municipal bond mutual funds are prohibited by their prospectuses from purchasing non-investment grade bonds.

9. The Official Statement of the Commonwealth of Puerto Rico (the "Official Statement") disseminated in connection with the issue of the 2014 Bonds specifies in pertinent part that the 2014 Bonds "are issuable as registered bonds without coupons in denominations of \$100,000 and any multiple of \$5,000 in excess thereof." During the relevant period, MSRB Rule G-15(f) permitted dealers to effect customer transactions in the 2014 Bonds in amounts equal to the \$100,000 minimum denomination of the issue or amounts greater than \$100,000 in increments of \$5,000. Dealers could therefore have effected customer transactions for \$105,000, \$110,000, and so forth. Dealers were prohibited from effecting transactions with customers in the 2014 Bonds in amounts below \$100,000, regardless of a customer's aggregate position in the 2014 Bonds.⁴

**Sale in 2014 Bonds to a Customer
Below the \$100,000 Minimum Denomination of the Issue**

10. In March 2014, Respondent executed one unsolicited sales transaction in the 2014 Bonds with a customer in an amount below the \$100,000 minimum denomination of the issue established by the issuer, Puerto Rico, and specified in the Official Statement. The sales order was placed and effected through Respondent's online trading platform. The limited exceptions provided under MSRB Rule G-15(f) for customer transactions in municipal securities below the minimum denomination of an issue did not apply to this transaction.

Violations

11. As a result of the conduct described above, Respondent willfully⁵ violated MSRB Rule G-15(f).

12. As a result of Respondent's willful violations of MSRB Rule G-15(f), Respondent willfully violated Section 15B(c)(1) of the Exchange Act.

Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent. After it was made aware by Commission staff that it had effected a customer transaction in the 2014 Bonds below the minimum denomination of the issue, Respondent cancelled the transaction. In cancelling the transaction, Respondent incurred costs of

⁴ For example, a dealer could not have effected a customer transaction for \$100,000, followed by a separate below-minimum-denomination transaction for \$5,000, for a total of \$105,000. The second transaction would have violated MSRB Rule G-15(f). See Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 at n.12 (Dec. 28, 2001).

⁵ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." Id. (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).

\$4,000. Respondent also amended its policies and procedures to ensure compliance with MSRB Rule G-15(f).

Undertakings

Respondent will undertake to review the adequacy of its existing policies and procedures relating to compliance with MSRB Rule G-15(f). After that review, Respondent will make such changes as are necessary to effect compliance with MSRB Rule G-15(f), including adopting new policies or supplementing existing policies. Respondent will implement these policies and procedures, and conduct training as to the policies and procedures and compliance with MSRB Rule G-15(f). Respondent will inform Commission staff no later than six (6) months after the entry of this Order that it has complied with the above undertakings and shall provide the Commission staff with a copy of its existing policies and procedures as to MSRB Rule G-15(f) at that time.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 15(b), 15B(c)(2) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent cease and desist from committing or causing any violations and any future violations of Section 15B(c)(1) of the Exchange Act and MSRB Rule G-15(f).

B. Respondent is censured.

C. Respondent shall, within seven (7) days of the entry of this Order, pay a civil money penalty in the amount of \$56,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341

6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Interactive as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to LeeAnn G. Gaunt, Chief, Municipal Securities and Public Pensions Unit, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110.

By the Commission.

Brent J. Fields
Secretary


By **Jill M. Peterson**
Assistant Secretary

*Chair White
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73502 / November 3, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16236

In the Matter of

J.P. Morgan Securities LLC,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, PURSUANT TO
SECTIONS 15(b), 15B(c)(2) AND 21C OF
THE SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS AND
A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against J.P. Morgan Securities LLC ("J.P. Morgan" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Summary

These proceedings involve the sale of non-investment grade or "junk" bonds issued by the Commonwealth of Puerto Rico ("Puerto Rico") by J.P. Morgan, a registered broker-dealer and municipal securities dealer, to a customer in an amount below the minimum denomination of the issue. Rule G-15(f) promulgated by the Municipal Securities Rulemaking Board ("MSRB") prohibits dealers from effecting customer transactions in municipal securities in amounts below the minimum denominations of the issues. Minimum denominations are generally intended to limit sales of municipal securities to retail investors for whom such bonds may not be suitable, but the proscriptions of Rule G-15(f) apply to all transactions with customers, regardless of whether the securities are suitable for the customer. In March 2014, J.P. Morgan violated MSRB Rule G-15(f) by executing one sales transaction in the Puerto Rico bonds with a customer in an amount below the \$100,000 minimum denomination of the issue.

Respondent

1. J.P. Morgan is a Delaware limited liability company that maintains principal offices in New York, New York. It is a registered broker-dealer pursuant to Section 15(b) of the Exchange Act. It is also a municipal securities dealer and a municipal securities broker as defined in Sections 3(a)(30) and 3(a)(31) of the Exchange Act.

MSRB Rule G-15(f):

Minimum Denomination Requirements for Bond Sales to Customers

2. Section 15B(b) of the Exchange Act established the MSRB and empowered it to propose and adopt rules for transactions in municipal securities by brokers, dealers, and municipal securities dealers. Section 15B(c)(1) of the Exchange Act prohibits a broker, dealer, or municipal securities dealer from using the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the MSRB. As a municipal securities dealer, Respondent is subject to Section 15B(c)(1) of the Exchange Act and MSRB rules.

3. MSRB Rule G-15(f)(i) prohibits a broker, dealer, or municipal securities dealer from effecting a customer transaction in municipal securities issued after June 1, 2002 in an amount lower than the minimum denomination of the issue except pursuant to two limited exceptions. First, under MSRB Rule G-15(f)(ii), a dealer may purchase municipal securities from a customer in an amount below the minimum denomination of the issue if the dealer determines that the customer's position in the issue is already below the minimum denomination and the customer's

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

entire position in the issue would be liquidated by the transaction. Second, under MSRB Rule G-15(f)(iii), a dealer may sell municipal securities to a customer in an amount below the minimum denomination of the issue if the dealer determines that the position being sold resulted from the liquidation of another customer's entire position in the issue which was below the minimum denomination of the issue. Additionally, a dealer selling under MSRB Rule G-15(f)(iii) must, at or before the completion of the transaction, notify the customer that the amount of the transaction is below the minimum denomination of the issue and that this may adversely affect the liquidity of the customer's position.

4. Under MSRB Rule G-15(f), brokers, dealers, and municipal securities dealers may not sell municipal securities in amounts below the minimum denomination of an issue to a customer regardless of whether the customer holds or would hold a position in the issue which is equal to or exceeds the minimum denomination of the issue. The rule also prohibits brokers, dealers, and municipal securities dealers from purchasing municipal securities in amounts below the minimum denomination of an issue from a customer whose position in the securities equals or exceeds the minimum denomination of the issue unless the customer's position is being liquidated in its entirety.

5. The purpose of MSRB Rule G-15(f) is to ensure municipal securities dealers observe the minimum denominations stated in the official documents of municipal securities issues.² Official documents for municipal securities issues may state a "minimum denomination" larger than the normal \$5,000 par due to issuers' concerns that the securities may not be appropriate for those retail investors who would be likely to purchase securities in relatively small amounts.³

The Puerto Rico General Obligation Bonds of 2014

6. On March 11, 2014, Puerto Rico issued \$3.5 billion in General Obligation Bonds of 2014, Series A (CUSIP 74514LE86) (the "2014 Bonds").

7. The 2014 Bonds are non-investment grade securities and are considered "junk" bonds. In March 2014, the 2014 Bonds had a credit rating of "Ba2" by Moody's Investors Service, "BB+" by Standard & Poor's Rating Services, and "BB" by Fitch Ratings.

8. Non-investment grade bonds present substantial risks to retail investors. Risks of investing in non-investment grade bonds include liquidity risk (*i.e.*, risk that an investor will not be able to sell a bond quickly and at an efficient price), credit risk (*i.e.*, risk of loss due to an actual or perceived deterioration in the financial health of the issuer) and interest rate risk (*i.e.*, risk that rising interest rates may cause bond prices to decline). In addition, the market for non-investment

² Order Granting Approval of Proposed Rule Change Relating to Minimum Denominations, Exchange Act Release No. 45338, 67 Fed. Reg. 6960 (Feb. 14, 2002); Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 (Dec. 28, 2001).

³ Id.

grade bonds is constricted by the fact that many municipal bond mutual funds are prohibited by their prospectuses from purchasing non-investment grade bonds.

9. The Official Statement of the Commonwealth of Puerto Rico (the "Official Statement") disseminated in connection with the issue of the 2014 Bonds specifies in pertinent part that the 2014 Bonds "are issuable as registered bonds without coupons in denominations of \$100,000 and any multiple of \$5,000 in excess thereof." During the relevant period, MSRB Rule G-15(f) permitted dealers to effect customer transactions in the 2014 Bonds in amounts equal to the \$100,000 minimum denomination of the issue or amounts greater than \$100,000 in increments of \$5,000. Dealers could therefore have effected customer transactions for \$105,000, \$110,000, and so forth. Dealers were prohibited from effecting transactions with customers in the 2014 Bonds in amounts below \$100,000, regardless of a customer's aggregate position in the 2014 Bonds.⁴

**Sale in 2014 Bonds to a Customer
Below the \$100,000 Minimum Denomination of the Issue**

10. In March 2014, Respondent executed one unsolicited sales transaction in the 2014 Bonds with a customer in an amount below the \$100,000 minimum denomination of the issue established by the issuer, Puerto Rico, and specified in the Official Statement. The limited exceptions provided under MSRB Rule G-15(f) for customer transactions in municipal securities below the minimum denomination of an issue did not apply to this transaction. Respondent informed the customer of the risks of trading in the 2014 Bonds before executing the trade.

Violations

11. As a result of the conduct described above, Respondent willfully⁵ violated MSRB Rule G-15(f).

12. As a result of Respondent's willful violations of MSRB Rule G-15(f), Respondent willfully violated Section 15B(c)(1) of the Exchange Act.

Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent. After it was made aware by Commission staff that it had effected a customer transaction in the 2014 Bonds below the minimum denomination of the issue,

⁴ For example, a dealer could not have effected a customer transaction for \$100,000, followed by a separate below-minimum-denomination transaction for \$5,000, for a total of \$105,000. The second transaction would have violated MSRB Rule G-15(f). See Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 at n.12 (Dec. 28, 2001).

⁵ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F. 3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." Id. (quoting Gearhart & Otis, Inc. v. SEC, 348 F. 2d 798, 803 (D.C. Cir. 1965)).

Respondent cancelled the transaction prior to settlement. Following the transaction, Respondent conducted additional training regarding compliance with MSRB Rule G-15(f).

Undertakings

Respondent will undertake to review the adequacy of its existing policies and procedures relating to compliance with MSRB Rule G-15(f). After that review, Respondent will make such changes as are necessary to effect compliance with MSRB Rule G-15(f), including adopting new policies and procedures or supplementing existing policies and procedures. Respondent will implement these policies and procedures, and conduct training as to the policies and procedures and compliance with MSRB Rule G-15(f). Respondent will inform Commission staff no later than six (6) months after the entry of this Order that it has complied with the above undertakings and shall provide the Commission staff with a copy of its existing policies and procedures as to MSRB Rule G-15(f) at that time.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 15(b), 15B(c)(2) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent cease and desist from committing or causing any violations and any future violations of Section 15B(c)(1) of the Exchange Act and MSRB Rule G-15(f).

B. Respondent is censured.

C. Respondent shall, within seven (7) days of the entry of this Order, pay a civil money penalty in the amount of \$54,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:


Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341

6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying J.P. Morgan as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to LeeAnn G. Gaunt, Chief, Municipal Securities and Public Pensions Unit, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110.

By the Commission.

Brent J. Fields
Secretary


By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73504 / November 3, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16238

In the Matter of

TD Ameritrade, Inc.,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, PURSUANT TO
SECTIONS 15(b), 15B(c)(2) AND 21C OF
THE SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS AND
A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against TD Ameritrade, Inc. ("TD Ameritrade" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Summary

These proceedings involve the sale of non-investment grade or "junk" bonds issued by the Commonwealth of Puerto Rico ("Puerto Rico") by TD Ameritrade, a registered broker-dealer and municipal securities dealer, to customers in amounts below the minimum denomination of the issue. Rule G-15(f) promulgated by the Municipal Securities Rulemaking Board ("MSRB") prohibits dealers from effecting customer transactions in municipal securities in amounts below the minimum denominations of the issues. Minimum denominations are generally intended to limit sales of municipal securities to retail investors for whom such bonds may not be suitable, but the proscriptions of Rule G-15(f) apply to all transactions with customers, regardless of whether the securities are suitable for the customer. In March and May 2014, TD Ameritrade violated MSRB Rule G-15(f) by executing thirteen sales transactions in the Puerto Rico bonds with customers in amounts below the \$100,000 minimum denomination of the issue.

Respondent

1. TD Ameritrade is a New York corporation that maintains principal offices in Omaha, Nebraska. It is a registered broker-dealer pursuant to Section 15(b) of the Exchange Act. It is also a municipal securities dealer and a municipal securities broker as defined in Sections 3(a)(30) and 3(a)(31) of the Exchange Act.

MSRB Rule G-15(f):

Minimum Denomination Requirements for Bond Sales to Customers

2. Section 15B(b) of the Exchange Act established the MSRB and empowered it to propose and adopt rules for transactions in municipal securities by brokers, dealers, and municipal securities dealers. Section 15B(c)(1) of the Exchange Act prohibits a broker, dealer, or municipal securities dealer from using the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the MSRB. As a municipal securities dealer, Respondent is subject to Section 15B(c)(1) of the Exchange Act and MSRB rules.

3. MSRB Rule G-15(f)(i) prohibits a broker, dealer, or municipal securities dealer from effecting a customer transaction in municipal securities issued after June 1, 2002 in an amount lower than the minimum denomination of the issue except pursuant to two limited exceptions. First, under MSRB Rule G-15(f)(ii), a dealer may purchase municipal securities from a customer in an amount below the minimum denomination of the issue if the dealer determines that the customer's position in the issue is already below the minimum denomination and the customer's

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

entire position in the issue would be liquidated by the transaction. Second, under MSRB Rule G-15(f)(iii), a dealer may sell municipal securities to a customer in an amount below the minimum denomination of the issue if the dealer determines that the position being sold resulted from the liquidation of another customer's entire position in the issue which was below the minimum denomination of the issue. Additionally, a dealer selling under MSRB Rule G-15(f)(iii) must, at or before the completion of the transaction, notify the customer that the amount of the transaction is below the minimum denomination of the issue and that this may adversely affect the liquidity of the customer's position.

4. Under MSRB Rule G-15(f), brokers, dealers, and municipal securities dealers may not sell municipal securities in amounts below the minimum denomination of an issue to a customer regardless of whether the customer holds or would hold a position in the issue which is equal to or exceeds the minimum denomination of the issue. The rule also prohibits brokers, dealers, and municipal securities dealers from purchasing municipal securities in amounts below the minimum denomination of an issue from a customer whose position in the securities equals or exceeds the minimum denomination of the issue unless the customer's position is being liquidated in its entirety.

5. The purpose of MSRB Rule G-15(f) is to ensure municipal securities dealers observe the minimum denominations stated in the official documents of municipal securities issues.² Official documents for municipal securities issues may state a "minimum denomination" larger than the normal \$5,000 par due to issuers' concerns that the securities may not be appropriate for those retail investors who would be likely to purchase securities in relatively small amounts.³

The Puerto Rico General Obligation Bonds of 2014

6. On March 11, 2014, Puerto Rico issued \$3.5 billion in General Obligation Bonds of 2014, Series A (CUSIP 74514LE86) (the "2014 Bonds").

7. The 2014 Bonds are non-investment grade securities and are considered "junk" bonds. Between March and May 2014, the 2014 Bonds had a credit rating of "Ba2" by Moody's Investors Service, "BB+" by Standard & Poor's Rating Services, and "BB" by Fitch Ratings.

8. Non-investment grade bonds present substantial risks to retail investors. Risks of investing in non-investment grade bonds include liquidity risk (*i.e.*, risk that an investor will not be able to sell a bond quickly and at an efficient price), credit risk (*i.e.*, risk of loss due to an actual or perceived deterioration in the financial health of the issuer) and interest rate risk (*i.e.*, risk that rising interest rates may cause bond prices to decline). In addition, the market for non-investment

² Order Granting Approval of Proposed Rule Change Relating to Minimum Denominations, Exchange Act Release No. 45338, 67 Fed. Reg. 6960 (Feb. 14, 2002); Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 (Dec. 28, 2001).

³ Id.

grade bonds is constricted by the fact that many municipal bond mutual funds are prohibited by their prospectuses from purchasing non-investment grade bonds.

9. The Official Statement of the Commonwealth of Puerto Rico (the "Official Statement") disseminated in connection with the issue of the 2014 Bonds specifies in pertinent part that the 2014 Bonds "are issuable as registered bonds without coupons in denominations of \$100,000 and any multiple of \$5,000 in excess thereof." During the relevant period, MSRB Rule G-15(f) permitted dealers to effect customer transactions in the 2014 Bonds in amounts equal to the \$100,000 minimum denomination of the issue or amounts greater than \$100,000 in increments of \$5,000. Dealers could therefore have effected customer transactions for \$105,000, \$110,000, and so forth. Dealers were prohibited from effecting transactions with customers in the 2014 Bonds in amounts below \$100,000, regardless of a customer's aggregate position in the 2014 Bonds.⁴

Sales in 2014 Bonds to Customers
Below the \$100,000 Minimum Denomination of the Issue

10. In March 2014, Respondent executed ten unsolicited sales transactions in the 2014 Bonds with customers in amounts below the \$100,000 minimum denomination of the issue established by the issuer, Puerto Rico, and specified in the Official Statement. In May 2014, Respondent executed an additional three such sales transactions in the 2014 Bonds. The limited exceptions provided under MSRB Rule G-15(f) for customer transactions in municipal securities below the minimum denomination of an issue did not apply to these transactions.

11. Respondent did not have any policies or procedures concerning MSRB Rule G-15(f).

Violations

12. As a result of the conduct described above, Respondent willfully⁵ violated MSRB Rule G-15(f).

13. As a result of Respondent's willful violations of MSRB Rule G-15(f), Respondent willfully violated Section 15B(c)(1) of the Exchange Act.

Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent. After it was made aware by Commission staff that it had effected

⁴ For example, a dealer could not have effected a customer transaction for \$100,000, followed by a separate below-minimum-denomination transaction for \$5,000, for a total of \$105,000. The second transaction would have violated MSRB Rule G-15(f). See Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 at n.12 (Dec. 28, 2001).

⁵ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." Id. (quoting Gearhart & Otis, Inc. v. SEC, 348 F. 2d 798, 803 (D.C. Cir. 1965)).

customer transactions in the 2014 Bonds below the minimum denomination of the issue, Respondent cancelled the transactions.

Undertakings

Respondent will undertake to review the adequacy of its existing policies and procedures relating to compliance with MSRB Rule G-15(f). After that review, Respondent will make such changes as are necessary to effect compliance with MSRB Rule G-15(f), including adopting new policies and procedures or supplementing existing policies and procedures. Respondent will implement these policies and procedures, and conduct training as to the policies and procedures and compliance with MSRB Rule G-15(f). Respondent will inform Commission staff no later than six (6) months after the entry of this Order that it has complied with the above undertakings and shall provide the Commission staff with a copy of its existing policies and procedures as to MSRB Rule G-15(f) at that time.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 15(b), 15B(c)(2) and 21C of the Exchange Act, it is hereby ORDERED that:

- A. Respondent cease and desist from committing or causing any violations and any future violations of Section 15B(c)(1) of the Exchange Act and MSRB Rule G-15(f).
- B. Respondent is censured.
- C. Respondent shall, within seven (7) days of the entry of this Order, pay a civil money penalty in the amount of \$100,800 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341

6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying TD Ameritrade as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to LeeAnn G. Gaunt, Chief, Municipal Securities and Public Pensions Unit, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

*Chair White
Not participating*

SECURITIES EXCHANGE ACT OF 1934
Release No. 73505 / November 3, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16239

In the Matter of

UBS Financial Services Inc.,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, PURSUANT TO
SECTIONS 15(b), 15B(c)(2) AND 21C OF
THE SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS AND
A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against UBS Financial Services, Inc. ("UBS" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

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Summary

These proceedings involve the sale of non-investment grade or "junk" bonds issued by the Commonwealth of Puerto Rico ("Puerto Rico") by UBS, a registered broker-dealer and municipal securities dealer, to customers in amounts below the minimum denomination of the issue. Rule G-15(f) promulgated by the Municipal Securities Rulemaking Board ("MSRB") prohibits dealers from effecting customer transactions in municipal securities in amounts below the minimum denominations of the issues. Minimum denominations are generally intended to limit sales of municipal securities to retail customers for whom such bonds may not be suitable, but the proscriptions of Rule G-15(f) apply to all transactions with customers, regardless of whether the securities are suitable for the customer. In March 2014, UBS violated MSRB Rule G-15(f) by executing five sales transactions in the Puerto Rico bonds with customers in amounts below the \$100,000 minimum denomination of the issue.

Respondent

1. UBS is a Delaware corporation that maintains principal offices in Weehawken, New Jersey. It is a registered broker-dealer pursuant to Section 15(b) of the Exchange Act. It is also a municipal securities dealer and a municipal securities broker as defined in Sections 3(a)(30) and 3(a)(31) of the Exchange Act.

MSRB Rule G-15(f):

Minimum Denomination Requirements for Bond Sales to Customers

2. Section 15B(b) of the Exchange Act established the MSRB and empowered it to propose and adopt rules for transactions in municipal securities by brokers, dealers, and municipal securities dealers. Section 15B(c)(1) of the Exchange Act prohibits a broker, dealer, or municipal securities dealer from using the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the MSRB. As a municipal securities dealer, Respondent is subject to Section 15B(c)(1) of the Exchange Act and MSRB rules.

3. MSRB Rule G-15(f)(i) prohibits a broker, dealer, or municipal securities dealer from effecting a customer transaction in municipal securities issued after June 1, 2002 in an amount lower than the minimum denomination of the issue except pursuant to two limited exceptions. First, under MSRB Rule G-15(f)(ii), a dealer may purchase municipal securities from a customer in an amount below the minimum denomination of the issue if the dealer determines that the customer's position in the issue is already below the minimum denomination and the customer's entire position in the issue would be liquidated by the transaction. Second, under MSRB Rule G-15(f)(iii), a dealer may sell municipal securities to a customer in an amount below the minimum denomination of the issue if the dealer determines that the position being sold resulted from the liquidation of another customer's entire position in the issue which was below the minimum denomination of the issue. Additionally, a dealer selling under MSRB Rule G-15(f)(iii) must, at or before the completion of the transaction, notify the customer that the amount of the transaction is

below the minimum denomination of the issue and that this may adversely affect the liquidity of the customer's position.

4. Under MSRB Rule G-15(f), brokers, dealers, and municipal securities dealers may not sell municipal securities in amounts below the minimum denomination of an issue to a customer regardless of whether the customer holds or would hold a position in the issue which is equal to or exceeds the minimum denomination of the issue. The rule also prohibits brokers, dealers, and municipal securities dealers from purchasing municipal securities in amounts below the minimum denomination of an issue from a customer whose position in the securities equals or exceeds the minimum denomination of the issue unless the customer's position is being liquidated in its entirety.

5. The purpose of MSRB Rule G-15(f) is to ensure municipal securities dealers observe the minimum denominations stated in the official documents of municipal securities issues.² Official documents for municipal securities issues may state a "minimum denomination" larger than the normal \$5,000 par due to issuers' concerns that the securities may not be appropriate for those retail investors who would be likely to purchase securities in relatively small amounts.³

The Puerto Rico General Obligation Bonds of 2014

6. On March 11, 2014, Puerto Rico issued \$3.5 billion in General Obligation Bonds of 2014, Series A (CUSIP 74514LE86) (the "2014 Bonds").

7. The 2014 Bonds are non-investment grade securities and are considered "junk" bonds. In March 2014, the 2014 Bonds had a credit rating of "Ba2" by Moody's Investors Service, "BB+" by Standard & Poor's Rating Services, and "BB" by Fitch Ratings.

8. Non-investment grade bonds present substantial risks to retail investors. Risks of investing in non-investment grade bonds include liquidity risk (*i.e.*, risk that an investor will not be able to sell a bond quickly and at an efficient price), credit risk (*i.e.*, risk of loss due to an actual or perceived deterioration in the financial health of the issuer) and interest rate risk (*i.e.*, risk that rising interest rates may cause bond prices to decline). In addition, the market for non-investment grade bonds is constricted by the fact that many municipal bond mutual funds are prohibited by their prospectuses from purchasing non-investment grade bonds.

9. The Official Statement of the Commonwealth of Puerto Rico (the "Official Statement") disseminated in connection with the issue of the 2014 Bonds specifies in pertinent part that the 2014 Bonds "are issuable as registered bonds without coupons in denominations of \$100,000 and any multiple of \$5,000 in excess thereof." During the relevant period, MSRB Rule G-15(f) permitted dealers to effect customer transactions in the 2014 Bonds in amounts equal to the

² Order Granting Approval of Proposed Rule Change Relating to Minimum Denominations, Exchange Act Release No. 45338, 67 Fed. Reg. 6960 (Feb. 14, 2002); Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 (Dec. 28, 2001).

³ Id.

\$100,000 minimum denomination of the issue or amounts greater than \$100,000 in increments of \$5,000. Dealers could therefore have effected customer transactions for \$105,000, \$110,000, and so forth. Dealers were prohibited from effecting transactions with customers in the 2014 Bonds in amounts below \$100,000, regardless of a customer's aggregate position in the 2014 Bonds.⁴

**Sales in 2014 Bonds to Customers
Below the \$100,000 Minimum Denomination of the Issue**

10. In March 2014, Respondent executed five unsolicited sales transactions in the 2014 Bonds with customers in amounts below the \$100,000 minimum denomination of the issue established by the issuer, Puerto Rico, and specified in the Official Statement. The limited exceptions provided under MSRB Rule G-15(f) for customer transactions in municipal securities below the minimum denomination of an issue did not apply to these transactions. Respondent informed the customers of the risks of trading in the 2014 Bonds before executing the trades.

Violations

11. As a result of the conduct described above, Respondent willfully⁵ violated MSRB Rule G-15(f).

12. As a result of Respondent's willful violations of MSRB Rule G-15(f), Respondent willfully violated Section 15B(c)(1) of the Exchange Act.

Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent. After it became aware that it had effected customer transactions in the 2014 Bonds below the minimum denomination of the issue, Respondent cancelled the transactions and amended its policies and procedures to ensure compliance with MSRB Rule G-15(f).

Undertakings

Respondent will undertake to review the adequacy of its existing policies and procedures relating to compliance with MSRB Rule G-15(f). After that review, Respondent will make such changes as are necessary to effect compliance with MSRB Rule G-15(f), including adopting new policies and procedures or supplementing existing policies and procedures. Respondent will implement these policies and procedures, and conduct training as to the policies and procedures

⁴ For example, a dealer could not have effected a customer transaction for \$100,000, followed by a separate below-minimum-denomination transaction for \$5,000, for a total of \$105,000. The second transaction would have violated MSRB Rule G-15(f). See Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 at n.12 (Dec. 28, 2001).

⁵ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." Id. (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).

and compliance with MSRB Rule G-15(f). Respondent will inform Commission staff no later than six (6) months after the entry of this Order that it has complied with the above undertakings and shall provide the Commission staff with a copy of its existing policies and procedures as to MSRB Rule G-15(f) at that time.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 15(b), 15B(c)(2) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent cease and desist from committing or causing any violations and any future violations of Section 15B(c)(1) of the Exchange Act and MSRB Rule G-15(f).

B. Respondent is censured.

C. Respondent shall, within seven (7) days of the entry of this Order, pay a civil money penalty in the amount of \$56,400 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:


Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying UBS

as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to LeeAnn G. Gaunt, Chief, Municipal Securities and Public Pensions Unit, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110.

By the Commission.

Brent J. Fields
Secretary


By **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73506 / November 3, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16240

In the Matter of

Wedbush Securities Inc.,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, PURSUANT TO
SECTIONS 15(b), 15B(c)(2) AND 21C OF
THE SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS AND
A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Wedbush Securities Inc. ("Wedbush" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

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Summary

These proceedings involve the sale of non-investment grade or "junk" bonds issued by the Commonwealth of Puerto Rico ("Puerto Rico") by Wedbush, a registered broker-dealer and municipal securities dealer, to customers in amounts below the minimum denomination of the issue. Rule G-15(f) promulgated by the Municipal Securities Rulemaking Board ("MSRB") prohibits dealers from effecting customer transactions in municipal securities in amounts below the minimum denominations of the issues. Minimum denominations are generally intended to limit sales of municipal securities to retail customers for whom such bonds may not be suitable, but the proscriptions of Rule G-15(f) apply to all transactions with customers, regardless of whether the securities are suitable for the customer. In March 2014, Wedbush violated MSRB Rule G-15(f) by executing three sales transactions in the Puerto Rico bonds with customers in amounts below the \$100,000 minimum denomination of the issue.

Respondent

1. Wedbush is a California corporation that maintains principal offices in Los Angeles, California. It is a registered broker-dealer pursuant to Section 15(b) of the Exchange Act. It is also a municipal securities dealer and a municipal securities broker as defined in Sections 3(a)(30) and 3(a)(31) of the Exchange Act.

MSRB Rule G-15(f):

Minimum Denomination Requirements for Bond Sales to Customers

2. Section 15B(b) of the Exchange Act established the MSRB and empowered it to propose and adopt rules for transactions in municipal securities by brokers, dealers, and municipal securities dealers. Section 15B(c)(1) of the Exchange Act prohibits a broker, dealer, or municipal securities dealer from using the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the MSRB. As a municipal securities dealer, Respondent is subject to Section 15B(c)(1) of the Exchange Act and MSRB rules.

3. MSRB Rule G-15(f)(i) prohibits a broker, dealer, or municipal securities dealer from effecting a customer transaction in municipal securities issued after June 1, 2002 in an amount lower than the minimum denomination of the issue except pursuant to two limited exceptions. First, under MSRB Rule G-15(f)(ii), a dealer may purchase municipal securities from a customer in an amount below the minimum denomination of the issue if the dealer determines that the customer's position in the issue is already below the minimum denomination and the customer's entire position in the issue would be liquidated by the transaction. Second, under MSRB Rule G-15(f)(iii), a dealer may sell municipal securities to a customer in an amount below the minimum denomination of the issue if the dealer determines that the position being sold resulted from the liquidation of another customer's entire position in the issue which was below the minimum denomination of the issue. Additionally, a dealer selling under MSRB Rule G-15(f)(iii) must, at or before the completion of the transaction, notify the customer that the amount of the transaction is below the minimum denomination of the issue and that this may adversely affect the liquidity of the customer's position.

4. Under MSRB Rule G-15(f), brokers, dealers, and municipal securities dealers may not sell municipal securities in amounts below the minimum denomination of an issue to a customer regardless of whether the customer holds or would hold a position in the issue which is equal to or exceeds the minimum denomination of the issue. The rule also prohibits brokers, dealers, and municipal securities dealers from purchasing municipal securities in amounts below the minimum denomination of an issue from a customer whose position in the securities equals or exceeds the minimum denomination of the issue unless the customer's position is being liquidated in its entirety.

5. The purpose of MSRB Rule G-15(f) is to ensure municipal securities dealers observe the minimum denominations stated in the official documents of municipal securities issues.² Official documents for municipal securities issues may state a "minimum denomination" larger than the normal \$5,000 par due to issuers' concerns that the securities may not be appropriate for those retail investors who would be likely to purchase securities in relatively small amounts.³

The Puerto Rico General Obligation Bonds of 2014

6. On March 11, 2014, Puerto Rico issued \$3.5 billion in General Obligation Bonds of 2014, Series A (CUSIP 74514LE86) (the "2014 Bonds").

7. The 2014 Bonds are non-investment grade securities and are considered "junk" bonds. In March 2014, the 2014 Bonds had a credit rating of "Ba2" by Moody's Investors Service, "BB+" by Standard & Poor's Rating Services, and "BB" by Fitch Ratings.

8. Non-investment grade bonds present substantial risks to retail investors. Risks of investing in non-investment grade bonds include liquidity risk (*i.e.*, risk that an investor will not be able to sell a bond quickly and at an efficient price), credit risk (*i.e.*, risk of loss due to an actual or perceived deterioration in the financial health of the issuer) and interest rate risk (*i.e.*, risk that rising interest rates may cause bond prices to decline). In addition, the market for non-investment grade bonds is constricted by the fact that many municipal bond mutual funds are prohibited by their prospectuses from purchasing non-investment grade bonds.

9. The Official Statement of the Commonwealth of Puerto Rico (the "Official Statement") disseminated in connection with the issue of the 2014 Bonds specifies in pertinent part that the 2014 Bonds "are issuable as registered bonds without coupons in denominations of \$100,000 and any multiple of \$5,000 in excess thereof." During the relevant period, MSRB Rule G-15(f) permitted dealers to effect customer transactions in the 2014 Bonds in amounts equal to the \$100,000 minimum denomination of the issue or amounts greater than \$100,000 in increments of \$5,000. Dealers could therefore have effected customer transactions for \$105,000, \$110,000, and

² Order Granting Approval of Proposed Rule Change Relating to Minimum Denominations, Exchange Act Release No. 45338, 67 Fed. Reg. 6960 (Feb. 14, 2002); Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 (Dec. 28, 2001).

³ Id.

so forth. Dealers were prohibited from effecting transactions with customers in the 2014 Bonds in amounts below \$100,000, regardless of a customer's aggregate position in the 2014 Bonds.⁴

**Sales in 2014 Bonds to Customers
Below the \$100,000 Minimum Denomination of the Issue**

10. In March 2014, Respondent executed three sales transactions in the 2014 Bonds with customers in amounts below the \$100,000 minimum denomination of the issue established by the issuer, Puerto Rico, and specified in the Official Statement. The limited exceptions provided under MSRB Rule G-15(f) for customer transactions in municipal securities below the minimum denomination of an issue did not apply to these transactions. Respondent solicited all of the customer sales transactions.

Violations

11. As a result of the conduct described above, Respondent willfully⁵ violated MSRB Rule G-15(f).

12. As a result of Respondent's willful violations of MSRB Rule G-15(f), Respondent willfully violated Section 15B(c)(1) of the Exchange Act.

Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent. After it became aware that it had effected customer transactions in the 2014 Bonds below the minimum denomination of the issue, Respondent cancelled the transactions.

Undertakings

Respondent will undertake to review the adequacy of its existing policies and procedures relating to compliance with MSRB Rule G-15(f). After that review, Respondent will make such changes as are necessary to effect compliance with MSRB Rule G-15(f), including adopting new policies and procedures or supplementing existing policies and procedures. Respondent will implement these policies and procedures, and conduct training as to the policies and procedures and compliance with MSRB Rule G-15(f). Respondent will inform Commission staff no later than six (6) months after the entry of this Order that it has complied with the above undertakings

⁴ For example, a dealer could not have effected a customer transaction for \$100,000, followed by a separate below-minimum-denomination transaction for \$5,000, for a total of \$105,000. The second transaction would have violated MSRB Rule G-15(f). See Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 at n.12 (Dec. 28, 2001).

⁵ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." Id. (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).

and shall provide the Commission staff with a copy of its existing policies and procedures as to MSRB Rule G-15(f) at that time.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 15(b), 15B(c)(2) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent cease and desist from committing or causing any violations and any future violations of Section 15B(c)(1) of the Exchange Act and MSRB Rule G-15(f).

B. Respondent is censured.

C. Respondent shall, within seven (7) days of the entry of this Order, pay a civil money penalty in the amount of \$67,200 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:


Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Wedbush as a Respondent in these proceedings, and the file number of these proceedings; a copy

of the cover letter and check or money order must be sent to LeeAnn G. Gaunt, Chief, Municipal Securities and Public Pensions Unit, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110.

By the Commission.

Brent J. Fields
Secretary


By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73507 / November 3, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16241

In the Matter of

Lebenthal & Co., LLC,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, PURSUANT TO
SECTIONS 15(b), 15B(c)(2) AND 21C OF
THE SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS AND
A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Lebenthal & Co., LLC ("Lebenthal" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

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Summary

These proceedings involve the sale of non-investment grade or "junk" bonds issued by the Commonwealth of Puerto Rico ("Puerto Rico") by Lebenthal, a registered broker-dealer and municipal securities dealer, to a customer in an amount below the minimum denomination of the issue. Rule G-15(f) promulgated by the Municipal Securities Rulemaking Board ("MSRB") prohibits dealers from effecting customer transactions in municipal securities in amounts below the minimum denominations of the issues. Minimum denominations are generally intended to limit sales of municipal securities to retail customers for whom such bonds may not be suitable, but the proscriptions of Rule G-15(f) apply to all transactions with customers, regardless of whether the securities are suitable for the customer. In March 2014, Lebenthal violated MSRB Rule G-15(f) by executing one sales transaction in the Puerto Rico bonds with a customer in an amount below the \$100,000 minimum denomination of the issue.

Respondent

1. Lebenthal is a Delaware limited liability company that maintains principal offices in New York, New York. It is a registered broker-dealer pursuant to Section 15(b) of the Exchange Act. It is also a municipal securities dealer and a municipal securities broker as defined in Sections 3(a)(30) and 3(a)(31) of the Exchange Act.

MSRB Rule G-15(f): Minimum Denomination Requirements for Bond Sales to Customers

2. Section 15B(b) of the Exchange Act established the MSRB and empowered it to propose and adopt rules for transactions in municipal securities by brokers, dealers, and municipal securities dealers. Section 15B(c)(1) of the Exchange Act prohibits a broker, dealer, or municipal securities dealer from using the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the MSRB. As a municipal securities dealer, Respondent is subject to Section 15B(c)(1) of the Exchange Act and MSRB rules.

3. MSRB Rule G-15(f)(i) prohibits a broker, dealer, or municipal securities dealer from effecting a customer transaction in municipal securities issued after June 1, 2002 in an amount lower than the minimum denomination of the issue except pursuant to two limited exceptions. First, under MSRB Rule G-15(f)(ii), a dealer may purchase municipal securities from a customer in an amount below the minimum denomination of the issue if the dealer determines that the customer's position in the issue is already below the minimum denomination and the customer's entire position in the issue would be liquidated by the transaction. Second, under MSRB Rule G-15(f)(iii), a dealer may sell municipal securities to a customer in an amount below the minimum denomination of the issue if the dealer determines that the position being sold resulted from the liquidation of another customer's entire position in the issue which was below the minimum denomination of the issue. Additionally, a dealer selling under MSRB Rule G-15(f)(iii) must, at or before the completion of the transaction, notify the customer that the amount of the transaction is below the minimum denomination of the issue and that this may adversely affect the liquidity of the customer's position.

4. Under MSRB Rule G-15(f), brokers, dealers, and municipal securities dealers may not sell municipal securities in amounts below the minimum denomination of an issue to a customer regardless of whether the customer holds or would hold a position in the issue which is equal to or exceeds the minimum denomination of the issue. The rule also prohibits brokers, dealers, and municipal securities dealers from purchasing municipal securities in amounts below the minimum denomination of an issue from a customer whose position in the securities equals or exceeds the minimum denomination of the issue unless the customer's position is being liquidated in its entirety.

5. The purpose of MSRB Rule G-15(f) is to ensure municipal securities dealers observe the minimum denominations stated in the official documents of municipal securities issues.² Official documents for municipal securities issues may state a "minimum denomination" larger than the normal \$5,000 par due to issuers' concerns that the securities may not be appropriate for those retail investors who would be likely to purchase securities in relatively small amounts.³

The Puerto Rico General Obligation Bonds of 2014

6. On March 11, 2014, Puerto Rico issued \$3.5 billion in General Obligation Bonds of 2014, Series A (CUSIP 74514LE86) (the "2014 Bonds").

7. The 2014 Bonds are non-investment grade securities and are considered "junk" bonds. In March 2014, the 2014 Bonds had a credit rating of "Ba2" by Moody's Investors Service, "BB+" by Standard & Poor's Rating Services, and "BB" by Fitch Ratings.

8. Non-investment grade bonds present substantial risks to retail investors. Risks of investing in non-investment grade bonds include liquidity risk (*i.e.*, risk that an investor will not be able to sell a bond quickly and at an efficient price), credit risk (*i.e.*, risk of loss due to an actual or perceived deterioration in the financial health of the issuer) and interest rate risk (*i.e.*, risk that rising interest rates may cause bond prices to decline). In addition, the market for non-investment grade bonds is constricted by the fact that many municipal bond mutual funds are prohibited by their prospectuses from purchasing non-investment grade bonds.

9. The Official Statement of the Commonwealth of Puerto Rico (the "Official Statement") disseminated in connection with the issue of the 2014 Bonds specifies in pertinent part that the 2014 Bonds "are issuable as registered bonds without coupons in denominations of \$100,000 and any multiple of \$5,000 in excess thereof." During the relevant period, MSRB Rule G-15(f) permitted dealers to effect customer transactions in the 2014 Bonds in amounts equal to the \$100,000 minimum denomination of the issue or amounts greater than \$100,000 in increments of \$5,000. Dealers could therefore have effected customer transactions for \$105,000, \$110,000, and

² Order Granting Approval of Proposed Rule Change Relating to Minimum Denominations, Exchange Act Release No. 45338, 67 Fed. Reg. 6960 (Feb. 14, 2002); Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 (Dec. 28, 2001).

³ Id.

so forth. Dealers were prohibited from effecting transactions with customers in the 2014 Bonds in amounts below \$100,000, regardless of a customer's aggregate position in the 2014 Bonds.⁴

**Sale in 2014 Bonds to a Customer
Below the \$100,000 Minimum Denomination of the Issue**

10. In March 2014, Respondent executed one sales transaction in the 2014 Bonds with a customer in an amount below the \$100,000 minimum denomination of the issue established by the issuer, Puerto Rico, and specified in the Official Statement. The limited exceptions provided under MSRB Rule G-15(f) for customer transactions in municipal securities below the minimum denomination of an issue did not apply to this transaction.

Violations

11. As a result of the conduct described above, Respondent willfully⁵ violated MSRB Rule G-15(f).

12. As a result of Respondent's willful violations of MSRB Rule G-15(f), Respondent willfully violated Section 15B(c)(1) of the Exchange Act.

Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent. After it was made aware by Commission staff that it had effected a customer transaction in the 2014 Bonds below the minimum denomination of the issue, Respondent cancelled the transaction.

Undertakings

Respondent will undertake to review the adequacy of its existing policies and procedures relating to compliance with MSRB Rule G-15(f). After that review, Respondent will make such changes as are necessary to effect compliance with MSRB Rule G-15(f), including adopting new policies and procedures or supplementing existing policies and procedures. Respondent will implement these policies and procedures, and conduct training as to the policies and procedures and compliance with MSRB Rule G-15(f). Respondent will inform Commission staff no later than six (6) months after the entry of this Order that it has complied with the above undertakings

⁴ For example, a dealer could not have effected a customer transaction for \$100,000, followed by a separate below-minimum-denomination transaction for \$5,000, for a total of \$105,000. The second transaction would have violated MSRB Rule G-15(f). See Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 at n.12 (Dec. 28, 2001).

⁵ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." Id. (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).

and shall provide the Commission staff with a copy of its existing policies and procedures as to MSRB Rule G-15(f) at that time.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 15(b), 15B(c)(2) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent cease and desist from committing or causing any violations and any future violations of Section 15B(c)(1) of the Exchange Act and MSRB Rule G-15(f).

B. Respondent is censured.

C. Respondent shall, within seven (7) days of the entry of this Order, pay a civil money penalty in the amount of \$54,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Lebenthal as a Respondent in these proceedings, and the file number of these proceedings; a copy

of the cover letter and check or money order must be sent to LeeAnn G. Gaunt, Chief, Municipal Securities and Public Pensions Unit, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73508 / November 3, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16242

In the Matter of

National Securities Corp.,

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, PURSUANT TO
SECTIONS 15(b), 15B(c)(2) AND 21C OF
THE SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS AND
A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against National Securities Corp. ("National Securities" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

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Summary

These proceedings involve the sale of non-investment grade or "junk" bonds issued by the Commonwealth of Puerto Rico ("Puerto Rico") by National Securities, a registered broker-dealer and municipal securities dealer, to a customer in an amount below the minimum denomination of the issue. Rule G-15(f) promulgated by the Municipal Securities Rulemaking Board ("MSRB") prohibits dealers from effecting customer transactions in municipal securities in amounts below the minimum denominations of the issues. Minimum denominations are generally intended to limit sales of municipal securities to retail investors for whom such bonds may not be suitable, but the proscriptions of Rule G-15(f) apply to all transactions with customers, regardless of whether the securities are suitable for the customer. In March 2014, National Securities violated MSRB Rule G-15(f) by executing one sales transaction in the Puerto Rico bonds with a customer in an amount below the \$100,000 minimum denomination of the issue.

Respondent

1. National Securities is a Washington corporation that maintains principal offices in Seattle, Washington. It is a registered broker-dealer pursuant to Section 15(b) of the Exchange Act. It is also a municipal securities dealer and a municipal securities broker as defined in Sections 3(a)(30) and 3(a)(31) of the Exchange Act.

MSRB Rule G-15(f):

Minimum Denomination Requirements for Bond Sales to Customers

2. Section 15B(b) of the Exchange Act established the MSRB and empowered it to propose and adopt rules for transactions in municipal securities by brokers, dealers, and municipal securities dealers. Section 15B(c)(1) of the Exchange Act prohibits a broker, dealer, or municipal securities dealer from using the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the MSRB. As a municipal securities dealer, Respondent is subject to Section 15B(c)(1) of the Exchange Act and MSRB rules.

3. MSRB Rule G-15(f)(i) prohibits a broker, dealer, or municipal securities dealer from effecting a customer transaction in municipal securities issued after June 1, 2002 in an amount lower than the minimum denomination of the issue except pursuant to two limited exceptions. First, under MSRB Rule G-15(f)(ii), a dealer may purchase municipal securities from a customer in an amount below the minimum denomination of the issue if the dealer determines that the customer's position in the issue is already below the minimum denomination and the customer's entire position in the issue would be liquidated by the transaction. Second, under MSRB Rule G-15(f)(iii), a dealer may sell municipal securities to a customer in an amount below the minimum denomination of the issue if the dealer determines that the position being sold resulted from the liquidation of another customer's entire position in the issue which was below the minimum denomination of the issue. Additionally, a dealer selling under MSRB Rule G-15(f)(iii) must, at or before the completion of the transaction, notify the customer that the amount of the transaction is

below the minimum denomination of the issue and that this may adversely affect the liquidity of the customer's position.

4. Under MSRB Rule G-15(f), brokers, dealers, and municipal securities dealers may not sell municipal securities in amounts below the minimum denomination of an issue to a customer regardless of whether the customer holds or would hold a position in the issue which is equal to or exceeds the minimum denomination of the issue. The rule also prohibits brokers, dealers, and municipal securities dealers from purchasing municipal securities in amounts below the minimum denomination of an issue from a customer whose position in the securities equals or exceeds the minimum denomination of the issue unless the customer's position is being liquidated in its entirety.

5. The purpose of MSRB Rule G-15(f) is to ensure municipal securities dealers observe the minimum denominations stated in the official documents of municipal securities issues.² Official documents for municipal securities issues may state a "minimum denomination" larger than the normal \$5,000 par due to issuers' concerns that the securities may not be appropriate for those retail investors who would be likely to purchase securities in relatively small amounts.³

The Puerto Rico General Obligation Bonds of 2014

6. On March 11, 2014, Puerto Rico issued \$3.5 billion in General Obligation Bonds of 2014, Series A (CUSIP 74514LE86) (the "2014 Bonds").

7. The 2014 Bonds are non-investment grade securities and are considered "junk" bonds. In March 2014, the 2014 Bonds had a credit rating of "Ba2" by Moody's Investors Service, "BB+" by Standard & Poor's Rating Services, and "BB" by Fitch Ratings.

8. Non-investment grade bonds present substantial risks to retail investors. Risks of investing in non-investment grade bonds include liquidity risk (*i.e.*, risk that an investor will not be able to sell a bond quickly and at an efficient price), credit risk (*i.e.*, risk of loss due to an actual or perceived deterioration in the financial health of the issuer) and interest rate risk (*i.e.*, risk that rising interest rates may cause bond prices to decline). In addition, the market for non-investment grade bonds is constricted by the fact that many municipal bond mutual funds are prohibited by their prospectuses from purchasing non-investment grade bonds.

9. The Official Statement of the Commonwealth of Puerto Rico (the "Official Statement") disseminated in connection with the issue of the 2014 Bonds specifies in pertinent part that the 2014 Bonds "are issuable as registered bonds without coupons in denominations of \$100,000 and any multiple of \$5,000 in excess thereof." During the relevant period, MSRB Rule G-15(f)

² Order Granting Approval of Proposed Rule Change Relating to Minimum Denominations, Exchange Act Release No. 45338, 67 Fed. Reg. 6960 (Feb. 14, 2002); Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 (Dec. 28, 2001).

³ Id.

permitted dealers to effect customer transactions in the 2014 Bonds in amounts equal to the \$100,000 minimum denomination of the issue or amounts greater than \$100,000 in increments of \$5,000. Dealers could therefore have effected customer transactions for \$105,000, \$110,000, and so forth. Dealers were prohibited from effecting transactions with customers in the 2014 Bonds in amounts below \$100,000, regardless of a customer's aggregate position in the 2014 Bonds.⁴

Sale in 2014 Bonds to a Customer
Below the \$100,000 Minimum Denomination of the Issue

10. In March 2014, Respondent executed one sales transaction in the 2014 Bonds with a customer in an amount below the \$100,000 minimum denomination of the issue established by the issuer, Puerto Rico, and specified in the Official Statement. The limited exceptions provided under MSRB Rule G-15(f) for customer transactions in municipal securities below the minimum denomination of an issue did not apply to this transaction. Respondent solicited the customer sales transaction. Respondent informed the customer of the risks of trading in the 2014 Bonds before executing the trade.

Violations

11. As a result of the conduct described above, Respondent willfully⁵ violated MSRB Rule G-15(f).

12. As a result of Respondent's willful violations of MSRB Rule G-15(f), Respondent willfully violated Section 15B(c)(1) of the Exchange Act.

Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent. After it was made aware by Commission staff that it had effected a customer transaction in the 2014 Bonds below the minimum denomination of the issue, Respondent cancelled the transaction.

Undertakings

Respondent will undertake to review the adequacy of its existing policies and procedures relating to compliance with MSRB Rule G-15(f). After that review, Respondent will make such changes as are necessary to effect compliance with MSRB Rule G-15(f), including adopting new

⁴ For example, a dealer could not have effected a customer transaction for \$100,000, followed by a separate below-minimum-denomination transaction for \$5,000, for a total of \$105,000. The second transaction would have violated MSRB Rule G-15(f). See Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 at n.12 (Dec. 28, 2001).

⁵ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." Id. (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).

policies and procedures or supplementing existing policies and procedures. Respondent will implement these policies and procedures, and conduct training as to the policies and procedures and compliance with MSRB Rule G-15(f). Respondent will inform Commission staff no later than six (6) months after the entry of this Order that it has complied with the above undertakings and shall provide the Commission staff with a copy of its existing policies and procedures as to MSRB Rule G-15(f) at that time.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 15(b), 15B(c)(2) and 21C of the Exchange Act, it is hereby ORDERED that:

- A. Respondent cease and desist from committing or causing any violations and any future violations of Section 15B(c)(1) of the Exchange Act and MSRB Rule G-15(f).
- B. Respondent is censured.
- C. Respondent shall, within seven (7) days of the entry of this Order, pay a civil money penalty in the amount of \$60,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying National Securities as a Respondent in these proceedings, and the file number of these

proceedings; a copy of the cover letter and check or money order must be sent to LeeAnn G. Gaunt, Chief, Municipal Securities and Public Pensions Unit, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73501 / November 3, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16235

In the Matter of

Investment Professionals Inc.,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, PURSUANT TO
SECTIONS 15(b), 15B(c)(2) AND 21C OF
THE SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS AND
A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Investment Professionals Inc. ("Investment Professionals" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Summary

These proceedings involve the sale of non-investment grade or "junk" bonds issued by the Commonwealth of Puerto Rico ("Puerto Rico") by Investment Professionals, a registered broker-dealer and municipal securities dealer, to customers in amounts below the minimum denomination of the issue. Rule G-15(f) promulgated by the Municipal Securities Rulemaking Board ("MSRB") prohibits dealers from effecting customer transactions in municipal securities in amounts below the minimum denominations of the issues. Minimum denominations are generally intended to limit sales of municipal securities to retail investors for whom such bonds may not be suitable, but the proscriptions of Rule G-15(f) apply to all transactions with customers, regardless of whether the securities are suitable for the customer. In March 2014, Investment Professionals violated MSRB Rule G-15(f) by executing four sales transactions in the Puerto Rico bonds with customers in amounts below the \$100,000 minimum denomination of the issue.

Respondent

1. Investment Professionals is a Texas corporation that maintains principal offices in San Antonio, Texas. It is a registered broker-dealer pursuant to Section 15(b) of the Exchange Act. It is also a municipal securities dealer and a municipal securities broker as defined in Sections 3(a)(30) and 3(a)(31) of the Exchange Act.

MSRB Rule G-15(f):

Minimum Denomination Requirements for Bond Sales to Customers

2. Section 15B(b) of the Exchange Act established the MSRB and empowered it to propose and adopt rules for transactions in municipal securities by brokers, dealers, and municipal securities dealers. Section 15B(c)(1) of the Exchange Act prohibits a broker, dealer, or municipal securities dealer from using the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the MSRB. As a municipal securities dealer, Respondent is subject to Section 15B(c)(1) of the Exchange Act and MSRB rules.

3. MSRB Rule G-15(f)(i) prohibits a broker, dealer, or municipal securities dealer from effecting a customer transaction in municipal securities issued after June 1, 2002 in an amount lower than the minimum denomination of the issue except pursuant to two limited exceptions. First, under MSRB Rule G-15(f)(ii), a dealer may purchase municipal securities from a customer in an amount below the minimum denomination of the issue if the dealer determines that the customer's position in the issue is already below the minimum denomination and the customer's

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

entire position in the issue would be liquidated by the transaction. Second, under MSRB Rule G-15(f)(iii), a dealer may sell municipal securities to a customer in an amount below the minimum denomination of the issue if the dealer determines that the position being sold resulted from the liquidation of another customer's entire position in the issue which was below the minimum denomination of the issue. Additionally, a dealer selling under MSRB Rule G-15(f)(iii) must, at or before the completion of the transaction, notify the customer that the amount of the transaction is below the minimum denomination of the issue and that this may adversely affect the liquidity of the customer's position.

4. Under MSRB Rule G-15(f), brokers, dealers, and municipal securities dealers may not sell municipal securities in amounts below the minimum denomination of an issue to a customer regardless of whether the customer holds or would hold a position in the issue which is equal to or exceeds the minimum denomination of the issue. The rule also prohibits brokers, dealers, and municipal securities dealers from purchasing municipal securities in amounts below the minimum denomination of an issue from a customer whose position in the securities equals or exceeds the minimum denomination of the issue unless the customer's position is being liquidated in its entirety.

5. The purpose of MSRB Rule G-15(f) is to ensure municipal securities dealers observe the minimum denominations stated in the official documents of municipal securities issues.² Official documents for municipal securities issues may state a "minimum denomination" larger than the normal \$5,000 par due to issuers' concerns that the securities may not be appropriate for those retail investors who would be likely to purchase securities in relatively small amounts.³

The Puerto Rico General Obligation Bonds of 2014

6. On March 11, 2014, Puerto Rico issued \$3.5 billion in General Obligation Bonds of 2014, Series A (CUSIP 74514LE86) (the "2014 Bonds").

7. The 2014 Bonds are non-investment grade securities and are considered "junk" bonds. In March 2014, the 2014 Bonds had a credit rating of "Ba2" by Moody's Investors Service, "BB+" by Standard & Poor's Rating Services, and "BB" by Fitch Ratings.

8. Non-investment grade bonds present substantial risks to retail investors. Risks of investing in non-investment grade bonds include liquidity risk (*i.e.*, risk that an investor will not be able to sell a bond quickly and at an efficient price), credit risk (*i.e.*, risk of loss due to an actual or perceived deterioration in the financial health of the issuer) and interest rate risk (*i.e.*, risk that rising interest rates may cause bond prices to decline). In addition, the market for non-investment

² Order Granting Approval of Proposed Rule Change Relating to Minimum Denominations, Exchange Act Release No. 45338, 67 Fed. Reg. 6960 (Feb. 14, 2002); Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 (Dec. 28, 2001).

³ Id.

grade bonds is constricted by the fact that many municipal bond mutual funds are prohibited by their prospectuses from purchasing non-investment grade bonds.

9. The Official Statement of the Commonwealth of Puerto Rico (the "Official Statement") disseminated in connection with the issue of the 2014 Bonds specifies in pertinent part that the 2014 Bonds "are issuable as registered bonds without coupons in denominations of \$100,000 and any multiple of \$5,000 in excess thereof." During the relevant period, MSRB Rule G-15(f) permitted dealers to effect customer transactions in the 2014 Bonds in amounts equal to the \$100,000 minimum denomination of the issue or amounts greater than \$100,000 in increments of \$5,000. Dealers could therefore have effected customer transactions for \$105,000, \$110,000, and so forth. Dealers were prohibited from effecting transactions with customers in the 2014 Bonds in amounts below \$100,000, regardless of a customer's aggregate position in the 2014 Bonds.⁴

Sales in 2014 Bonds to Customers
Below the \$100,000 Minimum Denomination of the Issue

10. In March 2014, Respondent executed four sales transactions in the 2014 Bonds with customers in amounts below the \$100,000 minimum denomination of the issue established by the issuer, Puerto Rico, and specified in the Official Statement. The limited exceptions provided under MSRB Rule G-15(f) for customer transactions in municipal securities below the minimum denomination of an issue did not apply to these transactions. Respondent solicited all of the customer sales transactions.

Violations

11. As a result of the conduct described above, Respondent willfully⁵ violated MSRB Rule G-15(f).

12. As a result of Respondent's willful violations of MSRB Rule G-15(f), Respondent willfully violated Section 15B(c)(1) of the Exchange Act.

⁴ For example, a dealer could not have effected a customer transaction for \$100,000, followed by a separate below-minimum-denomination transaction for \$5,000, for a total of \$105,000. The second transaction would have violated MSRB Rule G-15(f). See Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 at n.12 (Dec. 28, 2001).

⁵ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." Id. (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).

Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent. After it became aware that it had effected customer transactions in the 2014 Bonds below the minimum denomination of the issue, Respondent cancelled the transactions.

Undertakings

Respondent will undertake to review the adequacy of its existing policies and procedures relating to compliance with MSRB Rule G-15(f). After that review, Respondent will make such changes as are necessary to effect compliance with MSRB Rule G-15(f), including adopting new policies and procedures or supplementing existing policies and procedures. Respondent will implement these policies and procedures, and conduct training as to the policies and procedures and compliance with MSRB Rule G-15(f). Respondent will inform Commission staff no later than six (6) months after the entry of this Order that it has complied with the above undertakings and shall provide the Commission staff with a copy of its existing policies and procedures as to MSRB Rule G-15(f) at that time.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 15(b), 15B(c)(2) and 21C of the Exchange Act, it is hereby ORDERED that:

- A. Respondent cease and desist from committing or causing any violations and any future violations of Section 15B(c)(1) of the Exchange Act and MSRB Rule G-15(f).
- B. Respondent is censured.
- C. Respondent shall, within seven (7) days of the entry of this Order, pay a civil money penalty in the amount of \$67,800 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. Payment must be made in one of the following ways:
 - (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
 - (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
 - (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Investment Professionals as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to LeeAnn G. Gaunt, Chief, Municipal Securities and Public Pensions Unit, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73509 / November 3, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16243

In the Matter of

Oppenheimer & Co., Inc.,

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, PURSUANT TO
SECTIONS 15(b), 15B(c)(2) AND 21C OF
THE SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS AND
A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Oppenheimer & Co., Inc. ("Oppenheimer" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

Summary

These proceedings involve the sale of non-investment grade or "junk" bonds issued by the Commonwealth of Puerto Rico ("Puerto Rico") by Oppenheimer, a registered broker-dealer and municipal securities dealer, to customers in amounts below the minimum denomination of the issue. Rule G-15(f) promulgated by the Municipal Securities Rulemaking Board ("MSRB") prohibits dealers from effecting customer transactions in municipal securities in amounts below the minimum denominations of the issues. Minimum denominations are generally intended to limit sales of municipal securities to retail customers for whom such bonds may not be suitable, but the proscriptions of Rule G-15(f) apply to all transactions with customers, regardless of whether the securities are suitable for the customer. In March 2014, Oppenheimer violated MSRB Rule G-15(f) by executing three sales transactions in the Puerto Rico bonds with customers in amounts below the \$100,000 minimum denomination of the issue.

Respondent

1. Oppenheimer is a New York corporation that maintains principal offices in New York, New York. It is a registered broker-dealer pursuant to Section 15(b) of the Exchange Act. It is also a municipal securities dealer and a municipal securities broker as defined in Sections 3(a)(30) and 3(a)(31) of the Exchange Act.

MSRB Rule G-15(f):

Minimum Denomination Requirements for Bond Sales to Customers

2. Section 15B(b) of the Exchange Act established the MSRB and empowered it to propose and adopt rules for transactions in municipal securities by brokers, dealers, and municipal securities dealers. Section 15B(c)(1) of the Exchange Act prohibits a broker, dealer, or municipal securities dealer from using the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the MSRB. As a municipal securities dealer, Respondent is subject to Section 15B(c)(1) of the Exchange Act and MSRB rules.

3. MSRB Rule G-15(f)(i) prohibits a broker, dealer, or municipal securities dealer from effecting a customer transaction in municipal securities issued after June 1, 2002 in an amount lower than the minimum denomination of the issue except pursuant to two limited exceptions. First, under MSRB Rule G-15(f)(ii), a dealer may purchase municipal securities from a customer in an amount below the minimum denomination of the issue if the dealer determines that the customer's position in the issue is already below the minimum denomination and the customer's entire position in the issue would be liquidated by the transaction. Second, under MSRB Rule G-15(f)(iii), a dealer may sell municipal securities to a customer in an amount below the minimum denomination of the issue if the dealer determines that the position being sold resulted from the liquidation of another customer's entire position in the issue which was below the minimum denomination of the issue. Additionally, a dealer selling under MSRB Rule G-15(f)(iii) must, at or before the completion of the transaction, notify the customer that the amount of the transaction is below the minimum denomination of the issue and that this may adversely affect the liquidity of the customer's position.

4. Under MSRB Rule G-15(f), brokers, dealers, and municipal securities dealers may not sell municipal securities in amounts below the minimum denomination of an issue to a customer regardless of whether the customer holds or would hold a position in the issue which is equal to or exceeds the minimum denomination of the issue. The rule also prohibits brokers, dealers, and municipal securities dealers from purchasing municipal securities in amounts below the minimum denomination of an issue from a customer whose position in the securities equals or exceeds the minimum denomination of the issue unless the customer's position is being liquidated in its entirety.

5. The purpose of MSRB Rule G-15(f) is to ensure municipal securities dealers observe the minimum denominations stated in the official documents of municipal securities issues.² Official documents for municipal securities issues may state a "minimum denomination" larger than the normal \$5,000 par due to issuers' concerns that the securities may not be appropriate for those retail investors who would be likely to purchase securities in relatively small amounts.³

The Puerto Rico General Obligation Bonds of 2014

6. On March 11, 2014, Puerto Rico issued \$3.5 billion in General Obligation Bonds of 2014, Series A (CUSIP 74514LE86) (the "2014 Bonds").

7. The 2014 Bonds are non-investment grade securities and are considered "junk" bonds. In March 2014, the 2014 Bonds had a credit rating of "Ba2" by Moody's Investors Service, "BB+" by Standard & Poor's Rating Services, and "BB" by Fitch Ratings.

8. Non-investment grade bonds present substantial risks to retail investors. Risks of investing in non-investment grade bonds include liquidity risk (*i.e.*, risk that an investor will not be able to sell a bond quickly and at an efficient price), credit risk (*i.e.*, risk of loss due to an actual or perceived deterioration in the financial health of the issuer) and interest rate risk (*i.e.*, risk that rising interest rates may cause bond prices to decline). In addition, the market for non-investment grade bonds is constricted by the fact that many municipal bond mutual funds are prohibited by their prospectuses from purchasing non-investment grade bonds.

9. The Official Statement of the Commonwealth of Puerto Rico (the "Official Statement") disseminated in connection with the issue of the 2014 Bonds specifies in pertinent part that the 2014 Bonds "are issuable as registered bonds without coupons in denominations of \$100,000 and any multiple of \$5,000 in excess thereof." During the relevant period, MSRB Rule G-15(f) permitted dealers to effect customer transactions in the 2014 Bonds in amounts equal to the \$100,000 minimum denomination of the issue or amounts greater than \$100,000 in increments of \$5,000. Dealers could therefore have effected customer transactions for \$105,000, \$110,000, and

² Order Granting Approval of Proposed Rule Change Relating to Minimum Denominations, Exchange Act Release No. 45338, 67 Fed. Reg. 6960 (Feb. 14, 2002); Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 (Dec. 28, 2001).

³ Id.

so forth. Dealers were prohibited from effecting transactions with customers in the 2014 Bonds in amounts below \$100,000, regardless of a customer's aggregate position in the 2014 Bonds.⁴

**Sales in 2014 Bonds to Customers
Below the \$100,000 Minimum Denomination of the Issue**

10. In March 2014, Respondent executed three unsolicited sales transactions in the 2014 Bonds with customers in amounts below the \$100,000 minimum denomination of the issue established by the issuer, Puerto Rico, and specified in the Official Statement. The limited exceptions provided under MSRB Rule G-15(f) for customer transactions in municipal securities below the minimum denomination of an issue did not apply to these transactions.

11. Respondent did not have any policies or procedures concerning MSRB Rule G-15(f).

Violations

12. As a result of the conduct described above, Respondent willfully⁵ violated MSRB Rule G-15(f).

13. As a result of Respondent's willful violations of MSRB Rule G-15(f), Respondent willfully violated Section 15B(c)(1) of the Exchange Act.

Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent. After it was made aware that it had effected customer transactions in the 2014 Bonds below the minimum denomination of the issue, Respondent cancelled the transactions.

Undertakings

Respondent will undertake to review the adequacy of its existing policies and procedures relating to compliance with MSRB Rule G-15(f). After that review, Respondent will make such changes as are necessary to effect compliance with MSRB Rule G-15(f), including adopting new policies and procedures or supplementing existing policies and procedures. Respondent will implement these policies and procedures, and conduct training as to the policies and procedures and compliance with MSRB Rule G-15(f). Respondent will inform Commission staff no later than six (6) months after the entry of this Order that it has complied with the above undertakings

⁴ For example, a dealer could not have effected a customer transaction for \$100,000, followed by a separate below-minimum-denomination transaction for \$5,000, for a total of \$105,000. The second transaction would have violated MSRB Rule G-15(f). See Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 at n.12 (Dec. 28, 2001).

⁵ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." Id. (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).

and shall provide the Commission staff with a copy of its existing policies and procedures as to MSRB Rule G-15(f) at that time.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 15(b), 15B(c)(2) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent cease and desist from committing or causing any violations and any future violations of Section 15B(c)(1) of the Exchange Act and MSRB Rule G-15(f).

B. Respondent is censured.

C. Respondent shall, within seven (7) days of the entry of this Order, pay a civil money penalty in the amount of \$61,200 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Schwab as a Respondent in these proceedings, and the file number of these proceedings; a copy of

the cover letter and check or money order must be sent to LeeAnn G. Gaunt, Chief, Municipal Securities and Public Pensions Unit, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

*Chair White
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3964 / November 3, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16245

In the Matter of

Rajarengan (a/k/a Rengan)
Rajaratnam,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 203(f) OF THE
INVESTMENT ADVISERS ACT OF 1940,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Rajarengan (a/k/a Rengan) Rajaratnam ("Rengan Rajaratnam" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings and the findings contained in Section III.2., below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings and Imposing Remedial Sanctions ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Rengan Rajaratnam, 44 years old, is a resident of New York, NY. During 2007 through 2009, Rengan Rajaratnam was a portfolio manager of certain hedge funds advised by Galleon Management LP ("Galleon"), an investment adviser then registered with the Commission. Prior to his employment at Galleon, Rengan Rajaratnam was a portfolio manager at Sedna Capital Management, LLC, an investment adviser firm then registered with the Commission that he co-founded.

2. On October 28, 2014, a final judgment was entered on consent against Rengan Rajaratnam, permanently enjoining him from future violations of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder, in the civil action entitled S.E.C. v. Rajarengan (a/k/a Rengan) Rajaratnam, Civil Action Number 13-CV-1894 (JGK), in the United States District Court for the Southern District of New York.

3. The Commission's complaint alleged that Rengan Rajaratnam participated in multiple insider trading schemes to illegally trade securities based on material nonpublic information. The material nonpublic information Rengan Rajaratnam was alleged to have traded on related to merger and acquisition activity and quarterly earnings announcements. According to the complaint, Rengan Rajaratnam generated substantial insider trading profits for himself personally and for the portfolios he managed by trading on illegal tips.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Rajaratnam's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 203(f) of the Advisers Act, that Respondent Rengan Rajaratnam be, and hereby is:

barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent, with the right to apply for reentry after 5 years to the appropriate self-regulatory organization, or if there is none, to the Commission.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Brent J. Fields
Secretary

Kevin M. O'Neill
By: Kevin M. O'Neill
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73510 / November 3, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16244

In the Matter of

Riedl First Securities Co. of Kansas,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, PURSUANT TO
SECTIONS 15(b), 15B(c)(2) AND 21C OF
THE SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS AND
A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Riedl First Securities Co. of Kansas ("Riedl" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b), 15B(c)(2) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

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Summary

These proceedings involve the sale of non-investment grade or "junk" bonds issued by the Commonwealth of Puerto Rico ("Puerto Rico") by Riedl, a registered broker-dealer and municipal securities dealer, to customers in amounts below the minimum denomination of the issue. Rule G-15(f) promulgated by the Municipal Securities Rulemaking Board ("MSRB") prohibits dealers from effecting customer transactions in municipal securities in amounts below the minimum denominations of the issues. Minimum denominations are generally intended to limit sales of municipal securities to retail investors for whom such bonds may not be suitable, but the proscriptions of Rule G-15(f) apply to all transactions with customers, regardless of whether the securities are suitable for the customer. In March 2014, Riedl violated MSRB Rule G-15(f) by executing 28 sales transactions in the Puerto Rico bonds with customers in an amount below the \$100,000 minimum denomination of the issue.

Respondent

1. Riedl is a Kansas corporation that maintains principal offices in Wichita, Kansas. It is a registered broker-dealer pursuant to Section 15(b) of the Exchange Act. It is also a municipal securities dealer and a municipal securities broker as defined in Sections 3(a)(30) and 3(a)(31) of the Exchange Act.

MSRB Rule G-15(f):

Minimum Denomination Requirements for Bond Sales to Customers

2. Section 15B(b) of the Exchange Act established the MSRB and empowered it to propose and adopt rules for transactions in municipal securities by brokers, dealers, and municipal securities dealers. Section 15B(c)(1) of the Exchange Act prohibits a broker, dealer, or municipal securities dealer from using the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in contravention of any rule of the MSRB. As a municipal securities dealer, Respondent is subject to Section 15B(c)(1) of the Exchange Act and MSRB rules.

3. MSRB Rule G-15(f)(i) prohibits a broker, dealer, or municipal securities dealer from effecting a customer transaction in municipal securities issued after June 1, 2002 in an amount lower than the minimum denomination of the issue except pursuant to two limited exceptions. First, under MSRB Rule G-15(f)(ii), a dealer may purchase municipal securities from a customer in an amount below the minimum denomination of the issue if the dealer determines that the customer's position in the issue is already below the minimum denomination and the customer's entire position in the issue would be liquidated by the transaction. Second, under MSRB Rule G-15(f)(iii), a dealer may sell municipal securities to a customer in an amount below the minimum denomination of the issue if the dealer determines that the position being sold resulted from the liquidation of another customer's entire position in the issue which was below the minimum denomination of the issue. Additionally, a dealer selling under MSRB Rule G-15(f)(iii) must, at or before the completion of the transaction, notify the customer that the amount of the transaction is below the minimum denomination of the issue and that this may adversely affect the liquidity of the customer's position.

4. Under MSRB Rule G-15(f), brokers, dealers, and municipal securities dealers may not sell municipal securities in amounts below the minimum denomination of an issue to a customer regardless of whether the customer holds or would hold a position in the issue which is equal to or exceeds the minimum denomination of the issue. The rule also prohibits brokers, dealers, and municipal securities dealers from purchasing municipal securities in amounts below the minimum denomination of an issue from a customer whose position in the securities equals or exceeds the minimum denomination of the issue unless the customer's position is being liquidated in its entirety.

5. The purpose of MSRB Rule G-15(f) is to ensure municipal securities dealers observe the minimum denominations stated in the official documents of municipal securities issues.² Official documents for municipal securities issues may state a "minimum denomination" larger than the normal \$5,000 par due to issuers' concerns that the securities may not be appropriate for those retail investors who would be likely to purchase securities in relatively small amounts.³

The Puerto Rico General Obligation Bonds of 2014

6. On March 11, 2014, Puerto Rico issued \$3.5 billion in General Obligation Bonds of 2014, Series A (CUSIP 74514LE86) (the "2014 Bonds").

7. The 2014 Bonds are non-investment grade securities and are considered "junk" bonds. In March 2014, the 2014 Bonds had a credit rating of "Ba2" by Moody's Investors Service, "BB+" by Standard & Poor's Rating Services, and "BB" by Fitch Ratings.

8. Non-investment grade bonds present substantial risks to retail investors. Risks of investing in non-investment grade bonds include liquidity risk (*i.e.*, risk that an investor will not be able to sell a bond quickly and at an efficient price), credit risk (*i.e.*, risk of loss due to an actual or perceived deterioration in the financial health of the issuer) and interest rate risk (*i.e.*, risk that rising interest rates may cause bond prices to decline). In addition, the market for non-investment grade bonds is constricted by the fact that many municipal bond mutual funds are prohibited by their prospectuses from purchasing non-investment grade bonds.

9. The Official Statement of the Commonwealth of Puerto Rico (the "Official Statement") disseminated in connection with the issue of the 2014 Bonds specifies in pertinent part that the 2014 Bonds "are issuable as registered bonds without coupons in denominations of \$100,000 and any multiple of \$5,000 in excess thereof." During the relevant period, MSRB Rule G-15(f) permitted dealers to effect customer transactions in the 2014 Bonds in amounts equal to the \$100,000 minimum denomination of the issue or amounts greater than \$100,000 in increments of \$5,000. Dealers could therefore have effected customer transactions for \$105,000, \$110,000, and

² Order Granting Approval of Proposed Rule Change Relating to Minimum Denominations, Exchange Act Release No. 45338, 67 Fed. Reg. 6960 (Feb. 14, 2002); Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 (Dec. 28, 2001).

³ Id.

so forth. Dealers were prohibited from effecting transactions with customers in the 2014 Bonds in amounts below \$100,000, regardless of a customer's aggregate position in the 2014 Bonds.⁴

Sales in 2014 Bonds to Customers
Below the \$100,000 Minimum Denomination of the Issue

10. In March 2014, Respondent executed 28 sales transactions in the 2014 Bonds with customers in amounts below the \$100,000 minimum denomination of the issue established by the issuer, Puerto Rico, and specified in the Official Statement. The limited exceptions provided under MSRB Rule G-15(f) for customer transactions in municipal securities below the minimum denomination of an issue did not apply to this transaction. Respondent solicited all of the customer sales transactions.

Violations

11. As a result of the conduct described above, Respondent willfully⁵ violated MSRB Rule G-15(f).

12. As a result of Respondent's willful violations of MSRB Rule G-15(f), Respondent willfully violated Section 15B(c)(1) of the Exchange Act.

Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent. After it was made aware by Commission staff that it had effected customer transactions in the 2014 Bonds below the minimum denomination of the issue, Respondent cancelled the transactions. In cancelling the transactions, Respondent incurred costs of \$11,600.

Undertakings

Respondent will undertake to review the adequacy of its existing policies and procedures relating to compliance with MSRB Rule G-15(f). After that review, Respondent will make such changes as are necessary to effect compliance with MSRB Rule G-15(f), including adopting new policies and procedures or supplementing existing policies and procedures. Respondent will implement these policies and procedures, and conduct training as to the policies and procedures and compliance with MSRB Rule G-15(f). Respondent will inform Commission staff no later

⁴ For example, a dealer could not have effected a customer transaction for \$100,000, followed by a separate below-minimum-denomination transaction for \$5,000, for a total of \$105,000. The second transaction would have violated MSRB Rule G-15(f). See Notice of Filing of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Minimum Denominations, Exchange Act Release No. 45174, 66 Fed. Reg. 67342 at n.12 (Dec. 28, 2001).

⁵ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." Id. (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).

than six (6) months after the entry of this Order that it has complied with the above undertakings and shall provide the Commission staff with a copy of its existing policies and procedures as to MSRB Rule G-15(f) at that time.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 15(b), 15B(c)(2) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent cease and desist from committing or causing any violations and any future violations of Section 15B(c)(1) of the Exchange Act and MSRB Rule G-15(f).

B. Respondent is censured.

C. Respondent shall, within seven (7) days of the entry of this Order, pay a civil money penalty in the amount of \$130,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofin.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Riedl as a Respondent in these proceedings, and the file number of these proceedings; a copy of the

cover letter and check or money order must be sent to LeeAnn G. Gaunt, Chief, Municipal Securities and Public Pensions Unit, Securities and Exchange Commission, Boston Regional Office, 33 Arch Street, 23rd Floor, Boston, MA 02110.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-73511; File No. 4-657)

November 3, 2014

Joint Industry Plan; BATS Exchange, Inc., BATS Y-Exchange, Inc., Chicago Stock Exchange, Inc., EDGA Exchange, Inc., EDGX Exchange, Inc., Financial Industry Regulatory Authority, Inc., NASDAQ OMX BX, Inc., NASDAQ OMX PHLX LLC, The Nasdaq Stock Market LLC, New York Stock Exchange LLC, NYSE MKT LLC, and NYSE Arca, Inc.; Notice of Filing of Proposed National Market System Plan to Implement a Tick Size Pilot Program On a One-Year Pilot Basis

I. Introduction

Pursuant to Section 11A of the Securities Exchange Act of 1934 (“Act” or “Exchange Act”)¹ and Rule 608 thereunder², notice is hereby given that, on August 25, 2014, NYSE Group, Inc., on behalf of BATS Exchange, Inc., BATS Y-Exchange, Inc., Chicago Stock Exchange, Inc., EDGA Exchange, Inc., EDGX Exchange, Inc., Financial Industry Regulatory Authority, Inc., NASDAQ OMX BX, Inc., NASDAQ OMX PHLX LLC, the Nasdaq Stock Market LLC, New York Stock Exchange LLC, NYSE MKT LLC, and NYSE Arca, Inc. (collectively “SROs” or “Participants”), filed with the Securities and Exchange Commission (“Commission”) a proposed national market system (“NMS”) Plan to Implement a Tick Size Pilot Program (“Plan”). A copy of the proposed Plan, which includes the details of a proposed Tick Size Pilot Program (“Pilot”) is attached as Exhibit A hereto. The Commission is publishing this notice to solicit comments on the proposed Plan and Pilot.

¹ 15 U.S.C. 78k-1.

² 17 CFR 242.608.

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II. Background

On June 24, 2014, the Commission issued an order pursuant to Section 11A(a)(3)(B) of the Act³ directing the Participants to act jointly in developing and filing with the Commission a NMS plan to implement a pilot program that, among other things, would widen the quoting and trading increment for certain small capitalization stocks as described in the order by August 25, 2014 (“Order” or “Tick Size Pilot Plan Order”).⁴ Pursuant to the Order, the SROs filed the proposed Plan, which includes the proposed Pilot as described below.

III. Description of the Plan

Section III is the statement of purpose of the proposed Plan, along with the information required by Rule 608(a)(4) and (5) under the Act. The remainder of Section III appears exactly as prepared and submitted by the Participants.⁵

* * * * *

A. Statement of Purpose

The Participants are filing the proposed Plan in order to implement a pilot program for a one- year pilot period (“Pilot Period”) that, among other things, would widen the quoting and trading increments for certain small capitalization stocks (“Tick Size Pilot Program”). The purpose of the Plan, and the Tick Size Pilot Program it contains, is to assist the Commission, market participants, and the public in studying and assessing the impact of increment conventions on the liquidity and trading of stocks of small capitalization companies. The Plan

³ 15 U.S.C. 78k-1(a)(3)(B).

⁴ See Securities Exchange Act Release No. 72460, 79 FR 36840 (June 30, 2014).

⁵ See Letter from Brendon J. Weiss, Vice President, Intercontinental Exchange, Inc., to Secretary, Commission, dated August 25, 2014 (“Transmittal Letter”).

sets forth proposed procedures for selecting a representative group of stocks of small capitalization companies ("Pilot Securities") and subjecting groups of those Pilot Securities ("Test Groups") to various requirements with regards to quoting and trading increments. As set forth in more detail in the Plan, Participants will be required to adopt rules to ensure that Pilot Securities in the Test Groups are quoted and traded in permitted increments.⁶

Selection of Pilot Securities for Inclusion in the Tick Size Pilot Program

Pilot Securities will consist of those NMS common stocks⁷ that satisfy the following criteria: (1) A market capitalization of \$5 billion or less on the last day of the Measurement Period,⁸ where market capitalization is calculated by multiplying the total number of shares outstanding on such day by the Closing Price⁹ of the security on such day; (2) A Closing Price of at least \$2.00 on the last day of the Measurement Period; (3) A Closing Price on every trading day during the Measurement Period that is not less than \$1.50; (4) A Consolidated Average Daily Volume ("CADV") during the Measurement Period of one million shares or less, where the CADV is calculated by adding the single-counted share volume of all reported transactions in the NMS common stock during the Measurement Period and dividing by the total number of

⁶ Participants operating trading centers will be required, pursuant to the Plan, to ensure that Pilot Securities in the Test Groups are quoted and traded in permitted increments. As applicable, members of Participants will be required, pursuant to rules of self-regulatory organizations, to ensure that Pilot Securities in the Test Groups are quoted and traded in permitted increments.

⁷ NMS common stock is defined in the Plan as NMS stock that is common stock of an operating company.

⁸ Measurement Period is defined in the Plan as the U.S. trading days during the three-calendar-month period ending at least 30 days prior to the effective date of the Pilot Period.

⁹ Closing Price is defined in the Plan as the closing auction price on the primary listing exchange, or if not available, then the last regular-way trade reported by the processor prior to 4:00 p.m. ET.

U.S. trading days during the Measurement Period; and (5) A Measurement Period Volume-Weighted Average Price ("Measurement Period VWAP") of at least \$2.00, where the Measurement Period VWAP is determined by calculating the VWAP of the NMS common stock for each U.S. trading day during the Measurement Period, summing the daily VWAP across the Measurement Period, and dividing by the total number of U.S. trading days during the Measurement Period.¹⁰

The Participants believe that the above criteria will result in the selection of those stocks that are most likely to benefit from a larger tick size because such stocks will tend to have higher average effective spreads. Additionally, the criteria should help to ensure that those stocks most likely to fall below \$1.00 during the Pilot Period are not included in the Tick Size Pilot Program.¹¹

The Participants have decided not to include any NMS common stock that has its initial public offering within six months of the start of the Pilot Period. Such stocks will not have the full set of data required to be collected under the Plan for the six-month period before the start of the Tick Size Pilot Program. The Participants believe that the value of subjecting such stocks to the quoting and trading requirements of the Plan is diminished because market participants will not be able to analyze the effects of the quoting and trading requirements against a sufficient baseline.

Once the complete list of Pilot Securities is determined, the Participants will select, by means of a stratified random sampling process, the Pilot Securities to be placed into the three

¹⁰ For purposes of the CADV and Measurement Period VWAP calculations, U.S. trading days during the Measurement Period with early closes will be excluded.

¹¹ While the criteria are designed to avoid selecting an NMS common stock likely to fall below \$1.00, a Pilot Security that falls below \$1.00 during the Pilot Period will remain in the Tick Size Pilot Program.

Test Groups. Those Pilot Securities not placed into the three Test Groups will constitute the Control Group. To effect the stratified random sampling, the Pilot Securities will be categorized based on price, market capitalization, and trading volume, and each of those three categories will be further subdivided into low, medium, or high subcategories.¹² As a result, the Pilot Securities will be grouped into a total of 27 categories.

The Tick Size Pilot Plan Order called for the selection of Pilot Securities by means of a stratified random sampling process with the Pilot Securities categorized based on only price and market capitalization.¹³ The Plan also requires categorization by trading volume. The Participants believe that the addition of the trading volume category will create more detailed groups of Pilot Securities that will, in turn, lead to a diverse set of stocks selected for inclusion into each Test Group. The Participants believe that the more detailed groups will aid in the assessment process described below by permitting the Commission, market participants, and the public to review the effects of the quoting and trading increment requirements on stocks with a variety of characteristics.

A random sample of Pilot Securities from each of the 27 categories will be placed into the three Test Groups in a number proportional to the category's size relative to the population of Pilot Securities. So, for example, if the category consisting of high priced, high market capitalization, and medium trading volume Pilot Securities contained 5% of the Pilot Securities, that category would make up 5% of each Test Group. Further, a primary listing market's stocks will be selected from each category and included in the three Test Groups in the same proportion as that primary listing market's stocks comprise each category of Pilot Securities.

¹² Low, medium, and high subcategories will be established by dividing the categories into three parts, each containing a third of the population.

¹³ See Tick Size Pilot Plan Order at 36844.

Each Test Group will consist of 400 Pilot Securities and the Control Group will consist of the remaining Pilot Securities. The Participants believe that including 400 Pilot Securities in each Test Group will allow each Test Group to be statistically large enough to generate data to reliably test for the effects of a larger tick size. Additionally, if any Pilot Securities need to be removed from the data analysis due to unforeseen events, the Participants believe that including 400 Pilot Securities in each Test Group will ensure that the data on the remaining Pilot Securities will be sufficient to complete the required assessments.

Each primary listing exchange will make publicly available for free on its website a list of those Pilot Securities listed on that exchange and included in the Control Group and each Test Group. The list will be adjusted for ticker symbol changes and relevant corporate actions and will contain the data specified in Appendix A to the Plan.

Control and Test Groups' Increment Conventions and Trade-at Restrictions

During the Pilot Period, the Control Group and Test Groups will be subjected to quoting and trading increment requirements designed to allow the Commission, market participants, and the public to assess the effect of pricing increment decimalization on small capitalization companies.

Pilot Securities in the Control Group may be quoted and traded at any price increment that is currently permitted.¹⁴ Maintaining the Control Group with the current quoting and trading increments will provide a baseline to analyze the economic effects of the wider quoting and trading increments required by the Test Groups.

¹⁴ Consistent with Rule 612(b) of Regulation NMS, bids or offers, orders, or indications of interest priced less than \$1.00 per share for Pilot Securities in the Control Group may be displayed, ranked, or accepted in \$0.0001 increments.

Pilot Securities in Test Group One will be quoted in \$0.05 minimum increments but may continue to trade at any price increment that is currently permitted. Participants will adopt rules prohibiting Participants or any member of a Participant from displaying, ranking, or accepting from any person any displayable and non-displayable bids or offers, orders, or indications of interest in any Pilot Security in Test Group One in price increments other than \$0.05. However, orders priced to execute at the midpoint and orders entered into a Participant-operated retail liquidity program may be ranked and accepted in increments of less than \$0.05.

Pilot Securities in Test Group Two will be subject to the same quoting requirements as Test Group One, along with the applicable quoting exceptions. In addition, Pilot Securities in Test Group Two may only be traded in \$0.05 minimum increments. Participants will adopt rules prohibiting trading centers¹⁵ operated by Participants and members of Participants from executing orders in any Pilot Security in Test Group Two in price increments other than \$0.05.

The \$0.05 minimum trading increment will apply to brokered cross trades.¹⁶ Pilot Securities in Test Group Two may trade in increments less than \$0.05 under the following circumstances:

(1) Trading may occur at the midpoint between the National Best Bid and the National Best Offer (“NBBO”) or the midpoint between the best protected bid and the best protected offer;

(2) Retail Investor Orders¹⁷ may be provided with price improvement that is at least \$0.005 better than the best protected bid or the best protected offer; and

¹⁵ Trading center is defined in the Plan as having the same meaning as that provided in Rule 600(b)(78) of Regulation NMS under the Exchange Act.

¹⁶ A brokered cross trade is defined in the Plan as a trade that a broker-dealer that is a member of a Participant executes directly by matching simultaneous buy and sell orders for a Pilot Security.

(3) Negotiated Trades¹⁸ may trade in increments less than \$0.05.

Pilot Securities in Test Group Three will be subject to the same quoting and trading requirements as Test Group Two, along with the applicable quoting and trading exceptions. In addition, Pilot Securities in Test Group Three will be subject to a trade-at prohibition. The purpose of the trade-at prohibition is to assess and gather data with respect to the impact of market-wide restrictions on price-matching activity by market participants that are not quoting aggressively or otherwise offering liquidity in Pilot Securities at competitive prices. Toward that

¹⁷ A Retail Investor Order is defined in the Plan as an agency order or a riskless principal order originating from a natural person, provided that, prior to submission, no change is made to the terms of the order with respect to price or side of market and the order does not originate from a trading algorithm or any other computerized methodology. Such orders include those retail orders entered into Participant-operated retail liquidity programs. The Participant that is the Designated Examining Authority of a member of a Participant operating a trading center executing a Retail Investor Order will require such trading center to sign an attestation that substantially all orders to be executed as Retail Investor Orders will qualify as such under the Plan.

¹⁸ A Negotiated Trade is defined in the Plan as: (i) a Benchmark trade, including, but not limited to, a Volume-Weighted Average Price trade or a Time-Weighted Average Price trade, provided that, if such a trade is comprised of two or more component trades, each component trade complies with the quoting and trading increment requirements of the Plan, or with an exception to such requirements, or (ii) a Pilot Qualified Contingent Trade. A Benchmark Trade is defined in the Plan as the execution of an order at a price that was not based, directly or indirectly, on the quoted price of a Pilot Security at the time of execution and for which the material terms were not reasonably determinable at the time the commitment to execute the order was made. A Pilot Qualified Contingent Trade is defined in the Plan as a transaction consisting of two or more component orders, executed as agent or principal, where: (1) at least one component order is in an NMS common stock; (2) all components are effected with a product or price contingency that either has been agreed to by the respective counterparties or arranged for by a broker-dealer as principal or agent; (3) the execution of one component is contingent upon the execution of all other components at or near the same time; (4) the specific relationship between the component orders (*e.g.*, the spread between the prices of the component orders) is determined at the time the contingent order is placed; (5) the component orders bear a derivative relationship to one another, represent different classes of shares of the same issuer, or involve the securities of participants in mergers or with intentions to merge that have been announced or since cancelled; and (6) the transaction is fully hedged (without regard to any prior existing position) as a result of the other components of the contingent trade.

end, the trade-at prohibition of the Plan, operating in conjunction with applicable exceptions, generally will condition the ability of a trading center to execute at a protected quotation on that trading center's contemporaneous display of liquidity, either via a processor¹⁹ or an SRO quotation feed²⁰, at that, or a superior, price level, thereby discouraging passive price-matching and incentivizing aggressive quoting. Under the trade-at prohibition, the Plan will (1) prevent a trading center that was not quoting from price-matching protected quotations and (2) permit a trading center that was quoting at a protected quotation to execute orders at that level, but only up to the amount of its displayed size.

The Commission's Tick Size Pilot Plan Order stated that the trade-at prohibition "is intended to prevent price matching by a trading center not displaying the NBBO."²¹ Accordingly, the Plan seeks to protect displayed liquidity and to prevent passive-price matching. Based on their experience observing price competition on the market centers that they regulate and market-wide, the Participants believe that the most appropriate and workable reference point for formulating a restriction on price-matching is the standard of a "protected quotation" rather than "the NBBO." The "protected quotation" standard would appear to have the following policy, structural, and operational advantages.

First, the "protected quotation" standard would give broader protection to aggressively displayed quotes, in that the "NBBO" is limited to the single best order in the market, while the "protected quotation" standard encompasses the aggregate of the most aggressively priced

¹⁹ Processor is defined in the Plan as the single plan processor responsible for the consolidation of information for an NMS stock pursuant to Rule 603(b) of Regulation NMS under the Exchange Act.

²⁰ SRO quotation feed is defined in the Plan as any market data feed disseminated by a self-regulatory organization.

²¹ See Tick Size Pilot Plan Order at 36845.

displayed liquidity on all trading centers.²² Additionally, the Participants believe that not only should the best protected quotations be protected, but also that all protected quotations should be protected, as such protected quotations could likewise be the basis for passive price-matching.

Second, the only other difference between the NBBO and the best protected quotations is that the NBBO would include manual quotations. The Commission has previously recognized that manual quotations are not within the scope of liquidity that should be protected for Rule 611 of Regulation NMS (“Rule 611”) (i.e., trade-through) purposes. Based on their experience implementing Rule 611 and other provisions related to intermarket display and price priority, the Participants believe that the scope of the trade-at prohibition in the Plan should be appropriately aligned with that of Regulation NMS.

Third, Participants believe that the trend, in terms of the design and development of systems that perform matching and routing functions, is to reference “protected quotations” rather than “the NBBO” and that the approach of the Plan would therefore provide a more workable approach for the assessment contemplated by the Plan. Most market centers today track the market center's view of protected quotations in its automated execution systems in order to comply with Rule 611. Changing such view for trade-at purposes to the market center's view of the NBBO or to the NBBO as displayed by the processor would incur additional development time, operational complexity and risk, and potentially create unintended conflicts between the logic designed to comply with Rule 611 and trade-at compliance logic.

²² See 17 CFR. § 242.600(b)(42). When two or more market centers transmit to the plan processor identical bids or offers for an NMS security, the best bid or best offer is determined by ranking the identical bids or offers by size and then time. As a result, while two market centers may display identical prices, only one market center will display the national best bid or national best offer.

Fourth, from a textual and implementation perspective, the Participants believe that achieving as great a degree of definitional simplicity is imperative. Specifically, the Participants believe that the reference to “the NBBO,” with continued qualifications excluding manual quotations, would produce an approach that is unnecessarily more complex than grounding the trade-at prohibition in the more workable “protected quotation” standard.

In any event, the Plan, as demonstrated below, will prevent those trading centers not displaying at the best protected quotations from passively price matching those competitive quotations. If a trading center is not displayed at a best protected quotation, the trading center will not be able to execute any orders at that price level without first executing against that displayed liquidity. Accordingly, the Participants believe that the approach of the Plan is well-grounded in the discretion of Rule 611 and directly aligned with both the language and logic of the Commission's Tick Size Pilot Plan Order.

In accordance with the above reasoning, the Plan provides that Participants will adopt rules prohibiting trading centers operated by Participants and members of Participants from executing a sell order for a Pilot Security at the price of a protected bid or from executing a buy order for a Pilot Security at the price of a protected offer unless such execution falls within an exception set forth below.

Trading centers will be permitted to execute an order for a Pilot Security at a price equal to a protected bid or protected offer under the following circumstances:

- (1) The order is executed by a trading center that is displaying a quotation, via either a processor or an SRO quotation feed,²³ at a price equal to the traded-at protected quotation but

²³ The Participants believe that a trading center displaying a quotation either via a processor, as a protected quotation, or via an SRO quotation feed, as a quotation below

only up to the trading center's full displayed size. Where the quotation is displayed through a national securities exchange, the execution at the size of the order must occur against the displayed size on that national securities exchange. Where the quotation is displayed through the Alternative Display Facility or another facility approved by the Commission that does not provide execution functionality, the execution at the size of the order must occur against the displayed size in accordance with the rules of the Alternative Display Facility or such approved facility;

(2) The order is of Block Size;²⁴

(3) The order is a Retail Investor Order executed with at least \$0.005 price improvement;

(4) The order is executed when the trading center displaying the protected quotation that was traded at was experiencing a failure, material delay, or malfunction of its systems or equipment;

(5) The order is executed as part of a transaction that was not a "regular way" contract;²⁵

the trading center's top-of-book, should be able to avail themselves of this exception. As detailed in Example 3 below, a trading center would be able to trade at the price of a protected quotation against its depth-of-book displayed quotations in order to promote the display of protected quotations at a more aggressively-priced quotation.

²⁴ Block Size is defined in the Plan as having the same meaning as that provided in Rule 600(b)(9) of Regulation NMS under the Exchange Act.

²⁵ For purposes of the trade-at prohibition, "regular way" contract has the same meaning as the term is used in Rule 611(b). In the Regulation NMS Adopting Release, the Commission stated that "regular way" refers to "bids, offers, and transactions that embody the standard terms and conditions of a market." *See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496, 37537 n. 326 (June 29, 2005).*

- (6) The order is executed as part of a single-priced opening, reopening, or closing transaction by the trading center;
- (7) The order is executed when a protected bid was priced higher than a protected offer in the Pilot Security;
- (8) The order is identified as an Intermarket Sweep Order;
- (9) The order is executed by a trading center that simultaneously routed Trade-at Intermarket Sweep Orders ("Trade-at ISOs")²⁶ to execute against the full displayed size of any protected quotation in the Pilot Security that was traded at;
- (10) The order is executed as part of a Negotiated Trade;

²⁶ A Trade-at ISO is defined in the Plan as a limit order for a Pilot Security that meets the following requirements: (1) When routed to a trading center, the limit order is identified as an Intermarket Sweep Order; and (2) Simultaneously with the routing of the limit order identified as an Intermarket Sweep Order, one or more additional limit orders, as necessary, are routed to execute against the full displayed size of any protected bid, in the case of a limit order to sell, or the full displayed size of any protected offer, in the case of a limit order to buy, for the Pilot Security with a price that is equal to the limit price of the limit order identified as an Intermarket Sweep Order. These additional routed orders also must be marked as Intermarket Sweep Orders. The Tick Size Pilot Plan Order provides for an ISO exception to the trade-at prohibition that, as described above, involves routing ISOs to execute against the full displayed size of protected quotations. See Tick Size Pilot Plan Order, 79 FR at 36846. From the perspective of the sending market, and as described in the Tick Size Pilot Plan Order, this usage of an ISO differs from the definition of ISO in Rule 600(b)(30) of Regulation NMS in that the ISOs, for purposes of the trade-at prohibition, need to be routed to execute against protected quotations with a price that is *equal* to the limit price of the order routed to a protected quotation. See *id.* at n. 65. For purposes of the trade-through prohibition in Rule 611 of Regulation NMS, Rule 600(b)(30) provides that ISOs need to be routed to execute against those protected quotations with a price that is *superior* to the limit price of the order routed to a protected quotation. To account for the differences in ISO usage, the Participants have defined ISOs routed to take advantage of the exception to the trade-at prohibition as Trade-at ISOs. From the perspective of the receiving market, the receipt of an ISO routed to comply with the exception to the trade-at prohibition is no different from the receipt of an ISO routed to comply with the exception to the trade-through prohibition; in both cases, the ISO designation permits the receiving market to execute the ISO at its limit price without regard to prices on away markets.

(11) The order is executed when the trading center displaying the protected quotation that was traded at had displayed, within one second prior to execution of the transaction that constituted the trade-at, a best bid or best offer, as applicable, for the Pilot Security with a price that was inferior to the price of the trade-at transaction;

(12) The order is executed by a trading center which, at the time of order receipt, the trading center had guaranteed an execution at no worse than a specified price (a "stopped order"), where: a. The stopped order was for the account of a customer; b. The customer agreed to the specified price on an order-by-order basis; and c. The price of the trade-at transaction was, for a stopped buy order, equal to the national best bid in the Pilot Security at the time of execution or, for a stopped sell order, equal to the national best offer in the Pilot Security at the time of execution; or

(13) The order is for a fractional share of a Pilot Security, provided that such fractional share order was not the result of breaking an order for one or more whole shares of a Pilot Security into orders for fractional shares or was not otherwise effected to evade the requirements of the trade-at prohibition or any other provisions of the Plan.²⁷

The first exception to the trade-at prohibition is designed to address the intended scope of the trade-at prohibition, as discussed above and illustrated in the examples below. The Participants believe that a trading center displaying, either via a processor or an SRO quotation feed, at a protected quotation should only be able to execute against the full displayed size at that price, and should not be able to trade any hidden size at that price without complying with one of the exceptions detailed above. Without such a limitation, trading centers and market participants

²⁷ A trading center complying with one of these exceptions under the trade-at prohibition must still ensure that any execution complies with Rule 611.

may not be incentivized to display quotations for a significant number of shares of Pilot Securities, thus circumventing the purposes of the trade-at prohibition. Therefore, to incentivize the public display of liquidity, only those orders-and those portions of such orders that are fully displayed, either via a processor or an SRO quotation feed, on a trading center will be executable against a contra-side order at the price of a protected quotation before requiring a trading center to comply with another exception to the trade-at prohibition.

The Tick Size Pilot Order included the third and fourth exceptions to the trade-at prohibition.²⁸ The Participants, however, determined not to include in the Plan the significant price improvement exception set out in the Tick Size Pilot Plan Order. Because of the applicable trading and quoting increments, an execution of an order at a price superior to a protected quotation will necessarily result in significant price improvement. Therefore, the Participants believe the significant price improvement exception is superfluous.

The fifth through thirteenth exceptions apply the trade-through exceptions found in Rule 611(b) to the trade-at prohibition. The Participants believe that the rationales underlying the trade-through exceptions apply to the trade-at prohibition as well. Consistent with this belief, the Participants have included the trade-through exceptions as exceptions to the trade-at prohibition, subject to a few minor changes to account for the difference between the trade-at prohibition and the trade-through prohibition.

Finally, the fourteenth exception implements an exception for fractional shares, but only with respect to situations where the fractional shares were not the result of breaking an order for one or more whole shares into orders for fractional shares. Due to the difficulties of routing fractional shares to comply with the trade-at prohibition, and because the execution of fractional

²⁸ See Tick Size Pilot Plan Order at 36845-46, n. 63, 64.

shares will represent a negligible portion of overall trading, the Participants believe that fractional share orders should be excepted from the trade-at prohibition.

To illustrate the operation of the trade-at prohibition, the Participants have included the following examples:

Example 1

The NBBO for Pilot Security ABC is \$20.00 x \$20.10. Trading Center 1 is displaying a 100-share protected bid at \$20.00. Trading Center 2 is displaying a 100-share protected bid at \$19.95. There are no other protected bids. Trading Center 3 is not displaying any shares in Pilot Security ABC but has 100 shares hidden at \$20.00 and has 100 shares hidden at \$19.95. Trading Center 3 receives an incoming order to sell for 400 shares. To execute the 100 shares hidden at \$20.00, Trading Center 3 must respect the protected bid on Trading Center 1 at \$20.00. Trading Center 3 must route a Trade-at Intermarket Sweep Order to Trading Center 1 to execute against the full displayed size of the protected bid, at which point Trading Center 3 is permitted to execute against the 100 shares hidden at \$20.00. To execute the 100 shares hidden at \$19.95, Trading Center 3 must respect the protected bid on Trading Center 2 at \$19.95. Trading Center 3 must route a Trade-at Intermarket Sweep Order to Trading Center 2 to execute against the full displayed size of the protected bid, at which point Trading Center 3 is permitted to execute against the 100 shares hidden at \$19.95.

Example 2

The NBBO for Pilot Security ABC is \$20.00 x \$20.10. Trading Center 1 is displaying a 100-share protected bid at \$20.00. Trading Center 2 is displaying a 100-share protected bid at \$20.00. Trading Center 2 also has 300 shares hidden at \$20.00 and has 300 shares hidden at \$19.95. Trading Center 3 is displaying a 100-share protected bid at \$19.95. There are no other

protected bids. Trading Center 2 receives an incoming order to sell for 900 shares. Trading Center 2 may execute 100 shares against its full displayed size at the protected bid at \$20.00. To execute the 300 shares hidden at \$20.00, Trading Center 2 must respect the protected bid on Trading Center 1 at \$20.00. Trading Center 2 must route a Trade-at Intermarket Sweep Order to Trading Center 1 to execute against the full displayed size of Trading Center 1's protected bid, at which point Trading Center 2 is permitted to execute against the 300 shares hidden at \$20.00. To execute the 300 shares hidden at \$19.95, Trading Center 2 must respect the protected bid on Trading Center 3 at \$19.95. Trading Center 2 must route a Trade-at Intermarket Sweep Order to Trading Center 3 to execute against the full displayed size of Trading Center 3's protected bid, at which point Trading Center 2 is permitted to execute against the 300 shares hidden at \$19.95.

Example 3

The NBBO for Pilot Security ABC is \$20.00 x \$20.10. Trading Center 1 is displaying a 100-share protected bid at \$20.00. Trading Center 1 is also displaying 300 shares at \$19.90 on an SRO quotation feed. Trading Center 2 is displaying a 100-share protected bid at \$19.95. Trading Center 2 is also displaying 200 shares on an SRO quotation feed at \$19.90 and has 200 shares hidden at \$19.90. Trading Center 3 is displaying a 100-share protected bid at \$19.90. There are no other protected bids. Trading Center 2 receives an incoming order to sell for 700 shares. To execute against its protected bid at \$19.95, Trading Center 2 must comply with the trade-through restrictions in Rule 611 and route an intermarket sweep order to Trading Center 1 to execute against the full displayed size of Trading Center 1's protected bid at \$20.00. Trading Center 2 is then permitted to execute against its 100-share protected bid at \$19.95. Trading Center 2 may then execute 200 shares against its full displayed size at the price of Trading Center 3's protected bid. To execute the 200 shares hidden at \$19.90, Trading Center 2 must

respect the protected bid on Trading Center 3 at \$19.90. Trading Center 2 must route a Trade-at Intermarket Sweep Order to Trading Center 3 to execute against the full displayed size of Trading Center 3's protected bid, at which point Trading Center 2 is permitted to execute against the 200 shares hidden at \$19.90. Trading Center 2 does not have to respect Trading Center 1's displayed size at \$19.90 for trade-at purposes because it is not a protected quotation.

Collection of Pilot Data

Throughout the Pilot Period, the Participants will collect the data described in Appendix B to the Plan with respect to Pilot Securities. Such data will include:

- (1) Daily market quality statistics of orders by security, order type, original order size (as observed by the trading center), hidden status (as applicable), and coverage under Rule 605 of Regulation NMS;
- (2) Specified data regarding market orders and marketable limit orders;
- (3) Daily number of registered Market Makers;²⁹ and
- (4) Daily Market Maker participation statistics.

Each Participant that is the Designated Examining Authority of a member of a Participant operating a trading center will require such member to collect and provide to the Designated Examining Authority the data described in subparagraphs (1) and (2) above, subject to the terms and conditions in Appendix B to the Plan. The Participants and each member of a Participant operating a trading center will also be required to collect such data for dates starting six months prior to the Pilot Period through six months after the end of the Pilot Period.

²⁹ Market Maker is defined in the Plan as a dealer registered with any self-regulatory organization, in accordance with the rules thereof, as (i) a market maker or (ii) a liquidity provider with an obligation to maintain continuous, two-sided trading interest.

The data will be made publicly available for free on a disaggregated basis by trading center on the websites of the Participants and the Designated Examining Authorities and will be reported by the Participants and the Designated Examining Authorities to the Commission on a monthly basis. The data will be provided on a disaggregated basis by trading center. The data made publicly available will not identify the trading center that generated the data.

Participants will also require each Market Maker to provide to its Designated Examining Authority the data described in Appendix C to the Plan with respect to Pilot Securities, specifically data related to daily Market Maker trading profits. The Designated Examining Authority will aggregate such data, report it to the Commission, and make it publicly available for free on its website on a monthly basis. Such data will also be provided for dates starting six months prior to the Pilot Period through six months after the end of the Pilot Period. The Designated Examining Authority will develop policies and procedures reasonably designed to ensure the confidentiality of the non-aggregated data it receives from Market Makers. The data made publicly available will not identify the Market Makers that generated the data.

Each Participant will make available to the other Participants a list of members designated as Market Makers on that Participant's trading center. Because the data requested will be gathered by a Participant whether or not the member is registered as a Market Maker with that Participant's trading center, each Participant will need the list to determine those members about whom the Participant needs to report data.

Assessment of Pilot Data

Within six months after the end of the Pilot Period, the Participants will provide to the Commission and make publicly available a joint assessment of the impact of the Pilot. Such assessment will include:

- (1) An assessment of the statistical and economic impact of an increase in the quoting increment on market quality;
- (2) An assessment of the statistical and economic impact of an increase in the quoting increment on the number of Market Makers;
- (3) An assessment of the statistical and economic impact of an increase in the quoting increment on Market Maker participation;
- (4) An assessment of the statistical and economic impact of an increase in the quoting increment on market transparency;
- (5) An evaluation whether any market capitalization, daily trading volume, or other thresholds can differentiate the results of the above assessments across stocks (*e.g.*, does the quoting increment impact differently those stocks with daily trading volume below a certain threshold);
- (6) An assessment of the statistical and economic impact of the above assessments for the incremental impact of a trading increment and for the joint effect of an increase in a quoting increment with the addition of a trading increment;
- (7) An assessment of the statistical and economic impact of the above assessments for the incremental impact of a trade-at prohibition and for the joint effect of an increase in a quoting increment with the addition of a trading increment and a trade-at prohibition; and
- (8) An assessment of any other economic issues that the Participants believe the Commission should consider in any rulemaking that may follow the Pilot.

Further, Participants may individually submit to the Commission and make publicly available additional supplemental assessments of the impact of the Tick Size Pilot Program.

The Tick Size Pilot Plan Order originally called for the Participants to assess the effect of the quoting and trading increment requirements on Market Maker profitability.³⁰ The Exchanges believe that Market Makers will be in a better position than the Participants to analyze the effects of the Tick Size Pilot Program on Market Maker profitability. Therefore, the Participants have removed this assessment from the Tick Size Pilot Plan.

B. Governing or Constituent Documents

Not applicable.

C. Implementation of Plan

The initial date of the Tick Size Pilot Program will be no sooner than 180 calendar days following the publication of the Commission's Approval Order of the Plan in the Federal Register.

Development and Implementation Phases

The Plan will be implemented as a one-year pilot program.

³⁰ See Tick Size Pilot Plan Order at 36846.

D. Analysis of Impact on Competition

The proposed Plan does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. The Participants do not believe that the proposed Plan introduces terms that are unreasonably discriminatory for the purposes of Section 11A(c)(1)(D) of the Exchange Act.

E. Written Understanding or Agreements relating to Interpretation of, or Participation in, Plan

The Participants have no written understandings or agreements relating to the interpretation of the Plan. Section II(C) of the Plan sets forth how any entity registered as a national securities exchange or national securities association may become a Participant.

F. Approval of Amendment of the Plan

Not applicable.

G. Terms and Conditions of Access

Section II(C) of the Plan provides that any entity registered as a national securities exchange or national securities association under the Exchange Act may become a Participant by: (1) executing a copy of the Plan, as then in effect; (2) providing each then-current Participant with a copy of such executed Plan; and (3) effecting an amendment to the Plan as specified in Section III(B) of the Plan.

H. Method of Determination and Imposition, and Amount of, Fees and Charges

Not applicable.

I. Method and Frequency of Processor Evaluation

Not applicable

J. Dispute Resolution

The Plan does not include specific provisions regarding resolution of disputes between or among Participants. Section III(C) of the Plan provides for each Participant to designate an individual to represent the Participant as a member of an Operating Committee. No later than the initial date of the Plan, the Operating Committee shall designate one member of the Operating Committee to act as the Chair of the Operating Committee. The Operating Committee shall monitor the procedures established pursuant to the Plan and advise the Participants with respect to any deficiencies, problems, or recommendations as the Operating Committee may deem appropriate. Any recommendation for an amendment to the Plan from the Operating Committee that receives an affirmative vote of at least two-thirds of the Participants, but is less than unanimous, shall be submitted to the Commission as a request for an amendment to the Plan initiated by the Commission under Rule 608.

* * * * *

This marks the end of the Statement of Purpose as prepared and submitted by the Participants.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed Plan, which includes the proposed Tick Size Pilot Program, is consistent with the Act. In the Order, the Commission stated its belief that it was in the public interest for the Participants to develop and file a plan for a proposed tick size pilot, and noted that once filed, such plan would be published for public comment.

In the Order, however, the Commission also pointed out that support for a tick size pilot was not universal, with concerns being raised in particular about the potential costs to investors

of wider minimum tick sizes.³¹ In addition, a recent Commission staff paper suggests that there appears to be considerable variability among small capitalization stocks in their trading characteristics, liquidity, and spreads, with some stocks more closely resembling the trading of large capitalization stocks.³² Accordingly, the Commission generally requests comment on whether there are other market structure initiatives that the Commission should consider to address concerns about the market structure for small capitalization stocks in addition to, or instead of, the proposed Tick Size Pilot Program.

The Order contained certain terms and conditions for a tick size pilot that the Commission preliminarily believed would produce data that would allow the Commission and others to conduct studies on the effect of increased tick size on liquidity, execution quality for investors, volatility, market maker profitability, competition, transparency and institutional ownership. The Commission broadly requests comment on whether the proposed Tick Size Pilot Program filed by the Participants will generate measurable data to allow the Commission and others to conduct such studies.

³¹ See Order at 36843.

³² See SEC Staff Paper, A characterization of market quality for small capitalization US equities, Charles Collver (September 2014), available at http://www.sec.gov/marketstructure/research/small_cap_liquidity.pdf. Moreover, recent data seems to indicate that initial public offerings have rebounded since the financial crisis. See, e.g., The Epic Year in Initial Public Offerings, available at <http://blogs.wsj.com/moneybeat/2014/09/25/the-epic-year-in-initial-public-offerings/> (visited on September 29, 2014) (showing that 2014 is on pace for the second biggest year for U.S. listed IPOs by amount since 1995) and Renaissance Capital IPO Center, available at <http://www.renaissancecapital.com/ipohome/press/mediaroom.aspx?market=us> (visited on September 29, 2014) (showing that, for initial public offerings of greater than \$50 million market cap, a 41% increase in issuances, 59% increase in filing activity, and 122% increase in proceeds raised, as compared to similar time period in 2013).

The Commission notes that the Participants have proposed additional details for the Tick Size Pilot Program that were not specified in the Commission's Order. In addition, the Participants have proposed to modify some of the terms and conditions set forth in the Order. The Commission discusses these additions and modifications in more detail below, but also broadly requests comment on them.³³

A. General Questions

The Commission stated in the Order that it preliminarily believed that it should assess, through a short-term pilot program, whether wider minimum tick sizes for small capitalization stocks would enhance market quality to the benefit of market participants, issuers, and U.S. investors. The Commission requests comment on whether the proposed Tick Size Pilot Program would facilitate such an assessment and requests comment on the specific questions set forth below.

- How well does the structure of the proposed Tick Size Pilot Program, generally, facilitate analysis of the tradeoffs associated with increasing the quote increment for certain small capitalization securities? How could the proposed Pilot structure change to better facilitate such analysis? Please provide any other comments on the structure and selection process of the proposed Pilot.
- Does the structure of the proposed Pilot allow for a robust analysis of alternative quote increments in securities, including the determination of thresholds that distinguish stocks that should have different quote increments? How could the structure change to better facilitate such analysis?

³³ The Commission notes that the Participants described their additions and modifications and rationale in their Transmittal Letter, which is set forth above in Section III.

- What are the anticipated costs for implementing and operating the proposed Pilot? Are any components of the Pilot structure particularly costly? If so, please describe which market participants could be impacted.
- Could investors of the small capitalization securities included in the Pilot be harmed by the widening of quoting and trading increments?
- Is the proposed one-year Pilot Period period too long or too short? Should the Pilot Period be different? Is it appropriate that the proposed Pilot is structured to end before completion of the assessments by the Participants?
- What is the risk of unintended consequences from the Pilot? What might they be? Are these issues that could be tested during the Pilot, or do they raise more fundamental questions about the advisability of the Pilot? Will the Pilot lead to changes in trading behavior by market makers or other market participants?
- As noted above, the Commission preliminarily believes the Pilot would produce data that would allow the Commission and others to conduct studies on the effect of increased tick size on liquidity, execution quality for investors, volatility, market maker profitability, competition, transparency and institutional ownership. Should the Pilot be designed to produce data to allow the Commission and others to conduct studies in other areas? If so, how should the proposed Pilot be changed to accommodate these other studies?

B. Proposed Selection Process for Pilot Securities

- In the Order, the Commission set forth the criteria that it preliminarily believed would identify securities that should be included in a proposed Pilot. Are these criteria appropriate and sufficient for selecting securities to be included in the

Pilot? The Commission requests comment on whether small capitalization securities would benefit from the proposed Tick Size Pilot Program and if so, what types of small capitalization securities would benefit most. Should the proposed Tick Size Pilot Program assess different or additional criteria for identifying Pilot Securities? For example, should the market capitalization be higher or lower than \$5 billion? Should the CADV be more or less than one million shares? Should securities other than stocks of operating companies be included in the Plan, such as exchange-traded products?

- The Participants have proposed to exclude securities that have recently completed an initial public offering from the proposed Pilot. Should these securities be included?
- Should the proposed Pilot exclude any other small capitalization securities? For example, should small capitalization securities that are cross-listed in another jurisdiction be excluded from the Pilot?
- Should companies whose securities are included in the Pilot be allowed to opt-out of participating in the Pilot? If so, how should such an opt-out work and what impact would it have on the ability of the Commission and others to analyze the Pilot?
- As noted above, the proposed Tick Size Pilot Program contains different terms and conditions than specified in the Order. In particular, the Participants

proposed to evaluate potential Pilot Securities over a Measurement Period.³⁴ Is this period sufficient to evaluate and identify potential Pilot Securities?

- With regard to the selection of Pilot Securities, the Participants have proposed to consider two additional elements related to the price of potential Pilot Securities. First, the Participants proposed that the Closing Price on every trading day during the Measurement Period not be less than \$1.50. In addition, Participants proposed that the Measurement Period VWAP be at least \$2.00. Are these additional criteria useful? Are there other criteria related to the price of potential Pilot Securities that should be considered?

C. Proposed Control and Test Groups

- The Order specified that there should be three test groups. Would the three proposed test groups provide sufficient information to allow for analysis of quote increments in certain small capitalization stocks? Would different test groups with different criteria better facilitate such an analysis?
- Participants have proposed to include 400 securities per Test Group. The Commission preliminarily believed that 300 securities per Test Group was sufficiently large number to generate statistically reliable data, yet a number small enough to minimize potential disruption to the market. The Commission requests comment on whether the proposed inclusion of 400 securities per Test Group satisfies these goals. If not, what test group size should be required?
- Specifically, please describe whether the size of the three test groups is large enough to draw reliable conclusions from statistical tests of the tradeoffs

³⁴

See supra note 8.

associated with increasing the quote increment for certain small securities, including tests that attempt to identify approximate thresholds for changes in the quote increment. Is the control group size large enough to draw reliable conclusions? If not, what size should be required?

- How likely is it that the process for selection will result in three representative test groups that can be compared to each other and the Control Group or matched stocks from the Control Group? How important is it that the three Test Groups be representative and be suitable for comparison with each other and the Control Group? Is the selection plan for the categories with fewer than 10 securities reasonable for allocating potential Pilot Securities among the Test Groups? If not, please specify a more appropriate selection plan and explain how it improves on the Plan.
- With regard to assigning potential Pilot Securities to each Test Group and the Control Group, Participants have proposed to consider the trading volume of a security, in addition to price and market capitalization as specified in the Order. Is this additional criterion reasonable? Are there other criteria that would be useful? Would these additional criteria help to achieve representative samples of Pilot Securities in the Test Groups?
- The Commission designated \$0.05 as the increment to be tested in the proposed Pilot. Is the \$0.05 increment appropriately wide enough to encourage trading and liquidity in small capitalization securities? Should the increment be another amount? If so, please specify that increment and explain why it is preferable.

i. Test Group One

- In the Order, the Commission stated that quoting of securities in Test Group One should be in \$0.05 increments but that trading would continue to occur at any price that is permitted today. The Participants proposed to include two quoting exceptions for orders priced to execute at the midpoint and orders entered into a Participant-operated retail liquidity program. Do you agree with these proposed exceptions? Why or why not?

ii. Test Group Two

- The Order stated that quoting and trading should be in \$0.05 increments in Test Group Two with three exceptions: (1) trading could occur at the midpoint between the NBBO; (2) retail investor orders could be provided price improvement that is at least \$0.005 better than the NBBO; and (3) certain negotiated trades such as VWAP, TWAP, and qualified contingent trades, could continue at any increment permitted today. In the Order, the Commission noted that it preliminarily believed that Test Group Two should be established to examine the potential impact on displayed liquidity in conjunction with Test Group One. The Commission requests comment on whether the structure of Test Group Two supports this goal. Is Test Group Two necessary for the proposed Pilot?
- The Commission noted that it preliminarily believed that these three exceptions should be allowed so as not to prohibit certain categories of trades that are broadly beneficial to market participants today. The Commission requests comment on

whether these exceptions are necessary. Should there be other exceptions? If so, please describe those exceptions and explain why they are advisable.

• The Participants proposed additional exceptions and terms for Test Group Two. First, the Participants proposed to clarify that the \$0.05 trading increment would apply to brokered cross trades. Is this clarification necessary? Second, the Participants proposed that midpoint trades could occur between the best protected bid and best protected offer, in addition to the NBBO as the Commission Order specified. Should these additional midpoint trades be excepted from the trading increment requirement? Third, the Participants proposed that the price improvement for retail investor orders be calculated against the best protected bid or the best protected offer, rather than the NBBO as the Commission Order specified. Finally, the Participants proposed that qualified contingent trades would not include block size criteria, as specified in the Commission Order. Do you agree with the additional exceptions and terms proposed by the Participants? Why or why not?

iii. Test Group Three

The Order stated that the quoting and trading increments (and the exceptions thereto) in Test Group Three would be the same as Test Group Two, but Test Group Three would include a trade-at requirement. In the Order, the Commission generally described a trade-at requirement as one that is intended to prevent price matching by a trading center not displaying the NBBO.

The Commission further stated that under a trade-at requirement, a trading center that was not displaying the NBBO at the time it received an incoming

marketable order could either: (1) execute the order with significant price improvement (\$0.05 or the midpoint between the NBBO);³⁵ (2) execute the order at the NBBO if the size of the incoming marketable order is of block size; or (3) route intermarket sweep orders to execute against the full displayed size of the protected quotations at the NBBO and then execute the balance of the order at the NBBO price.

The Commission notes that, in the context of the Pilot, an important purpose of a trade-at requirement would be to test whether, in a wider tick size environment, the ability of market participants to match displayed prices, without quoting, would disproportionately affect market makers' quoting practices. If quoting practices are affected negatively, then it could undermine one of the central purposes of the Pilot, namely to determine whether wider tick sizes positively affect market maker participation and pre-trade transparency.

- The Commission generally requests comment on the advisability of testing a trade-at requirement as part of the Pilot. Is a trade-at requirement necessary to effectively analyze the impact of widened ticks on the trading and liquidity of small capitalization securities? If a trade-at requirement is advisable, has the Commission appropriately described such a requirement in the Order? Are exceptions to the trade-at requirement set forth in the Order appropriate?
- The Commission noted that a trade-at requirement could stem the possible migration of trading volume away from "lit" venues to "dark" venues. Is a trade-

³⁵ The Commission noted that it preliminarily believed that \$0.005 would be the required minimum price improvement for retail investor orders.

at requirement an appropriate regulatory tool for the proposed Pilot to address this potential concern? Are there other tools that could achieve the same goals?

Would a trade-at requirement improve trading and liquidity of small capitalization securities and benefit investors? How difficult and costly would it be to implement the trade-at restriction?

- The Participants have proposed several deviations from, or additions to, the trade-at component of Test Group Three that differ from or go beyond those specified in the Commission Order.³⁶ First, the Participants proposed that the trade-at requirement apply to any protected bid or protected offer, rather than just the NBBO.³⁷ Should the trade-at requirement apply to all protected quotes?
- Second, the Participants proposed that a trading center be permitted to execute an order at the price of a protected quotation, so long as it is displaying a quotation at that price through a processor or an SRO quotation feed. Should the display requirement be satisfied by displaying only through a proprietary market data feed, and not a processor? In other words, should a trade-at requirement permit

³⁶ See Section III *supra* for the rationale provided by the Participants for this proposal.

³⁷ Rule 600(b)(42) of Regulation NMS defines “National best bid and national best offer” as “with respect to quotations for an NMS security, the best bid and best offer for such security that are calculated and disseminated on a current and continuing basis by a plan processor pursuant to an effective national market system plan; provided, that in the event two or more market centers transmit to the plan processor pursuant to such plan identical bids or offers for an NMS security, the best bid or best offer (as the case may be) shall be determined by ranking all such identical bids or offers (as the case may be) first by size (giving the highest ranking to the bid or offer associated with the largest size), and then by time (giving the highest ranking to the bid or offer received first in time)” (emphasis added).

price matching through displayed quotes that are not protected quotes? Why or why not?

- Third, the Participants proposed that a trading center be permitted to execute an order at the price of a protected quotation, if it is displaying a quotation at that price, but only up to its displayed size. Is this restriction necessary to achieve the purpose of the Pilot's trade-at requirement? Why or why not?
- Fourth, the Participants proposed to restrict where and how a trading center that is displaying a quotation at the price of a protected quotation may execute orders at that price. Specifically, where a quotation is displayed through a national securities exchange, the execution must occur against the displayed size on that exchange; where a quotation is displayed on the Alternative Display Facility ("ADF") or other Commission-approved facility, the execution must occur in accordance with the rules of the ADF or other such facility. Is this restriction necessary to achieve the purpose of the Pilot's trade-at requirement? Why or why not?
- Fifth, the Participants proposed 13 exceptions to the trade-at restrictions, many of which are modeled after the trade-through exceptions in Rule 611 of Regulation NMS. Does it make sense to apply the trade-through exceptions in Rule 611 to a trade-at restriction? Why or why not?
- Finally, the Participants proposed to except fractional shares from the trade-at requirement. Is this proposed exception reasonable? Why or why not?

D. Proposed Data

As noted above, the Commission stated that one of the goals of a proposed Pilot would be to generate data on the impact of widened tick sizes on the trading and liquidity for certain small capitalization stocks. Therefore, in the Order, the Commission set forth details on the data that it preliminarily believed to be necessary to support analysis. This data is meant to supplement publicly available data such as data available on the Commission's market structure website³⁸ and should allow the Commission and others to conduct studies on the effect of increased tick size on liquidity, execution quality for investors, volatility, market maker profitability, competition, transparency and institutional ownership. The Commission requests comment on the data to be generated.

- How important is the public release of the data that is collected during the Pilot ("pilot data") to the usefulness of the Pilot (i.e., to achieve a reliable analysis of the tradeoffs associated with increasing the quote increment in certain small capitalization securities)? Are there readily available data that are already public and could substitute for the pilot data? If so, what are they and how well could they facilitate tests of the tradeoffs associated with changing quote increments? What are the most important tradeoffs to examine during the Pilot?
- Are researchers other than those in the securities industry or regulators likely to study the pilot data? Are they likely to use the pilot data to study the Pilot? If so, which sets of data are likely to be the most useful?

³⁸ See Market Structure website, available at <http://www.sec.gov/marketstructure/#.VCMPPyh39UQ>.

- How costly will the Pilot data be to produce and make public? Are there any components of the pilot data that are particularly costly? If so, which ones? Are there any unintended consequences of releasing the pilot data?
- The data is to be available starting six months prior to the start of the Pilot, and continue until six months after the Pilot ends. How valuable is the data availability before and after the proposed Pilot, and is six months the appropriate time frame? Please explain.
- Is the frequency of the Pilot data, and delay in its release, appropriate to balance the cost of the data, including the potential for unintended consequences, against the value of the data to the pilot analysis and the timeliness of Pilot analyses by researchers? If not, what would be more appropriate? Please explain.

i. Assessments

- How important are the Participant assessments of the proposed Pilot to the success of the Pilot? Are the Participants able to examine unique data or offer a unique perspective such that certain results would only be observed because the Participants assessed the Pilot? Should the Participants assess any additional issues beyond those specified in the plan? If so, what issues?
- The Order stated that the Participants would conduct an assessment of market maker profitability. The Participants did not propose to study market maker profitability. Should the Participants produce an assessment of market maker profitability as contemplated by the Order? Why or why not?

ii. Appendix A

- Will the data requirements specified in Appendix A allow market participants to effectively implement the Pilot? How could the data requirements be more useful? Is pipe-delimited ASCII the best format of the data for this purpose? If not, what other format would be more appropriate and why? Should the data in Appendix A have a common naming convention? Why or why not?
- Will the pilot data in Appendix A facilitate the analysis of the tradeoffs associated with increasing the quote increment for certain small capitalization securities? How could this data be more useful? Is pipe-delimited ASCII the best format of the data for this purpose? If not, what other format would be more appropriate and why?
- How costly is the data in Appendix A to produce? Are there any unintended consequences of releasing the data in Appendix A? Please explain.

iii. Appendices B and C

- Will each set of pilot data specified in Appendices B and C facilitate analysis of the tradeoffs associated with increasing the quote increment for certain small securities, including liquidity, execution quality for investors, market maker profitability, competition, and transparency? How much does each set of pilot data specified in Appendices B and C add to potential analyses of the proposed Pilot compared to what can be learned with publicly available data? How much does each set of pilot data specified in Appendices B and C add to potential analyses of the proposed Pilot compared to what can be learned with other pilot data? How could each set of data be more useful or how can the combinations of

data be more useful? Is pipe-delimited ASCII the best format of the data? If not, what other format would be more appropriate and why? Should the data in Appendices B and C have common naming conventions? Why or why not?

- How costly is the data in Appendices B and C to produce? Are there any unintended consequences of releasing the data in Appendices B and C? Please explain. Are there ways to reduce the cost of the data in Appendices B and C without sacrificing its value to the Pilot? Please explain.
- The data specified in Appendix B.1 provides data similar to Rule 605 market quality data, but with a few key differences. For example, the Pilot data specified in Appendix B.1 would provide daily data whereas Rule 605 provides for monthly disclosure. Further, the Pilot data would include more order types and sizes than what Rule 605 data includes, and provides additional time to execution and order size buckets than Rule 605 data. How important are the expansions to the Rule 605 data, such as the daily frequency and the inclusion of orders that are excluded from Rule 605 statistics? Please explain. On the other hand, the pilot data does not include orders that are routed to other trading venues and executed in full by those other trading venues. Should the Pilot data also include orders that are routed to other trading venues and executed in full by those other trading venues? Please explain. The data specified in Appendix B.1 includes only resting orders. This excludes "immediate or cancel" orders. Should immediate or cancel orders be included in the data in Appendix B.1?

- Can the data in Appendix B.1 be built from the same infrastructure that currently supports Rule 605 data? Why or why not? Would the costs of Appendix B.1 data depend on whether it can be built from the same infrastructure as Rule 605 data?
- The data specified in Appendix B.2 provides information on market and marketable limit orders. The data includes statistics for only the non-resting portion of the Marketable Limit Orders. Is this appropriate in light of potential Pilot analysis and data that are currently available? If not, why not? Should this data contain additional order information? If so, what other order information should be included? Please also specify which data items, if any, are less valuable or potentially problematic.
- The data specified in Appendix B.3 provides the number of registered market makers. Should this data also include a separate count of the number of unregistered market makers that provide liquidity in the Pilot Securities? Please explain.
- The data specified in Appendix B.4 provides aggregate participation statistics for registered market makers. Should this data also include separate participation statistics for unregistered market makers that provide liquidity in the Pilot Securities? Please explain.
- Should the data in Appendix B exclude orders entered or executed while a trading halt is in effect? Please explain.
- The Participants have proposed that each market maker shall provide to its Designated Examining Authority the market maker profitability data set forth in Appendix C of the Plan. The Designated Examining Authority will then

aggregate the data, report it to the Commission, and make it publicly available on the Designated Examining Authority's website. This aspect differs from the Order, which required the Participants to collect such data, make it public, and conduct an assessment. Is market maker profitability data necessary to analyze the effect of the Tick Size Pilot Program and to reach a conclusion about the tradeoffs associated with increasing the quote increment in certain small capitalization securities? Are there better ways to collect such Pilot data?

- The data specified in Appendix C provides aggregate market maker profitability statistics. Should this data also include separate profitability statistics for unregistered market makers that provide liquidity in the Pilot Securities? Please explain.

Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form

(<http://www.scc.gov/rules/sro.shtml>); or

- Send an e-mail to rule-comments@sec.gov. Please include File Number 4-657 on the subject line.

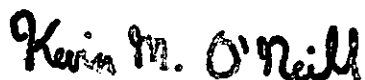
Paper comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number 4-657. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the

Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the Plan that are filed with the Commission, and all written communications relating to Plan between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between 10:00 a.m. and 3:00 p.m. Copies of the filing will also be available for inspection and copying at the Participants' principal offices. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number 4-657 and should be submitted on or before [insert date [45] days from publication in the Federal Register].

By the Commission.



Kevin M. O'Neill
Deputy Secretary

EXHIBIT A

PLAN TO IMPLEMENT A TICK SIZE PILOT PROGRAM
SUBMITTED TO
THE SECURITIES AND EXCHANGE COMMISSION
PURSUANT TO RULE 608 OF REGULATION NMS
UNDER THE
SECURITIES EXCHANGE ACT OF 1934

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Preamble

Pursuant to Section 11A(a)(3)(B) of the Exchange Act, which authorizes the SEC to require by order self-regulatory organizations to act jointly with respect to matters as to which they share authority in planning, developing, operating, or regulating a national market system, the SEC issued an order directing the Participants to submit a Tick Size Pilot Plan as a national market system plan pursuant to Rule 608(a)(3) of Regulation NMS under the Exchange Act. In response, the Participants submit this Plan to implement a Tick Size Pilot Program that will allow the Commission, market participants, and the public to study and assess the impact of increment conventions on the liquidity and trading of the common stocks of small capitalization companies. To do so, the Plan provides for the widening of quoting and trading increments for a group of Pilot Securities. As detailed herein, the Pilot Securities will be subdivided into three Test Groups and a Control Group, each with its own requirements and exceptions relating to quoting and trading increments to facilitate the referenced analysis.

I. Definitions

(A) "Average effective spread" has the meaning provided in Rule 600(b)(5) of Regulation NMS under the Exchange Act.

(B) "Average realized spread" has the meaning provided in Rule 600(b)(6) of Regulation NMS under the Exchange Act.

(C) "Benchmark trade" means the execution of an order at a price that was not based, directly or indirectly, on the quoted price of a Pilot Security at the time of execution and for which the material terms were not reasonably determinable at the time the commitment to execute the order was made.

(D) "Best protected bid" means the highest priced protected bid. (E)

"Best protected offer" means the lowest priced protected offer.

(F) "Block Size" has the meaning provided in Rule 600(b)(9) of Regulation NMS under the Exchange Act.

(G) "Brokered cross trade" means a trade that a broker-dealer that is a member of a Participant executes directly by matching simultaneous buy and sell orders for a Pilot Security.

(H) "Closing Price" means the closing auction price on the primary listing exchange, or if not available, then the last regular-way trade reported by the processor prior to 4:00 p.m. ET.

(I) "Designated Examining Authority" means, with respect to a member of two or more self-regulatory organizations, the self-regulatory organization responsible for (i) examining such member for compliance with the financial responsibility requirements imposed by the Exchange Act, or by Commission or self-regulatory organization rules, (ii) receiving regulatory reports from such member, (iii) examining such member for compliance with, and enforcing

compliance with, specified provisions of the Exchange Act, the rules and regulations thereunder, and self-regulatory organization rules, and (iv) carrying out any other specified regulatory functions with respect to such member.

(J) "Exchange Act" means the Securities Exchange Act of 1934, as amended.

(K) "Inside-the-quote limit order," "at-the-quote limit order," and "near-the-quote limit order" mean non-marketable buy orders that are ranked at a price, respectively, higher than, equal to, and lower by \$0.10 or less than the National Best Bid at the time of order receipt, and non-marketable sell orders that are ranked at a price, respectively, lower than, equal to, and higher by \$0.10 or less than the National Best Offer at the time of order receipt.

(L) "Market Maker" means a dealer registered with any self-regulatory organization, in accordance with the rules thereof, as (i) a market maker or (ii) a liquidity provider with an obligation to maintain continuous, two-sided trading interest.

(M) "Marketable limit order" means any buy order with a limit price equal to or greater than the National Best Offer at the time of order receipt, or any sell order with a limit price equal to or less than the National Best Bid at the time of order receipt. For price sliding, pegged, discretionary, or similar order types where the ranked price is different from the limit price, the ranked price will determine marketability.

(N) "Measurement Period" means the U.S. trading days during the three-calendar-month period ending at least 30 days prior to the effective date of the Pilot Period.

(O) "National Best Bid" and "National Best Offer" have the meanings provided in Rule 600(b)(42) of Regulation NMS under the Exchange Act.

(P) "Negotiated Trade" means (i) a Benchmark trade, including, but not limited to, a Volume-Weighted Average Price trade or a Time-Weighted Average Price trade, provided that,

if such a trade is composed of two or more component trades, each component trade complies with the quoting and trading increment requirements of the Plan, or with an exception to such requirements, or (ii) a Pilot Qualified Contingent Trade.

(Q) "NMS common stock" means an NMS stock that is common stock of an operating company.

(R) "NMS stock" has the meaning provided in Rule 600(b)(47) of Regulation NMS under the Exchange Act.

(S) "Operating Committee" has the meaning provided in Section III(C) of the Plan.

(T) "Participant" means a party to the Plan.

(U) "Pilot Period" means the operative period of the Tick Size Pilot Program, lasting one year from the date of implementation.

(V) "Pilot Qualified Contingent Trade" means a transaction consisting of two or more component orders, executed as agent or principal, where: (1) at least one component order is in an NMS common stock; (2) all components are effected with a product or price contingency that either has been agreed to by the respective counterparties or arranged for by a broker-dealer as principal or agent; (3) the execution of one component is contingent upon the execution of all other components at or near the same time; (4) the specific relationship between the component orders (*e.g.*, the spread between the prices of the component orders) is determined at the time the contingent order is placed; (5) the component orders bear a derivative relationship to one another, represent different classes of shares of the same issuer, or involve the securities of participants in mergers or with intentions to merge that have been announced or since canceled; and (6) the transaction is fully hedged (without regard to any prior existing position) as a result of the other components of the contingent trade.

(W) "Pilot Securities" means those securities that satisfy the criteria established in Section V.

(X) "Plan" means the plan set forth in this instrument, as amended from time to time in accordance with its provisions.

(Y) "Processor" means the single plan processor responsible for the consolidation of information for an NMS stock pursuant to Rule 603(b) of Regulation NMS under the Exchange Act.

(Z) "Protected bid" and "protected offer" have the meanings provided in Rule 600(b)(57) of Regulation NMS under the Exchange Act.

(AA) "Protected quotation" has the meaning provided in Rule 600(b)(58) of Regulation NMS under the Exchange Act.

(BB) "Quotation" has the meaning provided in Rule 600(b)(62) of Regulation NMS under the Exchange Act.

(CC) "Regular Trading Hours" has the meaning provided in Rule 600(b)(64) of Regulation NMS under the Exchange Act. For purposes of the Plan, Regular Trading Hours can end earlier than 4:00p.m. ET in the case of an early scheduled close.

(DD) "Retail Investor Order" means an agency order or a riskless principal order originating from a natural person, provided that, prior to submission, no change is made to the terms of the order with respect to price or side of market and the order does not originate from a trading algorithm or any other computerized methodology. The Participant that is the Designated Examining Authority of a member of a Participant operating a trading center executing a Retail Investor Order will require such trading center to sign an attestation that

substantially all orders to be executed as Retail Investor Orders will qualify as such under the Plan.

(EE) "Retail liquidity providing order" means an order entered into a Participant-operated retail liquidity program to execute against Retail Investor Orders.

(FF) "SEC" means the United States Securities and Exchange Commission. (GG)

"SRO quotation feed" means any market data feed disseminated by a self-regulatory organization.

(HH) "Tick Size Pilot Program" means the program established by this Plan and by the corresponding rules of the Participants.

(II) "Time of order execution" means the time (to the second, or to such smaller increments as are available) that an order was executed at any venue.

(JJ) "Time of order receipt" means the time (to the second, or to such smaller increments as are available) that an order was received by a trading center for execution.

(KK) "Time-Weighted Average Price" means the price calculated as the average price of a security over a specified period of time.

(LL) "Trade-at" means the execution by a trading center of a sell order for a Pilot Security at the price of a protected bid or the execution of a buy order for a Pilot Security at the price of a protected offer.

(MM) "Trade-at Intermarket Sweep Order" means a limit order for a Pilot Security that meets the following requirements:

- (1) When routed to a trading center, the limit order is identified as an Intermarket Sweep Order; and

(2) Simultaneously with the routing of the limit order identified as an Intermarket Sweep Order, one or more additional limit orders, as necessary, are routed to execute against the full displayed size of any protected bid, in the case of a limit order to sell, or the full displayed size of any protected offer, in the case of a limit order to buy, for the Pilot Security with a price that is equal to the limit price of the limit order identified as an Intermarket Sweep Order. These additional routed orders also must be marked as Intermarket Sweep Orders.

(NN) "Trading center" has the meaning provided in Rule 600(b)(78) of Regulation NMS under the Exchange Act.

(OO) "Volume-Weighted Average Price" means the price calculated by summing up the products of the number of single-counted shares traded and the respective share price, and dividing by the total number of single-counted shares traded.

II. Parties

(A) List of Parties

The parties to the Plan are as follows:

- (1) BATS Exchange, Inc.
8050 Marshall Drive
Lenexa, Kansas 66214
- (2) BATS Y-Exchange, Inc.
8050 Marshall Drive
Lenexa, Kansas 66214
- (3) Chicago Stock Exchange, Inc.
440 South LaSalle Street
Chicago, Illinois 60605
- (4) EDGA Exchange, Inc.
545 Washington Boulevard
Sixth Floor
Jersey City, NJ 07310

- (5) EDGX Exchange, Inc.
545 Washington Boulevard
Sixth Floor
Jersey City, NJ 07310
- (6) Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006
- (7) NASDAQ OMX BX, Inc.
One Liberty Plaza
New York, NY 10006
- (8) NASDAQ OMX PHLX LLC
1900 Market Street
Philadelphia, PA 19103
- (9) The Nasdaq Stock Market LLC
1 Liberty Plaza
165 Broadway
New York, NY 10006
- (10) New York Stock Exchange LLC
11 Wall Street
New York, NY 10005
- (11) NYSE MKT LLC
11 Wall Street
New York, NY 10005
- (12) NYSE Area, Inc.
11 Wall Street
New York, NY 10005
- (B) Compliance Undertaking

By subscribing to and submitting the Plan for approval by the SEC, each Participant agrees to comply with, and to enforce compliance by its members, as applicable, with the provisions of the Plan as required by Rule 608(c) of Regulation NMS under the Exchange Act. To this end, each Participant will adopt rules requiring compliance by its members with the

provisions of the Plan, as applicable, and adopt such other rules as are needed for such compliance.

(C) New Participants

The Participants agree that any entity registered as a national securities exchange or national securities association under the Exchange Act may become a Participant by: (1) executing a copy of the Plan, as then in effect; (2) providing each then-current Participant with a copy of such executed Plan; and (3) effecting an amendment to the Plan as specified in Section III(B) of the Plan.

III. Amendments to Plan

(A) General Amendments

Except with respect to the addition of new Participants to the Plan, any proposed change in, addition to, or deletion from the Plan will be effected by means of a written amendment to the Plan that: (1) sets forth the change, addition, or deletion; (2) is executed on behalf of each Participant; and (3) is approved by the SEC pursuant to Rule 608 of Regulation NMS under the Exchange Act, or otherwise becomes effective under Rule 608 of Regulation NMS under the Exchange Act.

(B) New Participants

With respect to new Participants, an amendment to the Plan may be effected by the new national securities exchange or national securities association executing a copy of the Plan, as then in effect (with the only changes being the addition of the new Participant's name in Section II(A) of the Plan) and submitting such executed Plan to the SEC for approval. The amendment will be effective when it is approved by the SEC in accordance with Rule 608 of Regulation

NMS under the Exchange Act, or otherwise becomes effective pursuant to Rule 608 of Regulation NMS under the Exchange Act.

(C) Operating Committee

(1) Each Participant will select from its staff one individual to represent the Participant as a member of an Operating Committee, together with a substitute for such individual. The substitute may participate in deliberations of the Operating Committee and will be considered a voting member thereof only in the absence of the primary representative. Each Participant will have one vote on all matters considered by the Operating Committee. No later than the initial date of Plan operations, the Operating Committee will designate one member of the Operating Committee to act as the Chair of the Operating Committee.

(2) The Operating Committee will monitor the procedures established pursuant to this Plan and advise the Participants with respect to any deficiencies, problems, or recommendations as the Operating Committee may deem appropriate. The Operating Committee will establish specifications and procedures for the implementation and operation of the Plan that are consistent with the provisions of this Plan. With respect to matters in this paragraph, Operating Committee decisions must be approved by a simple majority vote.

(3) Any recommendation for an amendment to the Plan from the Operating Committee that receives an affirmative vote of at least two-thirds of the Participants, but is less than unanimous, will be submitted to the SEC as a request for an amendment to the Plan initiated by the Commission under Rule 608 of Regulation NMS.

IV. Policies and Procedures

Consistent with the compliance undertakings set out in Section II(B), all Participants and members of Participants will be required to establish, maintain, and enforce written policies and

procedures that are reasonably designed to comply with applicable quoting and trading requirements specified in Section VI for the Pilot Securities.

Each Participant, as applicable, will develop appropriate policies and procedures that provide for collecting and reporting to the SEC the data described in Appendix B. In addition, each Participant that is the Designated Examining Authority of a member of a Participant operating a trading center will require such member to develop appropriate policies and procedures for collecting and reporting the data described in Items I and II of Appendix B, as applicable, to the Designated Examining Authority. Each Participant that is the Designated Examining Authority of a member of a Participant operating a trading center will develop appropriate policies and procedures, as applicable, that provide for collecting and reporting such data to the SEC. The data collection and reporting obligations are described below in Section VII.

Each Participant that is the Designated Examining Authority of a Market Maker will require such Market Maker to develop policies and procedures for collecting the data set out in Appendix C and reporting it to the Designated Examining Authority. Each Participant that is the Designated Examining Authority of a Market Maker will develop appropriate policies and procedures that provide for collecting and reporting such data to the SEC on an aggregated basis. The Designated Examining Authority will also develop policies and procedures reasonably designed to ensure the confidentiality of the non-aggregated data it receives from Market Makers. The data collection and reporting obligations are described below in Section VII.

V. Identification of Pilot Securities

(A) Criteria for Selection of Pilot Securities

Pilot Securities will consist of those NMS common stocks that satisfy the following criteria:

- (1) A market capitalization of \$5 billion or less on the last day of the Measurement Period, where market capitalization is calculated by multiplying the total number of shares outstanding on such day by the Closing Price of the security on such day;
- (2) A Closing Price of at least \$2.00 on the last day of the Measurement Period;
- (3) A Closing Price on every U.S. trading day during the Measurement Period that is not less than \$1.50;
- (4) A Consolidated Average Daily Volume ("CADY") during the Measurement Period of one million shares or less, where the CADY is calculated by adding the single-counted share volume of all reported transactions in the Pilot Security during the Measurement Period and dividing by the total number of U.S. trading days during the Measurement Period; and
- (5) A Measurement Period Volume-Weighted Average Price ("Measurement Period VWAP") of at least \$2.00, where the Measurement Period VWAP is determined by calculating the VWAP for each U.S. trading day during the Measurement Period, summing the daily VWAP across the Measurement Period, and dividing by the total number of U.S. trading days during the Measurement Period.

For purposes of the CADY and Measurement Period VWAP calculations described in Sections V(A)(4) and V(A)(5), U.S. trading days during the Measurement Period with early

closes will be excluded. An NMS common stock that had its initial public offering within six months of the start of the Pilot Period will not be eligible to be a Pilot Security.

(B) Grouping of Pilot Securities

The Operating Committee will oversee the Pilot Security grouping process in accordance with the methodology and criteria set out in this subsection. Once the population of Pilot Securities has been determined based on the criteria in Section V(A), the Operating Committee will select the Pilot Securities to be placed into three Test Groups by means of a stratified random sampling process. To effect this sampling, each of the Pilot Securities will be categorized as having (1) a low, medium, or high share price based on the Measurement Period VWAP, (2) low, medium, or high market capitalization based on the last day of the Measurement Period, and (3) low, medium, or high trading volume based on the CADY during the Measurement Period, yielding 27 possible categories. Low, medium, and high subcategories will be established by dividing the categories into three parts, each containing a third of the population.

Pilot Securities will be randomly selected from each of the 27 categories for inclusion into the Test Groups. If, however, a single category of Pilot Securities contains fewer than 10 securities, it will be combined with another of the 27 categories that contains at least 10 securities. If two or more categories of Pilot Securities contain fewer than 10 securities, those categories will be combined, provided the combined category contains at least 10 securities. If the combined category contains fewer than 10 securities, then the category will be combined with another of the 27 categories that contains at least 10 securities.

Pilot Securities will be randomly selected from each category for inclusion in the three Test Groups based on the percentage of Pilot Securities comprised of that category. As a result,

each category will be represented in the three Test Groups based on its relative proportion to the population of Pilot Securities. Further, a primary listing market's securities will be selected from each category and included in the three Test Groups in the same proportion as that primary listing market's securities comprise each category of Pilot Securities. Each Test Group will consist of 400 Pilot Securities. Those Pilot Securities not placed into the three Test Groups will constitute the Control Group.

(C) Publication of Pilot Securities and Groups

Each primary listing exchange will make publicly available for free on its website a list of those Pilot Securities listed on that exchange and included in the Control Group and each Test Group, adjusting for ticker symbol changes and relevant corporate actions. The list of Pilot Securities will contain the data specified in Appendix A.

VI. Pilot Test Groups

As described in Section V(B), the Pilot Securities will be divided into four groups: a Control Group and three Test Groups. Each Test Group will consist of 400 Pilot Securities. The Control Group will consist of the Pilot Securities not placed into a Test Group.

(A) Control Group

Pilot Securities in the Control Group may be quoted and traded at any price increment that is currently permitted.

(B) Test Group One

Pilot Securities in Test Group One will be quoted in \$0.05 minimum increments, but may continue to trade at any price increment that is currently permitted. Participants will adopt rules prohibiting Participants or any member of a Participant from displaying, ranking, or accepting from any person any displayable or non-displayable bids or offers, orders, or indications of

interest in any Pilot Security in Test Group One in price increments other than \$0.05. However, orders priced to execute at the midpoint and orders entered in a Participant-operated retail liquidity program may be ranked and accepted in increments of less than \$0.05.

(C) Test Group Two

Pilot Securities in Test Group Two will be subject to the same quoting requirements as Test Group One, along with the applicable quoting exceptions. In addition, Pilot Securities in Test Group Two may only be traded in \$0.05 minimum increments. Participants will adopt rules prohibiting trading centers operated by Participants and members of Participants from executing orders in any Pilot Security in Test Group Two in price increments other than \$0.05. The \$0.05 minimum trading increment applies to brokered cross trades. Pilot Securities in Test Group Two may trade in increments less than \$0.05, however, under the following circumstances:

- (1) Trading may occur at the midpoint between the National Best Bid and the National Best Offer or the midpoint between the best protected bid and the best protected offer;
- (2) Retail Investor Orders may be provided with price improvement that is at least \$0.005 better than the best protected bid or the best protected offer; and
- (3) Negotiated Trades may trade in increments less than \$0.05.

(D) Test Group Three

Pilot Securities in Test Group Three will be subject to the same quoting and trading requirements as Test Group Two, along with the applicable quoting and trading exceptions. In addition, Pilot Securities in Test Group Three will be subject to a trade-at prohibition.

Trade-at Prohibition. Under the trade-at prohibition, the Plan will (1) prevent a trading center that was not quoting from price-matching protected quotations and (2) permit a trading

center that was quoting at a protected quotation to execute orders at that level, but only up to the amount of its displayed size.

In accordance with the trade-at prohibition, Participants will adopt rules prohibiting trading centers operated by Participants and members of Participants from executing a sell order for a Pilot Security at the price of a protected bid or from executing a buy order for a Pilot Security at the price of a protected offer unless such executions fall within an exception set forth below.

Trade-at Prohibition Exceptions. Trading centers will be permitted to execute an order for a Pilot Security at a price equal to a protected bid or protected offer under the following circumstances:

- (1) The order is executed by a trading center that is displaying a quotation, via either a processor or an SRO quotation feed, at a price equal to the traded-at protected quotation but only up to the trading center's full displayed size. Where the quotation is displayed through a national securities exchange, the execution at the size of the order must occur against the displayed size on that national securities exchange. Where the quotation is displayed through the Alternative Display Facility or another facility approved by the Commission that does not provide execution functionality, the execution at the size of the order must occur against the displayed size in accordance with the rules of the Alternative Display Facility or such approved facility;
- (2) The order is of Block Size;
- (3) The order is a Retail Investor Order executed with at least \$0.005 price improvement;

- (4) The order is executed when the trading center displaying the protected quotation that was traded at was experiencing a failure, material delay, or malfunction of its systems or equipment;
- (5) The order is executed as part of a transaction that was not a "regular way" contract;
- (6) The order is executed as part of a single-priced opening, reopening, or closing transaction by the trading center;
- (7) The order is executed when a protected bid was priced higher than a protected offer in the Pilot Security;
- (8) The order is identified as an Intermarket Sweep Order;
- (9) The order is executed by a trading center that simultaneously routed Trade-at Intermarket Sweep Orders to execute against the full displayed size of the protected quotation that was traded at;
- (10) The order is executed as part of a Negotiated Trade;
- (11) The order is executed when the trading center displaying the protected quotation that was traded at had displayed, within one second prior to execution of the transaction that constituted the trade-at, a best bid or best offer, as applicable, for the Pilot Security with a price that was inferior to the price of the trade-at transaction.
- (12) The order is executed by a trading center which, at the time of order receipt, the trading center had guaranteed an execution at no worse than a specified price (a "stopped order"), where:
 - a. The stopped order was for the account of a customer;

- b. The customer agreed to the specified price on an order-by-order basis; and
 - c. The price of the trade-at transaction was, for a stopped buy order, equal to the national best bid in the Pilot Security at the time of execution or, for a stopped sell order, equal to the national best offer in the Pilot Security at the time of execution; or
- (13) The order is for a fractional share of a Pilot Security, provided that such fractional share order was not the result of breaking an order for one or more whole shares of a Pilot Security into orders for fractional shares or was not otherwise effected to evade the requirements of the trade-at prohibition or any other provisions of the Plan.

The following examples illustrate the basic operation of the trade-at prohibition:

Example 1

The NBBO for Pilot Security ABC is \$20.00 x \$20.10. Trading Center 1 is displaying a 100-share protected bid at \$20.00. Trading Center 2 is displaying a 100-share protected bid at \$19.95. There are no other protected bids. Trading Center 3 is not displaying any shares in Pilot Security ABC but has 100 shares hidden at \$20.00 and has 100 shares hidden at \$19.95. Trading Center 3 receives an incoming order to sell for 400 shares. To execute the 100 shares hidden at \$20.00, Trading Center 3 must respect the protected bid on Trading Center 1 at \$20.00. Trading Center 3 must route a Trade-at Intermarket Sweep Order to Trading Center 1 to execute against the full displayed size of the protected bid, at which point Trading Center 3 is permitted to execute against the 100 shares hidden at \$20.00. To execute the 100 shares hidden at \$19.95, Trading Center 3 must respect the protected bid on Trading Center 2 at \$19.95. Trading Center 3 must route a Trade-at Intermarket Sweep Order to Trading Center 2 to execute against the full

displayed size of the protected bid, at which point Trading Center 3 is permitted to execute against the 100 shares hidden at \$19.95.

Example 2

The NBBO for Pilot Security ABC is \$20.00 x \$20.10. Trading Center 1 is displaying a 100-share protected bid at \$20.00. Trading Center 2 is displaying a 100-share protected bid at \$20.00. Trading Center 2 also has 300 shares hidden at \$20.00 and has 300 shares hidden at \$19.95. Trading Center 3 is displaying a 100-share protected bid at \$19.95. There are no other protected bids. Trading Center 2 receives an incoming order to sell for 900 shares. Trading Center 2 may execute 100 shares against its full displayed size at the protected bid at \$20.00. To execute the 300 shares hidden at \$20.00, Trading Center 2 must respect the protected bid on Trading Center 1 at \$20.00. Trading Center 2 must route a Trade-at Intermarket Sweep Order to Trading Center 1 to execute against the full displayed size of Trading Center 1's protected bid, at which point Trading Center 2 is permitted to execute against the 300 shares hidden at \$20.00. To execute the 300 shares hidden at \$19.95, Trading Center 2 must respect the protected bid on Trading Center 3 at \$19.95. Trading Center 2 must route a Trade-at Intermarket Sweep Order to Trading Center 3 to execute against the full displayed size of Trading Center 3's protected bid, at which point Trading Center 2 is permitted to execute against the 300 shares hidden at \$19.95.

Example 3

The NBBO for Pilot Security ABC is \$20.00 x \$20.10. Trading Center 1 is displaying a 100-share protected bid at \$20.00. Trading Center 1 is also displaying 300 shares at \$19.90 on an SRO quotation feed. Trading Center 2 is displaying a 100-share protected bid at \$19.95. Trading Center 2 is also displaying 200 shares at \$19.90 on an SRO quotation feed and has 200 shares hidden at \$19.90. Trading Center 3 is displaying a 100-share protected bid at \$19.90.

There are no other protected bids. Trading Center 2 receives an incoming order to sell for 700 shares. To execute against its protected bid at \$19.95, Trading Center 2 must comply with the trade-through restrictions in Rule 611 of Regulation NMS and route an intermarket sweep order to Trading Center 1 to execute against the full displayed size of Trading Center 1's protected bid at \$20.00. Trading Center 2 is then permitted to execute against its 100-share protected bid at \$19.95. Trading Center 2 may then execute 200 shares against its full displayed size at the price of Trading Center 3's protected bid. To execute the 200 shares hidden at \$19.90, Trading Center 2 must respect the protected bid on Trading Center 3 at \$19.90. Trading Center 2 must route a Trade-at Intermarket Sweep Order to Trading Center 3 to execute against the full displayed size of Trading Center 3's protected bid, at which point Trading Center 2 is permitted to execute against the 200 shares hidden at \$19.90. Trading Center 2 does not have to respect Trading Center 1's displayed size at \$19.90 for trade-at purposes because it is not a protected quotation.

VII. Collection of Pilot Data

(A) Collection of Trading Center Pilot Data

Throughout the Pilot Period, the Participants will collect the following data with respect to Pilot Securities (as set forth in Appendix B):

- (1) Daily market quality statistics of orders by security, order type, original order size (as observed by the trading center), hidden status (as applicable), and coverage under Rule 605 of Regulation NMS;
- (2) Specified data regarding market orders and marketable limit orders;
- (3) Daily number of registered Market Makers; and
- (4) Daily Market Maker participation statistics.

Each Participant that is the Designated Examining Authority of a member of a Participant operating a trading center will require such member to collect and provide to the Designated Examining Authority the data described in subparagraphs (1) and (2) above, as applicable, subject to the terms and conditions in Appendix B. The Participants and each member of a Participant operating a trading center will also be required to collect such data for dates starting six months prior to the Pilot Period through six months after the end of the Pilot Period. Each Participant will make available to other Participants a list of members designated as Market Makers on that Participant's trading center.

On a monthly basis, the Participants and the Designated Examining Authority for each member of a Participant operating a trading center will make the data in the applicable subparagraphs specified above publicly available on their websites for free and will report such data to the SEC on a disaggregated basis by trading center. The data made publicly available will not identify the trading center that generated the data.

(B) Collection of Market Maker Profitability Data

Each Participant that is the Designated Examining Authority of a Market Maker will require such Market Maker to provide to the Designated Examining Authority the data specified in Appendix C regarding daily Market Maker trading profits with respect to Pilot Securities on a monthly basis. Each Market Maker will also be required to provide to its Designated Examining Authority such daily data for dates starting six months prior to the Pilot Period through six months after the end of the Pilot Period. On a monthly basis, the Designated Examining Authority will aggregate such data related to Market Makers and make the aggregated data publicly available on its website for free and will report such data to the SEC. The data made publicly available will not identify the Market Makers that generated the data.

VIII. Assessment of Pilot

No later than six months after the end of the Pilot Period, the Participants will provide to the Commission and make publicly available a joint assessment of the impact of the Pilot. The assessment will include:

- (1) An assessment of the statistical and economic impact of an increase in the quoting increment on market quality;
- (2) An assessment of the statistical and economic impact of an increase in the quoting increment on the number of Market Makers;
- (3) An assessment of the statistical and economic impact of an increase in the quoting increment on Market Maker participation;
- (4) An assessment of the statistical and economic impact of an increase in the quoting increment on market transparency;
- (5) An evaluation whether any market capitalization, daily trading volume, or other thresholds can differentiate the results of the above assessments across stocks (*e.g.*, does the quoting increment impact differently those stocks with daily trading volume below a certain threshold);
- (6) An assessment of the statistical and economic impact of the above assessments for the incremental impact of a trading increment and for the joint effect of an increase in a quoting increment with the addition of a trading increment;
- (7) An assessment of the statistical and economic impact of the above assessments for the incremental impact of a trade-at prohibition and for the joint effect of an increase in a quoting increment with the addition of a trading increment and a trade-at prohibition; and

- (8) An assessment of any other economic issues that the Participants believe the SEC should consider in any rulemaking that may follow the Pilot.

Participants may individually submit to the SEC and make publicly available additional supplemental assessments of the impact of the Pilot.

IX. Implementation

The Tick Size Pilot Program will be implemented on a one-year pilot basis. The Tick Size Pilot Program will be applicable during and outside of Regular Trading Hours.

X. Withdrawal from Plan

If a Participant obtains SEC approval to withdraw from the Plan, such Participant may withdraw from the Plan at any time on not less than 30 days' prior written notice to each of the other Participants. At such time, the withdrawing Participant will have no further rights or obligations under the Plan.

XL Counterparts and Signatures

The Plan may be executed in any number of counterparts, no one of which need contain all signatures of all Participants, and as many of such counterparts as will together contain all such signatures will constitute one and the same instrument.

IN WITNESS THEREOF, this Plan has been executed as of the ___ day of ____ 2014 by each of the parties hereto.

BATS EXCHANGE, INC.

BY: _____

CHICAGO STOCK EXCHANGE, INC.

BY: _____

EDGX EXCHANGE, INC.

BY: _____

NASDAQ OMX BX, INC.

BY: _____

THE NASDAQ STOCK MARKET LLC

BY: _____

NYSE MKT LLC

BY: _____

BATS Y-EXCHANGE, INC.

BY: _____

EDGA EXCHANGE, INC.

BY: _____

FINANCIAL INDUSTRY REGULATORY
AUTHORITY, INC.

BY: _____

NASDAQ OMX PHLX LLC

BY: _____

NEW YORK STOCK EXCHANGE LLC

BY: _____

NYSE ARCA, INC.

BY: _____

Appendix A – Publication of Pilot Securities

The following data will be made publicly available in a pipe delimited format regarding the list of Pilot Securities included in the Control Group and each Test Group. Each primary listing exchange will be responsible for making publicly available for free on its website the following data with respect to the Pilot Securities listed on that exchange and included in the Control Group and each Test Group.

I. Identification of Pilot Securities

- a. Ticker Symbol
- b. Security Name
- c. Listing Exchange
- d. Date
- e. Tick Size Pilot Program Group-character value of
 - i. "C" for Pilot Securities in the Control Group
 - ii. "G1" for Pilot Securities in Test Group One
 - iii. "G2" for Pilot Securities in Test Group Two
 - iv. "G3" for Pilot Securities in Test Group Three

II. Change in Pilot Securities' Ticker Symbols

- a. Ticker Symbol
- b. Security Name
- c. Listing Exchange
- d. Effective Date
- e. Deleted Date
- f. Tick Size Pilot Program Group – character value of

- i. "C" for Pilot Securities in the Control Group
 - ii. "G1" for Pilot Securities in Test Group One
 - iii. "G2" for Pilot Securities in Test Group Two
 - iv. "G3" for Pilot Securities in Test Group Three
- g. Old Ticker Symbol(s)
- h. Reason for the change

Appendix B – Data Collected by Participants and Trading Centers

Each Participant, as applicable, will collect and transmit the data described in Items I-IV with respect to Pilot Securities to the SEC in a pipe delimited format on a monthly basis. In addition, each Participant that is the Designated Examining Authority of a member of a Participant operating a trading center will require such member, as applicable, to collect and transmit the data described in Items I and II with respect to Pilot Securities to the Designated Examining Authority in a pipe delimited format on a monthly basis. Each Designated Examining Authority will transmit the data on a disaggregated basis to the SEC, *i.e.*, by trading center. The data will be provided to the SEC within 30 calendar days following month end. All trading centers, including Participants, will report the data described in Items 1.a(28) and 1.b with respect to only those orders executed, in whole or part, on that trading center. All trading centers will report the remaining data described in Item 1.a with respect to any order received by that trading center. The data described in Item 1 will only be collected for orders received during Regular Trading Hours. All trading centers, including Participants, will report the data described in Item 2 with respect to any market or marketable limit orders received by that trading center. The data described in Item 2 will be collected for orders received during and outside of Regular Trading Hours. Orders entered while a trading halt is in effect will be excluded from the data. The data will be provided for dates starting six months prior to the Pilot Period through six months after the end of the Pilot Period.

- I. **Market Quality Statistics** - Daily market quality statistics categorized by security, order type, original order size, hidden status, and coverage under Rule 605, including the following columns of information:

a. For regular hours orders which are market orders (10), marketable limit orders (11), inside-the-quote resting limit orders (12), at-the-quote resting limit orders (13), near-the-quote resting limit orders (within .10 from the NBBO) (14), resting intermarket sweep orders (15), retail liquidity providing orders (16), and midpoint passive liquidity orders (17) executed on the trading center:

- (1) Exchange code or trading center identifier;
- (2) Ticker Symbol;
- (3) Order Type, as defined in the Plan or in La of this Appendix;
- (4) Original Order size with the following modified categories from Rule 605 reports:
 - a. Less than 100 shares;
 - b. 100 to 499 shares;
 - c. 500 to 1999 shares;
 - d. 2000 to 4999 shares;
 - e. 5000 to 9999 shares; and
 - f. 10000 or more shares;
- (5) Hidden Status Category- indicates whether the orders fall into the following categories:
 - a. Entirely Displayable;
 - b. Partially Displayable; and
 - c. Not Displayable;
- (6) Rule 605 Coverage- indicates whether the orders are covered in Rule 605 (YIN);

- (7) The cumulative number of orders;
- (8) The cumulative number of shares of orders;
- (9) The cumulative number of shares of orders canceled;
- (10) The cumulative number of shares of orders executed on the receiving trading center;
- (11) The cumulative number of orders with special handling instructions (for example, slide, discretion, eligible counterparty, minimum quantity) excluded from price improvement and effective spread statistics;
- (12) The cumulative number of shares of orders with special handling instructions (for example slide, discretion, eligible counterparty, minimum quantity) excluded from price improvement and effective spread statistics;
- (13) The cumulative number of shares of orders executed at any other trading center;
- (14) The cumulative number of shares of orders executed from 0 to less than 100 microseconds after the time of order receipt;
- (15) The cumulative number of shares of orders executed from 100 microseconds to less than 100 milliseconds after the time of order receipt;
- (16) The cumulative number of shares of orders executed from 100 milliseconds to less than 1 second after the time of order receipt;
- (17) The cumulative number of shares of orders executed from 1 second to less than 30 seconds after the time of order receipt;
- (18) The cumulative number of shares of orders executed from 30 seconds to less than 60 seconds after the time of order receipt;

- (19) The cumulative number of shares of orders executed from 60 seconds to less than 5 minutes after the time of order receipt;
- (20) The cumulative number of shares of orders executed from 5 minutes to 30 minutes after the time of order receipt;
- (21) The cumulative number of shares of orders canceled from 0 to less than 100 microseconds after the time of order receipt;
- (22) The cumulative number of shares of orders canceled from 100 microseconds to less than 100 milliseconds after the time of order receipt;
- (23) The cumulative number of shares of orders canceled from 100 milliseconds to less than 1 second after the time of order receipt;
- (24) The cumulative number of shares of orders canceled from 1 second to less than 30 seconds after the time of order receipt;
- (25) The cumulative number of shares of orders canceled from 30 seconds to less than 60 seconds after the time of order receipt;
- (26) The cumulative number of shares of orders canceled from 60 seconds to less than 5 minutes after the time of order receipt;
- (27) The cumulative number of shares of orders canceled from 5 minutes to 30 minutes;
- (28) The share-weighted average realized spread for executions of orders;
- (29) Original Percentage Hidden - the received share-weighted average percentage of shares not displayable as of order receipt;
- (30) Final Percentage Hidden - the received share-weighted average percentage of shares not displayed prior to final order execution or cancellation;

- (31) Quoted Size at the National Best Bid and National Best Offer -the share-weighted average of the consolidated quoted size at the inside price at the time of order execution;
 - (32) Share-weighted average NBBO Spread at the time of order execution; and
 - (33) Share-weighted average BBO Spread of reporting exchange at the time of order execution.
- b. For market orders and marketable limit orders, except those noted as excluded: (1)
- The share-weighted average effective spread for executions of orders;
 - (2) The cumulative number of shares of orders executed with price improvement; (3) For shares executed with price improvement, the share-weighted average amount per share that prices were improved;
 - (4) For shares executed with price improvement, the share-weighted average period from the time of order receipt to the time of order execution;
 - (5) The cumulative number of shares of orders executed at the quote;
 - (6) For shares executed at the quote, the share-weighted average period from the time of order receipt to the time of order execution;
 - (7) The cumulative number of shares of orders executed outside the quote;
 - (8) For shares executed outside the quote, the share-weighted average amount per share that prices were outside the quote; and
 - (9) For shares executed outside the quote, the share-weighted average period from the time of order receipt to the time of order execution.

II. Market and Marketable Limit Order Data – The following columns of information with respect to Market Orders and non-booked portions of Marketable Limit Orders:

- a. Exchange code or trading center identifier;
- b. Ticker Symbol;
- c. Date;
- d. Time of order receipt;
- e. Order Type;
- f. Order Size in Shares;
- g. Order side-"B", "S" (including sell short exempt), "SS";
- h. Order price (if marketable limit);
- i. NBBO quoted price;
- j. NBBO quoted depth in lots;
- k. Receiving market offer for buy or bid for sell (as applicable);
- l. Receiving market depth (offer for buy and bid for sell) (as applicable);
- m. ISO flag (YIN);
- n. Retail Investor Order flag (YIN);
- o. Routable flag (YIN);
- p. IOC (YIN);
- q. Indicator for quote leader-"I" if the receiving market is the first market to post the NBB for a sell or NBO for a buy (as applicable);
- r. Average execution price-share-weighted average that includes only executions on the receiving market;
- s. Average execution time-share-weighted average period that includes only executions on the receiving market;
- t. Executed shares-the number of shares in the order that are executed;

- u. Canceled shares – the number of shares in the order that are canceled;
- v. Routed shares- the number of shares in the order that are routed to another exchange or market;
- w. Routed average execution price-share-weighted average that includes only shares routed away from the receiving market;
- x. Average routed execution time-share-weighted average period that includes only executions on the routed markets; and
- y. Indicator for special handling instructions (for example, slide, discretion, eligible counterparty, minimum quantity)- identifies orders that contain instructions that could result in delayed execution or an execution price other than the quote.

III. Daily Market Maker Registration Statistics - Each Participant that is a National Securities Exchange will collect daily Market Maker registration statistics categorized by security, including the following columns of information:

- a. Ticker Symbol;
- b. SRO;
- c. Number of registered market makers; and
- d. Number of other registered liquidity suppliers.

IV. Daily Market Maker Participation Statistics- Each Participant will collect daily Market Maker participation statistics with respect to each Market Maker engaging in trading activity on the trading center operated by the Participant. With respect to each Market Maker, the Participant will collect such statistics irrespective of whether the Market Maker is registered with the Participant. The participation statistics will be categorized by security, including the columns of information listed below, except that a

Participant that is a national securities association will not be required to collect such statistics unless a Market Maker registers with its Alternative Display Facility prior to or during the Pilot Period:

- a. Ticker Symbol;
- b. Share participation -the number of shares purchased or sold by Market Makers in a principal trade, not including riskless principal. When aggregating across Market Makers, share participation will be an executed share-weighted average per Market Maker;
- c. Trade participation -- the number of purchases and sales by Market Makers in a principal trade, not including riskless principal. When aggregating across Market Makers, trade participation will be a trade-weighted average per Market Maker;
- d. Cross-quote share (trade) participation-the number of shares purchased (the number of purchases) at or above the NBO and the number of shares sold (the number of sales) at or below the NBB at the time of the trade;
- e. Inside-the-quote share (trade) participation-the number of shares purchased (the number of purchases) and the number of shares sold (the number of sales) between the NBBO at the time of the trade;
- f. At-the-quote share (trade) participation-the number of shares purchased (the number of purchases) that are equal to the National Best Bid price and the number of shares sold (the number of sales) that are equal to the National Best Offer price at the time of or immediately before the trade. In the case of a downward moving National Best Bid or Offer, the National Best Bid or National Best Offer price immediately before the trade will be used; and

g. Outside-the-quote share (trade) participation-the number of shares purchased (the number of purchases) that are less than the National Best Bid price and the number of shares sold (the number of sales) that are greater than the National Best Offer price at the time of or immediately before the trade. In the case of a downward moving National Best Bid or Offer, the National Best Bid or National Best Offer price immediately before the trade will be used.

Appendix C – Data Collected by Market Makers

Each Participant that is the Designated Examining Authority of a Market Maker will require such Market Maker to collect the data described in Item I with respect to orders and executions in Pilot Securities on any trading center and to transmit such data in a pipe delimited format to the Designated Examining Authority on a monthly basis, to be provided within 30 calendar days following month end. Data will only be collected with respect to those orders and executions occurring during Regular Trading Hours. The data will be provided for dates starting six months prior to the Pilot Period through six months after the end of the Pilot Period. Each Designated Examining Authority will be responsible for aggregating the data provided by the Market Makers under Item I and providing the data described in Item II in a pipe delimited format to the SEC.

- I. **Market Maker Profitability**- Daily Market Maker profitability statistics categorized by security, including the following columns of information:
 - a. Total number of shares of orders executed by the Market Maker;
 - b. Raw Market Maker realized trading profits – the difference between the market value of Market Maker sales (shares sold x price) and the market value of Market Maker purchases (shares purchased x price). A LIFO-like method will be used for determining which share prices to use in the calculation;
 - c. Market Maker realized trading profits net of fees and rebates -realized trading profits plus rebates the Market Maker collects from trading on that day minus access fees the Market Maker pays for trading on that day (if estimated before allocation of rebates and fees, use expected rebates and fees); and

- d. Raw Market Maker unrealized trading profits – the difference between the purchase or sale price of the end-of-day inventory position of the Market Maker and the Closing Price. In case of a short position, the Closing Price from the sale will be subtracted. In the case of a long position, the purchase price will be subtracted from the Closing Price.

II. Aggregated Market Maker Profitability- Total Daily Market Maker profitability statistics categorized by security, including the following columns of information:

- a. Total Raw Market Maker realized trading profits-the difference between the market value of Market Maker sales (shares sold x price) and the market value of Market Maker purchases (shares purchased x price). A LIFO-like method will be used for determining which share prices to use in the calculation;
- b. Volume-weighted average of Raw Market Maker realized trading profits;
- c. Total Market Maker realized trading profits net of fees and rebates-realized trading profits plus rebates the Market Maker collects from trading on that day minus access fees the Market Maker pays for trading on that day (if estimated before allocation of rebates and fees, use expected rebates and fees);
- d. Volume-weighted average of Market Maker realized trading profits net of fees and rebates;
- e. Total Raw Market Maker unrealized trading profits-the difference between the purchase or sale price of the end-of-day inventory position of the Market Maker and the Closing Price. In case of a short position, the Closing Price from the sale will be subtracted. In the case of a long position, the purchase price will be subtracted from the Closing Price; and

f. Volume-weighted average of Market Maker unrealized trading profits.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9676 / November 4, 2014

SECURITIES EXCHANGE ACT OF 1934
Release No. 73513 / November 4, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16246

In the Matter of

**STEVEN DURRELLE
WILLIAMS,**

Respondent.

**ORDER INSTITUTING CEASE-AND-
DESIST PROCEEDINGS PURSUANT
TO SECTION 8A OF THE
SECURITIES ACT OF 1933 AND
SECTION 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, MAKING
FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS AND A
CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Steven Durrelle Williams ("Respondent" or "Williams").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, and except as provided herein in Section V, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act and Section 21C of the Securities Exchange Act, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

A. SUMMARY

1. This matter involves insider trading in the securities of Intellicheck Mobilisa, Inc. ("Intellicheck"), a mobile device computing company, by its former CEO Steven D. Williams in advance of its announcement of disappointing third quarter 2012 results.
2. By at least early September 2012, there were indications that Intellicheck's third quarter financial performance was off track and, by mid-September, Williams, the board, and Intellicheck CFO openly discussed the company's anticipated poor quarterly performance. In e-mail discussions, Williams and the CFO responded to questions from directors about an internal report showing how far off the company's results were as of September 14, 2012.
3. During these discussions, the CFO confirmed that revenues would definitely be off and that the company had not realized the September bump in sales that normally came from its defense contracting business. The CFO further reported that, while there were potential deals in various stages in the sales cycle, they would not "hit in Q3." Williams was copied on these e-mails. On September 18, 2012, Williams acknowledged in an email to the chairman of the board and other board members that it was unlikely Intellicheck would make revenue of Q3 2011, and that the quarter most likely would be Intellicheck's worst for its government identification group.
4. Over the next two days, September 19 and 20, 2012, while aware of the material nonpublic information described above, and in violation of his fiduciary duty to Intellicheck and its shareholders, Williams sold 191,887 of his 420,395 shares of Intellicheck stock, for a total of \$353,165. Williams used \$110,827.80 of the proceeds to exercise options in Intellicheck stock that were set to expire on March 14, 2013. A large portion of these shares was purchased by an existing shareholder with whom Williams had discussed the company a few days earlier. In those discussions, Williams had spoken positively about the company's prospects, inducing that shareholder to purchase additional shares.
5. On November 8, 2012, the company announced its poor performance for the quarter, and the stock price fell to \$1.30, an 11% decline from the previous day's close, and a decline of 29% from the price Williams received for his shares in September. Williams avoided losses in excess of \$100,000 by selling in advance of the announcement.

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

B. RESPONDENT

6. Steven Durrelle Williams, age 52, currently resides in Bryantown, Maryland. During the relevant time period, Williams was Chief Executive Officer of Intellicheck, and was based in Intellicheck's Alexandria, Virginia office.

C. RELEVANT ENTITY

7. Intellicheck Mobilisa, Inc. is a Delaware corporation based in Port Townsend, WA. Intellicheck's stock is registered pursuant to Section 12(b) of the Exchange Act and its shares trade on the New York Stock Exchange. Intellicheck provides identity systems products and wireless security applications for the government, military, and commercial markets.

D. FACTS

Intellicheck Struggles in Third Quarter of 2012

8. In August 2012, Williams filed an SEC Form 144, indicating his intent to sell some of his Intellicheck stock.

9. In the third quarter of 2012, Intellicheck's revenues slumped. In mid-September 2012, with just two weeks left in the quarter, an internal company report indicated that revenue was significantly below the previous third quarter's revenue. Williams, the Intellicheck board, and CFO discussed via e-mail the anticipated poor performance and how to handle the eventual public relations issues surrounding the disappointing numbers.

10. On September 14, 2012, the CFO sent an e-mail titled "Flash Report at September 14th" to Williams, the chairman of the board, and another director. The CFO reported that preliminary revenue, EBITDA, and net income were all significantly below the figures for the third quarter of 2011.

11. Two days later, on September 16, 2012, the CFO responded to an e-mail from another director who had expressed concern about the quarter-end results. In his e-mail, the CFO confirmed that revenues were down, stating the company had not realized the September bump as it had in prior years and that the company's revenues would definitely be off. The director responded by expressing concern about the quarter-end and how shareholders would react: "[t]his is going to be an ugly quarter, a difficult update call and shareholders [sic] meeting." Williams was copied on the director's reply e-mail.

12. In a September 18, 2012, e-mail to Williams (copied to the board), the chairman of the board questioned whether Williams had different information about the quarter-end results. The chairman of the board further instructed Williams to ask the company's investor relations firm for advice on addressing the poor quarter with shareholders. By reply email, Williams agreed to seek assistance from the IR firm and

added that, while he hoped to make breakeven EBITDA, it was unlikely that Intellicheck would achieve its revenues from the third quarter of 2011.

13. That same day, Williams spoke with the chairman of the board and acknowledged that it was going to be difficult quarter.

Williams Talks Up the Company's Prospects to the Shareholder Who Buys the Bulk of Williams's Shares

14. On September 14, 2012, days before placing his first sell order, Williams spoke positively about Intellicheck's business prospects to Investor, an Intellicheck shareholder interested in purchasing more shares. Williams told Investor that Intellicheck was working very closely with some large potential customers and expected them to place orders soon. Williams gave no indication that Intellicheck was struggling.

15. Based on his conversation with Williams, Investor purchased 175,000 Intellicheck shares on September 19 and 20, 2012, which represented approximately 80% of the stock's trading volume on those two days. Investor's purchases depreciated significantly when the information Williams possessed became public. As a result, Investor suffered at least \$98,514 in damages caused by Williams's conduct.

Williams Sells Intellicheck Shares

16. On September 18, 2012, just hours before responding to the board about the weak quarter, Williams entered a day order to sell 270,000 of his 420,395 shares at a limit price of \$1.90. The order went unfilled.

17. The following day, September 19, 2012, Williams again entered a day order to sell 200,000 shares, but lowered the limit price to \$1.83. He sold 98,700 shares for \$181,575.

18. Williams used \$110,827.80 of these proceeds to exercise Intellicheck options that he possessed, which would expire in March 2013.

19. The next day, September 20, 2012, Williams again called his broker and ordered the sale of the remaining 101,300 shares. Williams was able to sell 93,187 shares for \$171,590.

20. Williams's combined proceeds from the two days of sales were \$353,165. These trades were made while aware of material non-public information about the quarter-end results.

21. As a result of his improper use of material nonpublic information, Williams avoided losses of \$103,712.

Intellicheck's Third Quarter 2012 Results

22. On November 8, 2012, before the market opened, Intellicheck released its results for the third quarter of 2012 and reported quarterly revenue of \$2.123 million (down \$1.472 million from the third quarter of 2011) and a net loss of \$381,000 (down \$687,000 from the net income in the third quarter of 2011). The stock ended the day down 11.6% from the previous day's close.

23. Over the next two trading days, the stock declined further, eventually closing at \$0.95 on November 12, 2012, representing a decline of 35.4% over three trading days, and a decline of 48.4% from the price Williams received for his shares in September 2012.

E. VIOLATIONS

24. As a result of the conduct described above, Williams violated Section 17(a) of the Securities Act, which prohibits fraudulent conduct in the offer or sale of securities, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in connection with the purchase or sale of securities.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Williams's Offer.

Accordingly, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent Williams shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act or Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

B. Respondent Williams is prohibited, for two (2) years following the date of the entry of this Order, from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act [15 U.S.C. § 781] or that is required to file reports pursuant to Section 15(d) of the Exchange Act [15 U.S.C. § 78o(d)].

C. Respondent shall, within 30 calendar days of the entry of this Order, pay disgorgement of \$103,712 and a civil penalty of \$75,000, for a total payment of \$178,712 to the Securities and Exchange Commission, and the civil penalty shall be transferred to the U.S. Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and 31 U.S.C. 3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Williams as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Jeffrey B. Finnell, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5010.

D. After receipt of all payments of disgorgement, the Commission shall within 90 days pay \$98,514 of the disgorgement to the Investor. The Commission staff will seek appointment of a tax administrator for the payment to the Investor as the disgorgement funds constitute a qualified settlement fund under section 468B(g) of the Internal Revenue Code (IRC), 26 U.S.C. § 468B(g), and related regulation, 26 C.F.R. §§ 1.468B-1 through 1.458B-5. Taxes, if any, and related administrative expenses will be paid from the remaining disgorgement funds. After the distribution payment and all taxes and administrative expenses are paid, Commission staff will transfer the remaining funds to the U.S. Treasury.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondent, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73514 / November 4, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16247

In the Matter of

VHGI Holdings, Inc.,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS AND
NOTICE OF HEARING PURSUANT TO
SECTION 12(j) OF THE SECURITIES
EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate and for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent VHGI Holdings, Inc. ("Respondent" or "VHGI").

II.

After an investigation, the Division of Enforcement alleges that:

RESPONDENT

1. VHGI is a Delaware corporation with its principal offices in Sullivan, IN. VHGI purported to be involved in the exploration, acquisition, and development of mining, energy and technological assets. Respondent has a class of equity securities registered with the Commission pursuant to Section 12(g) of the Exchange Act. As of September 8, 2014, Respondent's common stock (ticker "VHGI") was quoted on OTC Link (previously "Pink Sheets") operated by OTC Markets Group, Inc., has 13 market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

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DELINQUENT FILINGS

2. Section 13(a) of the Exchange Act and the rules promulgated thereunder require issuers with classes of securities registered pursuant to Section 12 of the Exchange Act to file with the Commission current and accurate information in periodic reports. Specifically, Rule 13a-1 requires issuers to file annual reports and Rule 13a-13 requires issuers to file quarterly reports.

3. The Respondent filed its last Form 10-K for the year ended December 31, 2012 on June 26, 2013. Since then, the Respondent has not filed its required periodic reports.

4. The Respondent is delinquent in the following periodic filings:

<u>Form</u>	<u>Period Ended</u>	<u>Due on or about</u>
10-Q	March 31, 2013	May 15, 2013
10-Q	June 30, 2013	August 14, 2013
10-Q	September 30, 2013	November 14, 2013
10-K	December 31, 2013	March 31, 2014
10-Q	March 31, 2014	May 15, 2014
10-Q	June 30, 2014	August 14, 2014

5. As a result of the conduct described above, the Respondent has failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1 and/or 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors to institute public administrative proceedings to determine:

A. Whether the allegations set forth in Section II hereof are true and, in connection therewith, to afford Respondent an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondent, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of the Respondent.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice [17 C.F.R. § 201.220].

If Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310].

This Order shall be served forthwith upon Respondent personally or by certified mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73517 / November 5, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16248

In the Matter of

Mondial Ventures, Inc.

Respondent.

ORDER INSTITUTING CEASE-AND-
DESIST PROCEEDINGS PURSUANT TO
SECTION 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, MAKING
FINDINGS, AND IMPOSING A CEASE-
AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Mondial Ventures, Inc. ("Mondial" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over Mondial and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Company Background

1. Mondial Ventures, Inc. is a Nevada corporation headquartered in Scottsdale, Arizona. Mondial is a smaller reporting company under Rule 12b-2 of the Exchange Act and has been registered with the Commission under Section 12(g) of the Exchange Act since November 18, 2004. Mondial's last-filed periodic report was the Form 10-Q for the period ended March 31, 2014. Its shares are quoted on OTC Link (formerly "pink sheets") operated by OTC Markets Group Inc. under the symbol MNVN.

Applicable Reporting Requirements Concerning the Issuance of Unregistered Shares

2. Under Item 1.01 of Form 8-K, a registrant must disclose its entry into a material definitive agreement that provides for obligations that are material to and enforceable against the registrant. Under Item 3.02 of Form 8-K, a smaller reporting company must disclose the unregistered sales of equity securities unless such sales, in aggregate since its last report filed under Item 3.02 or its last periodic report, whichever is more recent, constitute less than five percent of the number of shares outstanding of the class of equity securities sold. For both items, the registrant must file within four business days of the date of the occurrence or when such agreement becomes enforceable against the registrant.

3. Form 10-Q requires an issuer to disclose the number of shares outstanding of the issuer's common stock as of the latest practicable date. The information reported in a Form 10-Q is required to be true, correct, and complete. *See SEC v. Dauplaise*, No. 6:05CV1391, 2006 WL 449175 at *7 (M.D. Fla. Feb. 22, 2006).

Mondial Failed to Disclose the Issuance of Unregistered Shares

4. On November 5, 2013, Mondial filed with the Commission its Form 10-Q for the quarter ended September 30, 2013, and incorrectly reported the number of shares of common stock outstanding by more than 87 million shares, or more than 24 percent.

5. Between November 6, 2013 and January 9, 2014, Mondial sold more than 190 million shares of its common stock in transactions that were not registered under the Securities Act of 1933 ("Securities Act"). On November 6, 2013, the common stock sold exceeded five percent of the number of shares of common stock outstanding reported on Mondial's November 5, 2013

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

Form 10-Q. Ultimately, the common stock sold exceeded 70 percent of the number of shares of common stock outstanding reported on Mondial's November 5, 2013 Form 10-Q.

6. Mondial failed to file a Form 8-K with the Commission between November 12, 2013 and January 15, 2014, disclosing the unregistered sales of equity securities.

7. On or around March 21, 2014, Mondial entered into an agreement with a financing company ("financing agreement") pursuant to which Mondial issued shares of common stock to the financing company purportedly in reliance on a registration exemption found in Section 3(a)(10) of the Securities Act.

8. Between February 12, 2014 and March 27, 2014, Mondial sold more than 12 million shares of its common stock to the financing company and other parties in transactions that were not registered under the Securities Act. On February 12, 2014, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on Mondial's January 30, 2014 Form 8-K. Ultimately, the common stock sold exceeded 3,000 percent of the number of shares of common stock outstanding reported on Mondial's January 30, 2014 Form 8-K.

9. Mondial failed to file a Form 8-K with the Commission between February 18, 2014 and April 2, 2014, disclosing the unregistered sales of equity securities.

10. Between April 21, 2014 and May 13, 2014, Mondial sold more than 7.5 million shares of its common stock to the financing company and other parties in transactions that were not registered under the Securities Act. By April 22, 2014, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on Mondial's April 15, 2014 Form 10-K. Ultimately, the common stock sold exceeded 75 percent of the number of shares of common stock outstanding reported on Mondial's April 15, 2014 Form 10-K.

11. Mondial failed to file a Form 8-K with the Commission between April 25, 2014 and May 19, 2014, disclosing the unregistered sales of equity securities.

12. Between May 22, 2014 and June 19, 2014, Mondial sold more than 31 million shares of its common stock to the financing company and other parties in transactions that were not registered under the Securities Act. On May 22, 2014, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on Mondial's May 20, 2014 Form 10-Q. Ultimately, the common stock sold exceeded 130 percent of the number of shares of common stock outstanding reported on Mondial's May 20, 2014 Form 10-Q.

13. Mondial failed to file a Form 8-K with the Commission between May 28, 2014 and August 1, 2014, disclosing the unregistered sales of equity securities.

14. As a result of the conduct described above, Mondial violated Section 13(a) of the Exchange Act and Rules 13a-11, 13a-13 and 12b-20 thereunder, which require every issuer of a security registered pursuant to Section 12 of the Exchange Act to file with the Commission

information as the Commission may require, including quarterly reports on Form 10-Q, and current reports on Form 8-K to disclose the occurrence of certain events.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Mondial's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent Mondial cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act and Rules 13a-11, 13a-13, and 12b-20 thereunder.

B. Respondent shall pay civil penalties of \$50,000 to the Securities and Exchange Commission. Payment shall be made in the following installments: \$20,000 on or before November 15, 2014; \$4,000 on or before December 15, 2014; \$4,000 on or before January 15, 2015; \$4,000 on or before February 15, 2015; \$4,000 on or before March 15, 2015; \$4,000 on or before April 15, 2015; \$4,000 on or before May 15, 2015; \$4,000 on or before June 15, 2015; and \$2,000 on or before July 15, 2015. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Mondial as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to William P. Hicks, Division of Enforcement, Securities and Exchange Commission, 950 East Paces Ferry Rd. N.E., Suite 900, Atlanta, Georgia 30326.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73518 / November 5, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16249

In the Matter of

Red Giant Entertainment,
Inc.

Respondent.

ORDER INSTITUTING CEASE-AND-
DESIST PROCEEDINGS PURSUANT TO
SECTION 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, MAKING
FINDINGS, AND IMPOSING A CEASE-
AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Red Giant Entertainment, Inc. ("Red Giant" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over Red Giant and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Company Background

1. Red Giant is a Nevada corporation headquartered in Clermont, Florida. Red Giant is a smaller reporting company under Rule 12b-2 of the Exchange Act and has been registered with the Commission under Section 12(g) of the Exchange Act since September 5, 2008. Red Giant's last-filed periodic report was the Form 10-Q for the period ended May 31, 2014. Its shares are quoted on OTC Link (formerly "pink sheets") operated by OTC Markets Group Inc. under the symbol REDG.

Applicable Reporting Requirements Concerning the Issuance of Unregistered Shares

2. Under Item 1.01 of Form 8-K, a registrant must disclose its entry into a material definitive agreement that provides for obligations that are material to and enforceable against the registrant. Under Item 3.02 of Form 8-K, a smaller reporting company must disclose the unregistered sale of equity securities unless such sales, in aggregate since its last report filed under Item 3.02 or its last periodic report, whichever is more recent, constitute less than five percent of the number of shares outstanding of the class of equity securities sold. For both items, the registrant must file within four business days of the date of the occurrence or when such agreement becomes enforceable against the registrant.

Red Giant Failed to Disclose the Issuance of Unregistered Shares and the Existence of a Related Financing Agreement

3. On February 5, 2014, Red Giant entered into an agreement with a financing company ("financing agreement") pursuant to which Red Giant issued shares of common stock to the financing company purportedly in reliance on a registration exemption found in Section 3(a)(10) of the Securities Act of 1933 ("Securities Act"). The financing agreement provided for obligations that were material to and enforceable against Red Giant.

4. Red Giant failed to file a Form 8-K with the Commission on or before February 11, 2014, or thereafter, disclosing the financing agreement.²

5. Between January 16, 2014 and April 11, 2014, Red Giant sold more than one billion shares of common stock to the financing company and other parties in transactions that were not registered under the Securities Act. By February 7, 2014, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

² Red Giant disclosed the existence of the financing agreement on April 21, 2014 in a Form 10-Q.

Red Giant's January 14, 2014 Form 10-Q, and ultimately, the common stock sold exceeded 190 percent of the number of shares of common stock outstanding reported on Red Giant's January 14, 2014 Form 10-Q.

6. Red Giant failed to file a Form 8-K with the Commission between February 13, 2014 and April 20, 2014 disclosing the unregistered sale of equity securities.

7. As a result of the conduct described above, Red Giant violated Section 13(a) of the Exchange Act and Rule 13a-11 thereunder, which require every issuer of a security registered pursuant to Section 12 of the Exchange Act to file with the Commission information as the Commission may require, including current reports on Form 8-K to disclose the occurrence of certain events.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Red Giant's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent Red Giant cease and desist from committing or causing any violations and any future violations of Sections 13(a) of the Exchange Act and Rule 13a-11 thereunder.

B. Respondent shall pay civil penalties of \$25,000 to the Securities and Exchange Commission. Payment shall be made in the following installments: \$10,000 on or before November 15, 2014; \$2,000 on or before December 15, 2014; \$2,000 on or before January 15, 2015; \$2,000 on or before February 15, 2015; \$2,000 on or before March 15, 2015; \$2,000 on or before April 15, 2015; \$2,000 on or before May 15, 2015; \$2,000 on or before June 15, 2015; and \$1,000 on or before July 15, 2015. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. 3717 shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Red Giant as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to William P. Hicks, Division of Enforcement, U.S. Securities and Exchange Commission, 950 East Paces Ferry Road, NE, Atlanta, GA 30326-1382.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73519 / November 5, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16250

In the Matter of

Monster Arts, Inc.

Respondent.

ORDER INSTITUTING CEASE-AND-
DESIST PROCEEDINGS PURSUANT TO
SECTION 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, MAKING
FINDINGS, AND IMPOSING A CEASE-
AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Monster Arts, Inc. ("Monster Arts" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over Monster Arts and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Company Background

1. Monster Arts is a Nevada corporation headquartered in San Clemente, California. Monster Arts is a smaller reporting company under Rule 12b-2 of the Exchange Act and has been registered with the Commission under Section 12(g) of the Exchange Act since June 3, 2008. Monster Arts' last-filed periodic report was the Form 10-Q for the period ended March 31, 2014. Its shares are quoted on OTC Link (formerly "pink sheets") operated by OTC Markets Group Inc. under the symbol APPZ.

Applicable Reporting Requirements Concerning the Issuance of Unregistered Shares

2. Under Item 1.01 of Form 8-K, a registrant must disclose its entry into a material definitive agreement that provides for obligations that are material to and enforceable against the registrant. Under Item 3.02 of Form 8-K, a smaller reporting company must disclose the unregistered sales of equity securities unless such sales, in aggregate since its last report filed under Item 3.02 or its last periodic report, whichever is more recent, constitute less than five percent of the number of shares outstanding of the class of equity securities sold. For both items, the registrant must file within four business days of the date of the occurrence or when such agreement becomes enforceable against the registrant.

Monster Arts Failed to Disclose the Issuance of Unregistered Shares and the Existence of the Related Financing Agreement

3. On April 25, 2014, Monster Arts entered into an agreement with a financing company ("financing agreement") pursuant to which Monster Arts issued shares of common stock to the financing company purportedly in reliance on a registration exemption found in Section 3(a)(10) of the Securities Act of 1933 ("Securities Act"). The financing agreement provided for obligations that were material to and enforceable against Monster Arts.

4. Monster Arts failed to file a Form 8-K with the Commission, on or before May 1, 2014, or thereafter, disclosing the financing agreement.

5. Between November 27, 2013 and March 27, 2014, Monster Arts sold more than 140 million shares of its common stock in transactions that were not registered under the Securities Act. By December 5, 2013, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on Monster Arts' November 19, 2013

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

Form 10-Q. Ultimately, the common stock sold exceeded 350 percent of the number of shares of common stock outstanding reported on Monster Arts' November 19, 2013, Form 10-Q.

6. Monster Arts failed to file a Form 8-K with the Commission between December 5, 2013 and April 14, 2014, disclosing the unregistered sales of equity securities.

7. Between April 16, 2014 and May 13, 2014, Monster Arts sold more than 85 million shares of its common stock to the financing company and other parties in transactions that were not registered under the Securities Act. On April 16, 2014, the common stock sold, in the aggregate, exceeded five percent of the number of common stock outstanding reported on Monster Arts' April 15, 2014 Form 10-K. Ultimately, the common stock sold exceeded 50 percent of the number of shares of common stock outstanding reported on Monster Arts' April 15, 2014 Form 10-K.

8. Monster Arts failed to file a Form 8-K with the Commission between April 22, 2014 and May 19, 2014, disclosing the unregistered sales of equity securities.

9. Between May 23, 2014 and June 24, 2014, Monster Arts sold more than 225 million shares of its common stock to the financing company and other parties in transactions that were not registered under the Securities Act. On May 23, 2014, the common stock sold exceeded five percent of the number of shares of common stock outstanding reported on Monster Arts' May 20, 2014 Form 10-Q. Ultimately, the common stock sold exceeded 100 percent of the number of shares of common stock outstanding reported on Monster Arts' May 20, 2014 Form 10-Q.

10. Monster Arts failed to file a Form 8-K with the Commission between May 29, 2014 and June 30, 2014, disclosing the unregistered sales of equity securities.

11. As a result of the conduct described above, Monster Arts violated Section 13(a) of the Exchange Act and Rule 13a-11 thereunder, which require every issuer of a security registered pursuant to Section 12 of the Exchange Act to file with the Commission information as the Commission may require, including current reports on Form 8-K to disclose the occurrence of certain events.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Monster Arts' Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent Monster Arts cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act and Rule 13a-11 thereunder.

B. Respondent shall pay civil penalties of \$25,000 to the Securities and Exchange Commission. Payment shall be made in the following installments: \$10,000 on or before

November 15, 2014; \$2,000 on or before December 15, 2014; \$2,000 on or before January 15, 2015; \$2,000 on or before February 15, 2015; \$2,000 on or before March 15, 2015; \$2,000 on or before April 15, 2015; \$2,000 on or before May 15, 2015; \$2,000 on or before June 15, 2015; and \$1,000 on or before July 15, 2015. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Monster Arts as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to William P. Hicks, Division of Enforcement, Securities and Exchange Commission, 950 East Paces Ferry Rd. N.E., Suite 900, Atlanta, Georgia 30326.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73520 / November 5, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16251

In the Matter of

Seaniemac International, Ltd.

Respondent.

ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Seaniemac International, Ltd. ("Seaniemac" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over Seaniemac and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Company Background

1. Seaniemac is a Nevada company headquartered in Glen Cove, New York. Seaniemac is a smaller reporting company under Rule 12b-2 of the Exchange Act and has been registered with the Commission under Section 12(g) since June 14, 2010. Seaniemac's last-filed periodic report was the Form 10-Q for the period ended September 30, 2013. Its shares are quoted on OTC Link (formerly "pink sheets") operated by OTC Markets Group Inc. under the symbol BETS.

Applicable Reporting Requirements Concerning the Issuance of Unregistered Shares

2. Under Item 1.01 of Form 8-K, a registrant must disclose its entry into a material definitive agreement that provides for obligations that are material to and enforceable against the registrant. Under Item 3.02 of Form 8-K, a smaller reporting company must disclose the unregistered sales of equity securities unless such sales, in aggregate since its last report filed under Item 3.02 or its last periodic report, whichever is more recent, constitute less than five percent of the number of shares outstanding of the class of equity securities sold. For both items, the registrant must file within four business days of the date of the occurrence or when such agreement becomes enforceable against the registrant.

3. Rules 13a-1 and 13a-13 of the Exchange Act require a registrant to file annual reports (Form 10-K) and quarterly reports (Form 10-Q), respectively, with the Commission.

Seaniemac Failed to File Annual and Quarterly Reports, Failed to Disclose the Issuance of Unregistered Shares, and Failed to Disclose the Existence of the Related Financing Agreement

4. On March 13, 2014 and May 12, 2014, Seaniemac entered into agreements with a financing company ("financing agreements") pursuant to which Seaniemac issued shares of common stock to the financing company purportedly in reliance on a registration exemption found in Section 3(a)(10) of the Securities Act of 1933 ("Securities Act"). The financing agreements provided for obligations that were material to and enforceable against Seaniemac.

5. Seaniemac failed to file Forms 8-K with the Commission, on or before March 19, 2014 or thereafter, or on or before May 16, 2014 or thereafter, disclosing the respective financing agreements.

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

6. Between April 1, 2014 and July 2, 2014, Seaniemac sold more than ten million shares of its common stock to the financing company and other parties in transactions that were not registered under the Securities Act. By May 1, 2014, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on Seaniemac's November 19, 2013 Form 10-Q, and ultimately, the common stock sold exceeded 25 percent of the number of shares of common stock outstanding reported on Seaniemac's November 94, 2013 Form 10-Q.

7. Seaniemac failed to file a Form 8-K with the Commission between May 8, 2014 and July 27, 2014, disclosing the unregistered sales of equity securities.

8. Since November 19, 2013, Seaniemac has failed to make any of its required annual and quarterly filings on Forms 10-K and 10-Q, respectively. The most recent filing by Seaniemac is its Form 10-Q for the quarter ended September 30, 2013, filed with the Commission on November 19, 2013.

9. As a result of the conduct described above, Seaniemac violated Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11, 13a-13 thereunder, which require every issuer of a security registered pursuant to Section 12 of the Exchange Act to file with the Commission information as the Commission may require, including annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K to disclose the occurrence of certain events.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Seaniemac's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent Seaniemac cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11, 13a-13 thereunder.

B. Respondent shall pay civil penalties of \$50,000 to the Securities and Exchange Commission. Payment shall be made in the following installments: \$20,000 on or before November 15, 2014; \$4,000 on or before December 15, 2014; \$4,000 on or before January 15, 2015; \$4,000 on or before February 15, 2015; \$4,000 on or before March 15, 2015; \$4,000 on or before April 15, 2015; \$4,000 on or before May 15, 2015; \$4,000 on or before June 15, 2015; and \$2,000 on or before July 15, 2015. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Seaniemac as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to William P. Hicks, Division of Enforcement, Securities and Exchange Commission, 950 East Paces Ferry Rd. N.E., Suite 900, Atlanta, Georgia 30326.

By the Commission.

Brent J. Fields
Secretary


By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73521 / November 5, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16252

In the Matter of

Green Automotive Company

Respondent.

**ORDER INSTITUTING CEASE-AND-
DESIST PROCEEDINGS PURSUANT TO
SECTION 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, MAKING
FINDINGS, AND IMPOSING A CEASE-
AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Green Automotive Company ("Green Automotive" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over Green Automotive and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Company Background

1. Green Automotive Company is a Nevada company headquartered in Newport Beach, California. Green Automotive is a smaller reporting company under Rule 12b-2 of the Exchange Act and has been registered with the Commission under Section 12(g) of the Exchange Act since September 26, 2010. Green Automotive's last-filed periodic report was the Form 10-Q for the period ended March 31, 2014. Its shares are quoted on OTC Link (formerly "pink sheets") operated by OTC Markets Group Inc. under the symbol GACR.

Applicable Reporting Requirements Concerning the Issuance of Unregistered Shares

2. Under Item 1.01 of Form 8-K, a registrant must disclose its entry into a material definitive agreement that provides for obligations that are material to and enforceable against the registrant. Under Item 3.02 of Form 8-K, a smaller reporting company must disclose the unregistered sales of equity securities unless such sales, in aggregate since its last report filed under Item 3.02 or its last periodic report, whichever is more recent, constitute less than five percent of the number of shares outstanding of the class of equity securities sold. For both items, the registrant must file within four business days of the date of the occurrence or when such agreement becomes enforceable against the registrant.

3. Form 10-K requires a registrant to disclose the number of shares outstanding of the registrant's common stock as of the latest practicable date. The information reported in a Form 10-K is required to be true, correct, and complete. See *SEC v. Dauplaise*, No. 6:05CV1391, 2006 WL 449175 at *7 (M.D. Fla. Feb. 22, 2006).

Green Automotive Failed to Disclose the Issuance of Unregistered Shares and the Existence of the Related Financing Agreement

4. On December 4, 2013, Green Automotive entered into an agreement with a financing company ("financing agreement") pursuant to which Green Automotive issued shares of

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

common stock to the financing company purportedly in reliance on a registration exemption found in Section 3(a)(10) of the Securities Act of 1933 ("Securities Act"). The financing agreement provided for obligations that were material to and enforceable against Green Automotive.

5. Green Automotive failed to file a Form 8-K with the Commission, on or before December 10, 2013, or thereafter, disclosing the financing agreement.

6. Between November 18, 2013, and March 20, 2014, Green Automotive sold more than 100 million shares of its common stock to the financing company and other parties in transactions that were not registered under the Securities Act. By January 13, 2014, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on Green Automotive's November 14, 2013, Form 10-Q. Ultimately, the common stock sold exceeded twenty percent of the number of shares of common stock outstanding reported on Green Automotive's November 14, 2013, Form 10-Q.

7. Green Automotive failed to file a Form 8-K with the Commission between January 13, 2014, and March 30, 2014, disclosing the unregistered sales of equity securities.

8. On March 31, 2014, Green Automotive filed with the Commission its Form 10-K for the fiscal year ended December 31, 2013, and incorrectly reported the number of shares outstanding by more than 90 million shares, or more than twenty percent. In the Form 10-K, Green Automotive disclosed the existence of the financing agreement.

9. Between March 31, 2014, and April 9, 2014, Green Automotive sold more than 28 million shares of its common stock in transactions that were not registered under the Securities Act. By April 2, 2014, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on Green Automotive's March 31, 2014, Form 10-K. Ultimately, the common stock sold exceeded seven percent of the number of shares of common stock outstanding reported on Green Automotive's March 31, 2014, Form 10-K.

10. Green Automotive failed to file a Form 8-K with the Commission between April 2, 2014, and May 19, 2014, disclosing the unregistered sales of equity securities.

11. Between May 22, 2014, and July 10, 2014, Green Automotive sold more than 46 million shares of its common stock in transactions that were not registered under the Securities Act. By June 19, 2014, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on Green Automotive's May 20, 2014, Form 10-Q. Ultimately, the common stock sold exceeded seven percent of the number of shares of common stock outstanding reported on Green Automotive's May 20, 2014, Form 10-Q.

12. Green Automotive failed to file a Form 8-K with the Commission between June 19, 2014, and July 16, 2014, disclosing the unregistered sales of equity securities.

13. As a result of the conduct described above, Green Automotive violated Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11, and 12b-20 thereunder, which require every

issuer of a security registered pursuant to Section 12 of the Exchange Act to file with the Commission information as the Commission may require, including annual reports on Form 10-K and current reports on Form 8-K to disclose the occurrence of certain events.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Green Automotive's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent Green Automotive cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11, and 12b-20 thereunder.

B. Respondent shall pay civil penalties of \$50,000 to the Securities and Exchange Commission. Payment shall be made in the following installments: \$10,000 on or before November 15, 2014; \$5,000 on or before December 15, 2014; \$5,000 on or before January 15, 2015; \$5,000 on or before February 15, 2015; \$5,000 on or before March 15, 2015; \$5,000 on or before April 15, 2015; \$5,000 on or before May 15, 2015; \$5,000 on or before June 15, 2015; and \$5,000 on or before July 15, 2015. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:


- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofin.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Green Automotive as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to William P. Hicks, Division of Enforcement, Securities and Exchange Commission, 950 East Paces Ferry Rd. N.E., Suite 900, Atlanta, Georgia 30326.

By the Commission.

Brent J. Fields
Secretary


By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73522 / November 5, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16253

In the Matter of

APT Motovox Group, Inc.

Respondent.

ORDER INSTITUTING CEASE-AND-
DESIST PROCEEDINGS PURSUANT TO
SECTION 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, MAKING
FINDINGS, AND IMPOSING A CEASE-
AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against APT Motovox Group, Inc. ("Motovox") or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over Motovox and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Company Background

1. Motovox (formerly known as Frozen Food Gift Group, Inc.) is a Delaware corporation headquartered in Kansas City, Missouri. Motovox is a smaller reporting company under Rule 12b-2 of the Exchange Act and has been registered with the Commission under Section 12(g) of the Exchange Act since February 3, 2012. Motovox's last-filed periodic report was the form 10-Q/A for the period ended March 31, 2014. Its shares are quoted on OTC Link (formerly "pink sheets") operated by OTC Markets Group Inc. under the symbol MTVX.

Applicable Reporting Requirements Concerning the Issuance of Unregistered Shares

2. Under Item 3.02 of Form 8-K, a smaller reporting company must disclose the unregistered sales of equity securities unless such sales, in aggregate since its last report filed under Item 3.02 or its last periodic report, whichever is more recent, constitute less than five percent of the number of shares outstanding of the class of equity securities sold. The registrant must file within four business days of the date of the occurrence or when such agreement becomes enforceable against the registrant.

Motovox Failed to Disclose the Issuance of Unregistered Shares

3. On or around February 14, 2014, March 11, 2014, and March 21, 2014, Motovox entered into agreements with a financing company ("financing agreement") pursuant to which Motovox issued shares of common stock to the financing company purportedly in reliance on a registration exemption found in Section 3(a)(10) of the Securities Act of 1933 ("Securities Act").

4. Between January 15, 2014 and March 14, 2014, Motovox sold more than 540 million shares of its common stock to the financing company and other parties in transactions that were not registered under the Securities Act. On January 15, 2013, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on Motovox's November 19, 2013 Form 10-Q. Ultimately, the common stock sold exceeded 135 percent of the number of shares of common stock outstanding reported on Motovox's November 19, 2013 Form 10-Q, as amended on February 14, 2014.

5. Motovox failed to file a Form 8-K with the Commission between January 21, 2013 and March 20, 2014, disclosing the unregistered sales of equity securities.

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

6. Between April 23, 2014 and May 14, 2014, Motovox sold more than 650 million shares of its common stock in transactions that were not registered under the Securities Act. On April 23, 2014, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on Motovox's April 15, 2014 Form 10-K, as supplemented by its April 16, 2014 Form 8-K. Ultimately, the common stock sold exceeded 16 percent of the number of shares of common stock outstanding reported on Motovox's April 15, 2014 Form 10-K, as supplemented by its April 16, 2014 Form 8-K.

7. Motovox failed to file a Form 8-K with the Commission between April 29, 2013 and May 19, 2014, disclosing the unregistered sales of equity securities.

8. Between May 23, 2014 and June 16, 2014, Motovox sold more than 810 million shares of its common stock in transactions that were not registered under the Securities Act. On May 23, 2014, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on Motovox's May 20, 2014 Form 10-Q. Ultimately, the common stock sold exceeded 17 percent of the number of shares of common stock outstanding reported on Motovox's May 20, 2014 Form 10-Q.

9. Motovox failed to file a Form 8-K with the Commission between May 29, 2014 and June 20, 2014, disclosing the unregistered sales of equity securities.

10. As a result of the conduct described above, Motovox violated Section 13(a) of the Exchange Act and Rule 13a-11 thereunder, which require every issuer of a security registered pursuant to Section 12 of the Exchange Act to file with the Commission information as the Commission may require, including current reports on Form 8-K to disclose the occurrence of certain events.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Motovox's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act; Respondent Motovox cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act and Rule 13a-11 thereunder.

B. Respondent shall pay civil penalties of \$25,000 to the Securities and Exchange Commission. Payment shall be made in the following installments: \$10,000 on or before November 15, 2014; \$2,000 on or before December 15, 2014; \$2,000 on or before January 15, 2015; \$2,000 on or before February 15, 2015; \$2,000 on or before March 15, 2015; \$2,000 on or before April 15, 2015; \$2,000 on or before May 15, 2015; \$2,000 on or before June 15, 2015; and \$1,000 on or before July 15, 2015. If any payment is not made by the date the payment is required

by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Motovox as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to William P. Hicks, Division of Enforcement, Securities and Exchange Commission, 950 East Paces Ferry Rd. N.E., Suite 900, Atlanta, Georgia 30326.

By the Commission.

Brent J. Fields
Secretary


By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73523 / November 5, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16254

In the Matter of

COROWARE, INC.

Respondent.

**ORDER INSTITUTING CEASE-AND-
DESIST PROCEEDINGS PURSUANT TO
SECTION 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, MAKING
FINDINGS, AND IMPOSING A CEASE-
AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against CoroWare, Inc. ("CoroWare" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over CoroWare and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Company Background

1. CoroWare is a Delaware corporation headquartered in Kirkland, Washington. CoroWare is a smaller reporting company under Rule 12b-2 of the Exchange Act and has been registered with the Commission under Section 12(g) of the Exchange Act since October 9, 2001. CoroWare's last-filed periodic report was the Form 10-Q/A for the period ended September 30, 2013. Its shares are quoted on OTC Link (formerly "pink sheets") operated by OTC Markets Group Inc. under the symbol COWI.

Applicable Reporting Requirements Concerning the Issuance of Unregistered Shares

2. Under Item 1.01 of Form 8-K, a registrant must disclose its entry into a material definitive agreement that provides for obligations that are material to and enforceable against the registrant. Under Item 3.02 of Form 8-K, a smaller reporting company must disclose the unregistered sales of equity securities unless such sales, in aggregate since its last report filed under Item 3.02 or its last periodic report, whichever is more recent, constitute less than five percent of the number of shares outstanding of the class of equity securities sold. For both items, the registrant must file within four business days of the date of the occurrence or when such agreement becomes enforceable against the registrant.

CoroWare Failed to Disclose the Issuance of Unregistered Shares and the Existence of a Related Financing Agreement

3. On April 4, 2014, CoroWare entered into an agreement with a financing company ("financing agreement") pursuant to which CoroWare issued shares of common stock to the financing company purportedly in reliance on a registration exemption found in Section 3(a)(10) of the Securities Act of 1933 ("Securities Act"). The financing agreement provided for obligations that were material to and enforceable against CoroWare.

4. CoroWare failed to file a Form 8-K with the Commission, on or before April 10, 2014 or thereafter, disclosing the financing agreement.

5. Between January 10, 2014 and June 6, 2014, CoroWare sold more than seven billion shares of common stock to the financing company and other parties in transactions that were not registered under the Securities Act. By January 14, 2014, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on CoroWare's November 19, 2013 Form 10-Q as amended by CoroWare's November 25, 2013 DEF

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

14C. Ultimately, the common stock sold exceeded 35,000 percent of the number of shares of common stock outstanding reported on CoroWare's November 19, 2013 Form 10-Q as amended by CoroWare's November 25, 2013 DEF 14C.²

6. CoroWare failed to file a Form 8-K with the Commission between January 16, 2014 and June 12, 2014, disclosing the unregistered sales of equity securities.

7. As a result of the conduct described above, CoroWare violated Section 13(a) of the Exchange Act and Rule 13a-11 thereunder, which require every issuer of a security registered pursuant to Section 12 of the Exchange Act to file with the Commission information as the Commission may require, including current reports on Form 8-K to disclose the occurrence of certain events.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent CoroWare's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent CoroWare cease and desist from committing or causing any violations and any future violations of Sections 13(a) of the Exchange Act and Rule 13a-11 thereunder.

B. Respondent shall pay civil penalties of \$25,000 to the Securities and Exchange Commission. Payment shall be made in the following installments: \$10,000 on or before November 15, 2014; \$2,000 on or before December 15, 2014; \$2,000 on or before January 15, 2015; \$2,000 on or before February 15, 2015; \$2,000 on or before March 15, 2015; \$2,000 on or before April 15, 2015; \$2,000 on or before May 15, 2015; \$2,000 on or before June 15, 2015; and \$1,000 on or before July 15, 2015. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. 3717 shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or

² On November 25, 2013, CoroWare filed a DEF 14C announcing a 1:200 reverse stock split resulting in a reduction of the number of shares of common stock outstanding.


- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying CoroWare as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to William P. Hicks, Division of Enforcement, U.S. Securities and Exchange Commission, 950 East Paces Ferry Road, NE, Atlanta, GA 30326-1382.

By the Commission.

Brent J. Fields
Secretary


By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 73524 / November 5, 2014

ADMINISTRATIVE PROCEEDING

File No. 3-16255

In the Matter of

ERF Wireless, Inc.

Respondent.

ORDER INSTITUTING CEASE-AND-
DESIST PROCEEDINGS PURSUANT TO
SECTION 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, MAKING
FINDINGS, AND IMPOSING A CEASE-
AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against ERF Wireless, Inc. ("ERF" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over ERF and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Company Background

1. ERF is a Nevada corporation headquartered in League City, Texas. ERF is a smaller reporting company under Rule 12b-2 of the Exchange Act and has been registered with the Commission under Section 12(g) since November 26, 1999. ERF's last-filed periodic report was the Form 10-Q/A for the period ended March 31, 2014. Its shares are quoted on OTC Link (formerly "pink sheets") operated by OTC Markets Group Inc. under the symbol ERFB.

Applicable Reporting Requirements Concerning the Issuance of Unregistered Shares

2. Under Item 1.01 of Form 8-K, a registrant must disclose its entry into a material definitive agreement that provides for obligations that are material to and enforceable against the registrant. Under Item 3.02 of Form 8-K, a smaller reporting company must disclose the unregistered sales of equity securities unless such sales, in aggregate since its last report filed under Item 3.02 or its last periodic report, whichever is more recent, constitute less than five percent of the number of shares outstanding of the class of equity securities sold. For both items, the registrant must file within four business days of the date of the occurrence or when such agreement becomes enforceable against the registrant.

3. Form 10-K requires a registrant to disclose the number of shares outstanding of the registrant's common stock as of the latest practicable date. The information reported in a Form 10-K is required to be true, correct, and complete. See *SEC v. Dauplaise*, No. 6:05CV1391, 2006 WL 449175 at *7 (M.D. Fla. Feb. 22, 2006).

ERF Failed to Disclose the Issuance of Unregistered Shares and the Existence of the Related Financing Agreement

4. On April 24, 2014, ERF entered into an agreement with a financing company ("financing agreement") pursuant to which ERF issued shares of common stock to the financing company purportedly in reliance on a registration exemption found in Section 3(a)(10) of the Securities Act of 1933 ("Securities Act"). The financing agreement provided for obligations that were material to and enforceable against ERF.

5. ERF failed to file a Form 8-K with the Commission, on or before April 30, 2014, or thereafter, disclosing the financing agreement.

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

6. Between November 15, 2013 and April 7, 2014, ERF sold more than 12 million shares of its common stock in transactions that were not registered under the Securities Act. By November 18, 2013, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on ERF's November 14, 2013 Form 10-Q. Ultimately, the common stock sold exceeded 2,000 percent of the number of shares of common stock outstanding reported on ERF's November 14, 2013 Form 10-Q.
7. ERF failed to file a Form 8-K with the Commission between November 21, 2013 and April 14, 2014, disclosing the unregistered sales of equity securities.
8. On April 15, 2014, ERF filed with the Commission its Form 10-K for the fiscal year ended December 31, 2013, and incorrectly reported the number of shares outstanding by more than 450,000 shares, or more than 45 percent.
9. Between April 16, 2014 and May 13, 2014, ERF sold more than one million shares of its common stock to the financing company and other parties in transactions that were not registered under the Securities Act. By April 16, 2014, the common stock sold, in the aggregate, exceeded 12 percent of the number of shares of common stock outstanding reported on ERF's April 15, 2014 Form 10-K, and ultimately, the common stock sold exceeded 95 percent of the number of shares of common stock outstanding reported on ERF's April 15, 2014 Form 10-K.
10. ERF failed to file a Form 8-K with the Commission between April 22, 2014 and May 19, 2014, disclosing the unregistered sales of equity securities.
11. Between May 21, 2014 and July 28, 2014, ERF sold more than 3.8 million shares of its common stock to the financing company and other parties in transactions that were not registered under the Securities Act. By May 27, 2014, the common stock sold, in the aggregate, exceeded nine percent of the number of shares of common stock outstanding reported on ERF's May 20, 2014 Form 10-Q, and ultimately, the common stock sold exceeded 150 percent of the number of shares of common stock outstanding reported on ERF's May 20, 2014 Form 10-K.
12. ERF failed to file a Form 8-K with the Commission between May 27, 2014 and July 28, 2014, disclosing the unregistered sales of equity securities.
13. As a result of the conduct described above, ERF violated Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11, and 12b-20 thereunder, which require every issuer of a security registered pursuant to Section 12 of the Exchange Act to file with the Commission information as the Commission may require, including annual reports on Form 10-K and current reports on Form 8-K to disclose the occurrence of certain events.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent ERF's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent ERF cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11, and 12b-20 thereunder.

B. Respondent shall pay civil penalties of \$50,000 to the Securities and Exchange Commission. Payment shall be made in the following installments: \$20,000 on or before November 15, 2014; \$4,000 on or before December 15, 2014; \$4,000 on or before January 15, 2015; \$4,000 on or before February 15, 2015; \$4,000 on or before March 15, 2015; \$4,000 on or before April 15, 2015; \$4,000 on or before May 15, 2015; \$4,000 on or before June 15, 2015; and \$2,000 on or before July 15, 2015. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Green Automotive as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to William P. Hicks, Division of Enforcement, Securities and Exchange Commission, 950 East Paces Ferry Rd. N.E., Suite 900, Atlanta, Georgia 30326.

By the Commission.

Brent J. Fields
Secretary


By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73525 / November 5, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16256

In the Matter of

MineralRite Corporation

Respondent.

ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against MineralRite Corporation ("MineralRite" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over MineralRite and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Company Background

1. MineralRite is a Nevada corporation headquartered in Ferndale, Washington. MineralRite is a smaller reporting company under Rule 12b-2 of the Exchange Act and has been registered with the Commission under Section 12(g) of the Exchange Act since December 19, 1999. MineralRite's last-filed periodic report was the Form 10-Q/A for the period ended March 31, 2014. Its shares are quoted on OTC Link (formerly "pink sheets") operated by OTC Markets Group Inc. under the symbol RITE.

Applicable Reporting Requirements Concerning the Issuance of Unregistered Shares

2. Under Item 1.01 of Form 8-K, a registrant must disclose its entry into a material definitive agreement that provides for obligations that are material to and enforceable against the registrant. Under Item 3.02 of Form 8-K, a smaller reporting company must disclose the unregistered sales of equity securities unless such sales, in aggregate since its last report filed under Item 3.02 or its last periodic report, whichever is more recent, constitute less than five percent of the number of shares outstanding of the class of equity securities sold. For both items, the registrant must file within four business days of the date of the occurrence or when such agreement becomes enforceable against the registrant.

MineralRite Failed to Disclose the Issuance of Unregistered Shares and the Existence of the Related Financing Agreement

3. On April 4, 2014, MineralRite entered into an agreement with a financing company ("financing agreement") pursuant to which MineralRite issued shares of common stock to the financing company purportedly in reliance on a registration exemption found in Section 3(a)(10) of the Securities Act of 1933 ("Securities Act"). The financing agreement provided for obligations that were material to and enforceable against MineralRite.

4. MineralRite failed to file a Form 8-K with the Commission, on or before April 10, 2014, or thereafter, disclosing the financing agreement.

5. Between December 11, 2013 and May 14, 2014, MineralRite sold more than 145 million shares of its common stock to the financing company and other parties in transactions that were not registered under the Securities Act. By December 11, 2013, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

reported on MineralRite's November 19, 2013 Form 10-Q, and ultimately, the common stock sold exceeded 135 percent of the number of shares of common stock outstanding reported on MineralRite's November 19, 2013, Form 10-Q.

6. MineralRite failed to file a Form 8-K with the Commission between December 17, 2013 and May 20, 2014, disclosing the unregistered sales of equity securities.

7. Between May 21, 2014 and June 10, 2014, MineralRite sold more than 26 million shares of its common stock to the financing company in transactions that were not registered under the Securities Act. By May 27, 2014, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on MineralRite's May 21, 2014 Form 10-K, and ultimately, the common stock sold exceeded 15 percent of the number of shares of common stock outstanding reported on MineralRite's May 21, 2014 Form 10-K.

8. MineralRite failed to file a Form 8-K with the Commission between May 21, 2014 and July 8, 2014, disclosing the unregistered sales of equity securities.

9. As a result of the conduct described above, MineralRite violated Section 13(a) of the Exchange Act and Rule 13a-11 thereunder, which require every issuer of a security registered pursuant to Section 12 of the Exchange Act to file with the Commission information as the Commission may require, including current reports on Form 8-K to disclose the occurrence of certain events.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent MineralRite's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent MineralRite cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act and Rule 13a-11 thereunder.

B. Respondent shall pay civil penalties of \$25,000 to the Securities and Exchange Commission. Payment shall be made in the following installments: \$10,000 on or before November 15, 2014; \$2,000 on or before December 15, 2014; \$2,000 on or before January 15, 2015; \$2,000 on or before February 15, 2015; \$2,000 on or before March 15, 2015; \$2,000 on or before April 15, 2015; \$2,000 on or before May 15, 2015; \$2,000 on or before June 15, 2015; and \$1,000 on or before July 15, 2015. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying MineralRite as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to William P. Hicks, Division of Enforcement, Securities and Exchange Commission, 950 East Paces Ferry Rd. N.E., Suite 900, Atlanta, Georgia 30326.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73526 / November 5, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16257

In the Matter of

Worthington Energy, Inc.

Respondent.

**ORDER INSTITUTING CEASE-AND-
DESIST PROCEEDINGS PURSUANT TO
SECTION 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, MAKING
FINDINGS, AND IMPOSING A CEASE-
AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Worthington Energy, Inc. ("Worthington Energy" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over Worthington Energy and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Company Background

1. Worthington Energy is a Nevada corporation headquartered in San Francisco, California. Worthington Energy is a smaller reporting company under Rule 12b-2 of the Exchange Act and has been registered with the Commission under Section 12(g) of the Exchange Act since April 27, 2007. Worthington Energy's last-filed periodic report was the Form 10-Q for the period ended March 31, 2014. Its shares are quoted on OTC Link (formerly "pink sheets") operated by OTC Markets Group Inc. under the symbol WGAS.

Applicable Reporting Requirements Concerning the Issuance of Unregistered Shares

2. Under Item 1.01 of Form 8-K, a registrant must disclose its entry into a material definitive agreement that provides for obligations that are material to and enforceable against the registrant. Under Item 3.02 of Form 8-K, a smaller reporting company must disclose the unregistered sales of equity securities unless such sales, in aggregate since its last report filed under Item 3.02 or its last periodic report, whichever is more recent, constitute less than five percent of the number of shares outstanding of the class of equity securities sold. For both items, the registrant must file within four business days of the date of the occurrence or when such agreement becomes enforceable against the registrant.

Worthington Energy Failed to Disclose the Issuance of Unregistered Shares and the Existence of the Related Financing Agreement

3. On April 24, 2014, Worthington Energy entered into an agreement with a financing company ("financing agreement") pursuant to which Worthington Energy issued shares of common stock to the financing company purportedly in reliance on a registration exemption found in Section 3(a)(10) of the Securities Act of 1933 ("Securities Act"). The financing agreement provided for obligations that were material to and enforceable against Worthington Energy.

4. Worthington Energy failed to file a Form 8-K with the Commission, on or before April 30, 2014, or thereafter, disclosing the financing agreement.

5. Between January 27, 2014 and April 9, 2014, Worthington Energy sold more than 210 million shares of its common stock in transactions that were not registered under the Securities Act. By January 28, 2014, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on Worthington Energy's January 24,

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

2014, Form 10-Q. Ultimately, the common stock sold exceeded 340 percent of the number of shares of common stock outstanding reported on Worthington Energy's January 24, 2014 Form 10-Q.

6. Worthington Energy failed to file a Form 8-K with the Commission between February 3, 2014 and April 15, 2014, disclosing the unregistered sales of equity securities.

7. Between April 17, 2014 and May 13, 2014, Worthington Energy sold more than 700 million shares of its common stock to the financing company and other parties in transactions that were not registered under the Securities Act. By April 21, 2014, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on Worthington Energy's April 16, 2014 Form 10-K, and ultimately, the common stock sold exceeded 170 percent of the number of shares of common stock outstanding reported on Worthington Energy's April 16, 2014 Form 10-K.

8. Worthington Energy failed to file a Form 8-K with the Commission between April 23, 2014 and May 19, 2014, disclosing the unregistered sales of equity securities.

9. Between May 21, 2014 and June 10, 2014, Worthington Energy sold more than 1.1 billion shares of its common stock to the financing company and other parties in transactions that were not registered under the Securities Act. On May 21, 2014, the common stock sold, in the aggregate, exceeded five percent of the number of shares of common stock outstanding reported on Worthington Energy's May 20, 2014 Form 10-Q, and ultimately, the common stock sold exceeded 13 percent of the number of shares of common stock outstanding reported on Worthington Energy's May 20, 2014 Form 10-Q.

10. Worthington Energy failed to file a Form 8-K with the Commission between May 27, 2014 and June 19, 2014, disclosing the unregistered sales of equity securities.

11. As a result of the conduct described above, Worthington Energy violated Section 13(a) of the Exchange Act and Rule 13a-11 thereunder, which require every issuer of a security registered pursuant to Section 12 of the Exchange Act to file with the Commission information as the Commission may require, including current reports on Form 8-K to disclose the occurrence of certain events.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Worthington Energy's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent Worthington Energy cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act and Rule 13a-11 thereunder.

B. Respondent shall pay civil penalties of \$25,000 to the Securities and Exchange Commission. Payment shall be made in the following installments: \$10,000 on or before November 15, 2014; \$2,000 on or before December 15, 2014; \$2,000 on or before January 15, 2015; \$2,000 on or before February 15, 2015; \$2,000 on or before March 15, 2015; \$2,000 on or before April 15, 2015; \$2,000 on or before May 15, 2015; \$2,000 on or before June 15, 2015; and \$1,000 on or before July 15, 2015. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Worthington Energy as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to William P. Hicks, Division of Enforcement, Securities and Exchange Commission, 950 East Paces Ferry Rd. N.E., Suite 900, Atlanta, Georgia 30326.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73532 / November 5, 2014

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3595 / November 5, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-13226

In the Matter of
David Blain, CPA

:
: ORDER GRANTING APPLICATION FOR
: REINSTATEMENT TO APPEAR AND PRACTICE
: BEFORE THE COMMISSION AS AN ACCOUNTANT
:

On September 19, 2008, David Blain, CPA ("Blain") was denied the privilege of appearing or practicing as an accountant before the Commission as a result of settled public administrative proceedings instituted by the Commission against Blain pursuant to Rule 102(e)(1)(iii) of the Commission's Rules of Practice.¹ This order is issued in response to Blain's application for reinstatement to practice before the Commission as an accountant.

In May 2007, The BISYS Group, Inc. ("BISYS") was the subject of a settled Commission enforcement action charging BISYS with violations of the financial reporting, books-and-records, and internal control provisions of the Securities Exchange Act of 1934 ("Exchange Act"). In the September 19, 2008 order the Commission found that from at least July 2000 until at least March 2002, while serving as a director of finance of the Insurance Services division of BISYS, Blain participated in a variety of improper accounting practices that had the purpose and effect of materially overstating BISYS's income and revenue in the company's reported financial results and rendering its books and records inaccurate. By virtue of this conduct, Blain willfully aided and abetted, and was a cause of, BISYS's violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 12b-20, 13a-1 and 13a-13 thereunder.

Blain has met all of the conditions set forth in the original order and, in his capacity as an independent accountant, has stated that he will comply with all requirements of the Commission

¹ See Accounting and Auditing Enforcement Release No. 2882 dated September 19, 2008. Blain was permitted, pursuant to the order, to apply for reinstatement after one year upon making certain showings.

and the Public Company Accounting Oversight Board, including, but not limited to all requirements relating to registration, inspections, concurring partner reviews and quality control standards. In his capacity as a preparer or reviewer, or as a person responsible for the preparation or review, of financial statements of a public company to be filed with the Commission, Blain attests that he will undertake to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, while practicing before the Commission in this capacity.

Blain is currently subject to probation under the Pennsylvania State Board of Accountancy. Failure to abide by the terms of his probation could result in the suspension of Blain's CPA license. Blain has attested that he will notify the Commission if he is found to have violated the terms of the probation. He also has attested that he understands that the suspension of his CPA license could result in the revocation of the reinstatement of his privilege to appear or practice before the Commission as an accountant.

Rule 102(e)(5) of the Commission's Rules of Practice governs applications for reinstatement, and provides that the Commission may reinstate the privilege to appear and practice before the Commission "for good cause shown."² This "good cause" determination is necessarily highly fact specific.

On the basis of the information supplied, representations made, and undertakings agreed to by Blain, it appears that he has complied with the terms of the September 19, 2008 order denying him the privilege of appearing or practicing before the Commission as an accountant, that no information has come to the attention of the Commission relating to his character, integrity, professional conduct or qualifications to practice before the Commission that would be a basis for adverse action against him pursuant to Rule 102(e) of the Commission's Rules of Practice, and that Blain, by undertaking to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the Commission, in his practice before the Commission as a preparer or reviewer of financial statements required to be filed with the Commission, and that Blain, by undertaking to comply with all requirements of the Commission and the Public Company Accounting Oversight Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards, in his practice before the Commission as an independent accountant has shown good cause for reinstatement. Therefore, it is accordingly,

² Rule 102(e)(5)(i) provides:

"An application for reinstatement of a person permanently suspended or disqualified under paragraph (e)(1) or (e)(3) of this section may be made at any time, and the applicant may, in the Commission's discretion, be afforded a hearing; however, the suspension or disqualification shall continue unless and until the applicant has been reinstated by the Commission for good cause shown." 17 C.F.R. § 201.102(e)(5)(i).

ORDERED pursuant to Rule 102(e)(5)(i) of the Commission's Rules of Practice that David Blain, CPA is hereby reinstated to appear and practice before the Commission as an accountant.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 73533 / November 5, 2014

INVESTMENT ADVISERS ACT OF 1940

Release No. 3965 / November 5, 2014

INVESTMENT COMPANY ACT OF 1940

Release No. 31330 / November 5, 2014

ADMINISTRATIVE PROCEEDING

File No. 3-16258

In the Matter of

BERNICE G. NJOROGE

Respondent.

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act"), against Bernice G. Njoroge ("Respondent" or "Njoroge").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over her and the subject matter of these

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proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Sections 203(f) and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

1. Respondent Bernice G. Njoroge, age 38, is a resident of Charlotte, North Carolina. From at least June 2011 through at least September 2013, Njoroge was a person associated with Yatalie Capital Management, a/k/a Yatalie Capital Management Co, Creato Funds L.P., a/k/a Yatalie Capital, Inc., a/k/a Creato Funds, L.P., a/k/a Yatalie Capital Management Co. (collectively, "Yatalie").

2. Yatalie, a sole proprietorship, was an investment adviser registered with the Commission from November 2010 until approximately December 2013. Yatalie's principal was Frank Dappah ("Dappah"), age 33, a resident of Charlotte, North Carolina. Dappah and Njoroge have been married since approximately January 2012.

3. On November 21, 2013, in a civil action captioned SEC v. Dappah, C.A. No. 3:13-cv-00546 (W.D.N.C. Sept. 27, 2013), a judgment was entered by consent against Dappah and Yatalie that permanently enjoined them from future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Sections 203A, 204, 206(1), 206(2), 206(4) and 207 of the Advisers Act and Rules 204-2 and 206(4)-1 thereunder.

4. The Commission's complaint in SEC v. Dappah, alleged, among other things, that Dappah and Yatalie wrongfully charged and then deducted excessive fees from Yatalie's clients' accounts, without the authorization or consent of clients.

5. Njoroge was Yatalie's only other associated person besides Dappah. She was listed on Yatalie's Form-ADV as its Chief Compliance Officer, and she signed numerous client advisory agreements in a compliance capacity on behalf of Yatalie. Multiple Yatalie client-victims identified Njoroge as having been their sole point of contact while their money was invested with Yatalie. Njoroge successfully recruited multiple client-victims to enter into advisory agreements with Yatalie, and while the excessive fee scheme was ongoing, Njoroge had communications with multiple Yatalie client-victims in which they specifically discussed with her concerns about excessive fees. Moreover, all of the fees that were improperly charged to the

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

Yatalie client-victims were deposited into a checking account that was opened by Njoroge in her and Yatalie's name and from which Njoroge and Dappah paid their regular living expenses.

6. Additionally, after Dappah consented to the entry of an administrative order before the Commission that barred him from association with any investment adviser, Njoroge attempted to become the sole investment adviser to several former Yatalie client-victims.

7. While still associated with Yatalie and soliciting those former Yatalie client-victims to become her new investment advisory clients, Njoroge misled clients with respect to the circumstances surrounding the Commission's actions against Dappah and Yatalie, her relationships with Dappah and Yatalie, and the reasons that the client-victims of Dappah and Yatalie needed to change investment advisers. In doing so, Njoroge omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

8. As a result of the conduct described above, Njoroge willfully violated Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in connection with the purchase or sale of securities.

9. As a result of the conduct described above, Njoroge also willfully aided and abetted and caused Yatalie's and Dappah's violations of Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in connection with the purchase or sale of securities.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Njoroge's Offer.

Accordingly, pursuant to Section 21C of the Exchange Act, Sections 203(f) and 203(k) of the Advisers Act, and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent Njoroge cease and desist from committing or causing any violations and any future violations of Sections 206(1) and 206(2) of the Advisers Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

B. Respondent Njoroge be, and hereby is:

barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and

prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter.

C. Any reapplication for association by Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

D. Based upon Respondent's sworn representations in her notarized declaration of Complete Financial Disclosure dated July 28, 2014, and other documents submitted to the Commission, the Commission is not imposing a penalty against Respondent.

E. The Division of Enforcement ("Division") may, at any time following the entry of this Order, petition the Commission to: (1) reopen this matter to consider whether Respondent provided accurate and complete financial information at the time such representations were made; and (2) seek an order directing payment of the maximum civil penalty allowable under the law. No other issue shall be considered in connection with this petition other than whether the financial information provided by Respondent was fraudulent, misleading, inaccurate, or incomplete in any material respect. Respondent may not, by way of defense to any such petition: (1) contest the findings in this Order; (2) assert that payment of a penalty should not be ordered; (3) contest the imposition of the maximum penalty allowable under the law; or (4) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9677 / November 6, 2014

SECURITIES EXCHANGE ACT OF 1934
Release No. 73539 / November 6, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16259

In the Matter of

CITY OF ALLEN PARK, MICHIGAN,

Respondent.

ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against the City of Allen Park, Michigan (the "City" or "Respondent").

II.

In anticipation of these proceedings, the City has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, the City consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, as set forth below.

III.

On the basis of this Order and the City's Offer, the Commission finds¹ that:

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

Summary

This matter involves municipal securities issued by the City pertaining to a movie studio project ("Studio Project") that the City began planning for in 2008. The City's securities were "double barreled" bonds, with debt service to be repaid initially from revenues derived from the Studio Project, but if need be from tax revenues of the City. The Studio Project's original plan was that it would be a \$146 million facility with eight sound stages, led by a Hollywood executive director, and that the City initially would repay the bond debt service with \$1.6 million of revenue from leases at the site. The City planned to develop the Studio Project in part by issuing bonds, which it ultimately did on November 12, 2009 and June 16, 2010 (collectively "Bonds"). By the time the City issued the Bonds, however, the plans to implement and pay for the Studio Project had deteriorated significantly. None of these changes, however, were reflected in the Bond offering documents nor in any of the City's other public statements. Instead, the Bond offering documents continued to repeat the original plans. In fact, by the time the Bonds were issued, the Studio Project had deteriorated to the point where it was a much smaller project, consisting of building and operating a vocational school. The deterioration put the City's ability to service the debt for the Bond offering at substantial risk. Without revenues from the Studio Project, the expected annual debt payments on the Bonds represented approximately 10% of the City's total budget. In addition, in connection with the Bond offerings, the City included outdated budget information which did not reflect the City Administrator's knowledge that the City had a projected deficit for Fiscal 2010 of at least \$2 million, or over 8.4% of its total budgeted revenue for Fiscal 2010.

Background

1. In April 2008 the State of Michigan enacted legislation that provided significant tax credits to film studios conducting business in Michigan. In August 2008 the City was approached by an owner and operator of a California film and post-production sound studio ("Producer") who inquired about building a Studio Project in the City.

2. The City believed that the Studio Project would bring much-needed economic development to the City. To support the Project, it therefore agreed to offer what ultimately became a total of \$28.275 million of general obligation limited tax bonds issued on November 12, 2009 ("2009 Bonds") and another \$2.725 million of general obligation limited tax bonds issued on June 16, 2010 ("2010 Bonds").

The Public Private Partnership

3. The City and the Producer planned that the Studio Project would be financed and built through a Public Private Partnership ("PPP"), consisting of a limited liability corporation with the City, the Producer and a private developer ("Developer") as members. The City would use the municipal bond proceeds to buy land which it then would donate to the PPP to use for the Studio Project. The Developer would finance and build structures while the Producer would manage the Project and find investors to fund the film production.

4. In April 2009 the City issued a press release that included relevant plans about the Studio Project that were available at that point. These plans, which the City then maintained on its website through at least June 2010, were that the Studio Project would be a full-service film and media production facility that would employ thousands of skilled workers, be located on 104 acres, include 750,000 feet of facilities and have eight sound stages, and would be led by a Hollywood production executive at a cost of \$146 million.

5. In May 2009, as the City was preparing its Fiscal 2010 budget, it faced a deficit of approximately \$2 million. The Producer offered to provide up to \$2 million to remove the deficit. Although the City Administrator originally understood the \$2 million would be a "financial gift," the Producer sent the City Administrator a letter on May 14, 2009, stating that the \$2 million was a "capital repayment" contingent on the City's contribution of land to the PPP.

6. In early June 2009, the Producer, the City, and the Developer signed an agreement for the PPP, pursuant to which the Developer committed \$20 million for the Project's first phase.

The Collapse of the PPP and the City's \$2 Million Budget Shortfall

7. In July 2009 the City's bond counsel advised the City that bond proceeds could not be used to purchase land that then would be donated to the PPP.

8. Because the City could not donate assets purchased with bond proceeds, it could not meet the contribution requirements necessary for membership in the PPP. The collapse of the PPP meant that the Developer, who had pledged to contribute \$20 million, no longer had any obligations to the Studio Project.

9. The collapse of the PPP also meant that the City's Fiscal 2010 budget now had a \$2 million shortfall because the Producer no longer had any obligation to pay the \$2 million. Although the City Administrator knew this, he took steps to create the false impression that the City would still receive this money and did not have a \$2 million deficit. The \$2 million purported "donation" represented 8.4% of the City's budgeted \$22 million in Fiscal 2010 revenue and was instrumental in creating the false appearance that the City's budget for Fiscal 2010 had no deficit.

10. In addition, the Producer's proposal to attract investors, media producers and tenants for the Studio Project had been based on the assumption that he would manage and control the entire Project. When the PPP collapsed, however, the City decided to own and manage the property itself. By August 2009, the plan was that the Producer was only going to lease 100,000 square feet and to operate a vocational school to train potential workers in the movie production business.

11. Thus, the City's plan for the Studio Project deteriorated significantly between April 2009, when the City issued its first press release, and November 12, 2009, when the City issued the 2009 Bonds. By the time the 2009 Bonds were issued, the City no longer had any private investor money in place to build or develop the Studio Project and the Producer no longer had the ability to lead the development or attract investors. In addition, the amount of funding

that the City initially believed that Wayne County, Michigan would provide had decreased significantly.

The 2009 Bonds Did Not Disclose Material Negative Information

12. The City, however, did not disclose any of these adverse facts in the offering documents for the bonds it issued on November 12, 2009.

13. Instead, the offering documents for the 2009 Bonds included a "Development" section that continued to describe the Studio Project by repeating substantially all of the same information that had been contained in the City's initial April 2009 press release announcing the Project.

14. In addition, the offering documents for the 2009 Bonds stated that the City intended initially to repay the 2009 Bonds by leasing facilities at the Studio Project and using the lease revenues towards payment of the 2009 Bonds. This representation was highly relevant to the City's ability to service its debt since the expected annual debt service otherwise would have constituted approximately 10% of the City's annual budget. The Official Statement for the 2009 Bonds also said that the City had existing leases "under contract" totaling \$1.6 million (in annual revenues) for 48% of available space and that additional lease arrangements, representing 27% of available space, were currently in negotiation.

15. At the time the 2009 Bonds were issued, however, the projected \$1.6 million annual revenues included at least \$300,000 from the Producer which the City's Administrator knew to be unreliable. The City's Administrator also was aware that there were no existing negotiations regarding 27% of available space.

16. Finally, the City attached its Fiscal Year 2010 budget as an appendix to the Official Statements for both its 2009 and its 2010 Bonds. The budget, which reflected the City's expectation that it would have a general fund surplus at the end of Fiscal Year 2010, appeared to be balanced because it was based on the assumption that the Producer would donate \$2 million to the City. The City Administrator, however, knew this \$2 million would not be forthcoming because it had depended on the existence of the PPP. The budget attached to the 2009 Official Statements thus was materially inaccurate because the City had a projected \$2 million deficit for Fiscal 2010.

The Bonds were rated "A" and Issued in November 2009

17. On October 20, 2009 Standard & Poor ("S&P") assigned the 2009 Bonds an "A" rating. S&P's write-up noted that the FY 2010 budget was balanced only because of the \$2 million donation, and pointed out that the City would have to address this structural imbalance.

18. Several investors who purchased the 2009 Bonds would not have done so had the 2009 Bonds not been rated "A."

Additional Adverse Developments Occurred Before the City Issued its June 2010 Bonds

19. After the 2009 Bonds were issued, the City retained a company to manage the Studio Project site. On February 12, 2010, the management company advised that the City's net cash flow from lease revenue at the site would decrease significantly, at least for the first three years.

20. On May 6, 2010 the City served the Producer with an eviction notice, on the grounds that the Producer had not paid his rent on time. The parties later negotiated an amended lease for only one-half the amount of space at one-half the rent – with rent payments to begin in August 2010.

21. Despite these additional significant negative developments affecting the Studio Project, the City prepared to and did issue the second set of Bonds it had planned for the Project on June 16, 2010. Although two weeks before the 2010 Bonds were issued, the City Council had adopted a budget for Fiscal Year 2011 which acknowledged the \$2 million budget shortfall, the Official Statement for the 2010 Bonds again incorporated the City's Fiscal 2010 budget figures which omitted the \$2 million shortfall.

22. The 2010 Bond offering documents misleadingly also continued to list tenants at the Studio Property with purported "total leases under contract represent[ing] approximately \$1.6 million of annual revenue" with total annual debt service accurately estimated at \$2.6 million.

23. Finally, notwithstanding that the Producer by this time had reduced his presence at the Studio Project by half, the offering documents falsely continued describing the Studio Project as a "\$146 million, full-service movie, television and new media production studio" that would include 750,000 square feet, eight sound stages, employ thousands of unionized skilled workers and be led by the Producer.

24. On September 29, 2010 the Producer advised the City that he was terminating his lease at the Studio Property and vacated the site on October 4, 2010. The City Administrator resigned on February 27, 2011 and the Mayor resigned on May 24, 2011.

The Effect of the Studio Project Collapse on the City

25. The collapse of the Studio Project had a significant impact on the City's financial condition. The City filed a notice on the Electronic Municipal Market Access system ("EMMA") on December 29, 2010 that it was not filing an annual report for fiscal year 2010.

26. On March 8, 2011 S&P downgraded the City's unlimited tax bonds to BB+ and its limited tax GO bonds to BB+.

27. The City did not file any continuing disclosure until January 4, 2012, at which time it announced it had received a going concern emphasis of matter paragraph from its auditor. On June 21, 2012 the Michigan State Treasurer began a Preliminary Review of the City, pursuant to State law, and issued a Final Report on August 8, 2012 recommending the appointment of an Emergency Manager. The Studio Project was listed as a primary factor in the

City's deteriorating economic condition. An Emergency Manager was appointed in October 2012 and governed for two years. The City is currently transitioning to a Receivership Transition Advisory Board who will oversee the City's transition to home rule and governance by an elected City Council again.

28. The City's most recent annual audit report, dated December 16, 2013, for Fiscal 2013, again includes a going concern emphasis of matter paragraph because of the City's general fund deficit of \$694,185 and its Studio Project fund deficit of \$10,370,611.

Remedial Measures

29. The City has agreed to implement certain remedial measures including:
- a. the adoption of written policies and procedures drafted by disclosure counsel, a copy of which will be provided to the Commission staff, to facilitate the City's the City's compliance with its obligations under federal securities law when issuing municipal bonds;
 - b. for any securities offering conducted by the City within two years from the entry of a cease-and-desist order, a designated individual will certify, upon consultation with disclosure counsel, that the offering documents do not contain any untrue statements of material fact or omit to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. The terms of the Order will be disclosed in offering documents the City issues for two years from the date of the Order; and
 - c. the designation of disclosure counsel responsible for training all personnel involved in the City's bond offering and disclosure process. Training shall include a complete review of the Policies and Procedures and the City's obligations under the federal securities laws. When complete, the individual will send to the Commission staff certification that the training took place and the titles of the attendees.

Legal Discussion

30. Issuers of municipal securities are responsible for the accuracy of their disclosure documents. Proper disclosure allows investors to understand and evaluate the financial risk of the security in which they are investing. The omission of material facts can render statements and disclosures, which are made, materially misleading.

31. Section 17(a)(2) of the Securities Act prohibits any person from, directly or indirectly, "obtain[ing] money or property by means of any untrue statement of a material fact" or misleading omissions. Section 17(a)(2) of the Securities Act can be violated by negligent conduct. In the Matter of Credit Suisse Securities (USA LLC, Securities Act Release No. 9368, 2012 SEC LEXIS 3569, *18 (Nov. 16, 2012). Section 10(b) and Rule 10b-5(b) of the Exchange Act prohibit the making of: (a) a false statement or omission; (b) of material fact; (c) with scienter; (d) in connection with the purchase or sale of any security. See SEC v. George, 426 F.3d 786, 792 (6th Cir. 2005). A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. See Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988). The Supreme Court previously has defined scienter as "a mental state embracing intent to deceive, manipulate or defraud." *Id.* Recklessness is

sufficient to establish scienter under Section 10(b) and Rule 10b-5. Miller v. Champion Enter., Inc., 346 F.3d 660, 672 (6th Cir. 2003). For purposes of liability under Section 10(b) of the Exchange Act, "recklessness" has been defined as "highly unreasonable conduct which is an extreme departure from the standards of ordinary care. While the danger need not be known, it must at least be so obvious that any reasonable man would have known of it." Louisiana School Employees' Retirement System v. Ernst & Young, LLP, 622 F.3d 471, 479 (6th Cir. 2010).

Violations

32. As a result of the conduct described above, the City violated Section 17(a)(2) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5(b) thereunder.

Remedial Measures

33. In determining to accept the Offer, the Commission considered the remedial measures the City has agreed to conduct, as described in Paragraph 29, and the cooperation afforded the Commission staff during the investigation.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in the City's Offer.

Accordingly, it is hereby ORDERED that, pursuant to Section 21C of the Exchange Act and Section 8A of the Securities Act, the City of Allen Park, Michigan shall cease and desist from committing or causing any violations and any future violations of Sections 10(b) of the Exchange Act and Rule 10b-5 thereunder and Section 17(a) of the Securities Act

By the Commission.

Brent J. Fields
Secretary


By: Jill M. Peterson
Assistant Secretary

*Commissioner Gallagher
Not participating*

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Release No. 73555 / November 6, 2014

Admin. Proc. File No. 3-15508

In the Matter of the Application of

SMARTHEAT INC.
c/o James L. Kopecky
Kopecky, Schumacher, Bleakley & Rosenberg,
P.C.
203 N. LaSalle St., Suite 1620
Chicago, Illinois 60601

For Review of Action Taken by

The NASDAQ Stock Market, LLC

OPINION OF THE COMMISSION

NATIONAL SECURITIES EXCHANGE—DELISTING FROM THE NASDAQ
STOCK MARKET, LLC

Risks to Prospective Investors Posed by Liquidity Crisis and Related Issues

National securities exchange delisted issuer's securities based on issuer allowing a \$33 million cash balance to decrease to approximately \$25,000 over fourteen months, leaving it without a means to adequately fund its operations. *Held*, the application for review is *dismissed*.

APPEARANCES:

James L. Kopecky, Kopecky, Schumacher, Bleakley & Rosenberg, P.C., for SmartHeat Inc.

Edward S. Knight, *Arnold P. Golub*, and *T. Sean Bennett*, for The NASDAQ Stock Market, LLC.

Appeal filed: September 18, 2013
Last brief received: January 2, 2014

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SmartHeat Inc. ("SmartHeat" or the "Company") seeks review of The NASDAQ Stock Market's¹ decision to delist SmartHeat's common stock from the NASDAQ Capital Market. NASDAQ based its delisting decision on its finding that SmartHeat, a United States holding company with no material assets other than ownership of its subsidiaries,² allowed a \$33 million cash balance to decrease to approximately \$25,000 over fourteen months, leaving it without a means to adequately fund its operations. NASDAQ found that the Company had been slow to respond to its liquidity crisis, had little control over its subsidiaries and no contractual arrangements for them to transfer funds to the holding company, had considered only one source of financing to avoid insolvency, and had experienced significant management turnover. On the basis of these findings, and to protect the markets and the investing public, NASDAQ delisted the Company. Based on our independent review of the record, we have concluded, for the reasons set forth below, that the specific grounds on which NASDAQ based the delisting exist in fact; that the delisting was in accordance with the applicable NASDAQ rules; and that those rules are consistent with, and were applied in a manner consistent with, the purposes of the Exchange Act. We therefore dismiss SmartHeat's application for review.

I. BACKGROUND

A. **After SmartHeat announced a change in management and disclosed liquidity issues, NASDAQ halted trading in SmartHeat's common stock and conducted an investigation.**

SmartHeat is a U.S. holding company with subsidiaries that design, manufacture and sell service plate heat exchangers and related systems in the People's Republic of China and Germany.³ The Company became public through a reverse merger in 2008⁴ and was listed on NASDAQ in January 2009.⁵ In 2009 and 2010, SmartHeat raised over \$100 million in the U.S.

¹ The name of the market appears in the record as both "Nasdaq" and "NASDAQ." For consistency, we use "NASDAQ."

² SmartHeat's Form 10-K for the period ended Dec. 31, 2012, at 1. Pursuant to Rule of Practice 323, 17 C.F.R. § 201.323, we take official notice of SmartHeat's EDGAR filings.

³ Form 10-K for the period ended Dec. 31, 2012, at 1.

According to SmartHeat, "A [plate heat exchanger ('PHE')] is a device that transfers heat from one fluid to another fluid across large metal plates. PHE units are used in the industrial, residential and commercial sectors to make energy use more efficient and to reduce pollution by reducing the need for coal fired boilers." Form 10-K for the period ended Dec. 31, 2012, at 1.

⁴ Form 10-K for the period ended Dec. 31, 2009, at F-7.

⁵ Form 10-K for the period ended Dec. 31, 2009, at 26.

through public offerings.⁶ In its Form 10-K for the year ended December 31, 2010, the Company reported to the Commission that it had approximately \$33 million in cash in the U.S.⁷ In its Form 10-Q for the quarter ended March 31, 2012, however, it reported only \$27,469 in cash and equivalents in its U.S. accounts.⁸

On May 30, 2012, SmartHeat issued a press release (the "Press Release") announcing a change in management and disclosing liquidity issues. The Press Release stated that four of SmartHeat's executive officers, including both its Chief Executive Officer, James Jung Wang ("J. Wang"), and its CFO had resigned.⁹ Three of the four former officers, including J. Wang, were to continue their roles with SmartHeat's subsidiaries.¹⁰ The Press Release also announced that the Board of Directors had appointed a new President and Director, Oliver Bialowons, and had approved the appointment of Nimbus Restructuring Manager LLC ("Nimbus") as Restructuring Adviser to assist SmartHeat's Board in addressing its financial and liquidity issues. Further, the Press Release disclosed that to address the Company's immediate cash needs, the Board approved borrowing up to \$1,000,000 to fund ordinary course operating expenses under a binding commitment letter, subject to an acceptable fairness opinion and negotiation of final terms and a definitive agreement. Upon reviewing the Press Release, NASDAQ staff immediately halted trading in SmartHeat's common stock and began an investigation.¹¹

⁶ Form 10-K for the period ended Dec. 31, 2010, at F-20.

⁷ Form 10-K for the period ended Dec. 31, 2010, at F-23.

⁸ Form 10-Q for the period ended March 31, 2012, at 8.

⁹ J. Wang also served as SmartHeat's President and Chairman of the Board. In addition to J. Wang, the officers who resigned were Zhijuan Guo, Chief Financial Officer; Wen Sha, Vice President of Marketing; and Xudong Wang, Vice President of Strategy ("X. Wang"). The Press Release is available on EDGAR as Exhibit 99.1 to Smart Heat's Form 8-K dated May 25, 2012.

¹⁰ J. Wang continued to serve as CEO of all of SmartHeat's operating subsidiaries. Form 10-Q for the period ended June 30, 2012, at 2. Sha and X. Wang also continued their involvement with SmartHeat's subsidiaries. Guo resigned from any further responsibilities with SmartHeat and its subsidiaries.

¹¹ Form 10-K for the period ended Dec. 31, 2012, at 4. SmartHeat subsequently admitted, in its written submission to the Hearings Panel, *see infra* at I.C., that "[i]n hindsight, the Company probably should have notified NASDAQ that it would be making an important announcement and asked for a temporary trading halt" in connection with its issuance of the Press Release.

NASDAQ staff attached various letters and emails containing its requests for information and SmartHeat's responses to its submission to the Hearings Panel when SmartHeat sought review of the staff's delisting determination. *See infra* at I.C. (discussing NASDAQ review procedures). These materials thereby became part of the record. But "due to the size of the file and the number of pages," the staff chose to omit attachments to SmartHeat's letters of June 12 and July 10, 2012 from its submission to the Hearings Panel. Those attachments are thus not part of the record, and were not available for our consideration.

During the investigation, NASDAQ staff learned that since December 30, 2010, when SmartHeat had \$33 million in cash, SmartHeat had transferred \$27.8 million to a subsidiary, Shenyang Taiyu Machinery and Electronic Equipment Co., Ltd. ("Taiyu"). SmartHeat told the staff that it projected expenses for the Company during the twelve-month period ending June 30, 2012, at \$1,802,500.

Additionally, NASDAQ staff learned that SmartHeat had not implemented service agreements that would provide for the Chinese operating subsidiaries to make regular payments to the Company, although the Company conceded in a letter to NASDAQ staff that such agreements "are commonly put in place prior to, or in connection with, the structuring of China operations as Wholly Foreign Owned Entities."¹² SmartHeat informed the staff that each of its subsidiaries was responsible for hiring its own personnel, and that it did not believe it had the right to "interfere" with the management of those subsidiaries, nor did its board of directors believe that such interference would serve the best interests of the Company's stockholders.

NASDAQ staff also learned that Northtech, Inc. ("Northtech"), an entity formed solely for the purpose of providing financing to SmartHeat, would provide the revolving line of credit mentioned in the Press Release. J. Wang, SmartHeat's former CEO, served as a principal and director of Northtech. The other two SmartHeat officers who had recently resigned, but stayed with SmartHeat's subsidiaries, were principal shareholders, as was SmartHeat's corporate secretary. As of July 10, 2012, SmartHeat reported, Nimbus had not approached any entities other than Northtech about securing short-term financing for the Company.

In July 2012, SmartHeat's board of directors approved a \$2 million revolving credit line from Northtech, instead of the \$1 million mentioned in the Press Release. The line of credit had a 4% origination fee and an initial term of nine months; SmartHeat could renew the loan for four additional nine-month periods, with a 4% renewal fee payable for each renewal. Despite SmartHeat's payment of this fee, there was no guarantee that any loan would be forthcoming, because Northtech retained complete discretion over whether to make any given loan.

On August 20, 2012, SmartHeat filed its Form 10-Q for the quarter that ended June 30, 2012. In that form, the Company acknowledged the recent "significant changes" in senior management and stated that the transition to the new management team could be disruptive to the Company's operations and could materially adversely affect its business. Additionally, Biolowons and Michael Wilhelm, SmartHeat's recently hired CFO, provided only a qualified attestation to SmartHeat's financial reports filed with the Form 10-Q, citing a lack of opportunity for the new management team to fully assess the Company's internal controls and reporting. The

¹² In the same letter, SmartHeat explained the failure to put into place such agreements was "due to [the Company's] prior history of rapid revenue growth and profitable operations." It went on to state, however, that its management was "working with management of its subsidiaries, local counsel and the appropriate government agencies to obtain approval for such arrangements."

Company also stated that it lacked sufficient personnel with the appropriate level of knowledge, experience, and training in U.S. GAAP for the preparation of financial statements in accordance with U.S. GAAP.

B. After investigating, NASDAQ delisted SmartHeat's securities.

By letter dated August 23, 2012, NASDAQ informed SmartHeat that the staff had decided to delist SmartHeat's securities (the "Delisting Determination").¹³ The staff relied on NASDAQ Listing Rule 5101, which provides NASDAQ with "broad discretionary authority" over the listing of securities on NASDAQ.¹⁴ The staff concluded that "recent events and transactions undertaken by the Company raise public interest concerns regarding the Company's solvency, viability, operational structure and suitability for listing."

The staff had public interest concerns about SmartHeat's solvency, viability, and operational structure because SmartHeat's cash holdings had fallen from over \$33 million in January 2011 to only \$27,469 as of March 31, 2012,¹⁵ and SmartHeat had transferred most of

¹³ The Delisting Determination explicitly relies on one of the attachments to SmartHeat's June 12 letter. It states that "as recently as January 2011, Smart Heat had over \$33 million in cash," and identifies "documents provided by [SmartHeat] as exhibits to a letter dated June 12, 2012" as the source of this information. Letter from Gary N. Sundick to Oliver Bialowons, August 23, 2012, at 5 n.3. Although the exhibits mentioned are not included in the record, *see supra* note 11, SmartHeat's Form 10-K for the period ended December 31, 2010 shows that SmartHeat had approximately \$33 million in cash for the year ending December 31, 2010. Form 10-K for the period ended Dec. 31, 2010, at F-25. Because we take official notice of the filing on EDGAR, *see supra* note 2, the absence of the attachments does not prevent us from making a finding as to the amount of cash SmartHeat had on hand at year-end 2010. We emphasize, however, that the parties should ensure that all materials on which they rely are made part of the record. *See CleanTech Innovations, Inc.*, Exchange Act Rel. No. 69968 (July 11, 2013), 2013 SEC LEXIS 1998, at *33 n.56 (Commission must base decision on record and cannot rely on unsworn representations to fill evidentiary gaps).

¹⁴ Delisting Determination at 1. Rule 5101 recognizes that NASDAQ has broad discretionary authority over the initial and continued listing of securities in Nasdaq in order to maintain the quality of and public confidence in its market, to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest. Nasdaq may use such discretion to . . . apply additional or more stringent criteria for the initial or continued listing of particular securities, or suspend or delist particular securities based on any event, condition, or circumstance that exists or occurs that makes initial or continued listing of the securities on Nasdaq inadvisable or unwarranted in the opinion of Nasdaq, even though the securities meet all enumerated criteria for initial or continued listing on Nasdaq.

¹⁵ The Delisting Determination states, "[i]n a meeting with Staff on July 24, 2012, the Company represented that the [Company] had roughly \$25,000 in its bank accounts." Delisting Determination at 2. This representation would not support a finding of fact that the Company had only \$25,000 in cash as of July 24, 2012. *See supra* note 13. In the context of a reduction in
(continued...)

this money to subsidiaries in China, with no mechanism for repatriating the funds. In the staff's view, SmartHeat's structure was not conducive to remedying its liquidity problems: the Company could not rely on receiving dividend payments from subsidiary profits in the near future, because the Chinese subsidiaries were not profitable; there were no agreements providing for regular payments from the subsidiaries to the Company, and the Chinese authorities might not accept such agreements; and SmartHeat's management had little ability or willingness to control the management of its subsidiaries. The staff was also concerned that SmartHeat saw the Northtech line of credit as its only option for dealing with its liquidity needs. In addition to noting these concerns, the staff expressed concern about SmartHeat's involvement with a stock promoter. Finally, the staff was concerned about SmartHeat's recent management turnover. Based on these concerns, the staff found that SmartHeat's continued listing was not in the public interest.

C. A NASDAQ Hearings Panel reviewed and affirmed the delisting determination.

NASDAQ's rules provide that an issuer seeking to appeal a delisting decision by the staff may obtain initial review by a NASDAQ Listing Qualifications Hearings Panel ("Hearings Panel").¹⁶ An issuer may appeal a Hearings Panel decision to the NASDAQ Listing and Hearings Review Council (the "Listing Council" or "Council").¹⁷ After the Listing Council has issued a decision, the NASDAQ Board of Directors may, at its discretion, call the matter for additional review.¹⁸

SmartHeat sought initial review of the staff's Delisting Determination, and a Hearings Panel affirmed the determination, finding it in the public interest to delist SmartHeat during its management transition. The Hearings Panel based its findings on both written submissions by SmartHeat and the staff, and a hearing at which Bialowons, the Company's new president; Wilhelm, the new CFO; and William McGrath, a principal of Nimbus, testified for SmartHeat. Three members of NASDAQ's Listing Qualifications staff also participated. At the hearing, McGrath testified that promoters had told SmartHeat's previous management that once the Company's shares were listed, it would be able to raise more money at will simply by issuing more shares.¹⁹ Thus, McGrath testified, SmartHeat had invested the proceeds of its offerings in acquisitions because the board believed it could always turn to the capital markets to replenish its

(...continued)

cash from \$33 million, however, we do not consider the difference between \$27,649 and \$25,000 significant. We understand the reference to "roughly \$25,000" to signify no significant change from the \$27,649 figure used in SmartHeat's filing with the Commission. We note that SmartHeat does not object to NASDAQ's use of the \$25,000 figure in its decision.

¹⁶ See generally NASDAQ Rule 5815 (procedures related to review by Hearings Panel).

¹⁷ See generally NASDAQ Rule 5820 (procedures applicable to review by Listing Council). The Listing Council may also call a Hearings Panel decision for review on its own initiative. *Id.*

¹⁸ See NASDAQ Rule 5825 (procedures applicable to review by NASDAQ Board).

¹⁹ McGrath emphasized that the Company had acted "to clearly separate itself from [the promoter], so that today there is . . . no association" with him.

coffers. McGrath acknowledged that the liquidity situation at the Company had become "quite serious" over the years, but he said that the credit agreement with Northtech would allow the Company to pay some outstanding bills. McGrath said that the recent management changes happened because the former managers realized that they did not understand the capital markets and decided that it would be better for them to focus on the operating subsidiaries. He asserted that the management turnover had benefitted SmartHeat because the newly hired executives better understood the U.S. capital markets, and that SmartHeat's governance was much better than it had been six months earlier.

Wilhelm testified that getting cash from the operating subsidiaries to the Company was still problematic; when SmartHeat was established, no "typical arrangement of contracts between subsidiary and parent [such as] service agreements [or] royalties" was put in place, so that method of moving cash was not available,²⁰ and "the Chinese structure" made it very difficult to move cash to the Company. He testified, however, that the line of credit should be sufficient to handle SmartHeat's anticipated cash needs for the next twelve months.

Wilhelm further testified that SmartHeat had "not been able to find anything better" than the Northtech credit facility in the months between the issuance of the Press Release and the October 11, 2012 hearing. McGrath testified that SmartHeat had contacted "over 700 people" in its attempts to arrange financing, but that "very, very few people . . . have shown any interest and we really had only one person out of that that's actually making a proposal so far."

Wilhelm stated that when he took over as CFO in July 2011, he was unwilling to sign an unqualified certification for the quarter that ended June 30. He explained that SmartHeat's local operations were accounted for under Chinese GAAP, and that translating those results into a consolidated set of financial statements that conform to United States GAAP required multiple steps.

Based on this evidence, the Hearings Panel found that "the extreme fragility of the Company's financial situation and its admitted inability to raise or access funds in the near term, put in doubt the Company's viability." It also found that the new management team faced a steep learning curve regarding the Company's operations, internal controls, and finances, and that the team's task would likely be made more difficult by various factors including their lack of Chinese language skills and their dependence on managers of the Company's subsidiaries, who were not attuned to the regulatory requirements of a listed company. Based on these findings, the Hearings Panel concluded that it was in the public interest to delist the Company while the transition to the new management team was underway.²¹

²⁰ Wilhelm conceded at the hearing that service agreements "really should have been here four and five years ago."

²¹ The Hearings Panel reached this conclusion despite its findings that the Company was "taking steps to resolve some of the issues that have raised Staff's concerns" and that it "appear[ed] to be distancing itself from association" with the promoter.

D. NASDAQ's Listing Council affirmed the Hearings Panel's decision.

On November 19, 2012, SmartHeat appealed the Hearing Panel's decision to the NASDAQ Listing Council. After a de novo review, the Listing Council found that delisting SmartHeat's securities was in the public interest and affirmed the Hearings Panel's decision. The Listing Council found that SmartHeat's actions were "irresponsible, reckless, and inconsistent with the conduct expected" of a company listed on NASDAQ when it allowed its \$33 million cash balance to decrease to approximately \$25,000 over the course of fourteen months without having any means to adequately fund its operations.

The Listing Council criticized SmartHeat for having been "slow to react to its liquidity crisis," finding that the record showed that SmartHeat knew of its liquidity issues several months before it secured the Northtech line of credit. Further, the Council questioned whether the remedial steps taken by SmartHeat would adequately address the issues that gave rise to the Delisting Determination. The Council noted that SmartHeat was unable to require its subsidiaries to fund its operations, and that executives of the subsidiaries controlled the line of credit that the Company depended on for its operating capital. Moreover, the Listing Council noted, the lack of control over the subsidiaries raised other concerns, including questions surrounding the Company's controls over accounting and other U.S. federal regulatory obligations. The Listing Council also observed that SmartHeat's new executives had provided a only a qualified attestation to SmartHeat's financial reports on Form 10-Q.²²

The Listing Council recognized that the Commission has held that even if delisting may hurt existing investors, "the primary emphasis must be placed on the interest of prospective [future] investors," who are entitled to assume that listed securities meet NASDAQ's standards.²³ Although SmartHeat was free to use its business judgment in decisionmaking, those decisions could lead to financial, regulatory, or other consequences. Thus, the Listing Council concluded, SmartHeat was "clearly not prepared for the rigors and responsibilities that are demanded of listed companies," and it was consistent with the discretion afforded to NASDAQ under Rule 5101 to delist the Company to protect investors so that the Company could demonstrate, over time, its ability to act as a responsible corporate citizen.²⁴

On August 5, 2013, NASDAQ notified SmartHeat that the Listing Council's decision had become the final action of NASDAQ when the NASDAQ Board of Directors declined to call it for review. This appeal followed.

²² See *supra* at I.A.

²³ Citing *Tassaway, Inc.*, Securities Exchange Act Release No. 11291, 1975 SEC LEXIS 2057, at *6 (Mar. 13, 1975).

²⁴ The Council reached this conclusion notwithstanding its recognition that SmartHeat had taken steps to resolve some of the issues that had raised the staff's concerns and to sever ties to the promoter and his affiliates. The Council did not consider the relationship with certain affiliates of the promoter a determining factor in its decision.

II. ANALYSIS

A. Standard of Review

Our review is governed by Section 19(f) of the Securities Exchange Act of 1934.²⁵ Section 19(f) requires us to dismiss SmartHeat's appeal if we determine that the specific grounds on which the delisting is based exist in fact, that the delisting is in accordance with the applicable NASDAQ rules, and that those rules are consistent with, and were applied in a manner consistent with, the purposes of the Exchange Act.

B. The specific grounds on which the delisting is based exist in fact.

We find that the specific grounds on which the delisting is based exist in fact. There is no dispute that SmartHeat spent down its cash balance from \$33 million to approximately \$25,000 over a period of approximately fourteen months. Nor does the Company dispute that it depleted its resources to this level notwithstanding the lack of any established way to fund its operations—the Company had no operations that would bring in cash, there were no contractual obligations for the subsidiaries to remit cash to the Company, and there were no arrangements for the Company to borrow money.

The complicating factors to which NASDAQ alluded also are based in fact. SmartHeat does not dispute that it chose to rely on the Northtech line of credit without seeking alternative proposals (although SmartHeat argues that circumstances made that a prudent course of action). SmartHeat admitted in a Commission filing that its management turnover was significant, and it told NASDAQ that it did not (and did not wish to) exercise control over the management of its subsidiaries.

C. The delisting is in accordance with applicable NASDAQ rules.

Under Listing Rule 5101, NASDAQ "has broad discretionary authority over the initial and continued listing of securities in Nasdaq in order to maintain the quality of and public confidence in its market . . . and to protect investors and the public interest."²⁶ Based on the record in this case, we find that NASDAQ acted in accordance with Rule 5101 when it delisted SmartHeat based on its depletion of cash at the holding company level to a mere \$25,000, with

²⁵ 15 U.S.C. § 78s(f); *cf. Fog Cutter Capital Grp., Inc.*, Exchange Act Release No. 52993, 58 SEC 1049, 2005 SEC LEXIS 3280, at *13-14 (Dec. 21, 2005) (applying § 19(f) standard to NASD delisting decision), *petition denied*, 474 F.3d 822 (D.C. Cir. 2007). SmartHeat has not alleged, and the record does not establish, that NASDAQ's action has created "any burden on competition not necessary or appropriate in furtherance of the purposes of [the Exchange Act]" such that the Commission is required by § 19(f) to set aside NASDAQ's action.

²⁶ On review, we are not free to substitute our discretion for NASDAQ's. *Cf. Tassaway, Inc.*, 1975 SEC LEXIS 2057, at *7 (stating that Commission may not substitute its discretion for the NASD's in determining whether a security should be removed from an automated quotation system).

no means in place to assure more cash, and related considerations. In essence, SmartHeat raised money in the U.S. capital markets, then sent the lion's share of its available cash to its foreign subsidiaries without any way of getting that cash back for the benefit of its shareholders.

The record supports NASDAQ's conclusion that delisting was appropriate because SmartHeat was "clearly not prepared for the rigors and responsibilities that are demanded of listed companies." We agree with NASDAQ's findings that the expenditure of corporate assets until SmartHeat was on the brink of insolvency, with no adequate means to replenish its coffers, and no attention paid to financing such that it had to take the first deal offered, was irresponsible, reckless, and inconsistent with the conduct expected of companies listed on NASDAQ.

SmartHeat does not dispute the facts on which NASDAQ based its decision. Instead, SmartHeat's arguments focus on how those facts should be interpreted. In essence, it argues that its situation was not as dire as NASDAQ thought, and that it has taken steps to remedy any problems that do exist. As explained below, it argues that its liquidity problems were not so serious; that it should not be faulted for problems related to its status as a holding company with Chinese subsidiaries operating under Chinese law; that the decisions to spend down cash and adopt the line of credit were legitimate exercises of business judgment; and that the Company will benefit from the new management team. SmartHeat also argues that NASDAQ's explanation of the basis for delisting was inadequate. We address these arguments in turn.

1. Magnitude of Liquidity Problems

The Company contends that the depletion of holding company cash to approximately \$25,000 did not create a liquidity crisis for the Company, but rather a "short-term liquidity issue." It takes issue with NASDAQ's finding that it was "slow to react" to the liquidity crisis, arguing that the situation "arose quickly—in approximately 14 months."

SmartHeat's attempt to downplay the significance of the liquidity problem it faced in May 2012 by calling it a "short-term liquidity issue" is at odds with the record. SmartHeat's projected expenses for the year ending June 30, 2012 were roughly \$1.8 million; its cash on hand, approximately \$25,000. SmartHeat admitted in its submission to the Hearings Panel that in spring 2012, short-term liquidity was "urgently needed," and Wilhelm testified at the hearing that the liquidity situation at the Company had become "quite serious." Moreover, as NASDAQ found, SmartHeat allowed this situation to develop notwithstanding the lack of contractual arrangements that would move money from the subsidiaries to the Company.

2. Problems Related to Status as Holding Company with Chinese Subsidiaries

SmartHeat also argues that NASDAQ should not fault the Company for the lack of a mechanism for obtaining capital from its subsidiaries because other holding companies also have problems getting cash from their Chinese subsidiaries. But NASDAQ considered the entire constellation of circumstances facing SmartHeat—including cash depletion, new management,

and lack of control over subsidiaries, as well as the lack of funding arrangements—in deciding to delist SmartHeat's shares. The lack of funding arrangements might have been less of a concern if SmartHeat's cash management had been more prudent. SmartHeat knew that the subsidiaries were not obligated to make payments to the Company, and it should have managed its resources accordingly.

SmartHeat contends that NASDAQ based its decision on factors inherent in its status as a holding company with Chinese subsidiaries operating under Chinese law. It argues that its corporate structure was in place when the Company was listed, is shared by many listed companies, and was fully described in its SEC filings. It further contends that the holding company structure is necessary because China does not permit direct ownership by foreign investors of assets in China, that the limitations on obtaining capital from subsidiaries that NASDAQ noted are not unique to the Company and are the effect of law rather than choice or omission, and that "[t]he rights of a parent corporation towards its subsidiaries are strictly limited to the rights of a stockholder and not the rights of a manager."²⁷ But if the constraints of Chinese law cause a listed company to operate in a way that NASDAQ deems inconsistent with the public interest, it is within NASDAQ's discretion to delist the company.

SmartHeat also contends that the issues related to moving cash from the subsidiaries to the Company were disclosed both to NASDAQ staff and to the public. But NASDAQ did not base the delisting on a finding that SmartHeat's disclosures regarding the absence of service agreements were inadequate. In any event, disclosing facts to the public does not preclude NASDAQ from considering such facts in a delisting determination.²⁸

²⁷ SmartHeat cites its Memorandum in Support of Appeal of Staff Delisting Determination as authority for these statements, but that memorandum in most instances simply makes statements about Chinese law and business without offering any support for them. Such unsupported statements do not present an evidentiary basis on which we could make factual findings. See *CleanTech Innovations, Inc.*, 2013 SEC LEXIS 1998, at *33 n.56 (Commission must base decision on record and cannot rely on unsworn representations to fill evidentiary gaps).

A newsletter attached to SmartHeat's Memorandum in Support of Appeal of Staff Delisting Determination provides some support for the proposition that foreign investors may find it difficult to repatriate funds "trapped" in China. But the newsletter was published in 2009. To the extent that "trapped cash" was known to be a problem in 2009, SmartHeat should have taken it into account in its planning.

²⁸ See *Fog Cutter*, 2005 SEC LEXIS 3280 (dismissing review proceeding challenging determination to delist issuer's securities from NASDAQ where securities were delisted "based on public interest concerns relating to [a key executive's] guilty plea and Fog Cutter's response to it," *id.* at *12, even though the issuer had disclosed the guilty plea and facts relevant to its response in a filing with the Commission).

3. Spending Down Cash and Adoption of Line of Credit

SmartHeat argues that the Company's decision to invest approximately \$28 million in its subsidiaries after March 2011—a chief contributor to the liquidity crisis—was a reasonable exercise of business judgment, and that "[d]eciding how to deploy financial assets is fundamentally a decision for [the] Company's management, not NASDAQ." But NASDAQ correctly found that the freedom of listed companies to make business decisions does not exempt those companies from the regulatory consequences of those decisions. In delisting cases, "[t]he issue . . . is not . . . business judgment but, rather, the public interest."²⁹ Here, NASDAQ found that allowing SmartHeat's shares to remain listed was not in the public interest.

SmartHeat does not dispute NASDAQ's finding that it spent down its cash to approximately \$25,000. But it argues that the Northtech line of credit, under consideration by the time the Press Release was issued, would cover the Company's expenses for twelve months. While SmartHeat admits that it chose to accept funding from Northtech without considering other options, it argues that NASDAQ "ignores the many complications that would prevent the rapid recapitalization of [the] Company,"³⁰ and that seeking cash from insiders was its best option because it lacked the time and money to look elsewhere. These arguments do not support SmartHeat's position. Instead, they illustrate the extremity of SmartHeat's circumstances as a result of spending down its cash.

SmartHeat cannot divorce the need to arrange financing from the decision to move cash out of the Company. Although the line of credit was under consideration in late May, it was not finalized until several months later, meaning that SmartHeat drastically depleted its cash with no guarantees that it could obtain credit, much less any agreement as to the terms of such credit. If the Company had begun trying to arrange funding when it still had \$33 million,³¹ it might have had the time and money to explore other options, and it might have had more flexibility to deal with any complications that arose.³² Alternatively, if SmartHeat had recognized the lack of

²⁹ *Fog Cutter*, 2005 SEC LEXIS 3280, at *24.

³⁰ These complications include, according to SmartHeat's reply brief, "a) the time and expense needed to undertake due diligence by third-party lenders, b) the inability to refinance the whole enterprise (parent and subsidiaries) with one comprehensive credit line (as typically done for U.S. Businesses); and c) the complications created by Chinese law," as well as the fact that SmartHeat had been subpoenaed to produce certain information and had been requested not to disclose that fact, which, SmartHeat stated, "severely limited the Company['s] ability to secure funding without disclosing this material information to any potential lender or capital source other than a source with existing inside information."

³¹ As noted above, McGrath testified that contractual arrangements for getting money from the subsidiaries to the Company "really should have been here four and five years ago."

³² SmartHeat argues that the Northtech line of credit benefits the Company in ways that a loan from a third party would not. It contends that having managers of the Chinese subsidiaries involved in the line of credit shows their commitment and provides them with an incentive. It is also possible, however, that giving those managers control over the Company's operating funds

(continued...)

funding arrangements as a possible problem, it could have avoided spending the \$33 million down to \$25,000. Finally, it remains to be seen whether the line of credit will resolve SmartHeat's cash problems. Under the loan agreement, Smartheat will be paying a 4% origination or renewal fee every nine months, whether or not it borrows money, and Northtech retains complete discretion over whether to lend to SmartHeat. Thus, there is no guarantee that the line of credit will make SmartHeat's liquidity situation better rather than worse.

4. New Management Team

SmartHeat argues that it will benefit from the new management team because the managers are experienced executives who are familiar with U.S. corporate governance and accounting standards. But SmartHeat admitted in its Form 10-Q for the period ended June 30, 2012 that the transition to a new team could be disruptive to its operations and could adversely affect its business. It is also clear from the record that the new managers will need time to bring the situation at SmartHeat under control; Wilhelm testified that Chinese accounting practices are very different from U.S. practices, and that arranging for payments from the Chinese subsidiaries to the parent company would be "very difficult." As noted above, Wilhelm refused to provide an unqualified certification when he first joined SmartHeat because he needed more time to familiarize himself with the Company's financials.³³

5. NASDAQ's Criteria for Delisting

SmartHeat criticizes NASDAQ staff's application of "more stringent criteria" in its initial Delisting Determination and argues that because the staff did not identify the "more stringent criteria," SmartHeat could not understand the staff's reasoning or formulate an acceptable restructuring plan. We find no merit in this argument. The plain text of Rule 5101 permits NASDAQ to apply criteria other than those spelled out elsewhere in NASDAQ's rules.³⁴

(...continued)

will create tension in a situation where the Company has traditionally exercised little control over the subsidiaries. The Company also contends that certain terms in the Northtech agreement "may not be available from a third-party lender." But SmartHeat does not know whether such terms would have been available, because it chose to seek financing from Northtech rather than exploring third-party options.

³³ SmartHeat experienced additional management turnover when Wilhelm resigned the position of Chief Financial Officer on February 23, 2013. Form 10-K for the period ended Dec, 31, 2013, at 4. SmartHeat stated in its Form 10-K for the period ended December 31, 2013 that it had "difficulty finding a suitable replacement" for Wilhelm; in the interim, it appointed Yangkai Wang as Acting Chief Accountant on June 7, 2013. *Id.* at 5. SmartHeat further stated that Yang "has limited relevant education and training in U.S. GAAP and related SEC rules and regulations." *Id.* Our decision that NASDAQ's delisting decision should not be set aside is not based on these subsequent developments.

³⁴ See *supra* note 14 (quoting Rule 5101). See also *Fog Cutter*, 2005 SEC LEXIS 3280, at *21 (dismissing a review proceeding in which the delisting decision was based on a rule that allowed the exercise of discretion, and although no violations of other rules were charged or

(continued...)

NASDAQ laid out its concerns at every stage of the proceeding. Our review is of the Listing Council decision, not the staff's initial Delisting Determination, and that decision clearly sets forth the basis for delisting.³⁵

For the reasons discussed above, we find NASDAQ's action consistent with Rule 5101 in that the delisting helps to maintain public confidence in the market and to protect investors and the public interest. As we have held, "listing a security on a market creates expectations among investors that listed companies meet basic standards of corporate governance and financial soundness."³⁶ NASDAQ reasonably determined that SmartHeat did not meet its standards, and accordingly delisted the Company's securities.

(...continued)

found, the issuer was found to have "presented inappropriate non-market risk to public investors").

³⁵ In its petition for review and its brief, SmartHeat makes three arguments based on the Delisting Determination: (1) NASDAQ "explicitly stated that it was applying 'more stringent' listing criteria to the company, but never stated what criteria were being applied"; (2) NASDAQ based its decision on SmartHeat's past association with a promoter, "without any evidence, or even allegation, of wrong doing by the Company or even [the promoter]"; and (3) NASDAQ based its decision "on allegations regarding stock trading activity by the Company's former CEO that were without any foundation or evidence and clearly contrary to the factual evidence presented in the Company's public SEC filings and stock records." Because our review is of the Listing Council's decision—NASDAQ's final decision—rather than the staff's Delisting Determination, these arguments would be relevant to our review only if the issues they raise also are present in NASDAQ's decision. NASDAQ's decision says nothing about more stringent criteria, but we address the argument above under heading C.5. to the extent it raises procedural issues that could have tainted the proceeding. NASDAQ's decision also says nothing about stock trading by a former CEO. Although NASDAQ's decision mentions the promoter, it states that SmartHeat's relationship to affiliates of the promoter was not a determining factor in its delisting decision. Thus, these three arguments provide no basis for overturning NASDAQ's delisting decision.

In its reply brief, SmartHeat argues that the promoter's "presence clearly shaped and tainted NASDAQ's investigation" and its delisting decision. But the record indicates that NASDAQ's investigation was in response to issues raised by the Press Release, which did not mention the promoter. To the extent NASDAQ may have made inquiries regarding the promoter, it is not uncommon for investigations to touch on people or issues that do not, in the end, give rise to regulatory action. And as noted above, NASDAQ based its delisting decision on factors other than SmartHeat's involvement with the promoter or his affiliates.

³⁶ *Fog Cutter*, 2005 SEC LEXIS 3280, at *24.

D. Rule 5101 is consistent with, and was applied in a manner consistent with, the purposes of the Exchange Act.

Section 12(d) of the Exchange Act, 15 U.S.C. § 78l(d), provides that a security registered with a national securities exchange "may be withdrawn or stricken from listing . . . in accordance with the rules of the exchange." Section 6(b)(5) of the Exchange Act requires that the rules of a national securities exchange be designed, among other things, "to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . to perfect the mechanism of a free and open market . . . and . . . to protect investors and the public interest."³⁷ The relevant language of Rule 5101, under which NASDAQ exercised its authority to delist "in order to maintain the quality of and public confidence in the market" and "to protect investors and the public interest," is consistent with these Exchange Act provisions. We have previously found that the inclusion of such standards in the rules of NASDAQ is consistent with Section 6(b)(5) of the Act.³⁸

We find that NASDAQ applied Rule 5101 in a manner consistent with the Exchange Act. SmartHeat argues that its liquidity problems were the result of a reasonable business decision that turned out badly, and that outcome "should not allow NASDAQ, with the benefit of hindsight, to punish [the] Company and its investors with the extraordinary remedy of delisting."

³⁷ Before January, 2006, NASDAQ was part of the NASD, a registered national securities association. In January, 2006, NASDAQ became a registered national securities exchange under the Exchange Act. Section 15A(b)(6) of the Exchange Act, 15 U.S.C. § 78o(b)(6), requires that the rules of a national securities association be designed, among other things, "to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . to perfect the mechanism of a free and open market . . . and . . . to protect investors and the public interest." These statutory standards are identical to the standards, noted in the accompanying text, that apply to the rules of a national securities exchange under Section 6(b)(5) of the Exchange Act.

³⁸ See Exchange Act Release No. 52342, 2005 SEC LEXIS 2234, at *11-12 (Aug. 26, 2005) (approving proposed rule language directly linking NASD's broad discretionary authority over initial and continued inclusion of securities in NASDAQ to "protect[ion of] investors and the public interest"). This rule was later incorporated into the rules of NASDAQ when the Commission approved NASDAQ's registration as a national securities exchange. At that time the Commission found that the August 2005 NASDAQ rule changes concerning delisting were "consistent with Section 6(b)(5) of the Exchange Act for the same reasons that the Commission approved them under Section 15A(b)(6) of the Exchange Act." See Exchange Act Release No. 53128, 2006 SEC LEXIS 86, at *101 n.213 (Jan. 13, 2006). The NASDAQ rule has subsequently been renumbered and is currently Rule 5101. See also *Fog Cutter Capital Group Inc. v. SEC*, 474 F.3d 822, 825 26 (D.C. Cir. 2007) (finding that NASD rules giving the Nasdaq market "broad discretion to determine whether the public interest requires delisting securities" were "obviously consistent with the Exchange Act").

In determining to delist, NASDAQ acted in accordance with our long-held view that the primary emphasis in such listing determinations must be the protection of prospective investors.³⁹ The delisting decision is not punitive, but instead serves to protect those prospective investors.


Finally, SmartHeat contends that NASDAQ's delisting decision was "unwarranted, unnecessary, and inappropriate in the circumstances, *ultra vires* and contrary to the public interest because there is nothing in the record showing, and no other evidence of, self-dealing, lack of due care, absence of good faith, breach of fiduciary duty, or failure to make adequate and timely disclosure." The types of misconduct SmartHeat enumerates are by no means the only permissible bases for a delisting decision, and NASDAQ's decision to delist SmartHeat's securities was a permissible exercise of its discretion under Rule 5101. Thus we find, pursuant to Exchange Act Section 19(f), that Rule 5101 is consistent with the purposes of the Exchange Act and that NASDAQ applied Rule 5101 in a manner consistent with the purposes of the Exchange Act, acting for the good of both the market and prospective investors.

III. CONCLUSION

For the reasons discussed above, we conclude that the grounds on which the delisting was based exist in fact; that NASDAQ acted in accordance with its applicable rules in delisting SmartHeat's securities; and that those rules are, and were applied in a manner consistent with, the purposes of the Exchange Act. Accordingly, we dismiss this review proceeding.

An appropriate order will issue.⁴⁰

By the Commission (Chair WHITE and Commissioners AGUILAR, STEIN and PIWOWAR; Commissioner GALLAGHER not participating).


By: Lynn M. Powalski
Deputy Secretary

Brent J. Fields
 Secretary

³⁹ *Tassaway, Inc.*, 1975 SEC LEXIS 2057, at *6; See also *Biorelease Corp.*, Exchange Act Release No. 35575, 1995 SEC LEXIS 818, at *13 (Apr. 6, 1995) (citing *Tassaway, Inc.* for the proposition that "[a]lthough exclusion from the system may hurt existing investors, primary emphasis must be placed on the interests of prospective future investors.")

⁴⁰ We have considered all the arguments advanced by the parties. We reject or sustain them to the extent that they are inconsistent or in accord with the views expressed herein. Because the issues have been thoroughly briefed and can be adequately determined on the basis of the record filed by the parties, the Company's request for oral argument is denied. Rule of Practice 451, 17 C.F.R. § 201.451.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 773555 / November 6, 2014

Admin. Proc. File No. 3-15508

In the Matter of the Application of

SMARTHEAT INC.
c/o James L. Kopecky
Kopecky, Schumacher, Bleakley & Rosenberg,
P.C.
203 N. LaSalle St., Suite 1620
Chicago, Illinois 60601

For Review of Action Taken by

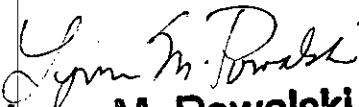
The NASDAQ Stock Market, LLC

ORDER DISMISSING APPLICATION FOR REVIEW OF ACTION OF NATIONAL
SECURITIES EXCHANGE

On the basis of the Commission's opinion issued this day, it is

ORDERED that the application for review of action taken by The NASDAQ Stock
Market, LLC against SmartHeat Inc. is hereby dismissed.

By the Commission.


By: **Lynn M. Powalski**
Deputy Secretary

Brent J. Fields
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 73551 / November 6, 2014

ADMINISTRATIVE PROCEEDING

File No. 3-16260

In the Matter of

**Brandeis Holdings, Inc.,
Brighton Investment Holding Co., Inc.,
Bristol Acquisitions Corp., and
The Continental Orinoco Co., Inc.,**

Respondents.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
AND NOTICE OF HEARING
PURSUANT TO SECTION 12(j) OF
THE SECURITIES EXCHANGE ACT
OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Brandeis Holdings, Inc., Brighton Investment Holding Co., Inc., Bristol Acquisitions Corp., and The Continental Orinoco Co., Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Brandeis Holdings, Inc. (CIK No. 1374025) is a Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Brandeis Holdings is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10 registration statement on September 29, 2006, which reported a net loss of \$421 from the company's May 10, 2006 inception to June 30, 2006.

2. Brighton Investment Holding Co., Inc. (CIK No. 1261656) is a Delaware corporation located in New York, New York with a class of securities registered with the

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Commission pursuant to Exchange Act Section 12(g). Brighton Investment is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2005, which reported a net loss of \$12,474 for the prior three months.

3. Bristol Acquisitions Corp. (CIK No. 1502942) is a Delaware corporation located in Merrick, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Bristol Acquisition is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10 registration statement on October 7, 2010, which reported a net loss of \$13,276 from the company's September 8, 2010 inception to September 17, 2010.

4. The Continental Orinoco Co., Inc. (CIK No. 804889) is a Colorado corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Continental Orinoco is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10 registration statement on May 28, 1996, which reported a net loss of \$195,565 for the nine months ended January 31, 1996.

B. DELINQUENT PERIODIC FILINGS

5. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

6. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

7. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and/or 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73552 / November 6, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16261

In the Matter of

**Bitech Pharma, Inc.,
Blue Chapman, Inc.,
BSN Systems, Inc., and
California Bancshares, Inc.,**

Respondents.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
AND NOTICE OF HEARING
PURSUANT TO SECTION 12(j) OF
THE SECURITIES EXCHANGE ACT
OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Bitech Pharma, Inc., Blue Chapman, Inc., BSN Systems, Inc., and California Bancshares, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Bitech Pharma, Inc. (CIK No. 1347188) is a Delaware corporation located in Costa Mesa, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Bitech Pharma is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the period ended June 30, 2006.

2. Blue Chapman, Inc. (CIK No. 1470088) is a Nevada corporation located in Matthews, North Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Blue Chapman is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10

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registration statement on August 13, 2009, which reported a net loss of \$9,208 from the company's February 2, 2009 inception to March 31, 2009.

3. BSN Systems, Inc. (CIK No. 1399362) is a Delaware corporation located in Newport Beach, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). BSN Systems is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended December 31, 2008, which reported a net loss of \$19,810 from the company's October 25, 2006 inception to December 31, 2008.

4. California Bancshares, Inc. (CIK No. 318779) is a Delaware corporation located in San Ramon, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). California Bancshares is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended March 31, 1996.

B. DELINQUENT PERIODIC FILINGS

5. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

6. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

7. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and/or 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the

Respondents identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Brent J. Fields
Secretary

By: *Jill M. Peterson*
Jill M. Peterson
Assistant Secretary

*Commissioner Gallagher
Not participating*

SECURITIES AND EXCHANGE COMMISSION

[Investment Company Act Release No. 31333; 812-14139]

Eaton Vance Management, et al.; Notice of Application

November 6, 2014

Agency: Securities and Exchange Commission ("Commission").

Action: Notice of an application for an order under section 6(c) of the Investment Company Act of 1940 ("Act") for an exemption from sections 2(a)(32), 5(a)(1), 22(d) and 22(e) of the Act and rule 22c-1 under the Act, under sections 6(c) and 17(b) of the Act for an exemption from sections 17(a)(1) and (a)(2) of the Act, and under section 12(d)(1)(J) of the Act for an exemption from sections 12(d)(1)(A) and (B) of the Act.

Applicants: Eaton Vance Management ("Eaton Vance"), Eaton Vance ETMF Trust ("ETMF Trust") and Eaton Vance ETMF Trust II ("ETMF Trust II").

Summary of Application: Applicants request an order that permits: (a) actively managed series of certain open-end management investment companies to issue shares ("Shares") redeemable in large aggregations only ("Creation Units"); (b) secondary market transactions in Shares to occur at the next-determined net asset value ("NAV") plus or minus a market-determined premium or discount ("premium/discount") that may vary during the trading day ("NAV-based Trading"); (c) certain series to pay redemption proceeds, under certain circumstances, more than seven days from the tender of Shares for redemption; (d) certain affiliated persons of the series to deposit securities into, and receive securities from, the series in connection with the purchase and redemption of Creation Units; (e) certain registered management investment companies and unit investment trusts outside of the same group of investment companies as the series to acquire Shares; and (f) certain series to create and redeem Shares in kind in a master-feeder structure.

Filing Dates: The application was filed on March 27, 2013 and amended on September 12, 2013, January 23, 2014, September 15, 2014, and September 25, 2014.

Hearing or Notification of Hearing: An order granting the requested relief will be issued unless the Commission orders a hearing. Interested persons may request a hearing by writing to the Commission's Secretary and serving applicants with a copy of the request, personally or by mail. Hearing requests should be received by the Commission by 5:30 p.m. on December 1, 2014, and should be accompanied by proof of service on applicants, in the form of an affidavit or, for lawyers, a certificate of service. Pursuant to rule 0-5 under the Act, hearing requests should state the nature of the writer's interest, any facts bearing upon the desirability of a hearing on the matter, the reason for the request, and the issues contested. Persons who wish to be notified of a hearing may request notification by writing to the Commission's Secretary.

Addresses: Secretary, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090. Applicants: Frederick S. Marius, Esq., Eaton Vance Management, Two International Place, Boston, MA 02110.

For Further Information Contact: Jean E. Minarick, Senior Counsel, Daniele Marchesani, Branch Chief or Dalia Osman Blass, Assistant Chief Counsel, at (202) 551-6821 (Division of Investment Management, Chief Counsel's Office).

Supplementary Information: The following is a summary of the application. The complete application may be obtained via the Commission's website by searching for the file number, or for an applicant using the Company name box, at <http://www.sec.gov/search/search.htm> or by calling (202) 551-8090.

APPLICANTS:

1. ETMF Trust and ETMF Trust II (each, a "Trust" and, together the "Trusts") will be registered as open-end management investment companies under the Act and are business trusts organized under the laws of Massachusetts. ETMF Trust and ETMF Trust II will initially offer ten and eight series, respectively (the "Initial ETMFs"). Each ETMF (as defined below) will invest in securities and other assets selected to pursue the ETMF's investment objective ("Portfolio Positions").¹

2. Eaton Vance, a Massachusetts business trust, will serve as investment adviser to the Initial ETMFs. An Adviser (as defined below) will serve as investment adviser to each ETMF. Eaton Vance is, and any other Adviser will be, registered as an investment adviser under the Investment Advisers Act of 1940 ("Advisers Act"). The Adviser may retain one or more subadvisers (each a "Subadviser") to manage the portfolios of the ETMFs (as defined below). Any Subadviser will be registered, or not subject to registration, under the Advisers Act.

APPLICANTS' PROPOSAL:

3. Applicants seek an exemptive order that would permit them to offer exchange-traded managed funds, a new kind of registered investment company that is a hybrid between traditional mutual funds and exchange-traded funds ("exchange-traded managed funds" or ETMFs, as defined below).² Like exchange-traded funds ("ETFs"), ETMFs would: list and

¹ If an ETMF (or, in the case of an ETMF Feeder (as defined below), its Master Fund (as defined below)) invests in derivatives, then (a) the board of trustees ("Board") of the ETMF will periodically review and approve the ETMF's (or, in the case of an ETMF Feeder, its Master Fund's) use of derivatives and how the ETMF's Adviser assesses and manages risk with respect to the ETMF's (or, in the case of an ETMF Feeder, its Master Fund's investment adviser's) use of derivatives and (b) the ETMF's disclosure of its (or in the case of an ETMF Feeder, its Master Fund's) use of derivatives in its offering documents and periodic reports will be consistent with relevant Commission and staff guidance.

² In accordance with the conditions to the requested relief, neither the Trusts nor any ETMF would be marketed or otherwise held out as an "open-end investment company," a "mutual fund" or "exchange-traded fund". Instead, each ETMF would be marketed as an "exchange-traded managed fund" or "ETMF".

trade on a national securities exchange, as defined in section 2(a)(26) of the Act ("Exchange"); directly issue and redeem Shares only in Creation Units; impose fees on Creation Units issued and redeemed to Authorized Participants (as defined below) to offset the related costs to the ETMFs; and primarily utilize in-kind transfers of Portfolio Positions in issuing and redeeming Creation Units. Like mutual funds, ETMFs would be bought and sold at prices linked to NAV and would seek to maintain the confidentiality of their current Portfolio Positions. Applicants have structured the product in this manner to provide certain cost and tax efficiencies of ETFs to investors, while maintaining the confidentiality of current Portfolio Positions.³

4. Applicants request that the order apply to the Initial ETMFs and any future series of the Trusts as well as any other open-end management investment companies or series thereof that: (a) are advised by Eaton Vance or an entity controlling, controlled by, or under common control with Eaton Vance (Eaton Vance and each such other entity, and any successor thereto, included in the term "Adviser");⁴ and (b) comply with the terms and conditions of the requested order ("Future ETMFs").⁵ An ETMF would offer its Shares in Creation Units only; individual

³ Through in-kind redemptions (as described below), ETMFs would seek to achieve tax efficiencies for its shareholders by avoiding the tax consequences of selling portfolio positions to meet redemption requests in cash. ETMFs could also limit the costs associated with managing inflows and outflows (e.g., trading costs and "cash drag"). By trading on an Exchange, ETMFs would greatly reduce their expenses for transfer agency services. (ETMF shareholders would still be able to receive comparable services through their brokers and would pay only for those services that they elect to receive.) Finally, applicants represent that ETMFs will not charge sales loads or pay any asset-based distribution or service fees.

⁴ For the purposes of the requested order, a "successor" is limited to an entity that results from a reorganization into another jurisdiction or a change in the type of business organization.

⁵ Eaton Vance has obtained patents with respect to certain aspects of ETMF's NAV-based Trading. Applicants anticipate that Eaton Vance or an affiliate thereof will license the patents to other registered investment advisers (each a "Licensed Adviser") advising a trust that intends to launch new series that will operate as exchange-traded managed funds (the Licensed Adviser and such trust together, the "Future Applicants"). Future Applicants will apply for a separate exemptive order that incorporates by reference all the terms and conditions of this requested order and any amendments thereto. Therefore, any future amendments to the requested order would become part of any separate exemptive orders granted to Future Applicants. Any separate order granted to Future Applicants also would contain a condition that the Future Applicants must ensure that they comply with any terms and conditions of the requested order and any amendments thereto.

Shares would trade on an Exchange using NAV-based Trading. The Initial ETMFs and the Future ETMFs together are the "ETMFs."⁶

A. Exchange Trading and NAV-Based Trading

5. Shares would be listed and traded on an Exchange ("Listing Exchange").⁷ Shares would trade throughout the day at NAV⁸ plus or minus a premium/discount that may vary during the trading day.⁹ This premium/discount (solely by way of example, +\$0.20/Share, -\$0.30/Share) would be quoted by Market Makers in Shares.¹⁰ Although Share prices would be quoted throughout the trading day relative to NAV (solely by way of example, NAV+\$0.20/share, NAV-\$0.30/share), there would not be a fixed relationship between Share trading prices and their NAVs. For each trade, the premium/discount (which may be zero) would be locked in at trade execution and the final transaction price (*i.e.*, NAV plus or minus the

⁶ All entities that currently intend to rely on the order are named as applicants. Any other entity that relies on the order in the future will comply with the terms and conditions of the requested order.

⁷ Applicants currently expect that The NASDAQ Stock Market LLC ("Nasdaq") will be the Listing Exchange for the Initial ETMFs. One or more member firms of the Listing Exchange will act as market maker ("Market Maker") and maintain a market for Shares trading on the Listing Exchange.

⁸ An ETMF's NAV will be determined at the end of each Business Day. A "Business Day" is any day the ETMF is open, including any day when it satisfies redemption requests as required by section 22(e) of the Act. ETMFs may compute their NAV more than once each Business Day or once daily at times other than 4:00 p.m. ET, consistent with rule 22c-1 under the Act.

⁹ Unlike other exchange-traded securities, there would not be an absolute dollar amount per Share until the end of the day. Accordingly, prior to the initial operations of ETMFs, the Exchanges and brokers would install systems for the entry of orders to buy and sell shares using NAV-based Trading. Applicants have been working with intermediaries and Nasdaq to ensure they are implementing appropriate operational arrangements to accommodate the unique pricing mechanism of ETMFs (*e.g.*, the convention for reporting the intraday pricing of Shares on the consolidated tape). Applicants have also represented that they would establish and support a robust education program to ensure that investors and the marketplace understand, among other things, how to buy and sell Shares. Applicants would also provide related information in the ETMFs' registration statements, website and advertising and marketing materials.

¹⁰ The amount of the premium/discount would depend on market factors, including the balance of supply and demand for Shares among investors, the Transaction Fees (as defined below) and other costs associated with creating and redeeming Creation Units, competition among Market Makers, Share inventory positions, inventory strategies of Market Makers, and the volume of Share trading. Premiums/discounts on market transactions in Shares are not sales charges, and therefore would not be subject to the limitation applicable to sales charges under NASD Conduct Rule 2830 or any other set limitation. Any reference to NASD Conduct Rule 2830 includes any successor or replacement rule that may be adopted by the Financial Industry Regulatory Authority.

premium/discount) would be determined at the end of the Business Day when the ETMF's NAV is calculated.¹¹

6. Accordingly, unlike ETFs, NAV-based Trading would not offer investors the opportunity to transact intraday at prices based on current (versus end-of-day) determinations of the Shares' value. Instead, like intraday orders to buy or sell shares of mutual funds, an ETMF investor would not know the NAV at the time the order is placed, but the levels of premium/discount would be fully transparent allowing investors to see the execution costs of buying or selling Shares.¹² Market Makers and other dealers, in turn, would compete for transactions in Shares at a profitable premium/discount level.

B. Issuance and Redemption of Creation Units

7. Shares would not be individually redeemable and owners of Shares may acquire those Shares from an ETMF, or tender such shares for redemption to the ETMF, in Creation Units only.¹³ Like ETFs, all orders to purchase Creation Units must be placed with a distributor ("Distributor") that is a broker-dealer registered under the Securities Exchange Act of 1934 ("Exchange Act") by or through a party (an "Authorized Participant") that has entered into a

¹¹ Transactions involving the purchases and sales of Shares on the Exchange would also be subject to customary brokerage commissions and charges.

¹² Trading prices of Shares would be available intraday through market data services and on the ETMFs' website. Quotations, however, would be expressed relative to NAV (solely by way of example, NAV+\$0.20/Share, NAV-\$0.20/Share) rather than as absolute dollar prices like ETF prices. Historical information regarding levels of premiums/discounts also would be available on the ETMFs' website.

¹³ In any advertising material that describes the purchase or sale of Creation Units or refers to redeemability there would be an appropriate statement to the effect that Shares are not individually redeemable. The Adviser also would maintain a public website disclosing current ETMF information and containing links to the current prospectus and other ETMF documents. The website also would include the disclosure required by condition 3 under ETMF Relief.

participant agreement with the Distributor with respect to the creation and redemption of Creation Units.¹⁴

8. Like ETFs, and to keep trading costs low and permit each ETMF to be as fully invested as possible, Shares would be purchased and redeemed in Creation Units and primarily on an in-kind basis. Authorized Participants would be required to purchase Creation Units by making an in-kind deposit of specified instruments (these instruments are referred to, in the case of either a purchase or redemption, as the "Basket Instruments," and, together as the "Basket"), specified by the ETMF at the beginning of each Business Day and Authorized Participants redeeming their Shares would receive an in-kind transfer of Basket Instruments.¹⁵ The Basket would not necessarily include all Portfolio Positions of the applicable ETMF in order to protect the confidentiality of current Portfolio Positions.

9. Each ETMF would process purchases and redemptions of Creation Units in a manner that would protect the ETMF from any investor who might seek advantageous treatment vis-à-vis other investors. Therefore, each Business Day, the Basket would be constructed in accordance with policies and procedures that: (a) have been approved by the relevant ETMF's Board based on a determination that such policies and procedures are in the best interests of the ETMF; and (b) are administered in accordance with rule 38a-1 under the Act by the chief compliance officer designated by the ETMF under that rule. Moreover, the names and quantities

¹⁴ An Authorized Participant would be either: (a) a Broker (as defined below) or other participant in the Continuous Net Settlement System of the National Securities Clearing Corporation ("NSCC"), a clearing agency registered with the Commission; or (b) a participant in The Depository Trust Company ("DTC") (such participant, "DTC Participant").

¹⁵ ETMFs must comply with the federal securities laws in accepting Basket Instruments and satisfying redemptions with Basket Instruments, including that the Basket Instruments would be sold in transactions that would be exempt from registration under the Securities Act of 1933 ("Securities Act"). In accepting Basket Instruments and satisfying redemptions with Basket Instruments that are restricted securities eligible for resale pursuant to Rule 144A under the Securities Act, ETMFs would comply with the conditions of Rule 144A.

of the instruments that constitute the Basket Instruments on a given Business Day would be identical for all purchasers and redeemers of an ETMF's Creation Units that day, except in certain limited circumstances.¹⁶

10. To preserve the confidentiality of an ETMF's trading activities, the Basket would normally not be a pro rata slice of the Portfolio Positions. Instruments being acquired by the ETMF would generally be excluded from the Basket until their purchase is completed and Basket Instruments being sold may not be removed from the Basket until the sale program is substantially completed. Further, when deemed by the Adviser to be in the best interests of an ETMF and its shareholders, other Portfolio Positions would be excluded from the Basket. Whenever Portfolio Positions are excluded from the Basket, the Basket may include proportionately more cash than is in the portfolio. Furthermore, if there is a difference between the NAV attributable to a Creation Unit and the aggregate market value of the Basket exchanged for the Creation Unit, the party conveying a Basket with the lower value would also pay to the other an amount in cash equal to that difference (the "Balancing Amount").

11. Each Business Day, before the open of trading on the Listing Exchange, the Adviser would cause to be published through the NSCC the names and quantities of the Basket Instruments, as well as the estimated Balancing Amount (if any), for that day. The published

¹⁶ An ETMF's Basket could vary if the required policies and procedures of the ETMF allowed such differences by permitting an Authorized Participant to deposit cash in lieu of some or all of the Basket Instruments solely because: (a) such Basket Instruments, in the case of a purchase of a Creation Unit, are not available in sufficient quantity; (b) such Basket Instruments are not eligible for trading by the Authorized Participant or the investor on whose behalf the Authorized Participant is acting; or (c) a holder of Shares of an ETMF investing in foreign instruments would be subject to unfavorable income tax treatment if the holder received redemption proceeds in kind. A "custom order" is any purchase or redemption of Shares made in whole or in part on a cash basis in reliance on clause (a) or (b). An ETMF may also determine, upon receiving a purchase or redemption order from an Authorized Participant, to require the purchase or redemption, as applicable, to be made entirely in cash.

Basket would apply until a new Basket is announced on the following Business Day, and there would be no intraday changes to the Basket except to correct errors in the published Basket.¹⁷

12. Any purchasers or redeemers of Creation Units are expected to incur a transaction fee ("Transaction Fee") to cover the estimated cost to the ETMF of processing the transaction, including the costs of clearance and settlement charged to it by NSCC or DTC, and the estimated trading costs incurred in converting the Basket to the desired Portfolio Positions. The Transaction Fee would be borne only by purchasers and redeemers of Creation Units and would be limited to amounts that have been authorized by the Board and determined appropriate by the Adviser to defray the transaction expenses that would be incurred by an ETMF when an investor purchases or redeems Creation Units.¹⁸ With respect to ETMFs operating in a master-feeder structure (as discussed below), the Transaction Fee may be paid to the Master Fund as a Master Fund Transaction Fee.¹⁹

¹⁷ ETMFs would arrange for an independent third party to disseminate every 15 minutes an amount representing, on a per Share basis, the intraday indicative value ("IIV") of the ETMFs' Shares throughout the regular trading session of the Listing Exchange each Business Day. An investor may use the IIV to estimate the number of Shares to buy or sell based on the dollar amount the investor wants to transact in. Applicants note that unlike for ETFs, IIVs for ETMFs would not provide pricing signals for market intermediaries or other buyers or sellers of Shares seeking to estimate the difference between the current value of the ETMF's portfolio and the price at which Shares are currently trading. With ETMF's NAV-based Trading, market intermediaries and other buyers or sellers of Shares assume no intraday market risk in their Share inventory positions and therefore would not need to estimate any such difference.

¹⁸ Where an ETMF permits an in-kind purchaser to deposit cash in lieu of depositing one or more Basket Instruments, the purchaser may be assessed a higher Transaction Fee to offset the cost to the ETMF of buying those particular Basket Instruments. In all cases, the Transaction Fee and the Master Fund Transaction Fee (as defined below) will be limited in accordance with the requirements of the Commission applicable to open-end management investment companies offering redeemable securities.

¹⁹ Applicants believe that, to treat investors fairly and consistently, a Master Fund with two or more Feeder Funds should transact with each Feeder Fund on a basis that protects the Master Fund (and, indirectly, other Feeder Funds) against the costs of accommodating the Feeder Fund's inflows and outflows. In the proposed structure, the Master Fund would accomplish this by imposing a fee ("Master Fund Transaction Fee") on Feeder Fund inflows and outflows, sized to cover the estimated cost to the Master Fund of, in connection with a sale of its interests, converting the cash and/or other instruments it receives to the desired Portfolio Positions and, in connection with a redemption of its interests, converting Portfolio Positions to cash and/or other instruments to be distributed. The Master Fund Transaction Fee would be applied to all Feeder Funds in the same manner so as to avoid discrimination by the Master Fund among Feeder Funds.

C. The Role of Market Intermediaries and Portfolio Transparency

13. Applicants assert that in light of NAV-based Trading, daily portfolio transparency is not necessary for ETMFs. Applicants recognize that contemporaneous portfolio holdings disclosure has been viewed as necessary for effective arbitrage and efficient secondary market trading of ETFs.²⁰ In particular, applicants note that in ETF trading, tight bid-ask spreads and narrow premiums/discounts cannot be assured unless Market Makers have sufficient knowledge of portfolio holdings to enable them to effectively arbitrage differences between an ETF's market price and its underlying portfolio value and to hedge the intraday market risk they assume as they take inventory positions in connection with their market-making activities. According to applicants, in NAV-based Trading, by contrast, Market Makers do not engage in arbitrage and assume no intraday market risk in their Share inventory positions because all trading prices are linked to NAV.²¹ Applicants state that no intraday market risk means no need for Market Makers to engage in intraday hedging activity, and therefore no associated requirement for current portfolio holdings disclosure to maintain a tight relationship between Share trading prices and NAV.²² Accordingly, applicants maintain that because Share transaction prices would be

²⁰ See Exchange-Traded Funds, Investment Company Act Release No. 28193 (Mar. 11, 2008) at text following note 29; ICI, 2014 INVESTMENT COMPANY FACT BOOK (2014) ("ICI Fact Book"), at 59, available at www.ici.org/pdf/2014_factbook.pdf.

²¹ Applicants state that Market Makers would realize a profit to the extent the premium/discount exceeded their cost in entering into these transactions. Applicants assert that these costs would include, indirectly if the Market Maker is not an Authorized Participant, the Transaction Fees paid to an ETMF and the cost of purchasing or selling the Basket Instruments exchanged with the ETMF. According to applicants, these costs would not include a cost of hedging an intraday position in Shares. Applicants assert that the cost of intermediation would be lower with respect to ETMFs than for ETFs and profits would be relatively more predictable, which should foster intermediary participation in the market for Shares and therefore the competition necessary to limit the levels of the premium/discount.

²² Applicants believe that Market Makers will generally seek to minimize their exposure to price risk in Shares by holding little or no overnight inventory. ETMFs also will have smaller creation unit sizes than ETFs. Applicants also believe that these smaller creation unit sizes will support secondary market trading efficiency by facilitating tighter market maker inventory management because it facilitates closing out positions at the end of each trading day. To the extent that Market Makers hold small positions in Shares overnight, applicants expect them to

based on end-of-day NAV, ETMFs can be expected to trade at consistently narrow premiums/discounts to NAV and tight bid-ask spreads even in the absence of full portfolio holdings disclosure.

14. Applicants claim that ETMFs, not being required to provide daily portfolio transparency, have the potential for providing investors with access to a broad range of active strategies in a structure that provides the cost and tax efficiencies and shareholder protections of an ETF.

REQUESTED EXEMPTIVE RELIEF:

15. Applicants request an order under section 6(c) of the Act for an exemption from sections 2(a)(32), 5(a)(1), 22(d) and 22(e) of the Act and rule 22c-1 under the Act, under sections 6(c) and 17(b) of the Act for an exemption from sections 17(a)(1) and 17(a)(2) of the Act, and under section 12(d)(1)(J) of the Act for an exemption from sections 12(d)(1)(A) and (B) of the Act.

16. Applicants' request for relief is novel only under section 22(d) and rule 22c-1 under the Act with respect to NAV-based Trading. In all other respects, applicants are seeking the same relief that the Commission has previously granted to permit the operation of ETFs. As discussed above, the requested relief would be available to any existing or future investment company that is an ETMF operating in compliance with the terms and conditions of the order and that is advised by an Adviser. In support of future ETMF relief, applicants assert that Future ETMFs raise no legal or policy questions different from those presented by the Initial ETMFs and that the arguments for exemptive relief are equally valid regardless of the type of assets or

aggregate such holdings with any other risk positions that they are holding and transact at or near the market close to buy or sell offsetting positions in appropriate, broad-based hedging instruments, such as S&P 500 and other index futures and ETFs.

investment strategy utilized by a specific ETMF. The Commission preliminarily agrees with these assertions.

17. Section 6(c) of the Act provides that the Commission may exempt any person, security or transaction, or any class of persons, securities or transactions, from any provisions of the Act, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act. Section 17(b) of the Act authorizes the Commission to exempt a proposed transaction from section 17(a) of the Act if evidence establishes that the terms of the transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned, and the proposed transaction is consistent with the policies of the registered investment company and the general purposes of the Act. Section 12(d)(1)(J) of the Act provides that the Commission may exempt any person, security, or transaction, or any class or classes of persons, securities or transactions, from any provision of section 12(d)(1) if the exemption is consistent with the public interest and the protection of investors.

A. Novel Relief under Section 22(d) and Rule 22c-1

18. Section 22(d) of the Act, among other things, prohibits a dealer from selling a redeemable security that is currently being offered to the public by or through a principal underwriter other than at a current public offering price described in the fund's prospectus. Rule 22c-1 under the Act requires open-end funds, their principal underwriters, and dealers in fund shares (and certain others) to sell and redeem fund shares at a price based on the current NAV next computed after receipt of an order to buy or redeem. Together, these provisions are designed to prevent dilution caused by riskless trading schemes, require that shareholders are

treated equitably when buying and selling fund shares, and assure an orderly distribution system of investment company shares.

19. Applicants request relief from these provisions to permit NAV-based Trading of Shares. Because of ETMFs' NAV-based Trading, the need for exemptive relief from section 22(d) and rule 22c-1 for ETMFs arises due to the portion of the trading price that is the negotiated amount (*i.e.*, premium/discount).

20. Applicants assert that the concerns underlying section 22(d) of the Act and rule 22c-1 under the Act with respect to pricing are addressed by the NAV-based Trading of Shares. Applicants maintain that while there is little legislative history regarding section 22(d), its provisions, as well as those of rule 22c-1, appear to have been designed to (a) prevent dilution caused by certain riskless-trading schemes by principal underwriters and contract dealers, (b) prevent unjust discrimination or preferential treatment among buyers resulting from sales at different prices, and (c) assure an orderly distribution system of investment company shares by eliminating price competition from brokers offering shares at less than the published sales price and repurchasing shares at more than the published redemption price.

21. Applicants believe that none of these purposes would be thwarted by permitting NAV-based Trading of Shares. Applicants state that NAV-based Trading in Shares would not cause dilution of the shareholders' beneficial interests in ETMFs because secondary market trading in Shares would not involve the ETMF's portfolio. Applicants assert that NAV-Based Trading responds to concerns of unjust price discrimination among purchasers and preserving an orderly distribution of Shares. Shares would trade on an Exchange, a regulated venue, at market-determined premiums/discounts. The current and historical premiums/discounts also would be transparent to investors and intermediaries. Applicants assert that transparent pricing on an

Exchange should foster competition among market intermediaries, which would create downward pressure on intermediaries' profits embedded in the premium/discount and therefore on the total amount of any such premium/discount. Accordingly, applicants contend that the mechanics of the distribution of Shares and competitive market forces on an Exchange would work to limit the premium/discount and allow contemporaneous investors to buy or sell Shares at approximately the same intraday price.

22. The relief from section 22(d) and rule 22c-1 requested by applicants is significantly different from the relief previously granted by the Commission to actively managed ETFs. ETFs require relief from these provisions because certain investors may purchase and sell individual ETF shares on the secondary market at current market prices; *i.e.*, at prices other than those described in the ETF's prospectus or based on the ETF's NAV. Among other things, the market prices are affected by changes in the value of the underlying portfolio positions of the ETF.

23. Historically, in making the findings necessary to grant exemptive relief from section 22(d) and rule 22c-1, the Commission has relied on representations by ETF sponsors that an arbitrage mechanism functions to keep the market price of the ETF's shares at or close to the NAV per share of the ETF. The close tie between the market price and the NAV per share of the ETF is the foundation for why the prices at which retail investors buy and sell shares are similar to the prices at which Authorized Participants are able to buy and redeem shares directly from the ETF at NAV.

24. ETMF trading prices, as discussed above, would be directly tied to NAV. Unlike ETFs, ETMFs' need for relief arises because their trading price deviate from NAV only with respect to the execution costs of buying and selling ETMF Shares (*i.e.*, the premium/discount). In contrast, ETFs need relief because of differences related to the value of the underlying

portfolio positions. Therefore, because ETMF Shares' trading prices are directly tied to NAV, an arbitrage mechanism that would keep market price close to or at NAV is not necessary.

25. Accordingly, the Commission preliminarily agrees that any amount of premium or discount will be limited in the manner explained by applicants and that the concerns underlying section 22(d) and rule 22c-1 thereunder are addressed by the NAV-based Trading of Shares proposed by the applicants. Any differences from the ETMF proposed model, however, would not necessarily address those concerns.

B. Other Relief²³

Sections 5(a)(1) and 2(a)(32) of the Act

26. Section 5(a)(1) of the Act defines an "open-end company" as a management investment company that is offering for sale or has outstanding any redeemable security of which it is the issuer. Section 2(a)(32) of the Act defines a redeemable security as any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer, is entitled to receive approximately a proportionate share of the issuer's current net assets, or the cash equivalent. Because Shares would not be individually redeemable, applicants request an order that would permit the Trusts to register as open-end investment companies and each ETMF to redeem Shares in Creation Units only.²⁴ Applicants state that investors may purchase Shares in Creation Units from each ETMF and redeem Creation Units from each ETMF. Applicants further state all investors would have the ability to buy and sell Shares throughout the day using

²³ This other relief is the same relief that the Commission has previously granted to permit the operation of ETFs, as stated above.

²⁴ The Master Funds will not require relief from sections 2(a)(32) and 5(a)(1) because the Master Funds will operate as traditional mutual funds and issue individually redeemable interests.

NAV-based Trading at trading prices that are directly linked to NAV and that can be expected to reflect narrow premium/discounts to NAV.

Section 22(e) of the Act

27. Section 22(e) of the Act generally prohibits a registered investment company from suspending the right of redemption or postponing the date of payment of redemption proceeds for more than seven days after the tender of a security for redemption. Applicants observe that settlement of redemptions of Creation Units of ETMFs holding Portfolio Positions traded on global markets ("Global ETMFs") is contingent not only on the settlement cycle of the U.S. securities markets but also on the delivery cycles present in foreign markets in which those ETMFs invest. Applicants represent that, under certain circumstances, the delivery cycles for transferring foreign-traded Basket Instruments to redeeming investors, coupled with local market holiday schedules, would require a delivery process of up to 14 calendar days. Applicants therefore request relief from section 22(e) in order to provide payment or satisfaction of redemptions within the maximum number of calendar days required for such payment or satisfaction in the principal local markets where transactions in the foreign-traded Basket Instruments of each Global ETMF customarily clear and settle, but in all cases no later than 14 calendar days following the tender of a Creation Unit.²⁵

28. Applicants state that section 22(e) was designed to prevent unreasonable, undisclosed and unforeseen delays in the actual payment of redemption proceeds. Applicants state that allowing redemption payments in kind for Creation Units of a Global ETMF to be

²⁵ Applicants acknowledge that no relief obtained from the requirements of section 22(e) would affect any obligations that applicants may otherwise have under rule 15c6-1 under the Exchange Act. Rule 15c6-1 requires that most securities transactions be settled within three business days of the trade date. Mutual Fund Feeders (as defined below) may need to separately seek relief from section 22(e) if they intend to permit or require their shareholders to redeem in kind. Mutual Fund Feeders are not seeking, and would not rely on, the section 22(e) relief requested herein.

made within a maximum of 14 calendar days would not be inconsistent with the spirit and intent of section 22(e). Applicants state each ETMF's statement of additional information ("SAI") would disclose those local holidays (over the period of at least one year following the date of the SAI), if any, that are expected to prevent the delivery of redemption proceeds in kind in seven calendar days and the maximum number of days (not to exceed 14 calendar days) needed to deliver the proceeds in kind for each affected ETMF. Applicants are not seeking relief from section 22(e) with respect to Global ETMFs that do not effect redemptions in kind.

Section 12(d)(1) of the Act

29. Section 12(d)(1)(A) of the Act prohibits a registered investment company from acquiring shares of an investment company if the securities represent more than 3% of the total outstanding voting stock of the acquired company, more than 5% of the total assets of the acquiring company, or, together with the securities of any other investment companies, more than 10% of the total assets of the acquiring company. Section 12(d)(1)(B) of the Act prohibits a registered open-end investment company, its principal underwriter, or any other broker or dealer from selling its shares to another investment company if the sale will cause the acquiring company to own more than 3% of the acquired company's voting stock, or if the sale will cause more than 10% of the acquired company's voting stock to be owned by investment companies generally.

30. Applicants are seeking relief so that an ETMF may be an acquired fund in a fund of funds structure. In particular, applicants request that pursuant to section 12(d)(1)(J) of the Act the order permit Acquiring Funds (as defined below) to acquire Shares of an ETMF beyond the limitations in section 12(d)(1)(A) and permit an ETMF, any principal underwriter for the

ETMFs,²⁶ and any Brokers (as defined below) to sell Shares to Acquiring Funds beyond the limitations in section 12(d)(1)(B) ("Section 12(d)(1) Relief"). Applicants request that the Section 12(d)(1) Relief apply to each management investment company or unit investment trust registered under the Act that is not part of the same "group of investment companies" as an ETMF within the meaning of section 12(d)(1)(G)(ii) of the Act and that enters into an Acquiring Fund Agreement (as defined below) with an ETMF (such management investment companies, "Acquiring Management Companies," such unit investment trusts, "Acquiring Trusts," and Acquiring Management Companies and Acquiring Trusts together, "Acquiring Funds").²⁷ Acquiring Funds do not include the ETMFs.²⁸ Applicants submit that the proposed conditions to the requested relief address the concerns underlying the limits in section 12(d)(1), which include concerns about undue influence, excessive layering of fees and overly complex structures.

31. Applicants submit that their proposed conditions address any concerns regarding the potential for undue influence. To limit the control that an Acquiring Fund may have over an ETMF, applicants propose a condition prohibiting the adviser of an Investing Management Company ("Acquiring Fund Adviser"), sponsor of an Acquiring Trust ("Sponsor"), any person controlling, controlled by, or under common control with the Acquiring Fund Adviser or Sponsor, and any investment company or issuer that would be an investment company but for sections 3(c)(1) or 3(c)(7) of the Act that is advised or sponsored by the Acquiring Fund Adviser,

²⁶ Applicants further request that the order apply to any future distributor and principal underwriter of the ETMFs (included in the term "Distributor"), which would be a registered broker-dealer under the Exchange Act (any registered broker-dealers, "Brokers") and would comply with the terms and conditions of the requested order. The Distributor of any ETMF may be an affiliated person of the Adviser.

²⁷ Under condition 11, the Section 12(d)(1) Relief would generally not apply to any ETMF that is, either directly or through a master-feeder structure, acquiring securities of any investment company or company relying on section 3(c)(1) or 3(c)(7) of the Act in excess of the limits in section 12(d)(1)(A) of the Act.

²⁸ An Acquiring Fund may rely on the order only to invest in ETMFs and not in any other registered investment companies.

the Sponsor, or any person controlling, controlled by, or under common control with the Acquiring Fund Adviser or Sponsor ("Acquiring Fund's Advisory Group") from controlling (individually or in the aggregate) an ETMF within the meaning of section 2(a)(9) of the Act. The same prohibition would apply to any sub-adviser to an Acquiring Management Company ("Acquiring Fund Sub-Adviser"), any person controlling, controlled by or under common control with the Acquiring Fund Sub-Adviser, and any investment company or issuer that would be an investment company but for sections 3(c)(1) or 3(c)(7) of the Act (or portion of such investment company or issuer) advised or sponsored by the Acquiring Fund Sub-Adviser or any person controlling, controlled by or under common control with the Acquiring Fund Sub-Adviser ("Acquiring Fund's Sub-Advisory Group").

32. To limit undue influence, applicants propose a condition to ensure that no Acquiring Fund or Acquiring Fund Affiliate²⁹ (except to the extent it is acting in its capacity as an investment adviser to an ETMF) will cause an ETMF (or, in the case of an ETMF Feeder, its Master Fund) to purchase a security in an offering of securities during the existence of an underwriting or selling syndicate of which a principal underwriter is an Underwriting Affiliate ("Affiliated Underwriting"). An "Underwriting Affiliate" is a principal underwriter in any underwriting or selling syndicate that is an officer, director, member of an advisory board, Acquiring Fund Adviser, Acquiring Fund Sub-Adviser, Sponsor, or employee of the Acquiring Fund, or a person of which any such officer, director, member of an advisory board, Acquiring Fund Adviser, Acquiring Fund Sub-Adviser, Sponsor, or employee is an affiliated person (except

²⁹ An "Acquiring Fund Affiliate" is any Acquiring Fund Adviser, Acquiring Fund Sub-Adviser, Sponsor, promoter and principal underwriter of an Acquiring Fund, and any person controlling, controlled by or under common control with any of these entities. "ETMF Affiliate" is an investment adviser, promoter, or principal underwriter of an ETMF (or, in the case of an ETMF Feeder, its Master Fund) and any person controlling, controlled by or under common control with any of these entities.

any person whose relationship to the ETMF is covered by section 10(f) of the Act is not an Underwriting Affiliate).

33. Applicants propose several conditions to address the potential for layering of fees. Applicants note that the board of directors or trustees of any Acquiring Management Company, including a majority of the directors or trustees who are not "interested persons" within the meaning of section 2(a)(19) of the Act ("disinterested directors or trustees"), would be required to find that the advisory fees charged under the Acquiring Management Company's advisory contract are based on services provided that would be in addition to, rather than duplicative of, services provided under the advisory contract of any ETMF (or, in the case of an ETMF Feeder, its Master Fund) in which the Acquiring Management Company may invest. Applicants also state that any sales charges and/or service fees charged with respect to shares of an Acquiring Fund will not exceed the limits applicable to a fund of funds as set forth in NASD Conduct Rule 2830.

34. Applicants submit that the proposed arrangement would not create an overly complex fund structure. Applicants note that an ETMF (and, in the case of an ETMF Feeder, the Master Fund) would be prohibited from acquiring securities of any investment company or company relying on section 3(c)(1) or 3(c)(7) of the Act in excess of the limits contained in section 12(d)(1)(A) of the Act, except to the extent that the ETMF acquires such securities in compliance with section 12(d)(1)(E) of the Act or this order or the ETMF (or, in the case of an ETMF Feeder, the Master Fund): (a) receives securities of another investment company as a dividend or as a result of a plan of reorganization of a company (other than a plan devised for the purpose of evading section 12(d)(1) of the Act); or (b) acquires (or is deemed to have acquired) securities of another investment company pursuant to exemptive relief from the Commission

permitting the ETMF (or in the case of a ETMF Feeder, the Master Fund) to (i) acquire securities of one or more investment companies for short-term cash management purposes or (ii) engage in interfund borrowing and lending transactions.

35. To ensure that an Acquiring Fund is aware of the terms and conditions of the requested order, the Acquiring Fund must enter into an agreement with the respective ETMFs ("Acquiring Fund Agreement"). The Acquiring Fund Agreement will include an acknowledgement from the Acquiring Fund that it may rely on the order only to invest in an ETMF and not in any other investment company.

36. Applicants further request relief to permit an ETMF to be a feeder (an "ETMF Feeder") in a master-feeder structure alongside one or more other registered open-end investment companies advised by the same Adviser (each such other open-end investment company, a "Mutual Fund Feeder," and together with any ETMF Feeder, the "Feeder Funds"). The requested relief would permit the ETMF Feeder to acquire shares of another registered investment company in the same group of investment companies having substantially the same investment objectives as the ETMF Feeder (a "Master Fund") beyond the limitations in section 12(d)(1)(A) of the Act and permit the Master Fund, and any principal underwriter for the Master Fund, to sell shares of the Master Fund to the ETMF Feeder beyond the limitations in section 12(d)(1)(B) of the Act ("Master-Feeder Relief").³⁰ There would be no ability by shareholders to exchange Shares of ETMF Feeders for shares of another Feeder Fund of the Master Fund or vice versa.

³⁰ Applicants may structure certain ETMFs as ETMF Feeders to generate economies of scale for shareholders of all Feeder Funds of the Master Fund that could not be otherwise realized. Operating in a master-feeder structure could also impose costs on an ETMF Feeder and reduce its tax efficiency. In determining whether an ETMF would operate in a master-feeder structure, the Board would weigh the potential advantages and disadvantages of such a structure for the ETMF. In a master-feeder structure, the Master Fund – rather than the ETMF Feeder – would invest the portfolio in compliance with the order.

37. Applicants are seeking the Master-Feeder Relief to permit ETMF Feeders to create and redeem in kind Shares with their Master Funds. Applicants assert that this structure is substantially identical to traditional master-feeder structures permitted pursuant to the exception provided in section 12(d)(1)(E) of the Act. Section 12(d)(1)(E) provides that the percentage limitations of sections 12(d)(1)(A) and (B) will not apply to a security issued by an investment company (in this case, the shares of the applicable Master Fund) if, among other things, that security is the only investment security held in the investing fund's portfolio (in this case, the ETMF Feeder's portfolio). Applicants believe the proposed master-feeder structure complies with section 12(d)(1)(E) because each ETMF Feeder would hold only investment securities issued by its corresponding Master Fund; however, the ETMF Feeders may receive securities other than securities of its corresponding Master Fund if an ETMF Feeder accepts an in-kind creation. To the extent that an ETMF Feeder may be deemed to be holding both shares of the Master Fund and other securities, applicants request relief from sections 12(d)(1)(A) and (B). The ETMF Feeders would operate in compliance with all other provisions of section 12(d)(1)(E).

Sections 17(a)(1) and (2) of the Act

38. Section 17(a) of the Act generally prohibits an affiliated person of a registered investment company, or an affiliated person of such a person ("second-tier affiliate"), from selling any security to or purchasing any security from the company. Section 2(a)(3) of the Act defines "affiliated person" to include any person directly or indirectly owning, controlling, or holding with power to vote, 5% or more of the outstanding voting securities of the other person and any person directly or indirectly controlling, controlled by, or under common control with, the other person. Section 2(a)(9) of the Act defines "control" as the power to exercise a controlling influence over the management or policies of a company and provides that a control

relationship will be presumed where one person owns more than 25% of another person's voting securities. Each ETMF may be deemed to be controlled by an Adviser and hence affiliated persons of each other. In addition, the ETMFs may be deemed to be under common control with any other registered investment company (or series thereof) advised by an Adviser (an "Affiliated Fund").

39. Applicants request an exemption under sections 6(c) and 17(b) of the Act from sections 17(a)(1) and 17(a)(2) of the Act to permit in-kind purchases and redemptions of Creation Units by persons that are affiliated persons or second-tier affiliates of the ETMFs solely by virtue of one or more of the following: (a) holding 5% or more, or in excess of 25% of the outstanding Shares of one or more ETMFs; (b) having an affiliation with a person with an ownership interest described in (a); or (c) holding 5% or more, or more than 25% of the Shares of one or more Affiliated Funds.³¹ Applicants also request an exemption in order to permit an ETMF to sell its Shares to and redeem its Shares from, and engage in the in-kind transactions that would accompany such sales and redemptions with, an Acquiring Fund of which the ETMF is an affiliated person or a second-tier affiliate.³²

40. Applicants assert that no useful purpose would be served by prohibiting such affiliated persons from making in-kind purchases or in-kind redemptions of Shares of an ETMF in Creation Units. Absent the limited circumstances discussed in the application, the Basket Instruments available for an ETMF would be the same for all purchasers and redeemers, respectively. The deposit procedures for in-kind purchases of Creation Units and the redemption

³¹ Applicants are not seeking relief from section 17(a) for, and the requested relief will not apply to, transactions where an ETMF could be deemed an affiliated person, or an affiliated person of an affiliated person, of an Acquiring Fund because the Adviser to the ETMF is also an investment adviser to an Acquiring Fund.

³² To the extent that purchases and sales of Shares occur in the secondary market and not through principal transactions directly between an Acquiring Fund and an ETMF, relief from section 17(a) would not be necessary. The requested relief is intended to cover, however, transactions directly between an Acquiring Fund and an ETMF.

procedures for in-kind redemptions would be the same for all purchases and redemptions. All Basket Instruments would be valued in the same manner as they are valued for purposes of calculating the ETMF's NAV, and such valuation would be made in the same manner regardless of the identity of the purchaser or redeemer. Applicants do not believe that in-kind purchases and redemptions would result in abusive self-dealing or overreaching of the ETMF.

41. Applicants also submit that the sale of Shares to and redemption of Shares from an Acquiring Fund meets the standards for relief under sections 17(b) and 6(c) of the Act. Applicants note that any consideration paid for the purchase or redemption of Shares directly from an ETMF would be based on the NAV of the ETMF in accordance with policies and procedures set forth in the ETMF's registration statement.³³ The Acquiring Fund Agreement will require any Acquiring Fund that purchases Creation Units directly from an ETMF to represent that the purchase of Creation Units from an ETMF by an Acquiring Fund will be accomplished in compliance with the investment restrictions of the Acquiring Fund and will be consistent with the investment policies set forth in the Acquiring Fund's registration statement. Applicants also state that the proposed transactions are consistent with the general purposes of the Act and appropriate in the public interest.

42. To the extent that an ETMF operates in a master-feeder structure, applicants also request relief permitting the ETMF Feeders to engage in in-kind creations and redemptions with the applicable Master Fund. Applicants state that the customary section 17(a)(1) and 17(a)(2) relief would not be sufficient to permit such transactions because the ETMF Feeders and the applicable Master Fund could also be affiliated by virtue of having the same investment adviser.

³³ Applicants acknowledge that the receipt of compensation by (a) an affiliated person of an Acquiring Fund, or a second-tier affiliate, for the purchase by the Acquiring Fund of Shares of the ETMF or (b) an affiliated person of an ETMF, or a second-tier affiliate, for the sale by the ETMF of its Shares to an Acquiring ETMF, may be prohibited by section 17(e)(1) of the Act. The Acquiring Fund Agreement also will include this acknowledgment.

However, applicants believe that in-kind creations and redemptions between an ETMF Feeder and a Master Fund advised by the same investment adviser do not involve "overreaching" by an affiliated person. Such transactions would occur only at the ETMF Feeder's proportionate share of the Master Fund's net assets, and the Basket Instruments would be valued in the same manner as they are valued for the purposes of calculating the applicable Master Fund's NAV. Further, all such transactions would be effected with respect to the Basket and on the same terms with respect to all investors. Finally, such transactions would only occur as a result of, and to effectuate, a creation or redemption transaction between the ETMF Feeder and a third party investor. Applicants believe that the terms of the proposed transactions are reasonable and fair and do not involve overreaching on the part of any person concerned and that the transactions are consistent with the general purposes of the Act.

Applicants' Conditions:

Applicants agree that any order of the Commission granting the requested relief will be subject to the following conditions:

A. ETMF Relief

1. As long as an ETMF operates in reliance on the requested order, its Shares will be listed on an Exchange.
2. Neither the Trusts nor any ETMF will be advertised or marketed as an open-end investment company, a mutual fund or an ETF. Any advertising material that describes the purchase or sale of Creation Units or refers to redeemability will prominently disclose that Shares are not individually redeemable and that owners of Shares may acquire those Shares from an ETMF and tender those Shares for redemption to the ETMF in Creation Units only.

3. The website for the ETMFs, which will be publicly accessible at no charge, will contain, on a per Share basis, for each ETMF, the prior Business Day's NAV; intraday high, low, average and closing trading prices (expressed as premiums/discounts to NAV); the midpoint of the highest bid and lowest offer prices as of the close of Exchange trading ("Closing Bid/Ask Midpoint") (expressed as a premium/discount to NAV); and the spread between the highest bid and lowest offer prices as of the close of Exchange trading ("Closing Bid/Ask Spread"). The website for the ETMFs also will contain charts showing the frequency distribution and range of values of trading prices, Closing Bid/Ask Midpoints and Closing Bid/Ask Spreads over time.

4. The Adviser or any Subadviser, directly or indirectly, will not cause any Authorized Participant (or any investor on whose behalf an Authorized Participant may transact with the ETMF) to acquire any Basket Instrument for the ETMF through a transaction in which the ETMF could not engage directly.

B. Section 12(d)(1) Relief

1. The members of an Acquiring Fund's Advisory Group will not control (individually or in the aggregate) an ETMF (or, in the case of an ETMF Feeder, its Master Fund) within the meaning of section 2(a)(9) of the Act. The members of an Acquiring Fund's Subadvisory Group will not control (individually or in the aggregate) an ETMF (or, in the case of an ETMF Feeder, its Master Fund) within the meaning of section 2(a)(9) of the Act. If, as a result of a decrease in the outstanding voting securities of the ETMF, the Acquiring Fund's Advisory Group or the Acquiring Fund's Subadvisory Group, each in the aggregate, becomes a holder of more than 25 percent of the outstanding voting securities of an ETMF, it will vote its Shares of the ETMF in the same proportion as the vote of all other holders of such Shares. This condition does not apply to the Acquiring Fund's Subadvisory Group with respect to an ETMF

(or, in the case of an ETMF Feeder, its Master Fund) for which the Acquiring Fund Subadviser or a person controlling, controlled by or under common control with the Acquiring Fund Subadviser acts as the investment adviser within the meaning of section 2(a)(20)(A) of the Act.

2. No Acquiring Fund or Acquiring Fund Affiliate will cause any existing or potential investment by the Acquiring Fund in an ETMF to influence the terms of any services or transactions between the Acquiring Fund or an Acquiring Fund Affiliate and the ETMF (or, in the case of an ETMF Feeder, its Master Fund) or an ETMF Affiliate.

3. The board of directors or trustees of an Acquiring Management Company, including a majority of the disinterested directors or trustees, will adopt procedures reasonably designed to ensure that the Acquiring Fund Adviser and any Acquiring Fund Subadviser are conducting the investment program of the Acquiring Management Company without taking into account any consideration received by the Acquiring Management Company or an Acquiring Fund Affiliate from an ETMF (or, in the case of an ETMF Feeder, its Master Fund) or an ETMF Affiliate in connection with any services or transactions.

4. Once an investment by an Acquiring Fund in the Shares of an ETMF exceeds the limit in section 12(d)(1)(A)(i) of the Act, the Board of the ETMF, including a majority of the disinterested directors or trustees, will determine that any consideration paid by the ETMF (or, in the case of an ETMF Feeder, its Master Fund) to an Acquiring Fund or an Acquiring Fund Affiliate in connection with any services or transactions: (i) is fair and reasonable in relation to the nature and quality of the services and benefits received by the ETMF (or, in the case of an ETMF Feeder, its Master Fund); (ii) is within the range of consideration that the ETMF (or, in the case of an ETMF Feeder, its Master Fund) would be required to pay to another unaffiliated entity in connection with the same services or transactions; and (iii) does not involve

overreaching on the part of any person concerned. This condition does not apply to any services or transactions between an ETMF (or, in the case of an ETMF Feeder, its Master Fund) and its investment adviser(s), or any person controlling, controlled by or under common control with such investment adviser(s).

5. No Acquiring Fund or Acquiring Fund Affiliate (except to the extent it is acting in its capacity as an investment adviser to an ETMF (or, in the case of an ETMF Feeder, its Master Fund)) will cause an ETMF (or, in the case of an ETMF Feeder, its Master Fund) to purchase a security in an Affiliated Underwriting.

6. The Board of an ETMF (or, in the case of an ETMF Feeder, its Master Fund), including a majority of the disinterested directors or trustees, will adopt procedures reasonably designed to monitor any purchases of securities by the ETMF (or, in the case of an ETMF Feeder, its Master Fund) in an Affiliated Underwriting, once an investment by an Acquiring Fund in the securities of the ETMF exceeds the limit of section 12(d)(1)(A)(i) of the Act, including any purchases made directly from an Underwriting Affiliate. The Board will review these purchases periodically, but no less frequently than annually, to determine whether the purchases were influenced by the investment by the Acquiring Fund in the ETMF. The Board will consider, among other things: (i) whether the purchases were consistent with the investment objectives and policies of the ETMF (or, in the case of an ETMF Feeder, its Master Fund); (ii) how the performance of securities purchased in an Affiliated Underwriting compares to the performance of comparable securities purchased during a comparable period of time in underwritings other than Affiliated Underwritings or to a benchmark such as a comparable market index; and (iii) whether the amount of securities purchased by the ETMF (or, in the case of an ETMF Feeder, its Master Fund) in Affiliated Underwritings and the amount purchased

directly from an Underwriting Affiliate have changed significantly from prior years. The Board will take any appropriate actions based on its review, including, if appropriate, the institution of procedures designed to assure that purchases of securities in Affiliated Underwritings are in the best interest of shareholders of the ETMF.

7. Each ETMF (or, in the case of an ETMF Feeder, its Master Fund) will maintain and preserve permanently in an easily accessible place a written copy of the procedures described in the preceding condition, and any modifications to such procedures, and will maintain and preserve for a period of not less than six years from the end of the fiscal year in which any purchase in an Affiliated Underwriting occurred, the first two years in an easily accessible place, a written record of each purchase of securities in Affiliated Underwritings, once an investment by an Acquiring Fund in the securities of the ETMF exceeds the limit of section 12(d)(1)(A)(i) of the Act, setting forth from whom the securities were acquired, the identity of the underwriting syndicate's members, the terms of the purchase, and the information or materials upon which the determinations of the Board were made.

8. Before investing in an ETMF in excess of the limits in section 12(d)(1)(A), an Acquiring Fund and the ETMF will execute an Acquiring Fund Agreement stating that their boards of directors or trustees and their investment advisers, or Trustee and Sponsor, as applicable, understand the terms and conditions of the order, and agree to fulfill their responsibilities under the order. At the time of its investment in Shares of an ETMF in excess of the limit in section 12(d)(1)(A)(i), an Acquiring Fund will notify the ETMF of the investment. At such time, the Acquiring Fund will also transmit to the ETMF a list of the names of each Acquiring Fund Affiliate and Underwriting Affiliate. The Acquiring Fund will notify the ETMF of any changes to the list of the names as soon as reasonably practicable after a change occurs.

The ETMF and the Acquiring Fund will maintain and preserve a copy of the order, the Acquiring Fund Agreement, and the list with any updated information for the duration of the investment and for a period of not less than six years thereafter, the first two years in an easily accessible place.

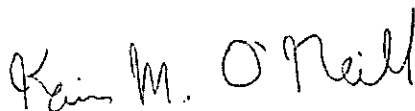
9. The Acquiring Fund Adviser, or Trustee or Sponsor, as applicable, will waive fees otherwise payable to it by the Acquiring Fund in an amount at least equal to any compensation received from an ETMF (or, in the case of an ETMF Feeder, its Master Fund) by the Acquiring Fund Adviser, or Trustee, or Sponsor, or an affiliated person of the Acquiring Fund Adviser, or Trustee, or Sponsor, other than any advisory fees paid to the Acquiring Fund Adviser, or Trustee, or Sponsor, or its affiliated person by the ETMF (or, in the case of an ETMF Feeder, its Master Fund), in connection with the investment by the Acquiring Fund in the ETMF. Any Acquiring Fund Subadviser will waive fees otherwise payable to the Acquiring Fund Subadviser, directly or indirectly, by the Acquiring Management Company in an amount at least equal to any compensation received from an ETMF (or, in the case of an ETMF Feeder, its Master Fund) by the Acquiring Fund Subadviser, or an affiliated person of the Acquiring Fund Subadviser, other than any advisory fees paid to the Acquiring Fund Subadviser or its affiliated person by the ETMF (or, in the case of an ETMF Feeder, its Master Fund), in connection with any investment by the Acquiring Management Company in the ETMF made at the direction of the Acquiring Fund Subadviser. In the event that the Acquiring Fund Subadviser waives fees, the benefit of the waiver will be passed through to the Acquiring Management Company.

10. Any sales charges and/or service fees charged with respect to shares of an Acquiring Fund will not exceed the limits applicable to a fund of funds as set forth in NASD Conduct Rule 2830.

11. No ETMF (or, in the case of an ETMF Feeder, its Master Fund) relying on the Section 12(d)(1) relief will acquire securities of any investment company or company relying on section 3(c)(1) or 3(c)(7) of the Act in excess of the limits contained in section 12(d)(1)(A) of the Act, except to the extent that the ETMF acquires such securities in compliance with section 12(d)(1)(E) of the Act or acquires shares of a Master Fund; or the ETMF (or, in the case of an ETMF Feeder, its Master Fund) (a) receives securities of another investment company as a dividend or as a result of a plan of reorganization of a company (other than a plan devised for the purpose of evading section 12(d)(1) of the Act), or (b) acquires securities of another investment company pursuant to exemptive relief from the Commission permitting such ETMF (or, in the case of an ETMF Feeder, its Master Fund) to (i) acquire securities of one or more investment companies for short-term cash management purposes or (ii) engage in interfund borrowing and lending transactions.

12. Before approving any advisory contract under section 15 of the Act, the board of each Acquiring Management Company, including a majority of the disinterested directors or trustees, will find that the advisory fees charged under such advisory contract are based on services provided that will be in addition to, rather than duplicative of, the services provided under the advisory contracts of any ETMF (or, in the case of an ETMF Feeder, its Master Fund) in which the Acquiring Management Company may invest. These findings and their basis will be recorded fully in the minute books of the appropriate Acquiring Management Company.

By the Commission.



Kevin M. O'Neill
Deputy Secretary

*Chair White
Not participating*

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-73562; File No. SR-NASDAQ-2014-020)

November 7, 2014

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1 Thereto, Relating to Listing and Trading of Exchange-Traded Managed Fund Shares

I. Introduction

On February 26, 2014, The NASDAQ Stock Market LLC (“Nasdaq” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act” or “Exchange Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to adopt Nasdaq Rule 5745, which would govern the listing and trading of Exchange-Traded Managed Fund Shares (“ETMF Shares” or “ETMFs”), and to amend related references under Nasdaq Rules 4120, 5615, IM-5615-4, and 5940. The proposed rule change was published for comment in the Federal Register on March 12, 2014.³ The Commission initially received four comment letters on the proposal.⁴ On April 23, 2014, pursuant to Section 19(b)(2) of the Act,⁵ the Commission designated a longer period within which to either approve the proposed rule change, disapprove the proposed rule change, or

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 71657 (Mar. 6, 2014), 79 FR 14092 (Mar. 12, 2014) (SR-NASDAQ-2014-020) (“Notice”).

⁴ See Letters to the Commission from Christopher Davis, President, Money Management Institute, dated March 27, 2014 (“MMI Letter”); Robert Tull, President, Robert Tull & Co., dated March 31, 2014 (“Tull Letter”); Avi Nachmany, Co-Founder, Director of Research, E.V.P., Strategic Insight, dated Apr. 1, 2014 (“Strategic Insight Letter”); and Eric Noll, President and Chief Executive Officer, ConvergEx Group, LLC, dated Apr. 1, 2014 (“ConvergEx Letter”).

⁵ 15 U.S.C. 78s(b)(2).

institute proceedings to determine whether to disapprove the proposed rule change.⁶ On June 9, 2014, the Commission instituted proceedings to determine whether to approve or disapprove the proposed rule change.⁷ In response to the Order Instituting Proceedings, the Commission received one comment letter on the proposal.⁸ On September 4, 2014, the Commission issued a notice of designation of a longer period for Commission action on proceedings to determine whether to approve or disapprove the proposed rule change.⁹ On September 12, 2014, the

⁶ See Securities Exchange Act Release No. 72007 (Apr. 23, 2014), 79 FR 24045 (Apr. 29, 2014) (SR-NASDAQ-2014-020). The Commission determined that it was appropriate to designate a longer period within which to take action on the proposed rule change so that it had sufficient time to consider the proposed rule change. Accordingly, the Commission designated June 10, 2014 as the date by which it should approve, disapprove, or institute proceedings to determine whether to disapprove the proposed rule change.

⁷ See Securities Exchange Act Release No. 72350 (Jun. 9, 2014), 79 FR 33959 (Jun. 13, 2014) (SR-NASDAQ-2014-020) (“Order Instituting Proceedings”). In the Order Instituting Proceedings, the Commission noted, among other things, that questions remained as to whether the Exchange’s proposal is consistent with the requirements of Section 6(b)(5) of the Act, specifically whether it is designed to prevent fraudulent and manipulative acts and practices, promotes just and equitable principles of trade, and protects investors and the public interest.

⁸ See Letter to the Commission from Thomas E. Faust, Jr., Chairman and Chief Executive Officer, on behalf of Eaton Vance Corporation and its subsidiaries Eaton Vance Management and Navigate Fund Solution LLC (collectively, “Eaton Vance”), dated July 3, 2014 (“Eaton Vance Letter”). Eaton Vance Management and the Eaton Vance ETMF Trust have, as co-applicants, filed an application with the Commission seeking relief from certain provisions of the Investment Company Act of 1940 (“1940 Act”) to permit them to offer ETMFs. The Commission published notice of this application (“Notice of Application for Exemptive Relief”) on November 6, 2014. See Investment Company Act Release No. 31333 (Nov. 6, 2014) (Eaton Vance Management, et al.; Notice of Application). Navigate Fund Solutions LLC (“Navigate”) owns patent rights and other protected intellectual property relating to ETMFs and NAV-Based Trading that it intends to license to Nasdaq to support the listing and trading of ETMFs that have themselves entered into license agreements with Navigate.

⁹ See Securities Exchange Act Release No. 72987 (Sept. 4, 2014), 79 FR 53808 (Sept. 10, 2014) (SR-NASDAQ-2014-020).

Exchange filed Amendment No. 1 to the proposed rule change.¹⁰ Thereafter, the Commission received two additional comment letters on the proposed rule change.¹¹ The Commission is publishing this notice to solicit comments from interested persons on Amendment No. 1 to the proposed rule change and is approving the proposed rule change, as modified by Amendment No. 1 thereto, on an accelerated basis.

II. Description of the Proposal¹²

The Exchange proposes to adopt new Nasdaq Rule 5745 to govern the listing and trading of ETMF Shares.¹³ At this time, Nasdaq is not proposing to list any ETMF Shares under new Nasdaq Rule 5745.¹⁴ Unlike actively-managed exchange-traded funds, ETMFs will not be

¹⁰ In Amendment No.1, Nasdaq confirmed that all ETMFs listed on the Exchange will have a unique identifier associated with their ticker symbols and that, in the systems used to transmit and process transactions in ETMF Shares, an ETMF's next-determined NAV will be represented by a proxy price. Previously, the filing stated that Nasdaq expects all ETMFs listed on the Exchange to have a unique identifier associated with their ticker symbols and that Nasdaq expects an ETMF's next-determined NAV to be represented by a proxy price. Additionally, the Exchange removed references to ETMF entry and annual fees as the Exchange intends to address such fees in a separate filing.

¹¹ See Letters to the Commission from Daniel J. McCabe, Chief Executive Officer, Precidian Investments LLC ("Precidian"), dated October 30, 2014 ("Precidian Letter") and Thomas E. Faust, Jr., Chairman and Chief Executive Officer, on behalf of Eaton Vance, dated October 31, 2014 ("Eaton Vance Response Letter").

¹² The Commission notes that more detailed information regarding the proposal is included in the Notice. See Notice, supra note 3.

¹³ Nasdaq intends to enter into a license agreement to allow for the listing and trading of ETMF Shares on the Exchange. The Exchange states that aspects of ETMFs and NAV-Based Trading (described below) are protected intellectual property subject to issued and pending U.S. patents held by Navigate, a wholly owned subsidiary of Eaton Vance Corporation. Nasdaq will enter into a license agreement with Navigate to allow for NAV-Based Trading on the Exchange of ETMFs that have themselves entered into license agreements with Navigate.

¹⁴ Nasdaq Rule 5745(b)(1) provides that Nasdaq will file separate proposals under Section 19(b) of the Act before the listing of any specific ETMF Shares.

required under Nasdaq Rule 5745 to disclose their holdings on a daily basis.¹⁵ The Exchange states that, as required for traditional open-end investment companies, ETMFs will disclose their full portfolio positions at least quarterly, with a delay (not to exceed 60 days). Nasdaq will deem ETMF Shares to be equity securities, thus rendering trading in ETMF Shares subject to Nasdaq's existing rules governing the trading of equity securities.

ETMF Shares will trade on Nasdaq using a new trading protocol called "NAV-Based Trading."¹⁶ In NAV-Based Trading, as described in Nasdaq Rule 5745(b)(3), all bids, offers, and execution prices will be expressed as a premium/discount (which may be zero) to the ETMF's next-determined net asset value, or NAV¹⁷ (e.g., NAV-\$0.01; NAV+\$0.01). An ETMF's NAV will be determined each business day, normally as of 4:00 p.m. Eastern Time. Executions using NAV-Based Trading will be binding at the time orders are matched on Nasdaq's facilities, with the transaction prices contingent upon the determination of the ETMF's NAV at the end of the business day.¹⁸

Member firms will utilize existing order types and interfaces to transmit ETMF Share bids and offers to Nasdaq, which will process ETMF Share trades like trades in shares of ETFs

¹⁵ Nasdaq lists actively-managed funds under Nasdaq Rule 5735, which requires the identities and quantities of the securities and other assets held by a fund to be disseminated at least once daily. See Nasdaq Rule 5735 (d)(2)(B)(i).

¹⁶ Nasdaq represents that all ETMFs listed on the Exchange will have a unique identifier associated with their ticker symbols, which would indicate that their Shares are traded using NAV-Based Trading. See Amendment No. 1, supra note 10.

¹⁷ As with other registered open-end investment companies, the NAV of ETMF Shares generally would be calculated daily Monday through Friday as of the close of regular trading on the New York Stock Exchange, normally 4:00 p.m. Eastern Time. NAV would be calculated by dividing the ETMF's net asset value by the number of ETMF Shares outstanding. See Notice at note 9, supra note 3.

¹⁸ Because, in NAV-Based Trading, prices of executed trades are not determined until the reference NAV is calculated, buyers and sellers of ETMF Shares during the trading day will not know the final value of their purchases and sales until the end of the trading day.

and other listed securities. Nasdaq represents that an ETMF's next-determined NAV will be represented by a proxy price (e.g., 100.00) and a premium/discount of a stated amount to the next-determined NAV to be represented by the same increment/decrement from the proxy price used to denote NAV (e.g., NAV-\$0.01 would be represented as 99.99; NAV+\$0.01 as 100.01).¹⁹ To avoid potential investor confusion, Nasdaq will work with member firms and providers of market data services to seek to ensure that representations of intraday bids, offers, and execution prices for ETMFs that are made available to the investing public follow the "NAV-\$0.01/NAV+\$0.01" (or similar) display format, rather than displaying proxy prices.

Nasdaq will report intraday bids, offers, and trades for ETMFs in real-time to the Consolidated Tape using the proxy price format. In addition, Nasdaq will disseminate intraday ETMF bids, offers, and trades through a proprietary exchange data feed using the NAV + \$.01 / NAV - \$.01 format.²⁰ The Exchange will also provide the member firms participating in each ETMF Share trade with a contemporaneous notice of trade execution, indicating the number of

¹⁹ See Amendment No. 1, supra note 10. Order transmission and processing systems currently in common use by exchanges and member firms are generally not designed to accommodate pricing arrangements, such as NAV-Based Trading, in which bids, offers, and execution prices are determined by reference to a price or value that is unknown at the time of trade execution. Compared to the alternative of building and maintaining (and requiring member firms to build and maintain) a dedicated NAV-Based Trading order transmission and processing system, the Exchange believes that the proposed approach (using, for processing purposes, a proxy price to represent next-determined NAV) offers major advantages in terms of cost, efficiency, and time to implement. To convert proxy prices used to represent intraday bids, offers, and execution prices into prices expressed in relation to the next-determined NAV, member firms would subtract from the reported proxy price (e.g., 99.99) the proxy for NAV (e.g., 100.00) and insert "NAV" in front of the calculated number expressed in dollars (e.g., 99.99 - 100.00 = -0.01, expressed as "NAV-\$0.01").

²⁰ The ETMF bid, offer, and trade information disseminated to the Consolidated Tape will be the same information disseminated through a proprietary Nasdaq data feed and will differ only in the format in which the information is provided (proxy price format on the Consolidated Tape versus NAV plus or minus format on the proprietary Nasdaq data feed).

ETMF Shares bought or sold and the executed premium/discount to NAV.²¹

After the Reporting Authority (defined below) calculates an ETMF's NAV and provides this information to the Exchange, Nasdaq will price each ETMF Share trade entered into during the day at the ETMF's NAV plus/minus the trade's executed premium/discount. Using the final trade price, each ETMF Share trade will then be disseminated through a proprietary exchange data feed and confirmed to the member firms participating in the trade, supplementing the previously provided information with final pricing information. After the final trade price is determined, Nasdaq will deliver the ETMF Share trading data to the National Securities Clearing Corporation ("NSCC") for clearance and settlement, following the same processes used for the clearance and settlement of trades in other exchange-traded securities.

Proposed Listing Rules for Exchange-Traded Managed Fund Shares

Nasdaq Rule 5745(b)(1) provides that Nasdaq will file separate proposals under Section 19(b) of the Act before the listing of any specific ETMF Shares. Nasdaq Rule 5745(b)(2) provides that transactions in ETMF Shares will occur during Nasdaq's Regular Market Session through 4:00 p.m.²² Nasdaq Rule 5745(b)(3) provides that ETMF Shares will trade on Nasdaq at market-determined premiums or discounts to the next-determined NAV, and that the minimum price variation for quoting and entry of orders in ETMF Shares will be \$0.01. Nasdaq Rule 5745(b)(4) provides that Nasdaq will implement written surveillance procedures for ETMF Shares. Nasdaq Rule 5745(b)(5) provides that, for ETMF Shares based on an international or global portfolio, the statutory prospectus or the application for exemption from provisions of the

²¹ All orders to buy or sell an ETMF Share that are not executed on the day the order is submitted would be automatically cancelled as of the close of trading on such day.

²² Nasdaq Rule 4120(b)(4) defines the Regular Market Session as the trading session from 9:30 a.m. to 4:00 p.m. or 4:15 p.m. ETMF Shares would trade until 4:00 p.m.

1940 Act for such series of ETMF Shares must state that such series must comply with the federal securities laws in accepting securities for deposit and satisfying redemptions with securities, including that the securities accepted for deposit and the securities used to satisfy redemption requests are sold in transactions that would be exempt from registration under the Securities Act of 1933 ("Securities Act").

Definitions. Nasdaq Rule 5745(c)(1) defines the term "ETMF Share" as a security that: (1) represents an interest in a registered investment company organized as an open-end management investment company that invests in a portfolio of securities and other assets selected and managed by the ETMF's investment adviser consistent with the ETMF's investment objectives and policies; (2) is issued in specified aggregate unit quantities in return for a deposit of a specified portfolio of securities and/or a cash amount with a value per Share equal to the ETMF's NAV; (3) when aggregated in the same specified unit quantities, may be redeemed in exchange for a specified portfolio of securities and/or cash with a value per Share equal to the ETMF's NAV; and (4) is traded on Nasdaq or another national securities exchange using NAV-Based Trading, including pursuant to unlisted trading privileges.

In addition, Nasdaq Rule 5745(c)(2) defines the term "Intraday Indicative Value" ("IIV") as the estimated indicative value of an ETMF Share based on current information regarding the value of the securities and other assets held by the ETMF. Nasdaq Rule 5745(c)(3) defines the term "Composition File" as the specified portfolio of securities and/or cash that an ETMF will accept as a deposit in issuing ETMF Shares and the specified portfolio of securities and/or cash that an ETMF will deliver in a redemption of ETMF Shares. The current Composition File will be disseminated through the NSCC once each business day before the open of trading in ETMF Shares on Nasdaq on such day. To maintain the confidentiality of current portfolio trading, an

ETMF's Composition File generally will not be a pro rata reflection of the ETMF's securities positions. Each security included in the Composition File will be a current holding of the ETMF, but the Composition File generally will not include all of the securities in the ETMF's portfolio or match the weightings of the included securities in the portfolio. The Composition File also may consist entirely of cash, in which case it would not include any of the securities in the ETMF's portfolio.

Nasdaq Rule 5745(c)(4) defines the term "Reporting Authority" as Nasdaq, an institution or a reporting service designated by Nasdaq as the official source for calculating and reporting information relating to such series of ETMF Shares, including, but not limited to, the IIV, the amount of any cash distribution to holders of ETMF Shares, NAV, the Composition File, or other information relating to the issuance, redemption, or trading of ETMF Shares. A series of ETMF Shares may have more than one Reporting Authority, each having different functions.

Initial and Continued Listing. Nasdaq Rule 5745(d) sets forth the initial and continued listing criteria applicable to ETMF Shares. Nasdaq Rule 5745(d)(1)(A) provides that, for each series of ETMF Shares, Nasdaq will establish a minimum number of ETMF Shares required to be outstanding at the time of commencement of trading. In addition, under Nasdaq Rule 5745(d)(1)(B), Nasdaq will obtain a representation from the issuer of each series of ETMF Shares that the NAV for such series will be calculated on each business day that the New York Stock Exchange is open for trading and that the NAV will be made available to all market participants at the same time. Under Nasdaq Rule 5745(d)(1)(C), the Reporting Authority that provides the Composition File must implement and maintain, or be subject to, procedures designed to prevent the use and dissemination of material, non-public information regarding the ETMF's portfolio positions and changes in positions.

Nasdaq Rule 5745(d)(2)(A) provides that each series of ETMF Shares could continue to be listed and traded if the IIV for the ETMF Shares is widely disseminated by one or more major market data vendors at intervals of not more than 15 minutes during the Regular Market Session when the ETMF Shares trade on Nasdaq. As stated in the Notice, the purpose of IIVs in NAV-Based Trading is to enable investors to determine the number of ETMF Shares to buy or sell if they want to transact in an approximate dollar amount. For this purpose, Nasdaq believes that dissemination of IIVs at intervals of not more than 15 minutes should generally be sufficient. The Exchange states that more frequent dissemination of IIVs may increase fund costs without apparent benefit and could focus unwarranted investor attention on these disclosures. Moreover, for certain strategies, more frequent IIV disclosure could provide unintended information about current portfolio trading activity to market participants who possess the requisite analytical capabilities, computation power, and motivation to reverse engineer the ETMF's portfolio positions. An ETMF will be permitted to disseminate IIVs at intervals of less than 15 minutes, but would not be required to do so to maintain trading on the Exchange.

Nasdaq Rule 5745(d)(2)(B) provides that Nasdaq will consider the suspension of trading in, or removal from listing of, a series of ETMF Shares under any of the following circumstances: (1) if, following the initial twelve-month period after commencement of trading on the Exchange of a series of ETMF Shares, there are fewer than 50 beneficial holders of the series of ETMF Shares for 30 or more consecutive trading days; (2) if the ETMF's IIV or NAV is no longer calculated or if its IIV, NAV, or Composition File is no longer available to all market participants at the same time; (3) if the ETMF has failed to submit any filings required by the Commission or if Nasdaq is aware that the ETMF is not in compliance with the conditions of any exemptive order or no-action relief granted by the Commission with respect to the series of

ETMF Shares; or (4) if such other event shall occur or condition exists which, in the opinion of Nasdaq, makes further dealings on Nasdaq inadvisable.

Nasdaq Rule 5745(d)(2)(C) provides that, if the IIV of a series of ETMF Shares is not being disseminated as required, Nasdaq may halt trading during the day in which the interruption to the dissemination of the IIV occurs. If the interruption to the dissemination of the IIV persists past the trading day in which it first occurred, Nasdaq will halt trading no later than the beginning of the trading day following the interruption. In addition, if the Exchange becomes aware that the NAV with respect to a series of ETMF Shares is not calculated on each business day that the New York Stock Exchange is open for trading and disseminated to all market participants at the same time, it will halt trading in such series until such time as the NAV is available to all market participants at the same time. If Nasdaq becomes aware that the Composition File with respect to a series of ETMF Shares is not disseminated to all market participants at the same time, it will halt trading in such series until such time as the Composition File is available to all market participants at the same time.

In addition, Nasdaq Rule 5745(d)(2)(D) provides that, upon termination of an ETMF, the ETMF Shares issued in connection with such entity must be removed from listing on Nasdaq. Nasdaq Rule 5745(d)(2)(E) provides that voting rights must be as set forth in the applicable ETMF prospectus.

Additional Provisions. Nasdaq Rule 5745(e) provides that neither Nasdaq, the Reporting Authority, nor any agent of Nasdaq shall have any liability for damages, claims, losses, or expenses caused by any errors, omissions, or delays in calculating or disseminating any of the following: the current portfolio value; the current value of the securities and other assets required to be deposited in connection with the issuance of ETMF Shares; the amount of any

dividend-equivalent payment or cash distribution to holders of ETMF Shares; NAV; the Composition File; or other information relating to the purchase, redemption, or trading of ETMF Shares, resulting from any negligent act or omission by Nasdaq, the Reporting Authority, or any agent of Nasdaq, or any act, condition, or cause beyond the reasonable control of Nasdaq, its agent, or the Reporting Authority, including, but not limited to, an act of God, fire, flood, extraordinary weather conditions, war, insurrection, riot, strike, accident, action of government, communications or power failure, equipment or software malfunction, or any error, omission, or delay in the reports of transactions in one or more underlying securities.

Nasdaq Rule 5745(f) applies only to series of ETMF Shares that are the subject of an order by the Commission exempting such series from certain prospectus delivery requirements under Section 24(d) of the 1940 Act and are not otherwise subject to prospectus delivery requirements under the Securities Act. Nasdaq will inform its members regarding application of Nasdaq Rule 5745(f) to a particular series of ETMF Shares by means of an information circular prior to commencement of trading in such series. Under the rule, Nasdaq requires that members provide to all purchasers of a series of ETMF Shares a written description of the terms and characteristics of those securities, in a form prepared by the open-end management investment company issuing such securities, not later than the time a confirmation of the first transaction in such series is delivered to such purchaser. In addition, members shall include such a written description with any sales material relating to a series of ETMF Shares that is provided to customers or the public. Any other written materials provided by a member to customers or the public making specific reference to a series of ETMF Shares as an investment vehicle must include a statement in substantially the following form: "A circular describing the terms and characteristics of (the series of ETMF Shares) has been prepared by the (open-end management

investment company name) and is available from your broker. It is recommended that you obtain and review such circular before purchasing (the series of ETMF Shares).” A member carrying an omnibus account for a non-member broker-dealer is required to inform such non-member that execution of an order to purchase a series of ETMF Shares for such omnibus account would be deemed to constitute agreement by the non-member to make such a written description available to its customers on the same terms as are directly applicable to members under this rule. Upon request of a customer, a member shall also provide a prospectus for the particular series of ETMF Shares.

Nasdaq Rule 5745(g) provides that, if the investment adviser to an ETMF issuing Shares is a registered broker-dealer or affiliated with a broker-dealer, such investment adviser shall erect a “fire wall” between the investment adviser and the broker-dealer personnel or broker-dealer affiliate, as applicable, with respect to access to information concerning the composition and/or changes to such ETMF’s portfolio holdings. Personnel who make decisions on the ETMF’s portfolio composition must be subject to procedures designed to prevent the use and dissemination of material, non-public information regarding the applicable ETMF portfolio.

Other Rule Changes

The Exchange is also making conforming changes to: (1) Nasdaq Rule 4120(a)(9) and (10) to add provisions applicable to ETMF Shares with respect to trading halts; (2) Nasdaq Rule 4120(b)(4)(A) and (E) to modify certain defined terms to include references to ETMF Shares; and (3) Nasdaq Rule 5615(a)(5) and IM-5615-4 to add references to ETMFs for purposes of

certain corporate governance requirements.²³

III. Summary of Comment Letters

As noted above, the Commission received a total of seven comment letters from six commenters concerning the Exchange's proposal.²⁴ Five of the commenters support the proposal, and one commenter opposes the proposal. Generally, the supporting commenters believe that ETMFs could offer investment managers and investors a tax-efficient alternative to today's mutual funds.²⁵ In addition to the benefits of tax-efficiency, some commenters state their belief that ETMFs would offer the benefits of lower costs to investors as a result of lower expenses,²⁶ and one commenter states its belief that a benefit would be transparency of ETMF transaction costs.²⁷ The same commenter also states its view that the non-disclosed nature of the ETMF portfolio would serve as a barrier to front-running of portfolio trades of actively managed funds and that the proposed ETMFs would promote renewed competition in the fund marketplace by encouraging investment managers concerned about maintaining the confidentiality of their portfolio trading to offer their leading strategies in a better performing product structure.²⁸ The opposing commenter, however, believes that ETMFs would likely not provide tax benefits and may cost more to operate than existing ETFs, because the ETMF will be

²³ The Exchange also is making certain other minor technical changes to these rules unrelated to ETMFs. Specifically, the Exchange is amending Rules 4120(a)(9), (b)(4)(A), and (b)(4)(E) to include appropriate references to various derivative securities defined in Rule 5711, and to make certain other typographical corrections and clarifications.

²⁴ See supra notes 4, 8, and 11.

²⁵ See MMI Letter; Tull Letter; Strategic Insight Letter; ConvergeX Letter at 1; and Eaton Vance Letter at 2, supra notes 4 and 8.

²⁶ See Tull Letter; Strategic Insight Letter; and ConvergeX Letter at 1, supra note 4.

²⁷ See Tull Letter, supra note 4.

²⁸ Id.

forced to rebalance its portfolio every time there is a creation or redemption causing the fund to incur additional costs.²⁹ In response to the opposing commenter, Eaton Vance, the sponsor of ETMFs, states its view that the more relevant comparison for ETMFs is mutual funds and that it expects ETMFs to achieve significant performance and tax efficiency advantages over similar mutual funds by utilizing in-kind purchases and redemptions and by imposing Creation Unit transaction fees to offset the associated processing and trading costs to the fund.³⁰ The opposing commenter also states its view that NAV-Based Trading provides no discernable benefit to investors and would likely add to investor confusion because the proposal would allow the listing of products on an exchange that would not trade at current market prices.³¹ In response, Eaton Vance acknowledges that ETMF Shares will not trade at prices determined intraday, but notes that each ETMF's registration statement, website, and any advertising or marketing materials will include prominent disclosure of this fact.³² Eaton Vance further responds with its view that ETMFs provide several advantages over traditional mutual funds³³ and actively managed ETFs.³⁴

²⁹ See Precidian Letter at 5-6, supra note 11. Precidian states its view that the fewer securities contained in the creation or redemption basket, the worse the problem becomes.

³⁰ See Eaton Vance Response Letter at 6, supra note 11.

³¹ See Precidian Letter at 2, supra note 11. Precidian states its belief that intraday liquidity is a foundational principle of exchanges and the secondary market as a whole.

³² See Eaton Vance Response Letter at 3, supra note 11. Eaton Vance also responded to concerns about investor confusion in its first comment letter. See infra notes 43-51 and accompanying text.

³³ Eaton Vance believes that the potential advantages ETMFs have over mutual funds are: (a) protecting fund shareholders from the dilutive effects of other shareholders' transactions; (b) protecting fund shareholders from tax realizations in connection with other shareholders' transactions; (c) realizing savings in shareholder servicing and other fund expenses; and (d) enhancing the competitiveness of fund distribution. See Eaton Vance Response Letter at 3-4, supra note 11.

In addition, several commenters state their belief about the potential positive impact the proposed ETMF product may have on arbitrage and pricing. Specifically, one commenter states its view that NAV-Based Trading for ETMFs should expand market maker opportunities as the arbitrage moves towards order management control and away from sophisticated arbitrage pricing models using real-time pricing that makes it difficult for an investor to calculate personal market entry and exit costs.³⁵ Another commenter states its view that, because ETMFs could promote competition in the fund marketplace, such competition might enable ETMFs to trade close to the underlying fund value on a consistent basis.³⁶ The opposing commenter, however, believes that market professionals will be unable to effectively hedge their ETMF positions due to a stale and possibly inaccurate IIV that is published every 15 minutes.³⁷ Eaton Vance responds to the opposing commenter by stating that the sole purpose of the IIV is to help investors determine the number of ETMF Shares to buy or sell if they want to transact in an approximate dollar amount and that market makers will never have any reason to refer to the IIV in connection with their market making function.³⁸ In response to the need for a market maker to hedge their ETMF positions, Eaton Vance asserts that a market maker holding positions in ETMF Shares is not exposed to intraday market risk, and, as such, there would be no need for

³⁴ Eaton Vance believes that the potential advantages ETMFs have over actively managed ETFs are: (a) maintaining the confidentiality of portfolio trading activity; (b) providing trade execution cost transparency and quality control to fund investors; and (c) facilitating tight bid-ask spreads and narrow premiums/discounts in secondary market trading. See Eaton Vance Response Letter at 3-4, supra note 11.

³⁵ See Tull Letter, supra note 4.

³⁶ See ConvergEx Letter at 2, supra note 4.

³⁷ See Precidian Letter at 5, supra note 11.

³⁸ See Eaton Vance Response Letter at 5, supra note 11.

market makers to hedge their positions intraday.³⁹

One commenter states its view that the promise of ETMFs can be realized if a “common Chassis” is adopted by multiple fund managers, who would then simultaneously educate the marketplace about the benefits of ETMFs.⁴⁰ The same commenter also believes that the adoption curve of ETMFs might parallel the acceleration in the use of mutual funds triggered by the introduction in the early 1990s of the Schwab’s Mutual Fund OneSource® supermarket, when numerous fund managers articulated the benefit of a common administrative platform.⁴¹ The commenter concludes that ETMFs have the potential to significantly improve returns to investors in actively-managed funds, and to encourage additional investment and savings by millions of American over the coming decades.⁴²

In response to the questions raised in the Order Instituting Proceedings regarding the ability of market participants to fully understand NAV-Based Trading and the public availability of information for ETMFs, Eaton Vance submitted a comment letter stating that the Exchange intends to provide members with a detailed explanation of NAV-Based Trading through a Trading Alert and will inform members of the special characteristics and risks associated with trading ETMF Shares in an information circular – both to be issued prior to the commencement of ETMF trading.⁴³ Additionally, Eaton Vance states that, in conjunction with the Exchange’s communications to its members, it will also educate the marketplace through its website materials and disclosures in fund prospectuses and marketing literature by focusing on the key

³⁹ See Eaton Vance Response Letter at 6, supra note 11.

⁴⁰ See Strategic Insight Letter, supra note 4.

⁴¹ Id.

⁴² Id.

⁴³ See Eaton Vance Letter at 3, supra note 8.

distinctions of ETMF investing which will include: (a) how to enter orders; (b) how to use IIV to help size ETMF orders; (c) the portfolio disclosures of ETMFs; and (d) the risks of NAV-Based Trading.⁴⁴ Further, Eaton Vance emphasizes that it would make available an extensive library of ETMF educational materials and would maintain a website to provide a comprehensive, one-stop source of market information and investor education regarding ETMFs and NAV-Based Trading.⁴⁵ Eaton Vance believes that these methods will provide adequate information to support NAV-Based Trading.⁴⁶

In response to the Commission's concerns regarding public availability of ETMF trading information, Eaton Vance states that NAV-Based trade prices, best bids and offers for ETMF Shares, volume of ETMF Shares traded, and other intraday trading information will be continuously available for ETMFs on a real-time basis throughout each trading day on brokers' computer terminals and electronic market data services.⁴⁷ In addition, Eaton Vance represents that it and Nasdaq will work with the Exchange's members and providers of market data services to ensure that representation of intraday bids, offers, and trade prices for ETMFs follow a "NAV-\$0.01/NAV+\$0.01" display format in an effort to avoid investor confusion.⁴⁸ Eaton Vance further states that all ETMFs listed on Nasdaq will have a unique identifier associated with their

⁴⁴ Id.

⁴⁵ See Eaton Vance Letter at 4, supra note 8.

⁴⁶ Id.

⁴⁷ Id.

⁴⁸ Id. The opposing commenter believes that ETMF pricing displayed in proxy prices will be confusing to investors. See Precidian Letter at 5, supra note 11. In response, Eaton Vance reiterates that it and the Exchange are working with member firms and providers of market data to ensure that representations of intraday bids, offers, and execution prices for ETMFs that are available to the public consistently follow the NAV + \$.01 / NAV - \$.01 display format. See Eaton Vance Response Letter at 5, supra note 11.

ticker symbols indicating that the Shares are trading using NAV-Based Trading.⁴⁹ Finally, Eaton Vance states that it will maintain a public website for ETMFs that will disclose, among other things, detailed fund information and contain links to current fund documents, including a fact sheet, summary and full prospectuses, statement of additional information, and shareholder reports for each fund.⁵⁰ According to Eaton Vance, this website will also display per Share, the prior trading day's NAV and the following trading information for such day: (a) intraday high, low, average, and closing prices of Shares in exchange trading; (b) the midpoint of the highest bid and lowest offer prices as of the close of exchange trading (expressed as a premium/discount to NAV); (c) the spread between highest bid and lowest offer prices as of the close of exchange trading; and (d) volume of Shares traded. Eaton Vance believes that such trading information will provide useful guidance to current buyers and sellers of Shares and accordingly believes there will be minimal risk of investor confusion.⁵¹

The opposing commenter raises several other concerns.⁵² The opposing commenter states its belief that a market professional buying ETMF Shares from an investor would have an economic interest in providing the worst price to the investor.⁵³ In response, Eaton Vance states

⁴⁹ See Eaton Vance Letter at 5, supra note 8. See also Eaton Vance Response Letter at 5, supra note 11.

⁵⁰ See Eaton Vance Letter at 5, supra note 8.

⁵¹ Id.

⁵² The opposing commenter states its belief that ETMFs are not redeemable securities. See Precidian Letter at 2, supra note 11. In response, Eaton Vance states that it believes ETMFs satisfy the definition of a "redeemable security" as defined in the 1940 Act, but because the shares would not be individually redeemable, Eaton Vance has requested exemptive relief under the 1940 Act. See Eaton Vance Response Letter at 2, supra note 11. Eaton Vance's request for exemptive relief is currently before the Commission. See supra note 8.

⁵³ See Precidian Letter at 2, supra note 11.

that ETMF Shares are no different from other traded securities and that market forces exert pressure on market professionals to offer competitive prices to investors, so that a market maker who seeks to trade ETMF Shares at uncompetitive prices will not attract the volume of trading required to earn meaningful profits.⁵⁴ The opposing commenter also states its view that traders who accumulate large ETMF positions will be incentivized to move the NAV in their favor.⁵⁵ Eaton Vance responds with its view that this is “completely false,” as the amount of profit a market maker or other trader earns by trading ETMFs is not affected by movements in the NAV.⁵⁶ Eaton Vance argues that it doesn’t matter whether an ETMF’s NAV has moved higher or lower intraday as no level of NAV provides market makers with more profit than any other NAV.⁵⁷

The opposing commenter also argues that because an ETMF’s trade price is not determined until the end of the day, there may be significant problems for brokers and investors with respect to determining the buying power of an investor’s account.⁵⁸ For example, the commenter argues that an investor with a cash account may not have sufficient funds in the account to cover a purchase of an ETMF entered into during the day if the ETMF’s NAV at the end of the day is higher than the investor expected.⁵⁹ In response, Eaton Vance states that, based on extensive discussions with multiple broker-dealers and a review of broker-dealer account funding guidelines, Eaton Vance believes that broker-dealer account control procedures are

⁵⁴ See Eaton Vance Response Letter at 3, supra note 11.

⁵⁵ See Precidian Letter at 2, supra note 11.

⁵⁶ See Eaton Vance Response Letter at 3, supra note 11.

⁵⁷ Id. Eaton Vance’s response does not appear to take into account a trader holding a position overnight or longer. See infra notes 82-83 and accompanying text.

⁵⁸ See Precidian Letter at 3, supra note 11.

⁵⁹ See id.

adequate to accommodate trading of ETMF Shares and to mitigate the associated risks of inadequate investor account funding.⁶⁰ The opposing commenter further questions how brokers will be able to calculate their net capital at any point in time during the day, noting its view that a firm with ETMF positions would not be able to determine the value of its ETMF positions during the day as quotes and last-sale prices are based on a future price, and the IIV is only published at 15 minute intervals.⁶¹ In response, Eaton Vance states its belief that ETMFs are likely not the only asset held by broker-dealers that does not lend itself to minute-by-minute intraday updated valuations.⁶² Eaton Vance further states that, based on how it expects ETMF market making to function, it does not believe that market makers will hold large ETMF inventory positions and that an ETMF market maker operating within relatively tight limits of its net capital requirement may build a buffer into the valuation of its ETMF positions to ensure continued capital adequacy.⁶³

Further, the opposing commenter states its view that inclusion of foreign stocks in an ETMF's portfolio will create problems in calculating the ETMF's NAV.⁶⁴ The opposing commenter argues that if a portfolio includes stocks that trade in different time zones, it may be impossible to accurately set the NAV until the foreign market opens for trading.⁶⁵ The opposing commenter believes that this would require the NSCC to reduce the settlement cycle for the portfolio's securities and would lessen the time that brokers can prepare confirmations, resulting

⁶⁰ See Eaton Vance Response Letter at 4, supra note 11.

⁶¹ See Precidian Letter at 4, supra note 11.

⁶² See Eaton Vance Response Letter at 4, supra note 11.

⁶³ Id.

⁶⁴ See Precidian Letter at 3-4, supra note 11.

⁶⁵ See id. at 3, supra note 11.

in a delay in calculating margin calls and other time critical problems, such as stale pricing of the IIV.⁶⁶ In response, Eaton Vance states that mutual funds holding foreign securities routinely apply fair value pricing procedures to determine their daily NAV, and it expects ETMFs to do the same.⁶⁷

Finally, the opposing commenter raises the concern that brokerage firms, vendors, the Consolidated Tape, and quote system operators will have to alter their systems to support the ETMFs' price quotations of NAV+/NAV- notations.⁶⁸ With regard to the Consolidated Tape, Eaton Vance does not believe that this is a valid concern, stating that ETMF trading prices and quotes will be reported in proxy price format requiring no special changes to the Consolidated Tape.⁶⁹ Eaton Vance further states that the process of buying and selling ETMFs will be similar to buying and selling other exchange-traded securities, with the only significant distinction being that the price limits for limit orders will be expressed relative to NAV rather than as an absolute dollar price.⁷⁰ Further, according to Eaton Vance, the execution, reporting, clearance, and settlement of ETMF trades will be substantially the same as for other exchange-traded securities. Separately, based on discussions with broker-dealers and providers of market data services, Eaton Vance believes that any systems modifications to accommodate ETMFs will be relatively modest and can readily be achieved in a timely manner.⁷¹

⁶⁶ See *id.* at 4, *supra* note 11.

⁶⁷ See Eaton Vance Response Letter at 4, *supra* note 11.

⁶⁸ See Precidian Letter at 4, *supra* note 11.

⁶⁹ See Eaton Vance Response Letter at 5, *supra* note 11.

⁷⁰ See *id.*

⁷¹ See *id.*

IV. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rule and regulations thereunder applicable to a national securities exchange.⁷² In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,⁷³ which requires that the rules of an exchange be designed, among other things, to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest. The Commission finds that Nasdaq's proposal contains adequate rules and procedures to govern the listing and trading of ETMFs on the Exchange. Except for certain requirements relating to the daily disclosure of the fund portfolio, dissemination of the IIV, and NAV-Based trading (as discussed further below), the proposed listing standards of new Nasdaq Rule 5745 are substantively identical to the provisions of Nasdaq Rule 5735, which governs the listing of Managed Fund Shares on the Exchange. Further, all securities listed under proposed Nasdaq Rule 5745 will be subject to the full panoply of Nasdaq rules and procedures that currently govern the trading of equity securities on the Exchange, except that ETMFs will trade using NAV-Based Trading.

As noted, ETMF Shares will not provide a "Disclosed Portfolio" on a daily basis.⁷⁴ According to the Exchange, the purpose of the daily portfolio disclosure requirement for actively-managed ETFs is to provide market makers in those products with the portfolio

⁷² In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

⁷³ 15 U.S.C. 78f(b)(5).

⁷⁴ In contrast, Nasdaq Rule 5735 requires Managed Fund Shares to disclose publicly their full portfolio positions at least once daily.

information needed to hedge the intraday market risk they assume as they take inventory positions in the ETF shares in connection with their market making activities. Nasdaq states that, in ETF trading, a condition to maintaining a tight relationship between market-based trading prices for the ETF shares and contemporaneous ETF underlying portfolio values is that market makers have sufficient information regarding portfolio positions to enable them to earn reliable arbitrage profits by entering into long (or short) positions in ETF shares and offsetting short (or long) positions in the underlying holdings (or a suitable proxy). Nasdaq states that, in ETMF trading, by contrast, a market maker will assume no intraday market risk in connection with its inventory positions in ETMF shares because all ETMF Share transaction prices are based on the next-determined NAV.⁷⁵ According to the Exchange, the process that connects ETMF trading prices to the NAV of the shares of ETMFs is effected at the end of each trading day when a market maker creates (redeems) Creation Units of ETMF Shares through an Authorized Participant to offset the net amount of ETMF Shares it has sold (bought) over the course of the trading day, and buys (sells) the quantity of Composition File instruments corresponding to the

⁷⁵ According to the Exchange, whether an ETMF's underlying value goes up or down over the course of a trading day would not affect how much profit a market maker earns by selling (or buying) ETMF Shares in the market at a net premium (discount) to NAV, and then creating (redeeming) an offsetting number of ETMF Shares at the end of the day in transactions with the ETMF. The Exchange states that no intraday market risk means no requirement for intraday hedging, and therefore no associated requirement for portfolio disclosure to maintain a tight relationship between ETMF Share trading prices and the NAV of the ETMF.

number of Creation Units created (redeemed).⁷⁶

The Exchange states that, different from actively-managed ETFs, ETMFs offer market makers a profit opportunity that does not depend on either corresponding intraday adjustments in ETMF Share and underlying portfolio positions or the use of a hedge portfolio to manage intraday market risk.⁷⁷ According to the Exchange, because the mechanism that underlies ETMF trading is simpler, more reliable, and exposes market makers to less risk than actively-managed ETF arbitrage, market makers should require less profit inducement to establish and maintain markets in ETMF Shares than for actively-managed ETFs, thereby enabling ETMFs to routinely trade at smaller premiums/discounts and narrower bid-ask spreads.

The Commission agrees that ETMFs will offer market makers a profit opportunity that

⁷⁶ The Exchange states that an ETMF market maker that creates (redeems) a Creation Unit at the end of a trading day to offset its net intraday sales (purchases) of a Creation Unit quantity of ETMF Shares would earn profits to the extent that it either sells (buys) Shares at an aggregate premium (discount) to NAV or buys (sells) a Creation Unit-equivalent quantity of Composition File instruments at an aggregate discount (premium) to their end-of-day values, and the net amount of ETMF premium (discount) plus Composition File instruments discount (premium) exceeds the transaction fee that applies to a creation (redemption) of a Creation Unit of ETMF Shares. Nasdaq further states that this process is simplified for cash creations and redemptions, stating that an ETMF market maker that creates (or redeems) a Creation Unit in cash to offset its net intraday sales (purchases) of a Creation Unit quantity of ETMF Shares would earn profits to the extent that it sells (buys) ETMF Shares in the secondary market at an aggregate premium (discount) to NAV that exceeds the transaction fee that applies to a cash creation (redemption) of a Creation Unit of ETMF Shares.

⁷⁷ According to the Exchange, market makers are expected generally to seek to minimize their exposure to price risk in ETMF Shares by holding little or no overnight inventory. The Exchange states that establishing Creation Unit sizes for ETMFs that are somewhat smaller (i.e., in a range of 5,000 to 50,000 Shares) than is customary for ETFs should facilitate tighter market maker inventory management. To the extent that market makers hold small positions in ETMF Shares overnight, they are expected to aggregate such holdings with other risk positions and transact at or near the market close to buy or sell offsetting positions in appropriate, broad-based hedging instruments. Nasdaq states that such hedging of overnight inventory risk on a macro basis does not require disclosure of non-Composition File portfolio positions.

does not require intraday hedging of ETMF Share price movements or changes in the value of the underlying portfolio positions. Because market makers will not need to engage in intraday hedging, the Commission believes that daily portfolio disclosure is not necessary. The Commission believes that NAV-Based Trading removes the need for market makers to hedge their ETMF positions intraday. Because all ETMF Share transaction prices are based on the next-determined NAV, a market maker will assume no intraday market risk in connection with its ETMF inventory positions and will not need to hedge the position. At the end of each day, a market maker will be able to offset its position of ETMF Shares by creating or redeeming through an authorized participant.⁷⁸

The opposing commenter also raises a concern that market professionals will have an economic incentive to provide the worst price to an investor for ETMF Shares.⁷⁹ In response, Eaton Vance states that ETMF Shares are no different from other traded securities and that market forces exert pressure on market professionals to offer competitive prices to investors, so that a market maker who seeks to trade ETMF Shares at uncompetitive prices will not attract the volume of trading required to earn meaningful profits.⁸⁰ The Commission believes that competitive forces will provide incentives for market professionals to provide competitive prices to investors and that ETMFs, in this respect, are not any different than other exchange-traded securities.

The opposing commenter also raises a concern that traders who accumulate large ETMF

⁷⁸ See supra notes 76 and 77 and accompanying text.

⁷⁹ See Precidian Letter at 2, supra note 11.

⁸⁰ See Eaton Vance Response Letter at 3, supra note 11.

positions will be incentivized to move the NAV in their favor.⁸¹ Eaton Vance responds with its view that the amount of profit a market maker or other trader will earn by trading ETMFs will not be affected by movements in the NAV.⁸² Eaton Vance explains that it does not matter whether an ETMF's NAV has moved higher or lower intraday, as no level of NAV provides market makers with more profit than any other NAV.⁸³ The Commission agrees with Eaton Vance's response with respect to a trader's incentives on an intraday basis because the amount of profit a trader could earn on an intraday basis will not be affected by movements in the NAV. However, traders that hold a large ETMF position overnight or longer could have an incentive to move the NAV in their favor (i.e., to move the NAV up so that they can sell their position at a profit). This, however, is not any different than the incentive a trader would have holding a large position in any exchange-traded security or mutual fund. Under the proposal, Nasdaq Rule 5745(b)(4) requires that Nasdaq implement written surveillance procedures for ETMF Shares. Exchanges routinely conduct surveillance activities to identify manipulative trading activity such as that described by the opposing commenter.⁸⁴ And, with an ETMF, a trader would have less ability to influence the ETMF's NAV by trading in the underlying securities because of the lack of daily portfolio disclosure.

Nasdaq Rule 5745(d)(2)(A) requires that the IIV for ETMF Shares be widely disseminated by one or more major market data vendors at intervals of not more than 15 minutes

⁸¹ See Precidian Letter at 2, supra note 11.

⁸² See Eaton Vance Response Letter at 3, supra note 11.

⁸³ Id.

⁸⁴ The Commission also notes that the Exchange Act and the rules thereunder prohibit manipulative trading activity. See e.g., 15 U.S.C. 78j(b) and 17 CFR 240.10b-5.

during the Regular Market Session when the ETMF Shares trade on Nasdaq.⁸⁵ According to the Exchange, the purpose of IIVs in NAV-Based Trading is to enable investors to estimate the number of ETMF Shares to buy or sell if they want to transact in an approximate dollar amount. For this purpose, Nasdaq believes that dissemination of IIVs at intervals of not more than 15 minutes should generally be sufficient. An ETMF will be permitted to disseminate IIVs at intervals of less than 15 minutes, but will not be required to do so to maintain trading on the Exchange. The Commission agrees that IIV dissemination in intervals of not more than 15 minutes should be sufficient to permit investors to determine the number of ETMF Shares they want to buy or sell associated with an approximate dollar amount.

As noted above, the opposing commenter believes that market professionals will be unable to effectively hedge their ETMF positions due to a stale and possibly inaccurate IIV that is published every 15 minutes.⁸⁶ Eaton Vance responds to the opposing commenter by stating that the sole purpose of the IIV is to help investors determine the number of ETMF Shares roughly corresponding to a given dollar amount and that market makers will never have any reason to refer to the IIV in connection with their market making function.⁸⁷ In response to the need for market makers to hedge their ETMF positions, Eaton Vance asserts that market makers holding positions in ETMF Shares are not exposed to intraday market risk, and, as such, there would be no need for market makers to hedge their positions intraday.⁸⁸ As detailed above, ETMFs will trade intraday at prices based on NAV and, unlike ETFs, ETMFs would not provide

⁸⁵ In contrast, Nasdaq Rule 5735 requires the IIV for Managed Fund Shares to be widely disseminated by one or more major market data vendors at least every 15 seconds during the time when the Managed Fund Shares trade on Nasdaq.

⁸⁶ See Precidian Letter at 5, supra note 11.

⁸⁷ See Eaton Vance Response Letter at 5, supra note 11.

⁸⁸ See Eaton Vance Response Letter at 6, supra note 11.

pricing signals for market intermediaries or other buyers or sellers of ETMF Shares seeking to estimate the difference between the value of the ETMF's portfolio and the price at which ETMF Shares are currently trading. As such, the Commission believes that a more frequently-disseminated IIV is not necessary for market participants to estimate the value of the ETMF's underlying portfolio for hedging purposes or the management of intraday market risk.

The Commission believes that the proposed listing standards under new Nasdaq Rule 5745 are designed to promote just and equitable principles of trade and to protect investors and the public interest. Under proposed Nasdaq Rule 5745(d)(1)(B), the Exchange will obtain a representation from the issuer of each series of ETMF Shares that the NAV per share for the series will be calculated on each business day that the New York Stock Exchange is open for trading and that the NAV per share will be made available to all market participants at the same time. In addition, under Nasdaq Rule 5745(d)(1)(C), the Reporting Authority (as defined in proposed Nasdaq Rule 5745(c)(4))⁸⁹ must implement and maintain or be subject to procedures designed to prevent the use and dissemination of material, non-public information regarding the ETMF's portfolio positions and changes in the positions.

Under Nasdaq Rule 5745(d)(2)(B)(ii), the Exchange will consider suspension of trading in, or removal from listing of, a series of ETMF Shares if the IIV or the NAV is no longer calculated, or if the IIV, NAV, or Composition File is no longer available to all market

⁸⁹ The term "Reporting Authority" in respect of a particular series of ETMF Shares means Nasdaq, an institution, or a reporting service designated by Nasdaq as the official source for calculating and reporting information relating to such series of ETMF Shares, including, but not limited to, the IIV, the amount of any cash distribution to holders of ETMF Shares, NAV per share, and the Composition File or other information relating to the issuance, redemption, or trading of ETMF Shares. A series of ETMF Shares may have more than one Reporting Authority, each having different functions. See Nasdaq Rule 5745(c)(4).

participants at the same time. In addition, Nasdaq Rule 5745(d)(2)(C) provides additional circumstances that could result in a trading halt of ETMF Shares on the Exchange. If the IIV of a series of ETMF Shares is not being disseminated as required, Nasdaq may halt trading during the day in which the interruption to the dissemination of the IIV occurs. If the interruption to the dissemination of the IIV persists past the trading day in which it first occurred, Nasdaq will halt trading no later than the beginning of the trading day following the interruption. If Nasdaq becomes aware that the NAV per share with respect to a series of ETMF Shares is not calculated on each business day that the New York Stock Exchange is open for trading and disseminated to all market participants at the same time, it will halt trading in such series until such time as the NAV per share is available to all market participants. In addition, if Nasdaq becomes aware that the Composition File with respect to a series of ETMF Shares is not disseminated to all market participants at the same time, it will halt trading in such series until such time as the Composition File is available to all market participants.⁹⁰

Further, under Nasdaq Rule 5745(g), if the investment adviser to an ETMF issuing ETMF Shares is a registered broker-dealer or is affiliated with a broker-dealer, such investment adviser must erect a "fire wall" between the investment adviser and the broker-dealer personnel or broker-dealer affiliate, as applicable, with respect to access to information concerning the composition and/or changes to such ETMF's portfolio holdings. Nasdaq Rule 5745(g) further requires personnel who make decisions on the ETMF's portfolio composition to be subject to procedures designed to prevent the use and dissemination of material, non-public information regarding the applicable ETMF portfolio. Lastly, Nasdaq Rule 5745(b)(4) requires that Nasdaq implement written surveillance procedures for ETMF Shares.

⁹⁰ See Nasdaq Rule 5745(d)(2)(C).

As explained in more detail above, ETMFs will be traded using a novel and unique trading protocol called NAV-Based Trading. Orders to buy and sell ETMFs will be submitted to, and processed by, the Exchange in the customary manner for other exchange-traded securities, with the exception that the price limits for limit orders will be expressed relative to NAV rather than as an absolute dollar price. Further, the execution, reporting, clearance, and settlement of ETMF trades will be substantially the same as for other exchange-traded securities, except that the price of an execution will be expressed relative to NAV rather than as an absolute dollar price until the actual price is determined at the end of the day. Specifically, in NAV-Based Trading, all bids, offers, and execution prices will be expressed as a premium/discount (which may be zero) to the ETMF's next-determined NAV. Trades using NAV-Based Trading will be binding at the time orders are matched on Nasdaq's facilities, with the transaction prices contingent upon the determination of the ETMF's NAV at the end of the business day. All ETMF bids, offers, and trades will be reported intraday in real-time by the Exchange to the Consolidated Tape and separately disseminated to member firms and market data services through a proprietary Nasdaq data feed.

The opposing commenter raises several concerns about the potential for NAV-Based Trading to lead to investor confusion. Specifically, the opposing commenter believes that investors will be confused because they will not be trading at current market prices.⁹¹ In addition, the opposing commenter believes that investors will be confused by the proxy price format.⁹² The Commission believes that Nasdaq and Eaton Vance have made a number of representations regarding steps that will be taken to diminish the risk of investor confusion. For

⁹¹ See Precidian Letter at 2, supra note 11.

⁹² See Precidian Letter at 4-5, supra note 11.

example, Nasdaq has committed to providing certain information regarding NAV-Based Trading to Nasdaq's members and other market participants. The Exchange will provide members with a detailed explanation of NAV-Based Trading through a Trading Alert and will inform members of the special characteristics and risks associated with trading ETMF Shares in an information circular – both to be issued prior to the commencement of ETMF trading.⁹³

Also with regard to the public availability of ETMF trading information, the Exchange represents that information regarding NAV-Based Trading prices and volumes will be continuously available for ETMFs on a real-time basis throughout each trading day on brokers' computer terminals and through established electronic market data services.⁹⁴ Additionally, to avoid investor confusion, the Exchange and organizations offering ETMFs will work with the Exchange's member firms and providers of market data services to ensure that representations of intraday bids, offers, and execution prices consistently follow an "NAV plus or minus" display format.⁹⁵ Further, the Commission notes that Nasdaq has represented that all ETMFs listed on the Exchange will have a unique identifier associated with their ticker symbols to clearly indicate that the Shares are traded using NAV-Based Trading.

With regard to the public availability of information on ETMFs for investors and other market participants, Eaton Vance represents that it will educate market participants about the features of ETMFs, the potential risks and benefits of investing in ETMFs, the features of NAV-Based Trading, and the distinction between IIV and NAV by posting educational materials on its

⁹³ See Notice, supra note 3.

⁹⁴ Id.

⁹⁵ Id.

website and by including disclosure in fund prospectuses and marketing literature.⁹⁶ Further, Eaton Vance states that it is committed, along with distribution partners among major broker-dealers, registered investment advisors, and other fund sponsors to support and provide the marketplace with the materials, education, and training to ensure a successful ETMF investor experience.⁹⁷

The Commission acknowledges the concerns expressed by the opposing commenter regarding investor understanding of how ETMFs will be priced and how they will trade.⁹⁸ As described above, however, the Exchange makes detailed representations regarding the education and information that will be available regarding ETMFs and the manner in which NAV-Based Trading will occur. Given all of the above representations, which are designed to address concerns about investor understanding of the products and how they will trade, the Commission believes that the proposal to allow for the listing and trading of ETMFs is consistent with the protection of investors and the public interest.

The opposing commenter also believes that NAV-Based Trading will cause all brokerage firms, vendors, the Consolidated Tape, and quotation system operators to have to significantly alter their systems.⁹⁹ The Commission recognizes that the implementation of NAV-Based Trading will necessitate some system modifications. Eaton Vance states its view, based on its

⁹⁶ See Eaton Vance Letter at 3, supra note 8.

⁹⁷ See Eaton Vance Letter at 4, supra note 8.

⁹⁸ As noted above, the opposing commenter also stated its belief that ETMFs would likely not provide tax benefits and may cost more to operate than existing ETFs, while other commenters stated their views that ETMFs could offer investors a tax-efficient alternative to mutual funds and lower costs. See supra notes 25-30 and accompanying text. Similar to other investment decisions, investors will need to determine whether the tax-efficiency and costs are appropriate for them based on the particular facts and circumstances.

⁹⁹ See Precidian Letter at 5, supra note 11.

extensive discussions with broker-dealers and providers of market data services, that system modifications to accommodate the introduction of ETMF trading will be modest and can be achieved in a timely manner.¹⁰⁰ Nasdaq represents that the use of a proxy price format to facilitate NAV-Based Trading and to report intraday bids, offers, and trades for ETMFs to the Consolidated Tape will help to minimize the number of system modifications needed.¹⁰¹ As such, the Commission notes that the Consolidated Tape should not require any changes to accommodate the trading of ETMFs. With respect to customer and brokerage order entry screens, the Commission notes that participating in ETMF trading is voluntary and only broker-dealers and market participants interested in trading ETMF Shares will need to perform any system changes.

The opposing commenter raises a concern that the pricing of ETMF Shares at the end of the day may cause funding problems for investor brokerage accounts and may cause difficulties for broker-dealers in calculating their net capital.¹⁰² While the Commission recognizes that NAV-Based Trading presents certain issues for brokers to address with respect to managing their customer accounts and their net capital, the Commission does not believe that these issues are unique or insurmountable. For example, there are current order types, such as the market-on-close order type, where the final trade price is not determined until the end of the trading day, and broker-dealers have been able to implement procedures to manage their customer accounts and their net capital, despite the lack of an intraday trade price.

Finally, the opposing commenter raises a concern that inclusion of foreign stocks in an

¹⁰⁰ See Eaton Vance Response Letter at 5, supra note 11.

¹⁰¹ See Notice at notes 12-13 and accompanying text, supra note 3.

¹⁰² See Precidian Letter at 3-4, supra note 11.

ETMF's portfolio will create problems in calculating the ETMF's NAV.¹⁰³ The opposing commenter states its view that, if a portfolio includes stocks that trade in different time zones, it may be impossible to accurately set the NAV until the foreign market opens for trading.¹⁰⁴ In response, Eaton Vance states that, comparable to mutual funds that contain foreign securities, ETMFs holding foreign securities would use fair value pricing procedures to determine the NAV.¹⁰⁵ The Commission agrees that ETMFs holding foreign securities would be able to use fair value pricing procedures to determine the NAV. However, the Commission notes that Nasdaq is not, at this time, proposing to list and trade any specific ETMF Shares under its ETMF listing standards and that, as required under proposed Nasdaq Rule 5745(b)(1), the Exchange must file separate proposals under Section 19(b) of the Act to list and trade ETMF Shares on Nasdaq.

The Commission further believes that the corresponding changes to other existing Nasdaq Rules appropriately accommodate the listing and trading of ETMF Shares on the Exchange and provide additional clarity regarding the applicability of Nasdaq Rules and therefore are consistent with the Act.

For the foregoing reasons, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rule and regulations thereunder applicable to a national securities exchange.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning

¹⁰³ See Precidian Letter at 3-4, supra note 11.

¹⁰⁴ See id. at 3, supra note 11.

¹⁰⁵ See Eaton Vance Response Letter at 4, supra note 11.

the foregoing, including whether Amendment No. 1 to the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASDAQ-2014-020 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASDAQ-2014-020. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer

to File Number SR-NASDAQ-2014-020 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Accelerated Approval of Proposed Rule Change, As Modified by Amendment No. 1

As discussed above, the Exchange submitted Amendment No. 1 to confirm that all ETMFs listed on the Exchange will have a unique identifier associated with their ticker symbols and that, in the systems used to transmit and process transactions in ETMF Shares, an ETMF's next-determined NAV will be represented by a proxy price.¹⁰⁶ Previously, the filing stated that Nasdaq expects all ETMFs listed on the Exchange to have a unique identifier associated with their ticker symbols and that Nasdaq expects an ETMF's next-determined NAV to be represented by a proxy price. Additionally, the Exchange removed references to ETMF entry and annual fees as the Exchange intends to address such fees in a separate filing.¹⁰⁷ The Commission believes that Amendment No. 1 provides certainty with respect to the ticker symbol and proxy price aspects of the proposed rule change. The Commission further believes that Amendment No. 1 does not materially affect the substance of the proposed rule change or raise any novel or unique regulatory issues. Accordingly, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act,¹⁰⁸ for approving the proposed rule change, as modified by Amendment No. 1, prior to the 30th day after the date of publication of notice in the Federal Register.

¹⁰⁶ See supra note 10.

¹⁰⁷ See id.

¹⁰⁸ 15 U.S.C. 78s(b)(2).

VII. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁰⁹ that the proposed rule change (SR-NASDAQ-2014-020), as modified by Amendment No. 1 thereto, be, and it hereby is, approved on an accelerated basis.

By the Commission.

Brent J. Fields
Secretary

Kevin M. O'Neill

By: Kevin M. O'Neill
Deputy Secretary

¹⁰⁹

15 U.S.C. 78s(b)(2).

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9678 / November 10, 2014

SECURITIES EXCHANGE ACT OF 1934
Release No. 73569 / November 10, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16265

In the Matter of

EUREECA CAPITAL SPC

Respondent.

ORDER INSTITUTING ADMINISTRATIVE
AND CEASE-AND-DESIST PROCEEDINGS
PURSUANT TO SECTION 8A OF THE
SECURITIES ACT OF 1933 AND SECTIONS
15(b) AND 21C OF THE SECURITIES
EXCHANGE ACT OF 1934, MAKING
FINDINGS, AND IMPOSING REMEDIAL
SANCTIONS AND A CEASE-AND-DESIST
ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Eureeca Capital SPC ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

Summary

These proceedings arise out of Eureeca's failure to implement procedures reasonably designed to prevent U.S. persons from accessing and investing in securities through its crowdfunding website. Eureeca offered and sold securities in unregistered transactions to U.S. persons and acted as an unregistered broker dealer to U.S. persons. Eureeca violated Sections 5(a) and 5(c) of the Securities Act as a result of the unregistered offer and sale of securities to three U.S. investors because, after generally soliciting, it did not take reasonable steps to verify that the purchasers of the securities were accredited investors, as required under Rule 506(c) of Regulation D under the Securities Act. Eureeca also violated Section 5(c) of the Securities Act by offering the sale of securities in unregistered transactions between May and September 2013 because it was generally soliciting investors prior to Rule 506(c) being adopted. Additionally, Eureeca violated Section 15(a) of the Exchange Act by acting as an unregistered broker-dealer to U.S. registered users on its website. Eureeca solicited investors and participated in key parts of the transactions.

Respondent

1. Eureeca Capital SPC ("Eureeca") operates an online, securities-based, crowdfunding platform. It was incorporated in the Cayman Islands in May 2013. Eureeca has not been registered with the Commission in any capacity.

Background

2. In May 2013, Eureeca, through its website (www.eureeca.com), started a global, online, securities-based, crowdfunding platform that connects issuers with investors to raise funds in exchange for equity. Its website hosts offerings of securities from non-U.S. based companies.

3. The Eureeca website informed users that offerings of securities listed on the website pass its applications committee and also pass further compliance checks by Eureeca's third party compliance agency. The offerings of securities listed on its website have not been registered with the Commission.

4. Eureeca's posting of securities offerings on its unrestricted website constituted a general solicitation. Visitors to the Eureeca website were permitted access to the names of the offerings, the amount of the offerings, and informational videos about the offerings without registering. None of this information was password protected or restricted in any way.

5. Users had to register on the Eureeca website to gain access to additional information about the offerings of securities listed on its website and to invest in these offerings. To register, users had to provide their names, dates of birth, email addresses, countries, and phone numbers. No representation regarding accredited investor status was requested. Additionally, the website did not contain any disclaimer or definition of "accredited investor."

6. Eureeca had a disclaimer on its website that its services were not being offered to U.S. persons. This disclaimer appeared in the "Terms of Business" document, which investors were required to agree to prior to registering. The disclaimer also appeared in the "Eureeca Terms of Use" document referenced on the bottom of the Eureeca webpage; users were not required to access this document prior to viewing the website.

7. Eureeca did not implement procedures reasonably designed to prevent U.S. investors from using its services. Despite the disclaimer that Eureeca's services could not be used by U.S. persons, users who selected "United States" as their country were allowed to register on the Eureeca website and gain full access to offering materials, and under certain circumstances, deposited funds with Eureeca for the purpose of investing. As of May 2014, Eureeca permitted over 50 persons who selected the U.S. as their "country" during the website registration process to register on the website. Three U.S. residents who registered on the website invested in unregistered offerings of securities through the Eureeca website.

8. Once registered, Eureeca sent registered users automated emails about the open offerings of securities listed on its website. The emails detailed the investment status of specific offerings, provided a brief overview of the offerings, and encouraged investment in the offerings of securities.

9. To invest in offerings of securities on the Eureeca website, registered users had to wire money directly to Eureeca's escrow account. Users then could direct the money from their Eureeca account to be applied by Eureeca to the various offerings, with the minimum investment being \$100.

10. If the offerings did not fully fund, Eureeca represented that the money would be returned. If the offerings were fully funded, according to its website, Eureeca completed "the final legal requirements and manage[d] the swap of funds for the equity agreed."

11. Eureeca received a percentage of the funds of the fully funded offerings of securities as compensation for its services upon closing of a deal.

12. In 2013, Eureeca accepted funds from three U.S. persons that had registered on its website (the "U.S. Investors").

13. Each of the three U.S. Investors provided copies to Eureeca of their U.S. passports and provided Eureeca with proof of a United States address.

14. Eureeca did not take reasonable steps to verify that the U.S. Investors were accredited investors.

15. Eureeca allowed two of the U.S. Investors to self-certify that each was an accredited investor. Eureeca sent an email to two of the U.S. investors asking each to confirm their status as an accredited investor via email prior to investing in the offerings. The emails did not define or otherwise explain what the term "accredited investor" meant. Each of these U.S. investors confirmed they were accredited investors via email. Eureeca did not take any further action regarding whether these two U.S. investors were accredited investors prior to allowing them to invest in offerings of securities on its website.

16. Eureeca did not request any information to verify whether the third U.S. investor was an accredited investor prior to allowing him to invest in the offerings of securities on its website.

17. Eureeca permitted the three U.S. Investors to invest approximately \$20,000 total in four separate offerings for securities on its website.

18. As a result of the conduct described above, Eureeca willfully¹ violated Sections 5(a) and 5(c) of the Securities Act, which make it unlawful for any person, directly or indirectly, to sell or offer to sell a security for which a registration statement is not filed or not in effect or there is not an applicable exemption from registration.

19. As a result of the conduct described above, Eureeca willfully violated Section 15(a) of the Exchange Act, which makes it unlawful for any broker or dealer to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security, unless such broker or dealer is registered or associated with a registered broker-dealer.

Eureeca's Remedial Efforts

20. In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent and voluntary cooperation afforded the Commission staff.

IV.

In view of the foregoing, the Commission deems it appropriate, in the public interest, and for the protection of investors to impose the sanctions agreed to in Respondent Eureeca's Offer.

¹ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

Accordingly, pursuant to Section 8A of the Securities Act and Sections 15(b) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent Eureeca cease and desist from committing or causing any violations and any future violations of Sections 5(a) and 5(c) of the Securities Act and Section 15(a) of the Exchange Act.

B. Respondent Eureeca is censured.

C. Respondent shall pay civil penalties of \$25,000 to the Securities and Exchange Commission. Payment shall be made in the following installments:

- a. \$2,500 within 10 days of the entry of this Order;
- b. \$2,500 within 40 days of the entry of this Order;
- c. \$2,500 within 70 days of the entry of this Order;
- d. \$2,500 within 100 days of the entry of this Order;
- e. \$2,500 within 130 days of the entry of this Order;
- f. \$2,500 within 160 days of the entry of this Order;
- g. \$2,500 within 190 days of the entry of this Order;
- h. \$2,500 within 220 days of the entry of this Order;
- i. \$2,500 within 250 days of the entry of this Order;
- j. \$2,500 plus interest on the payments described in Section IV.C(a)-(j) pursuant to 31 U.S.C. 3717 within 280 days of the entry of this Order.

Prior to making the payment described in Section IV.C(j), Eureeca shall contact the Commission staff to ensure the inclusion of interest. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, at the discretion of the Commission staff, without further application. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341

6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Eureeca Capital SPC as a Respondent in these proceedings, and the file number of these proceedings (D-03396); a copy of the cover letter and check or money order must be sent to Thomas J. Krysa, Division of Enforcement, Securities and Exchange Commission, 1961 Stout Street, Suite 1700, Denver, CO 80294.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: **Jill M. Peterson**
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73573 / November 10, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16266

In the Matter of

**AARX, Inc.,
Acquirestuff.com, Inc.,
Advanced Scientific Asset Holding, Inc.,
Air South Airlines, Inc.,
Altek Power Corp.,
AM Build, Inc.,
Amber Hill, Inc., and
American Family Cookies, Inc.,**

Respondents.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
AND NOTICE OF HEARING
PURSUANT TO SECTION 12(j) OF
THE SECURITIES EXCHANGE ACT
OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents AARX, Inc., Acquirestuff.com, Inc., Advanced Scientific Asset Holding, Inc., Air South Airlines, Inc., Altek Power Corp., AM Build, Inc., Amber Hill, Inc., and American Family Cookies, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. AARX, Inc. (CIK No. 1306299) is a void Delaware corporation located in Akron, Ohio with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). AARX is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10 registration

statement on November 12, 2004, which reported a net loss of \$2,291 from the company's September 3, 2004 inception to September 30, 2004.

2. Acquirestuff.com, Inc. (CIK No. 1143602) is a void Delaware corporation located in Mississauga, Ontario, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Acquirestuff.com, Inc. is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the period ended December 31, 2002, which reported a net loss of \$28,943 for the prior twelve months.

3. Advanced Scientific Asset Holding, Inc. (CIK No. 1386977) is a forfeited Delaware corporation located in Arlington, Virginia with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Advanced Scientific is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2008, which reported a net loss of \$87,939 for the prior three months.

4. Air South Airlines, Inc. (CIK No. 1026724) is a forfeited Delaware corporation located in Columbia, South Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Air South Airlines is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q/A for the period ended June 30, 1997.

5. Altek Power Corp. (CIK No. 1198692) is a British Columbia corporation located in Kelowna, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Altek Power is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-FR registration statement on January 9, 2003.

6. AM Build, Inc. (CIK No. 1209532) is a permanently revoked Nevada corporation located in Toronto, Ontario, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). AM Build is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10 registration statement on March 28, 2003, which reported a net loss of \$8,085 from the company's June 25, 2002 inception to August 31, 2002.

7. Amber Hill, Inc. (CIK No. 1384395) is a Nevada corporation located in Sumter, South Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Amber Hill is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 2007, which reported a net loss of \$19,039 for the prior nine months.

8. American Family Cookies, Inc. (CIK No. 1164392) is a dissolved Delaware corporation located in Lavergue, Tennessee with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). American Family Cookies is delinquent in its periodic filings with the Commission, having not filed any periodic

reports since it filed a Form 10-QSB for the period ended June 30, 2002, which reported a net loss of \$31,186 for the prior six months.

B. DELINQUENT PERIODIC FILINGS

9. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

10. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

11. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and/or 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Brent J. Fields
Secretary


By: Jill M. Peterson
Assistant Secretary

*Commissioner Gallagher
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

November 10, 2014

IN THE MATTER OF	:	
KOLASCO CORP.	:	ORDER OF SUSPENSION
	:	OF TRADING
File No. 500-1	:	

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of Kolasco Corp. because of questions regarding control over the company and the accuracy of company information, including in filings with the Commission, concerning, among other things, the company's acting officers. Kolasco Corp. is a Nevada corporation with its principal place of business located in Toronto, Canada. Its stock is quoted on OTC Link, operated by OTC Markets Group Inc., under the ticker: KLSC.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of the above-listed company.

THEREFORE, IT IS ORDERED, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed company is suspended for the period from 9:30 a.m. EST, on November 10, 2014 through 11:59 p.m. EST, on November 21, 2014.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

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*Commissioner Gallagher
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73583 / November 12, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16271

In the Matter of

Pennington Capital Management LLC
Robert J. Evans

Respondents.

ORDER INSTITUTING CEASE-
AND-DESIST PROCEEDINGS
PURSUANT TO SECTION 21C OF
THE SECURITIES EXCHANGE
ACT OF 1934, MAKING
FINDINGS, AND IMPOSING A
CEASE-AND-DESIST ORDER
AND CIVIL PENALTY

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Pennington Capital Management LLC and Robert J. Evans ("Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement ("Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order and Civil Penalty ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds that:

Summary

1. These proceedings arise out of violations of Rule 105 of Regulation M of the Exchange Act by Pennington Capital Management LLC and Robert J. Evans, who managed a hedge fund

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located in Minneapolis, MN – Pennington Capital LLC. Rule 105 prohibits buying an equity security made available through a public offering conducted on a firm commitment basis, from an underwriter or broker or dealer participating in the offering, after having sold short the same security during a restricted period, as defined in the Rule.

2. During April 2012 and May 2012, Pennington Capital Management LLC and Robert J. Evans purchased equity securities in two offerings from an underwriter or broker or dealer participating in follow-on public offerings for the fund's investment portfolio after having sold short the same securities in the fund's investment portfolio during the restricted period. These violations collectively resulted in profits of \$95,204.55.

Respondents

3. Pennington Capital Management LLC, a Minnesota limited liability company located in Minneapolis, MN, is an unregistered investment adviser that managed the fund's investment portfolio for compensation.
4. Robert J. Evans, a resident of Saint Paul, MN, founded and solely owns and manages both Pennington Capital Management LLC and Pennington Capital LLC.

Legal Framework

5. Rule 105 makes it unlawful for a person to purchase equity securities from an underwriter, broker, or dealer participating in a public offering if that person sold short the security that is the subject of the public offering during the restricted period defined in the rule, absent an exception. 17 C.F.R Section 242.105; *see* Short Selling in Connection with a Public Offering, Rel. No. 34-56206, 72 Fed. Reg. 45094 (Aug. 10, 2007)(effective Oct. 9, 2007). The Rule 105 restricted period is the shorter of the period: (1) beginning five business days before the pricing of the offered securities and ending with such pricing; or (2) beginning with the initial filing of a registration statement or notification on Exchange Act Form 1-A or Form 1-E and ending with pricing.
6. "The goal of Rule 105 is to promote offering prices that are based upon market prices determined by supply and demand rather than artificial forces." *Id.* Rule 105 is prophylactic and prohibits the conduct irrespective of the short seller's intent in effecting the short sale. *Id.*

Violations of Rule 105 of Regulation M

7. Acting through Pennington Capital Management LLC, Robert J. Evans purchased 100,000 shares of the common stock of TearLab Corporation on April 11, 2012 for the fund's investment portfolio in a follow-on offering after selling short 23,500 shares of the stock in the fund's account on April 9, 2012, a day before the pricing of the follow-on offering. The fund profited by \$38,626.05 from this trading.

8. Acting through Pennington Capital Management LLC, Robert J. Evans received an allotment of 45,000 shares of the common stock of Gordmans Stores, Inc. in the fund's investment portfolio during a follow-on offering on May 25, 2012, after selling short 50,700 shares of the stock between May 21, 2012 and May 24, 2012, less than five days before the pricing of the follow-on offering on May 24, 2012. The fund profited by \$56,578.50 from these trades.

Violations

9. As a result of the conduct described above, Pennington Capital Management LLC and Robert J. Evans violated Rule 105 of Regulation M under the Exchange Act.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondents' Offers.

Accordingly, it is hereby ORDERED that:

- A. Pursuant to Section 21C of the Exchange Act, Respondents Pennington Capital Management LLC and Robert J. Evans cease and desist from committing or causing any violations and any future violations of Rule 105 of Regulation M of the Exchange Act;
- B. Respondents shall, within (14) days of the entry of this Order, pay disgorgement of \$95,204.55, prejudgment interest of \$5,604.69, and a civil money penalty in the amount of \$65,000 (for a total of \$165,809.24) to the Securities and Exchange Commission for transfer to the U.S. Treasury. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and 31 U.S.C. Section 3717. Payment must be made in one of the following ways:
 - (1) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;¹
 - (2) Respondents may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
 - (3) Respondents may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341

¹ The minimum threshold for transmission of payment electronically is \$1,000,000. For amounts below the threshold, respondents must make payments pursuant to options (2) or (3) above.

6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Pennington Capital Management LLC and Robert J. Evans as Respondents in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Timothy Warren, Associate Director, Division of Enforcement, Securities and Exchange Commission, Chicago Regional Office, 175 West Jackson Boulevard, Suite 900, Chicago, Illinois 60604.

- C. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that in any Related Investor Action, they shall not argue that they are entitled to, nor shall they benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondents' payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondents agree that they shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.
- D. It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondent, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

*Commissioner Gallagher
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3966 / November 12, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16272

In the Matter of

AARON E. OLSON,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 203(f) OF THE
INVESTMENT ADVISERS ACT OF 1940,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Aaron E. Olson ("Olson" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent admits the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Sections III.2 and III.4 below, and consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Respondent, age 40, is a resident of Rindge, New Hampshire. From at least January 2007 through March 2012, Respondent acted as an unregistered investment adviser through two purported investment businesses that he operated, AEO Associates ("AEO"), and KMO Associates, LLC ("KMO").

2. On May 15, 2014, the New Hampshire Bureau of Securities Regulation and Respondent executed a Consent Order (INV-2012000003) in which Respondent agreed that he acted as an unlicensed investment adviser representative from at least January 2007 through March 2012. He consented to a bar from any securities licensure in the State of New Hampshire, and to cease and desist from further violations of the New Hampshire securities law.

3. Respondent agreed in the Consent Order that he had obtained approximately \$27.8 million from investors to invest on their behalf, comingled investors' funds with his own funds, traded speculative securities, failed to maintain any separate accounting of the gains realized and losses incurred, sent some investors false earnings statements, and converted approximately \$2.6 million of the funds placed with him to personal use.

4. On May 15, 2014, Respondent executed a Plea Agreement and entered a plea of guilty to four counts of attempt to defeat taxes due and owing pursuant to 26 U.S.C. §7201 in the United States District Court, District of New Hampshire, in a criminal case entitled *United States of America v. Aaron E. Olson*, No. 1:14-CR-48-01-LM.

5. In the Plea Agreement, Respondent stipulated and agreed, *inter alia*, that he:
- a. used AEO and KMO to obtain approximately \$27.8 million from individuals and organizations ostensibly to invest on their behalf in various commodity, stock and bond markets;
 - b. comingled investor funds with his own funds;
 - c. converted approximately \$2.6 million of the investors' funds to his own use;
 - d. used some investor funds to make payments of what he falsely purported to be earnings to other investors;
 - e. sent investors false earnings statements that showed significant earnings on their investments to entice them to place more funds with him to invest; and
 - f. attempted to evade or defeat taxes due and owing the United States of America on income he obtained through AEO and KMO.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 203(f) of the Advisers Act, that Respondent be, and hereby is:

barred from association with any investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

Commissioner Gallagher
Commissioner Pinover
Disapproved

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73582 / November 12, 2014

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3596 / November 12, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16270

In the Matter of	:	
	:	
DR. L.S. SMITH,	:	ORDER INSTITUTING CEASE-AND-
	:	DESIST PROCEEDINGS PURSUANT TO
	:	SECTION 21C OF THE SECURITIES
	:	EXCHANGE ACT OF 1934, MAKING
Respondent.	:	FINDINGS, AND IMPOSING A CEASE-
	:	AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Dr. L.S. Smith ("Smith" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

A. Summary

This case arises out of financial reporting, books and records, and internal controls violations by DGSE Companies Inc. ("DGSE") and its former Chief Financial Officer, I. John Benson ("Benson"), that occurred during Smith's tenure as DGSE's Chief Executive Officer. These violations led to a number of accounting misstatements in DGSE's publicly-filed annual and quarterly reports, which were caused by fraudulent accounting entries made or directed by Benson. As a result, DGSE was required to restate its financial statements. The Commission does not allege that Smith participated in the wrongful conduct. Smith has not, however, reimbursed DGSE for incentive compensation and stock sale profits he received during the relevant period, as required by Section 304(a) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").

B. Respondent

1. Smith, age 67, was the Chairman of the Board of Directors and Chief Executive Officer of DGSE from 1980 until 2011.

C. Other Relevant Entity

2. DGSE was, at all relevant times, a Nevada corporation headquartered in Dallas, Texas that buys and sells jewelry and bullion products for individual consumers, dealers, and institutions. Its common stock is registered with the Commission under Section 12(b) of the Exchange Act and is traded on the NYSE MKT under the symbol "DGSE."

D. Facts

3. On June 2, 2014, final judgments were entered against DGSE and Benson in the civil action entitled Securities and Exchange Commission v. DGSE Companies Inc. and I. John Benson, Civil Action Number 3:14-cv-01909-B, in the United States District Court for the Northern District of Texas.

4. The judgments were based on significant accounting irregularities that occurred at DGSE between 2009 and 2011. The accounting irregularities were caused by fraudulent accounting entries made or directed by Benson, which materially overstated inventory and went undetected as a result of DGSE's failure to maintain appropriate accounting systems, policies, procedures, and controls. As a result, DGSE filed Forms 10-Q and 10-K for the fiscal years 2009 and 2010 that were in material non-compliance with its financial reporting requirements under the federal securities laws.

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

5. Due to DGSE's material non-compliance with its financial reporting requirements under the federal securities laws, and as a result of its misconduct that improperly inflated DGSE's inventory accounts, DGSE restated its financial statements for the fiscal years ended 2009 and 2010 (and the quarters in those years).

6. During the 12-month periods following DGSE's filing of its inaccurate financial statements, and before any restatement or correcting disclosure, Smith received, from DGSE, incentive bonuses as part of his employment with DGSE. During the same period, he also profited from the sale of DGSE stock.

7. Under Sarbanes-Oxley Section 304(a), "any bonus or other incentive-based or equity-based compensation" Smith received from DGSE and "any profits realized from the sale of [DGSE] securities" during the relevant period are subject to reimbursement to DGSE. However, Smith has not reimbursed DGSE as required by the statute.

8. The Commission has not exempted Smith, pursuant to Sarbanes-Oxley Section 304(b), from the application of Sarbanes-Oxley Section 304(a).

9. As a result of the conduct described above, Smith violated Sarbanes-Oxley Section 304(a).

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Smith's Offer.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent Smith cease and desist from committing or causing any violations and any future violations of Sarbanes-Oxley Section 304(a).

B. Respondent shall, within thirty (30) days of the entry of this Order, reimburse DGSE a total of \$106,250 and 59,738 shares of DGSE stock pursuant to Section 304(a) of the Sarbanes-Oxley Act, 15 U.S.C. § 7243. Respondent shall simultaneously deliver proof of satisfying this reimbursement obligation to: Chris Davis, Division of Enforcement, U.S. Securities and Exchange Commission, Burnett Plaza, Suite 1900, 801 Cherry Street, Unit 18, Fort Worth, TX 76102.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73578 / November 12, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16268

In the Matter of

ROBERT C. WEAVER, JR., Esq.,

Respondent.

**ORDER INSTITUTING PUBLIC
ADMINISTRATIVE PROCEEDINGS AND
IMPOSING TEMPORARY SUSPENSION
PURSUANT TO RULE 102(e)(3)(i)(A) OF
THE COMMISSION'S RULES OF
PRACTICE**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against Robert C. Weaver, Jr. ("Respondent" or "Weaver") pursuant to Rule 102(e)(3)(i)(A)¹ of the Commission's Rules of Practice [17 C.F.R. 200.102(e)(3)(i)(A)].

II.

The Commission finds that:

1. Robert C. Weaver, Jr. is an attorney licensed in California.
2. Between 2006 and 2011, Weaver participated with other individuals in a scheme to create, register and sell 15 public shell companies putatively engaged in mining operations. As part of the scheme, Weaver wrote various "opinion of legality" letters for registration statements filed on behalf of the shell companies, acted as counsel for three of the companies, and served as the sole officer and director for one of the companies, Centaurus Resources Corp.

¹ Rule 102(e)(3)(i) provides, in relevant part, that:

The Commission, with due regard to the public interest and without preliminary hearing, may, by order, temporarily suspend from appearing or practicing before it any attorney . . . who has been by name: (A) [p]ermanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder[.]

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("Centaurus"). Weaver also provided the initial funding for Centaurus and, in his capacity as officer and director, repeatedly made filings with the Commission that contained false and inaccurate statements.

3. On August 13, 2012, the Commission filed a complaint against Weaver and others in the United States District Court for the Eastern District of Texas that was later transferred to the United States District Court for the Central District of California (the "Court"). That complaint charged Weaver with violating Sections 17(a)(1), (2) and (3) of the Securities Act of 1933 ("Securities Act"), and Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act), and Rules 10b-5(a), (b) and (c) and 15d-14 thereunder; and aiding and abetting violations of Sections 10(b) and 15(d) of the Exchange Act, and Rules 10b-5, 12b-20, 15d-1 and 15d-13 thereunder. As to Weaver, the Commission's lawsuit sought a permanent injunction against future violations of the federal securities laws, disgorgement of unlawful proceeds, prejudgment interest, a financial penalty, an order prohibiting Weaver from acting as an officer or director of any public company, and an order prohibiting him from participating in an offering of penny stock. SEC v. Thomas D. Coldicutt, Jr., et al., Civil Action Number 2:13-cv-01865-RGK-VBK (C.D. CA).

4. On April 14, 2014, without admitting or denying the conduct alleged in the complaint, Weaver consented to the entry of a judgment that permanently enjoins him from violating certain provisions of the federal securities laws. On August 14, 2014, the Court permanently enjoined Weaver from violating Sections 17(a)(2) and (3) of the Securities Act, Section 15(d) of the Exchange Act and Rules 12b-20, 15d-1 and 15d-13 thereunder, and imposed certain other relief sought in the Commission's lawsuit.

III.

Based upon the foregoing, the Commission finds that a court of competent jurisdiction has permanently enjoined Weaver, an attorney, from violating the Federal securities laws within the meaning of Rule 102(e)(3)(i)(A) of the Commission's Rules of Practice. In view of this finding, the Commission deems it appropriate and in the public interest that Weaver be temporarily suspended from appearing or practicing before the Commission as an attorney.

IT IS HEREBY ORDERED that Weaver be, and hereby is, temporarily suspended from appearing or practicing before the Commission as an attorney. This Order will be effective upon service on the Respondent.

IT IS FURTHER ORDERED that Weaver may, within thirty days after service of this Order, file a petition with the Commission to lift the temporary suspension. If the Commission receives no petition within thirty days after service of the Order, the suspension will become permanent pursuant to Rule 102(e)(3)(ii).

If a petition is received within thirty days after service of this Order, the Commission will, within thirty days after the filing of the petition, either lift the temporary suspension, or set

the matter down for hearing at a time and place to be designated by the Commission, or both. If a hearing is ordered, following the hearing, the Commission may lift the suspension, censure the petitioner, or disqualify the petitioner from appearing or practicing before the Commission for a period of time, or permanently, pursuant to Rule 102(e)(3)(iii).

This Order shall be served upon Weaver personally or by certified mail at his last known address.

By the Commission.

Brent J. Fields
Secretary


By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9679 / November 12, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16267

In the Matter of

PANKAJ KUMAR SRIVASTAVA

and

NATARAJ KAVURI,

Respondents.

ORDER INSTITUTING
ADMINISTRATIVE AND
CEASE-AND-DESIST PROCEEDINGS
PURSUANT TO SECTION 8A OF
THE SECURITIES ACT OF 1933

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") against Pankaj Kumar Srivastava ("Srivastava") and Nataraj Kavuri ("Kavuri") (collectively, the "Respondents").

II.

After an investigation, the Division of Enforcement alleges that:

SUMMARY

1. These proceedings arise from an online high-yield securities offering fraud through which the Respondents solicited investments in a so-called pooled investment fund that would purportedly yield guaranteed profits. From approximately April 2013 until February 2, 2014, the Respondents operated a website, www.profitsparadise.com (hereafter "the Profits Paradise Website" or "the Website"), through which they solicited investments in securities. Investors were invited to deposit funds that would supposedly be pooled with other investors' funds to make "huge profits" in forex, stocks, and commodity trading. Profits Paradise offered three investment plans, each with a term of 120 business days. The first purportedly yielded 1.5% daily interest on investments of \$10 to \$749, the second purportedly yielded 1.75% daily interest on investments of \$750 to \$3,499, and the third purportedly yielded 2% daily interest on investments of \$3,500 and above. The Website and related social media sites described the profits as "huge," "lucrative," "handsome," and "guaranteed," and they characterized the risk as

“minimal.” These claims of guaranteed profits were false. The offering also was structured in such a way that, under certain conditions, investors could never recover their principal investments.

2. The investments offered by Profits Paradise had the hallmark of a type of highly suspicious offering called a high-yield investment program (“HYIP”). According to the Commission’s investor protection website at www.investor.gov, “The hallmark of a HYIP scam is the promise of incredible returns at little or no risk to the investor.... If you are approached online to invest in one of these, you should exercise extreme caution – it is likely a fraud.”

3. Srivastava, a software engineer turned Internet marketer, directed the scheme. At Srivastava’s request, his friend Kavuri took the lead in designing and marketing the Profits Paradise Website. In addition to the Website, Srivastava and Kavuri utilized Facebook, YouTube and other social media in an effort to attract investors. In conducting the fraud, the Respondents disguised their identities, including by communicating under pseudonyms. Based on this conduct, Srivastava and Kavuri violated Securities Act Sections 17(a)(1) and (3).

A. RESPONDENTS

4. Srivastava, a resident of Mumbai, India, is an Internet marketer who created the Profits Paradise Website. Srivastava also ran the Internet marketing businesses associated with the websites www.unitedpaycheck.com and www.revenuetimes.com. Until May 2014, Srivastava maintained a personal website at www.pankajsrivastava.com. To conceal his identity while conducting the Profits Paradise fraud, Srivastava used the pseudonym “Paul Allen.”

5. Kavuri, a resident of Hyderabad, India, is employed at a multinational software company and played a leading role in designing and marketing the Profits Paradise Website. Concealing his identity while conducting the Profits Paradise fraud, Kavuri used the pseudonym “Nathan Jones.” Kavuri admitted that he did so at Srivastava’s request.

B. BACKGROUND

6. Srivastava, trained as a software engineer, was previously employed at Tata Consultancy Services (“Tata”), a multinational information technology service, consulting and business solutions company headquartered in India. Kavuri, too, worked at Tata, where the two became acquainted. In 2005, Srivastava began a career as an affiliate marketer and worked for www.quixtar.com in Minneapolis, Minnesota. In 2007, he returned to India and became a full-time Internet marketer.

7. By November 2012, Srivastava was conducting his own Internet marketing business, called United Paycheck, through the website www.unitedpaycheck.com. Kavuri assisted Srivastava in conducting United Paycheck’s business. By February 2013, United Paycheck’s business was failing and Srivastava created other Internet businesses, one of which was Profits Paradise.

C. SRIVASTAVA AND KAVURI CREATED PROFITS PARADISE

8. On February 1, 2013, Srivastava directed the Uttar Pradesh, India office of a company that provides web design and other services (hereafter, the "web designer") to register the domain name www.profitsparadise.com, and paid the web designer for its services. He gave the web designer a detailed explanation of the concept of Profits Paradise.

9. Following Srivastava's instruction, on or about February 2, 2013, the web designer registered the domain name www.profitsparadise.com through GoDaddy.com, LLC. In doing so, the web designer provided GoDaddy with the following identifying information supplied by Kavuri:

Registrant Name	Registrant Address	Registrant Telephone Number	Registrant Email
Jane Roe	300 Boylston Ave. E., Seattle, WA 98102	866-564-3789	<u>janeroe032@gmail.com</u>

Jane Roe is a fictitious name, and there is no connection between Profits Paradise and the dwelling at 300 Boylston Ave E., in Seattle, Washington, or its residents. The telephone number provided to GoDaddy is a toll-free number for a conference call center that is unrelated to Profits Paradise, and the Internet Protocol ("IP") addresses from which janeroe032@gmail.com was routinely accessed were located in India, not Seattle.

10. Kavuri disguised Profits Paradise's physical location by providing the false "whois" data, indicating that Profit Paradise's operations were within the United States when they were not.

11. To register a domain name, registrants must provide their full name, postal address, e-mail address, telephone number, and fax number (if available) for publicly searchable "whois" purposes, and certify that they have provided accurate and reliable contact details. Publicly available "whois" searches are designed to allow members of the public to discover who has registered a domain name and where to find them. Conducting a "whois" search for the Profits Paradise Website yielded the pseudonym "Jane Roe," the Seattle address that is unrelated to the Website, and the telephone number for a conference call center that is also unrelated to the Website. By supplying this fictitious information, Kavuri effectively prevented members of the public from discovering who was responsible for the Website.

12. The phony name and address served a dual purpose. In addition to concealing the fact that Srivastava and Kavuri were behind the Website, the domain name registration to Jane Roe at a Seattle address was meant to attract American investors. Additionally, to create the illusion that mainly American investors were visiting the Profits Paradise Website, Srivastava instructed the web designer to ensure that the "Alexa detail" showed the Website's "rank in the United States" rather than its "rank in India." "Alexa" refers to a website (www.alexa.com) that ranks other websites, by country, based on the amount of Internet traffic directed to the website.

13. Once the Profits Paradise domain name was registered, Srivastava began using the fictitious name Paul Allen with the email address unitedforex47@gmail.com to disguise his association with Profits Paradise. He instructed Kavuri to "use this email ID for any further communications." At Srivastava's request, Kavuri used the fictitious name Nathan Jones, which was associated with the email address coolblu49@gmail.com.

14. By late February 2013, online payment processor accounts were opened to receive investor funds. On February 23, 2013, Srivastava provided the web designer with the account

numbers, and related information, for three Profits Paradise accounts at the payment processor Liberty Reserve. He also provided the web designer with information concerning a Profits Paradise account at another payment processor, Perfect Money. Kavuri directed the web designer to integrate the payment processor links into the Profits Paradise Website. On May 21, 2013, Srivastava provided the web designer with details for "Profits Paradise Testing accounts" at Perfect Money, Liberty Reserve, and another payment processor, EgoPay. In addition to providing the account information to the web designer, Srivastava indicated: "I have transferred 20\$ [sic] to each account."

15. Kavuri played the lead role in developing the content for the Profits Paradise Website. On February 3, 2013, he sent Srivastava the first page of the Website. Over the next two months, Kavuri sent content for the Website to Srivastava and the web designer, including a version of the Website he sent on March 1, 2013, and an email he sent later that day with "Plan details." The three plan details promised: daily returns of 1.5% on an investment of \$10-\$750 (for a total return on investment of 180%); daily returns of 1.75% on an investment of \$750-\$3,500 (for a total return on investment of 210%); and daily returns of 2% on an investment of \$3,500 and above (for a total return on investment of 240%) (hereinafter the "Plan Details"). Kavuri directed the web designer to "[u]se the numbers accordingly" and also wrote: "And compounding as we discussed earlier. Please call me if you need any clarification."

16. On March 1, 2013, under the subject line "About Profit [P]aradise business" Srivastava circulated key descriptive text for the Website that he and Kavuri had received earlier that day from an individual assisting them:

Profits Paradise is an investment management company that deals in multiple financial sectors. The current economic instability in the world makes it imperative to look for stable sources of income that provide guaranteed profits on your investment. Here's where we come in.

It is a known fact that massive profits require massive investment capital which is out of the reach of the average small investor. Not anymore. We at Profits Paradise allow investors to join in with small amounts which are pooled together to make huge profits in forex, stocks, and commodities trading. Whether you are an individual or a group, with small, medium or large investment budgets, we have something just for you.

Our dedicated staff works round the clock to tap the best financial deals across the globe. Your money is handled by a team of qualified professionals with several years of experience in investment portfolio management. Our unique trading strategy, extensive marketing research, and industry know-how guarantee profits with minimal risk so that you can relax and reap the benefits of our financial expertise.

17. Kavuri incorporated this language into the Profits Paradise Website and, on March 10, 2013, emailed it to Srivastava. This version of the Website included the Plan Details describing the three investment plans and their respective daily returns of 1.5%, 1.75% and 2%. The Website also explained how to open an account with Profits Paradise, and how to fund the account by depositing funds with a payment processor. It also offered "handsome commissions" for soliciting investments in Profits Paradise.

18. Kavuri provided instructions to the web designer as the Website was being developed. For example, on March 13, 2013, Kavuri emailed the web designer: "Could you pls ensure that Integrated version of PP [the Profits Paradise website] is launched on test site immediately. We want to complete final phase of testing and Launch it by this weekend."

Srivastava likewise provided instructions to the web designer. During this period, Kavuri and Srivastava worked hand in glove on the Website. For example, on March 22, 2013, Srivastava provided Kavuri with a critique of content Kavuri added to the Website. And at Kavuri's request, Srivastava agreed to provide him with a "Mission and Vision" paragraph for the Website.

19. Concurrently, Srivastava and Kavuri began to market Profits Paradise through social media sites that they or individuals assisting them created. On February 25, 2014, Kavuri emailed Srivastava: "And now the other imp. thing is the video creation for PP." Two weeks later, Kavuri emailed Srivastava a link to a YouTube video. His subject line read: "PP Video – Final Cut." A few weeks later, on March 23, Kavuri asked Srivastava to create a YouTube account and upload Kavuri's Profits Paradise video, which they could then link to the Profits Paradise Website. The published version of the YouTube video outlined the three investment plans and their returns—1.5% daily for Plan A, 1.75% daily for Plan B, and 2% daily for Plan C—and represented that an "experienced professional handles your investment portfolio." In truth, both Srivastava's and Kavuri's professional backgrounds are in software engineering and/or Internet marketing, and neither are investment advisers or have other professional investment experience. Like the Profits Paradise Website, the YouTube video did not include a mailing address, telephone number, or the name of any person associated with Profits Paradise. Excessive secrecy, such as hiding who is behind a Website and investment scheme, is a hallmark of high-yield investment schemes.

20. In March 2013, Srivastava assigned responsibilities for the marketing of Profits Paradise, including a "Facebook campaign," and marketing through Twitter and GooglePlus. In doing so, he announced that Kavuri "will lead the team from the front. With his passion we are sure of success." The Facebook page—created on or about February 23, 2013—described Profits Paradise as "an investment management company that deals in multiple financial sectors" and advertised the three investment plans that would purportedly yield daily returns of 1.5%, 1.75%, and 2%. The Facebook page also advertised Profits Paradise's "5% Referral Commission." Other postings on the Facebook page referred to the "[h]igh profits generated by our financial experts" and promised that investors could "Enjoy Hassle Free Income." The Facebook page did not include a mailing address, telephone number, or the name of any individual associated with Profits Paradise.

21. Profits Paradise's Twitter account linked to the Profits Paradise Website, and to the Profits Paradise YouTube video. One of the Tweets stated: "We allow investors to join with small amounts which are pooled together to make huge profits in Forex." Another Tweet stated: "Profits Paradise offers 3 lucrative plans that offer fixed returns daily." Yet another stated: "We encourage you to use your referral link and promotional banner on social media, blog, forum and email to share it with interested parties." The Twitter site did not include a mailing address, telephone number, or the name of any individual associated with Profits Paradise.

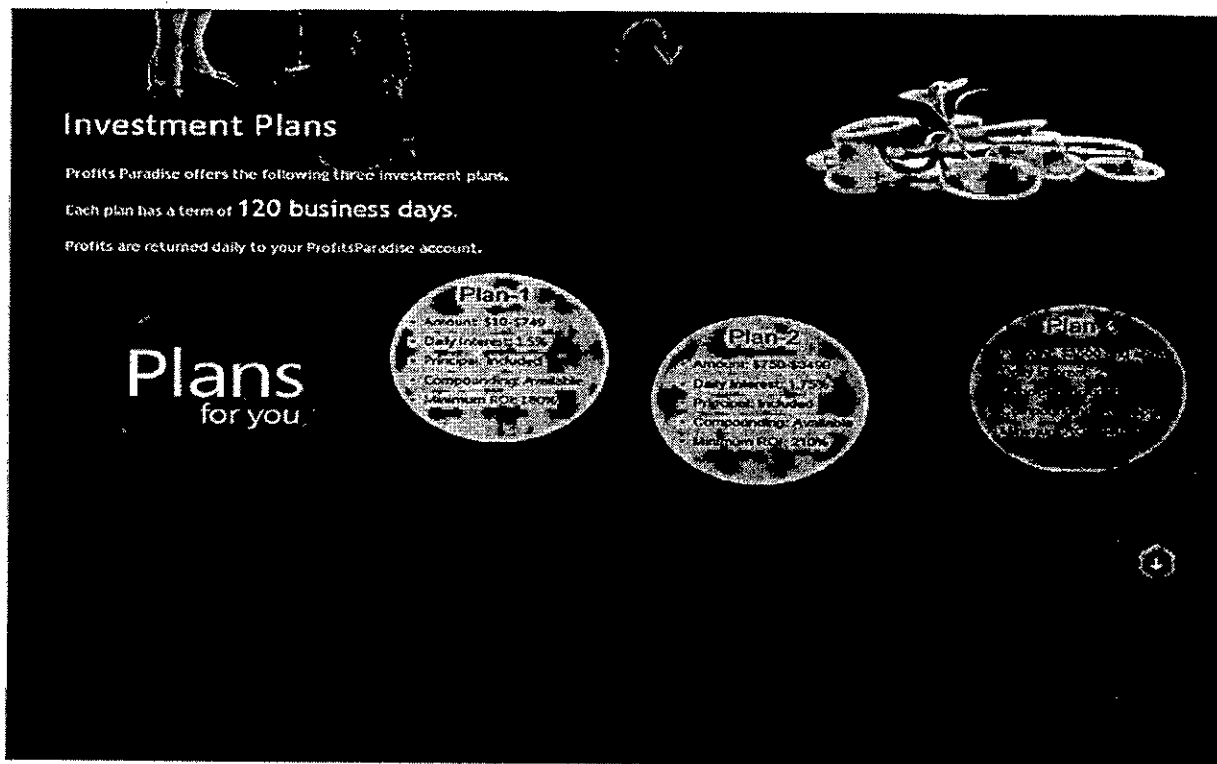
22. Profits Paradise's GooglePlus site also promoted investments in Profits Paradise. The GooglePlus site included the following statements, among others: "Our traders tap financial market trends and signals with stringent analysis and portfolio diversification spread over Forex, stocks, and commodity trading to ensure handsome profits for our customers," and "[w]e at Profits Paradise allow investors to join in with small amounts which are pooled together to make huge profits in forex, stocks and commodity trading." The GooglePlus site did not include a mailing address, telephone number, or the name of any individual associated with Profits Paradise.

23. The Profits Paradise Website and social media sites were available online from the spring of 2013 through early 2014. By December 2013, the Profits Paradise Facebook page

had more than 3,000 "Likes." By mid-January 14, 2014, the Website had more than 4,000 visits each day, including more than 200 U.S. visits.

D. PROFITS PARADISE WAS A CLASSIC HIGH-YIELD OFFERING FRAUD SCHEME

24. The published version of the Profits Paradise Website contained the description that Srivastava emailed Kavuri in early February 2013, including the representation that "[w]e at Profits Paradise allow investors to join in with small amounts which are pooled together to make huge profits in forex, stocks, and commodity trading." The Website also described the three investment plans that Profits Paradise was offering:



In offering these investments, the Website explained that "[e]ach plan has a term of 120 business days" and that "[p]rofits are returned daily to your ProfitsParadise account." The Website also explained that "you can compound your deposits in multiples of 10%," a subject Kavuri had instructed the web designer on.

25. The Website included links to online payment processors through which investors could fund their Profits Paradise accounts: "Opening an account with any of the four payment processors is a simple and easy process. Please click on your preferred processor to open on [sic] account and follow the instructions provided to fund them."

26. The Respondents offered investments in the United States and their conduct took place on U.S. territory. Their investment scheme also was directed at United States investors, and the scheme had foreseeable and substantial effects in the United States. Among other things, the Website used the ".com" domain name for global reach and appeal, was registered claiming a

physical location and point of contact within the United States, and contained writing in American English, using American spelling and the "\$" sign. Respondents' related social media sites, directed to attracting and funneling investors to the Website via Facebook, YouTube and GooglePlus, were likewise written in American English and designed to solicit United States investors. By mid-January 2014, the Respondents' Website had more than 200 visitors per day from the United States.

27. The Website also encouraged investors to solicit others to invest in Profits Paradise, by promising referral commissions: "Yes, you can earn handsome commissions through our Affiliate Partnership program without funding your account. Successful partners can expect extra bonuses from the management based on their marketing skills." The Website further encouraged investors to advertise Profits Paradise through social media and elsewhere: "We encourage you to use your referral link and promotional banners on social media, blogs, forums and email to share it with interested parties."

28. The investment returns promised by Profits Paradise were extraordinary—180%, 210%, or 240% in 120 business days—and far exceeded the returns investors could reasonably expect on legitimate investments. According to the Website, an investment of \$3,500 would yield a total return of \$8,400 (240%) in a 120-day period, without taking into account "compounding" that Profits Paradise offered. If the same investor reinvested only the principal amount for the second 120-day period available in a calendar year, he or she would have earned approximately \$16,800 (480%) annually, also without taking compounding into account.

29. The Website advertised that investors could "compound" their deposits "in multiples of 10%." It did not define the term compounding or otherwise explain its meaning. Instead, the Website contained a "Profits Calculator" that was intended to show investors the returns they could achieve through compounding. There, investors could type in two numbers: the dollar amount of their principal investment, and a "compounding %" of anywhere between 10% and 100% (in multiples of 10%). When the investor clicked the "Calculate" button, the Profits Calculator would display the results of compounding at the selected rate. According to the Website, compounded at a rate of 10%, an investor's initial \$3,500 deposit would yield a total return of \$9,483.01 (270.94%) after 120 days; at 50% compounding the same investment would yield USD \$16,102.71 (460.08%) after 120 days; at 100% compounding, \$34,178.07 (976.52%) after 120 days. If an investor reinvested the entire return (\$34,178.07) for a second 120-day period at 100% compounding, then that initial investment of \$3,500 would be worth \$333,753 (9,535.82%) at the end of a single year.

30. The Website used the following terms to describe the risk involved in the investment: "guaranteed profits," "guaranteed profits with minimal risk," and "stable sources of income."

31. The investment offered by the Respondents through their Website was never legitimate and is a classic example of a high-yield investment program. The fields of investment described in the Website—namely foreign exchange, stocks, and commodities—involve high risk and could not sustain the returns guaranteed by Profits Paradise. Such returns are far in excess of returns that would be yielded by a safe, if any, investment.

32. Also, the Profits Paradise offering was structured so that under certain conditions investors could never recover their principal investments. The Website set the following limitation on what investors could withdraw from their Profits Paradise accounts: "Minimum withdrawal is \$5. Maximum withdrawal is \$400 per day." As a result, if an investor were to invest \$20,000, he or she could not withdraw more than the earned interest at a rate of 2% per day or \$400; that is, the investor could not withdraw any of the principal. Therefore, any

investment above \$20,000 could never be repaid even if the investor withdrew \$400 each business day.

E. THE INVESTMENTS THAT PROFITS PARADISE OFFERED WERE SECURITIES

33. The products offered by Profits Paradise were investment contracts because the Website: (a) solicited investors to deposit money, (b) that would purportedly be pooled with other investor money, (c) resulting in very high daily returns derived solely from the efforts of a team of purportedly qualified investment professionals.

34. The Profits Paradise offering was available to investors in the United States and worldwide, through the Website www.profitsparadise.com. The Respondents never registered the Profits Paradise offering or filed anything with the Commission.

35. During the Enforcement Division's investigation, on February 2, 2014, the Respondents allowed the domain name registration for www.profitsparadise.com to expire, removing publication of the Website from the Internet.

VIOLATIONS

36. As a result of the conduct described above, the Respondents violated Sections 17(a)(1) and (3) of the Securities Act, which prohibit fraudulent conduct in the offer or sale of securities.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate that public administrative and cease-and-desist proceedings be instituted to determine:

A. Whether the allegations set forth in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and

B. Whether, pursuant to Section 8A of the Securities Act, the Respondents should be ordered to cease and desist from committing or causing any violations of, or any future violations of, Sections 17(a)(1) and (3) of the Securities Act, whether the Respondents should be ordered to pay a civil penalty pursuant to Section 8A(g) of the Securities Act, and whether the Respondents should be ordered to pay disgorgement with reasonable interest pursuant to Section 8A(e) of the Securities Act.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that the Respondents shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If the Respondents fail to file the directed answer, or fail to appear at a hearing after being duly notified, the Respondents may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served upon Respondents as provided for in Rule 141(a)(2)(iv) of the Commission's Rules of Practice, 17 C.F.R § 201.141(a)(2)(iv), by any method specified in paragraph (a)(2) of that rule, or by any other method reasonably calculated to give notice, provided that the method of service used is not prohibited by the law of the foreign country where Respondents may be found including in the case of India, service in accordance with the Hague Service Convention for Service Abroad of Judicial or Extrajudicial Documents in Civil or Commercial Matters.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Brent J. Fields
Secretary


By: Jill M. Peterson
Assistant Secretary

*Commissioner Gallagher
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9680 / November 12, 2014

SECURITIES EXCHANGE ACT OF 1934
Release No. 73581 / November 12, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16269

In the Matter of

Michael S. Geist and
Brent E. Taylor,

Respondents.

**ORDER INSTITUTING CEASE-
AND-DESIST PROCEEDINGS
PURSUANT TO SECTION 21C OF THE
SECURITIES EXCHANGE ACT OF 1934,
MAKING FINDINGS, IMPOSING
REMEDIAL SANCTIONS, AND A
CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Michael S. Geist ("Geist") and Brent E. Taylor ("Taylor") (collectively "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, Imposing Remedial Sanctions, and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds¹ that:

A. SUMMARY

1. This is an insider trading case in which the Respondents traded on the basis of material nonpublic information regarding the award of a U.S. Army contract, Blue Force Tracking-2 production ("BFT-2"), to ViaSat, Inc. ("ViaSat"). Geist, a ViaSat employee, learned of the award on July 19, 2010 from ViaSat, two days before it was publicly announced on July 21, 2010. Geist profitably traded in options for ViaSat stock as well as options for Comtech Telecommunications, Inc. ("Comtech Telecom"), the losing bidder on the Army award. Geist then tipped the information to his business colleague, Taylor. On the morning of July 21, 2010, Taylor also received information concerning the Army's decision from a company for whom he was working as a subcontractor. Taylor sold his Comtech Telecom stock on July 21, 2010 and avoided losses, just an hour before the public announcement of the award, and also at the same time arranged for his then wife to sell her Comtech Telecom stock and also avoid losses. Collectively, the Respondents and Taylor's then wife accrued \$120,975 in illegal gains and losses avoided from their trading.

B. RESPONDENTS

2. Geist, age 41, is a resident of Sykesville, Maryland. Geist worked for Comtech EF Data, a subsidiary of Comtech Telecom, between 2005 and 2008, as a Government Sales Manager. From 2008 to 2012, Geist worked for ViaSat in Maryland as a manager of government programs, and was promoted to Director of Business Development for ViaSat on July 1, 2012. Geist is a business associate of Taylor.

3. Taylor, age 55, is a resident of Gaithersburg, Maryland. Taylor is the former Chief Operating Officer and Executive Vice President of Comtech Mobile Datacom Corp. ("Comtech Mobile"), a subsidiary of Comtech Telecom. While at Comtech Mobile, Taylor was involved in procuring the previous iteration of the BFT-2 contract on behalf of Comtech Mobile, but left in 2004. Since 2004, Taylor has worked on various government satellite communications ("SATCOM") contracts through his Subchapter S corporation, Rationa-3, LLC. Taylor's former wife worked as an informal bookkeeper for Rationa-3, LLC. In July 2010, Taylor and Rationa-3, LLC had a subcontract to work on an Army contract proposal being prepared by a defense contractor based in Melbourne, Florida.

¹ The findings herein are made pursuant to Respondents' Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

C. FACTS

4. In his job at ViaSat, Geist frequently visited government contract offices and assisted with organizing and drafting information responses and bid responses to government requests for SATCOM capabilities, including ViaSat's response to a request for information pertaining to BFT-2, a precursor event to a request for bid. In 2008 or 2009, Geist met Taylor at an Association of the U.S. Army ("AUSA") convention, an annual trade show occurring every October in Washington, D.C.

5. Taylor was one of the original founders of Mobile Datacom Corp., Comtech Mobile's predecessor, which focused upon SATCOM technology for the defense industry. Mobile Datacom was acquired by Comtech Telecom in 1997, and was renamed Comtech Mobile. Through his experience at Comtech Mobile and through previous employers, Taylor worked on request for proposal solicitations for Department of Defense branches, including the Army. Through his career, he became aware of the government's practice of informing award recipients early, prior to public announcement, to facilitate final contract negotiations. He also understood the practice of maintaining the confidentiality of the information until after the government contracting agencies issued a public release. Taylor received options to purchase Comtech Telecom stock as part of his compensation while working for Comtech Mobile, which he retained after his departure from Comtech Mobile in August 2004, and later exercised.

6. The original Blue Force Tracking production contract was awarded to Comtech Mobile in the early 2000s, while Taylor worked there, which Comtech Mobile currently maintains. In April 2009, the program manager for the Blue Force Tracking program, Force XXI Battle Command Brigade and Below ("FBCB2"), posted a request for information, indicating that it would solicit bids for the next generation of Blue Force Tracking production through a request for proposal in the near future. Geist assisted in the assembly and drafting of ViaSat's response to the request for information. On or about this time, Geist and Taylor met for a meal and/or drink in Germantown, Maryland. At the meeting, Geist sought to learn specifics about Blue Force technology from Taylor, and also sought a working relationship with Taylor, including bringing Taylor in to consult for ViaSat on its SATCOM business and contract solicitation. They also discussed the Blue Force program.

7. On December 23, 2009, a request for proposal was officially solicited by FBCB2 and the U.S. Army's Communication—Electronic Command ("CECOM") to produce BFT-2. Only ViaSat and Comtech Mobile submitted bids for the BFT-2 contract. Following the bids for the BFT-2 solicitation, there was a consensus among market analysts that Comtech Mobile would win BFT-2. Many insiders, including Taylor, also believed that Comtech Mobile would win the contract again.

8. On July 19, 2010, at 2:24 p.m. EDT, two days prior to the July 21, 2010 public announcement of the award, the CECOM contracting officer for the BFT-2 solicitation sent an email to ViaSat informing it that CECOM had selected ViaSat as the BFT-2 awardee. The email attached drafts of the contract, but specifically noted that the award had not yet received Congressional approval, required before formal award and public announcement. The email

stated, in all capital letters, "BE ADVISED THAT THIS CORRESPONDANCE [*sic*] DOES NOT GRANT YOU AUTHORITY TO ANNOUNCE THIS SELECTION." The email further explained that ViaSat could not announce the award until after Congressional approval, expected on July 20, 2010, at the earliest. The email was forwarded to other ViaSat employees, including Geist, at 3:12 p.m. EDT.

9. Geist's first acknowledgment of the email occurred at 5:01 p.m. EDT on July 19, 2010, when he replied from his Blackberry "Woo Hoo!" At 6:10 p.m. EDT, Geist called Brent Taylor's cell phone.

10. That night, July 19, 2010, Geist logged into his online TD Ameritrade Individual Retirement Account ("IRA") and purchased two different types of options. At 8:47 p.m. EDT, Geist placed a limit order to purchase 200 August 2010 put option contracts on Comtech Telecom stock (each option conveying a right to sell 100 shares for a total of 20,000 Comtech shares) with a limit price of \$0.80. The option contracts would expire on August 21, 2010 and had a strike price of \$30.00 per share. At 11:24 p.m. EDT, Geist entered a limit order through this same account for 200 September 2010 call option contracts on ViaSat shares (each option giving a right to buy 100 shares for a total of 20,000 ViaSat shares) with a limit price of \$1.20. The option contracts would expire on September 18, 2010 and had a strike price of \$35.00 per share. Geist's order for ViaSat call options was executed at 9:30 a.m. EDT on July 20, 2010 for a total purchase price of \$24,159.99.

11. On July 20, 2010, at 9:53 a.m., Geist called TD Ameritrade to change his limit order for Comtech Telecom put options to a market order, as his limit order had not yet executed. The order was immediately executed at 9:53 a.m., and 189 options were purchased at \$0.90 and eleven options were purchased at \$0.95 for a total purchase price of \$18,214.99. The total purchase price of Geist's Comtech Telecom put options and ViaSat call options was \$42,374.98.

12. On July 20, 2010, Taylor returned Geist's call at 10:02 a.m. EDT, which began a series of back-and-forth phone calls, each two minutes or less, until they spoke for eleven minutes between 10:04 and 10:15 a.m. EDT. Immediately after Taylor finished speaking to Geist on July 20, 2010, Taylor called his broker at UBS Wealth Management ("UBS") at 10:17 a.m. EDT. During that call, Taylor told his UBS broker that he had heard from a friend at either "the company" or "Comtech" that Comtech Mobile would lose the BFT-2 contract. The UBS broker told Taylor that he had not seen any news about the award and that the market did not appear to reflect the news. Taylor did not place any trades at that time. The call between Taylor and his UBS broker lasted ten minutes.

13. On the evening of July 20th, the same day that Geist had acquired the options, between 7:55 and 7:58 p.m., Geist placed an order to sell the Comtech Telecom options he had purchased at \$1.00 or better and to sell the ViaSat options at \$2.50 or better. These orders were not executed until the following day and moments after Comtech Telecom's issue of a press release announcing its loss of the BFT-2 award at 11:14 AM. The Comtech Telecom options were sold for \$1.00 at 11:15 a.m., one minute after the Comtech Telecom press release, and the ViaSat

options were sold for \$2.50 at 11:29 a.m., fifteen minutes after the Comtech Telecom press release. Geist made a total profit of \$27,303.85 on his sales of the Comtech Telecom and ViaSat options.

14. On the morning of July 21, 2010, the Army's BFT-2 Deputy General Manager advised an engineer at a defense contractor for whom Taylor served as a subcontractor that ViaSat had won the BFT-2 award, because the defense contractor would be reporting to ViaSat on its current Movement Tracking System contract work for the Army. The engineer sent an email to the defense contractor's Director of Business Development and other employees at 10:11 a.m. At 10:14 a.m., the Director of Business Development telephoned Taylor's cellphone for two minutes and told Taylor that ViaSat had won the BFT-2 award.

15. On July 21, 2010, at 10:17 a.m. EDT, Taylor called Geist again, and then immediately thereafter, at 10:18 a.m. EDT, Taylor called his UBS broker and asked him whether he had seen any news about the award. During the course of the call, which lasted two minutes, the broker checked his firm's newswires and told Taylor that he did not see any news about the award, nor did he see any market activity suggestive of major news for Comtech Telecom. Taylor then told his broker that he heard the news from a friend. Taylor did not identify the friend. Even though the broker indicated to Taylor that he could not find any evidence that the BFT-2 award was public, Taylor nonetheless placed a market order with his broker to sell 4,000 shares of Comtech Telecom.

16. On July 21, 2010, at 10:18 a.m. EDT, the Army posted the award of the BFT-2 contract to ViaSat on its Interactive Business Opportunities ("IBOP") website. This award information could not be accessed without a password. Taylor did not have an IBOP password and never saw the BFT-2 award information posted on IBOP.

17. Taylor's order to sell 4,000 shares of Comtech at UBS was entered and executed at 10:21 a.m. EDT, and the shares were sold for an average price of \$31.14 per share, for a total of \$124,385.72. Taylor avoided losses of \$44,650.01 on his sale of Comtech Telecom stock. Taylor also asked his broker to sell shares of Comtech Telecom stock from his then wife's account, but his broker refused, stating that he could not sell the then wife's shares without her authorization.

18. On July 21, 2010, at 10:20 a.m. EDT, immediately after speaking to his UBS broker, Taylor called his then wife. Taylor's wife then called the same UBS broker, who was also her broker, and asked him to execute a market order to sell 5,000 shares of Comtech Telecom. Her sale of 5,000 shares was completed by 10:24 a.m. EDT, and the shares sold for an average price of \$31.16 per share, for a total of \$155,557.37. Taylor's then wife avoided losses of \$49,007.37 on her sales of Comtech Telecom stock. Shortly after the Taylors' trades, their UBS broker reported to his supervisor that the Taylors' actions appeared to be an insider trading violation. UBS had its counsel investigate, reported the possible insider trading to authorities, and cancelled the Taylors' accounts at UBS.

19. On July 21, 2010, at 10:38 a.m. EDT, Taylor called his other broker at Stifel Nicolaus, where Taylor also held shares of Comtech Telecom. At 11:02 a.m. EDT, Taylor's Stifel Nicolaus broker sent an email to Taylor, stating only, "Sell 4000 Comtech Telecom?" Taylor then

called his Stifel Nicolaus broker again at 11:02 a.m. EDT. At 11:10 a.m. EDT, Taylor's Stifel Nicolaus broker entered a limit order to sell 4,000 shares of Comtech Telecom at a minimum of \$30.50 per share. Between 11:10 a.m. and 11:15 a.m. EDT, Taylor was able to sell 598 Comtech Telecom shares before the price dropped below \$30.50. Taylor's sale of 598 shares totaled \$18,247.67. Taylor and his then wife avoided total combined losses on all of their July 21, 2010 sales of Comtech Telecom stock of \$93,657.71.

20. On July 21, 2010, at 11:14 a.m. EDT, Comtech Telecom issued a press release announcing that it had lost the BFT-2 award. This was the first public release of the award decision. Comtech Telecom's public release of the award immediately impacted the market. Comtech Telecom's stock price dropped precipitously from \$30.95 to \$22.38 within fifteen minutes of the release, a nearly 28% loss in value. Comtech Telecom's stock price closed at \$21.31 on July 21, 2010. There was a nearly 1500% spike in volume of Comtech Telecom stock within fifteen minutes of the press release. ViaSat's stock price rose following Comtech Telecom's release from \$33.33 to \$35.24 within fifteen minutes, and it closed at \$35.09 for the day. ViaSat stock trading volume increased nearly 70% in the fifteen minutes following the press release.

21. Geist owed a duty of trust and confidence to his employer, ViaSat, and to its shareholders, not to trade on or tip others with material, nonpublic information learned during the scope of his employment. By trading on July 19 and 20, 2010 in the securities of ViaSat and Comtech Telecom based on the material nonpublic information that ViaSat, Inc. had won the BFT-2 award, Geist breached his duty of trust and confidence to ViaSat. Geist also violated his duty to ViaSat when he knowingly or recklessly tipped Taylor, who could use the information in connection with securities trading. Geist did so for his own reputational and professional benefit.

22. Taylor knew or had reason to know that Geist breached his fiduciary duty of trust and confidence to his employer, ViaSat, when Geist tipped Taylor that ViaSat had won the BFT-2 award. Accordingly, Taylor inherited Geist's duty not to trade on that information and not to use it improperly for the benefit of others, including his then wife. Taylor knew the information provided to him by Geist was material and nonpublic and used that information when he traded and arranged for his wife to trade.

23. Taylor alternatively misappropriated information from the defense contractor for whom he served as a subcontractor when he used material, nonpublic information he learned from the defense contractor. The market had not absorbed the information contained in the IBOP BFT-2 award announcement prior to the press release issued by Comtech Telecom on July 21, 2010, at 11:14 a.m. EDT, nor had that information been impounded into the price of Comtech Telecom or ViaSat stock. The defense contractor gave Taylor the advance notice of the BFT-2 award that it received from the Army in order for Taylor to use that information in his role as a subcontractor, not to profit personally. The defense contractor had contracts and practices in place that protected this information as confidential and proprietary, so Taylor had a duty to the defense contractor not to trade on the information.

D. VIOLATIONS

24. As a result of the conduct described above, Geist and Taylor directly and indirectly violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondents' Offers.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondents cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

B. Pursuant to Section 21C of the Exchange Act, Respondents are prohibited from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act or that is required to file reports pursuant to Section 15(d) of the Exchange Act because Respondents' conduct demonstrates unfitness to serve as an officer or director of any such issuer, for a period of five years from the date of the Order.

C. Pursuant to Section 21C(e) of the Exchange Act, Respondent Geist shall, within ten days of the entry of this Order, pay disgorgement of \$27,303.85 and prejudgment interest of \$3,441.09 to the Securities and Exchange Commission for transfer to the United States Treasury. Respondent Taylor shall, within ten days of the entry of this Order, pay disgorgement of \$46,828.86 and prejudgment interest of \$11,808.74; and within 120 days of the entry of this Order, pay disgorgement of \$46,828.86 plus post-judgment interest pursuant to SEC Rule of Practice 600 to the Securities and Exchange Commission for transfer to the United States Treasury. Pursuant to Section 21B(a)(2) of the Exchange Act, Geist shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of \$27,303.85 to the Securities and Exchange Commission for transfer to the United States Treasury. Taylor shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of \$46,828.86; and within 120 days of the entry of this Order, pay a civil money penalty in the amount of \$46,828.86, plus post-judgment interest pursuant to 31 U.S.C. § 3717 to the Securities and Exchange Commission for transfer to the United States Treasury. Prior to making the payments ordered within 120 days of entry of this Order, Taylor shall contact the Commission staff to ensure the inclusion of post-judgment interest. If any payment is not made by the date the payment is required by the Order, the entire outstanding balance of disgorgement, prejudgment interest, and civil penalties, plus any additional interest accrued pursuant to SEC Rule of Practice 600 or pursuant to 31 U.S.C. § 3717, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

- (1) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;²
- (2) Respondents may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondents may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

D. Payments by check or money order must be accompanied by a cover letter identifying Geist or Taylor as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Gregory G. Faragasso, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-6010.

E. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that in any Related Investor Action, they shall not argue that they are entitled to, nor shall they benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondents' payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondents agree that they shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

F. It is further Ordered that, for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondents, and further, any debt for disgorgement, prejudgment interest, civil

² The minimum threshold for transmission of payment electronically is \$50,000.00 as of April 1, 2012. This threshold will be increased to \$1,000,000 by December 31, 2012. For amounts below the threshold, respondents must make payments pursuant to option (2) or (3) above.

penalty or other amounts due by Respondents under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondents of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
Secretary


By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-73579; File No. SR-OCC-2014-807)

November 12, 2014

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of an
Emergency Change to OCC's Procedures to Resize the Clearing Fund in Response to
Market Conditions

Pursuant to Section 806(e)(2) of Title VIII of the Dodd-Frank Wall Street Reform
and Consumer Protection Act, entitled Payment, Clearing, and Settlement Supervision
Act of 2010 ("Payment, Clearing and Settlement Supervision Act")¹ and Rule 19b-
4(n)(1)(i) under the Securities Exchange Act of 1934 ("Act"),² notice is hereby given that
on October 16, 2014, The Options Clearing Corporation ("OCC") filed with the
Securities and Exchange Commission ("Commission") the emergency notice as described
in Items I and II below, which Items have been prepared by OCC. The Commission is
publishing this notice to solicit comments on the emergency notice from interested
persons.

I. Clearing Agency's Statement of the Terms of Substance of the Emergency Notice

This notice is filed by OCC in connection an increase in the size of OCC's
Clearing Fund that it has implemented on an emergency basis pursuant to Section
806(e)(2) of the Payment, Clearing, and Settlement Supervision Act.

II. Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the
Emergency Notice

In its filing with the Commission, OCC included statements concerning the
purpose of and basis for the advance notice and discussed any comments it received on

¹ 12 U.S.C. 5465(e)(2).

² 17 CFR 240.19b-4(n)(1)(i).

the advance notice. The text of these statements may be examined at the places specified in Item IV below. OCC has prepared summaries, set forth in sections A and B below, of the most significant aspects of these statements.

(A) Clearing Agency's Statement on Comments on the Emergency Notice Received from Members, Participants or Others

Written comments were not and are not intended to be solicited with respect to the emergency notice and none have been received.

(B) Emergency Notices Filed Pursuant to Section 806(e)(2) of the Payment, Clearing and Settlement Supervision Act

Description of Change

Emergency Notice

This notice is being filed in connection with an emergency waiver of the provision of OCC's Rules calling for monthly adjustments of its Clearing Fund that would otherwise have required an advance notice under Section 806(e)(1) of the Payment, Clearing and Settlement Supervision Act. Pursuant to Section 806(e)(2) of the Payment, Clearing, and Settlement Supervision Act, a designated financial market utility such as OCC may implement a change that would otherwise require an advance notice if it determines that an emergency exists and immediate implementation is necessary to continue to provide services in a safe and sound manner.³ For the reasons discussed below, OCC believes that the change was appropriate under this framework, and OCC is now filing this emergency notice in accordance with the requirements under Sections 806(e)(2)(B) and (C) of the Payment, Clearing and Settlement Supervision Act.⁴

³ 12 U.S.C. 5465(e)(2).

⁴ 12 U.S.C. 5465(e)(2)(B), 12 U.S.C. 5465(e)(2)(C).

Sizing of the Clearing Fund

Under Commission Rule 17Ad-22(b)(3), OCC is obligated to maintain sufficient financial resources to withstand, at a minimum, a default by the Clearing Member Group to which OCC has the largest exposure in extreme but plausible market conditions.⁵ As part of OCC's ongoing compliance with this obligation, it readjusts the size of its Clearing Fund monthly pursuant to OCC's Rule 1001(a). Under Rule 1001(a), the monthly readjustment is based upon daily calculations by OCC during the preceding month of the size of the Clearing Fund that would be necessary, within certain confidence levels, to protect OCC from loss under simulated default scenarios. Recent increased volatility in the financial markets has affected these calculations such that OCC's daily results indicate that the size of the Clearing Fund should be increased to address the potential risk that it could be underfunded in the event of a Clearing Member default. OCC recently proposed a rule change and advance notice that would permit the Clearing Fund to be resized intra-month in the event that the five-day rolling average of projected draws against the Clearing Fund are 150% or more of its then current size.⁶ Although that proposal remains pending, OCC calculates that the recent increase in market volatility would have caused that proposed threshold to be exceeded as of October 15, 2014 and determined that an intra-month increase was necessary to minimize the risk of an underfunding of the Clearing Fund.

⁵ 17 CFR 240.17Ad-22(b)(3).

⁶ See, Securities Exchange Act Release No. 72752 (August 4, 2014), 79 FR 46490 (August 8, 2014) (SR-OCC-2014-17). See also, Securities Exchange Act Release No.72804 (August 11, 2014), 79 FR 48276 (August 15, 2014) (SR-OCC-2014-804).

Nature of the Emergency and Reasons the Clearing Fund Resizing was Necessary

To provide OCC with the necessary flexibility to respond to these dynamic market conditions and increase the size of its Clearing Fund prior to the next resizing scheduled to take place on the first business day in November, OCC has exercised certain emergency powers in Article IX, Section 14 of its By-Laws. In emergency circumstances and subject to certain conditions, that authority permits OCC's Board of Directors, Executive Chairman or President to waive or suspend its By-Laws, Rules, policies and procedures or any other rules issued by OCC or extend the time fixed thereby for the doing of any act or acts.⁷ Consistent with that authority, OCC's Executive Chairman on October 15, 2014 determined to waive the provisions in the second sentence of Rule 1001(a) under which the Clearing Fund is readjusted monthly based upon an average of the daily calculations performed by OCC during the preceding calendar month. To respond to the potential risk under prevailing market conditions that the Clearing Fund could be underfunded, which could affect OCC's ability to continue to facilitate prompt and accurate clearance and settlement and to operate in a safe and sound manner, OCC increased the size of the Clearing Fund for the remainder of October 2014 as is otherwise provided for in Rule 1001(a). Accordingly, the original Clearing Fund sizing calculation for October 2014 of approximately \$3.8 billion was suspended by OCC and the size of the Clearing Fund was reestablished in an amount of approximately \$5.6 billion. The Executive Chairman consulted with the Risk Committee of OCC's Board of Directors

⁷ See Securities Exchange Act Release No. 71571 (February 19, 2014), 79 FR 10581 (February 25, 2014) (SR-OCC-2013-23). As noted in the Commission's approval order for that rule change, the change generally aligned OCC's authority in this area with the authority of other registered clearing agencies that already had similar rules allowing them in comparable circumstances to waive or suspend their rules or extend the time fixed thereby for the performance of any act or acts.

and senior staff of the Commission before making this decision. Senior staff of the U.S. Commodity Futures Trading Commission was also informed.

Anticipated Effect on and Management of Risk

Overall, the increase in the size the Clearing Fund reduces the risks to OCC, its Clearing Members and the options market in general because it provides OCC with proper flexibility under current market conditions to establish a Clearing Fund size that OCC believes would be sufficient to protect against losses under current market conditions for a period of not more than 30 calendar days as specified in Article IX, Section 14(c). The change allowed OCC to increase the overall size of its Clearing Fund as a result of a projected increase in potential draws. Accordingly, the change makes it less likely that the Clearing Fund will be insufficient should OCC need to use it to manage a Clearing Member default. The change therefore reduces OCC's overall level of risk and facilitates its management of risk.

Consistency with the Payment, Clearing and Settlement Supervision Act

OCC believes that the increase in the total size of the Clearing Fund was consistent with Sections 805(b)(1)⁸ and 806(e)(2)⁹ of the Payment, Clearing and Settlement Supervision Act. The change promotes robust risk management¹⁰ by providing OCC with an amount of financial resources it believes would be sufficient to protect OCC against loss in an event of default. The change was appropriate on an emergency basis because OCC determined through daily calculations regarding the

⁸ 12 U.S.C. 5464(b)(1).

⁹ 12 U.S.C. 5465(e)(2).

¹⁰ 12 U.S.C. 5464(b)(1).

sufficiency of the Clearing Fund that increased financial market volatility represented a potential risk that the Clearing Fund could be underfunded if an event of default occurred. The determination to readjust the size of the Clearing Fund as described above was therefore necessary and advisable for the protection of OCC and in the public interest to ensure that OCC's Clearing Fund is sufficient for OCC to be able to provide its services in a safe and sound manner.

III. Date of Effectiveness of the Advance Notice and Timing for Commission Action

OCC implemented a proposed change that otherwise would be required to be filed as an advance notice because OCC determined that (i) an emergency existed and (ii) immediate implementation was necessary for OCC to continue to provide its services in a safe and sound manner. The Commission may require modification or rescission of the proposed change if it finds it is not consistent with the purposes of the Payment, Clearing and Settlement Supervision Act or any applicable rules, orders, or standards prescribed under Section 805(a) of the Payment, Clearing and Settlement Supervision Act.¹¹

Pursuant to Rule 19b-4(n) under the Act,¹² OCC shall post notice on its website of proposed changes that are implemented.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing. Comments may be submitted by any of the following methods:

¹¹ See 12 U.S.C. 5465(e)(2)(D), 12 U.S.C. 5464(a).

¹² 17 CFR 240.19b-4(n).

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-OCC-2014-807 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-OCC-2014-807. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the emergency notice that are filed with the Commission, and all written communications relating to the emergency notice between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 am and 3:00 pm. Copies of the filing also will be available for inspection and copying at the principal office of OCC. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer

to File Number SR-OCC-2014-807 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

By the Commission.

Kevin M. O'Neill

Kevin O'Neill
Deputy Secretary

COMMODITY FUTURES TRADING COMMISSION

RIN 3038-AE24

SECURITIES AND EXCHANGE COMMISSION

[Release No. 33-9681; 34-73584; File No. S7-16-11]

RIN 3235-AK65

Forward Contracts With Embedded Volumetric Optionality

AGENCY: Commodity Futures Trading Commission; Securities and Exchange Commission.

ACTION: Proposed Interpretation.

SUMMARY: In accordance with section 712(d)(4) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission ("SEC"), after consultation with the Board of Governors of the Federal Reserve System ("Board of Governors"), are jointly issuing the CFTC's proposed clarification of its interpretation concerning forward contracts with embedded volumetric optionality. The CFTC invites public comment on all aspects of its proposed interpretation.

DATES: Comments must be received on or before [insert date that is 30 days following publication in the Federal Register].

ADDRESSES: You may submit comments, identified by RIN number 3038-AE24, by any of the following methods:

- *CFTC Web site:* at <http://comments.cftc.gov>. Follow the instructions for submitting comments through the Web site.

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- *Federal eRulemaking Portal*: [http:// www.regulations.gov](http://www.regulations.gov). Follow the instructions for submitting comments.

- *Mail*: Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street N.W., Washington, DC 20581.

- *Hand Delivery/Courier*: Same as Mail, above. Please submit your comments using only one method.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to www.cftc.gov. You should submit only information that you wish to make available publicly. If you wish the CFTC to consider information that you believe is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedures established in § 145.9 of the CFTC's regulations, 17 CFR 145.9.

The CFTC reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of a submission from <http://www.cftc.gov> that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the notice will be retained in the public comment file and will be considered as required under all applicable laws, and may be accessible under the Freedom of Information Act.

FOR FURTHER INFORMATION CONTACT: CFTC: Elise Pallais, Attorney Advisor, (202) 418-5577, epallais@cftc.gov, Office of the General Counsel, Commodity Futures Trading Commission, 1155 21st Street, NW, Washington, DC 20581. SEC: Carol McGee, Assistant Director, (202) 551-5870, mcgeec@sec.gov, Office of

Derivatives Policy, Division of Trading and Markets, Securities and Exchange
Commission, 100 F Street, NE, Washington, DC 20549. **SUPPLEMENTARY**

INFORMATION:

I. Introduction

In *Further Definition of "Swap," Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping* (the "Products Release"), the CFTC provided an interpretation, in response to requests from commenters, with respect to forward contracts that provide for variations in delivery amount (*i.e.*, that contain "embedded volumetric optionality").¹ Specifically, the CFTC identified when an agreement, contract, or transaction would fall within the forward contract exclusion from the "swap" and "future delivery" definitions in the Commodity Exchange Act (the "CEA")² notwithstanding that it contains embedded volumetric optionality.³ In providing its interpretation, the CFTC was guided by and sought to reconcile agency precedent regarding forward contracts containing embedded optionality⁴ with the statutory definition of "swap" in section 1a(47) of the CEA, which provides, among other things, that commodity options are swaps, even if physically settled.⁵

¹ See 77 FR 48207, 48238-42 (Aug. 13, 2012).

² See 7 U.S.C. 1a(47)(B)(ii) (excluding from the definition of "swap" "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled"); 1a(27) (excluding from the definition of "future delivery" "any sale of any cash commodity for deferred shipment or delivery").

³ See 77 FR at 48238-42 & n.335. See also *id.* at 48227-36 (providing the CFTC's interpretation regarding the forward contract exclusion for nonfinancial commodities).

⁴ See *id.* at 48237-39 (citing *In re Wright*, CFTC Docket No. 97-02, 2010 WL 4388247 (CFTC Oct. 25, 2010), and *Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options*, 50 FR 39656 (Sept. 30, 1985) ("1985 CFTC OGC Interpretation").

⁵ See *id.* at 48236-37; 7 U.S.C. 1a(47)(A)(i) (defining "swap" to include "[an] option of any kind that is for the purchase or sale, or based on the value, of 1 or more * * * commodities * * *") (emphasis added). Part 32 of the CFTC's regulations includes an exemption for certain physically settled options, termed "trade options." See 17 C.F.R. 32.3. The trade option exemption is currently subject to CFTC staff no-action

The CFTC has received several comments from market participants requesting that it modify or further clarify its interpretation.⁶ According to commenters, uncertainty with regard to the meaning of certain language in the CFTC's interpretation, particularly the seventh element, has led to confusion among market participants with regard to how to characterize certain transactions, whether as excluded forward contracts with embedded volumetric optionality or regulated trade options.

II. Proposed Interpretation

In response to commenters, the CFTC is proposing to clarify its interpretation of when an agreement, contract, or transaction with embedded volumetric optionality would be considered a forward contract.⁷ Accordingly, the CFTC is proposing to provide that an agreement, contract, or transaction falls within the forward exclusion from the swap and future delivery definitions, notwithstanding that it contains embedded volumetric optionality, when:

1. The embedded optionality does not undermine the overall nature of the agreement, contract, or transaction as a forward contract;

relief. See CFTC Letter No. 13-08 (April 5, 2013), available at <http://www.cftc.gov/ucm/groups/public/@lrllettergeneral/documents/letter/13-08.pdf>.

⁶ The Products Release included a request for comment on the CFTC's interpretation. See 77 FR at 48241-42. CFTC staff also solicited comments in connection with a public roundtable to discuss issues concerning end users and the Dodd-Frank Act. These comments are available at <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=1256> and <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=1485>, respectively.

⁷ Section 712(d)(4) provides that "[a]ny interpretation of, or guidance by either Commission regarding, a provision of this title, shall be effective only if issued jointly by the Commodity Futures Trading Commission and the Securities and Exchange Commission, after consultation with the Board of Governors, if this title requires the Commodity Futures Trading Commission and the Securities and Exchange Commission to issue joint regulations to implement the provision." While the Dodd-Frank Act would require this interpretation to be issued jointly by the CFTC and the SEC, it would be an interpretation solely of the CFTC and would not apply to the exclusion from the swap and security-based swap definitions for security forwards or to the distinction between security forwards and security futures products.

2. The predominant feature of the agreement, contract, or transaction is actual delivery;

3. The embedded optionality cannot be severed and marketed separately from the overall agreement, contract, or transaction in which it is embedded;

4. The seller of a nonfinancial commodity underlying the agreement, contract, or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction to deliver the underlying nonfinancial commodity if the embedded volumetric optionality is exercised;

5. The buyer of a nonfinancial commodity underlying the agreement, contract or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction, to take delivery of the underlying nonfinancial commodity if the embedded volumetric optionality is exercised;

6. Both parties are commercial parties; and

7. The embedded volumetric optionality is primarily intended, at the time that the parties enter into the agreement, contract, or transaction, to address physical factors or regulatory requirements that reasonably influence demand for, or supply of, the nonfinancial commodity.

The first six elements are largely unchanged from the Products Release.⁸ Among them, the CFTC is proposing to modify only the fourth and fifth elements, to clarify that the CFTC's interpretation applies to embedded volumetric optionality in the form of both

⁸ See 77 FR at 48238.

puts and calls.⁹ Accordingly, the CFTC's discussion of these six elements in the Products Release would remain relevant and applicable.¹⁰

The seventh element addresses the primary reason for including embedded volumetric optionality in a forward contract. As commenters have explained, commercial parties are often unable to accurately predict their exact delivery needs or production capacity for a given nonfinancial commodity at contract initiation due to a variety of factors, such as weather and certain other "operational considerations" (e.g., transportation capacity).¹¹ The embedded volumetric optionality therefore offers commercial parties the flexibility to vary the amount of the nonfinancial commodity delivered during the life of the contract in response to uncertainty in the demand for or supply of the nonfinancial commodity.¹²

The seventh element ensures that this purpose, consistent with the historical interpretation of a forward contract,¹³ is the primary purpose for including embedded volumetric optionality in the contract. In other words, the embedded volumetric

⁹ As described in the Products Release, the fifth element did not appear to contemplate circumstances where the seller of the nonfinancial commodity might exercise the embedded volumetric optionality. *See* 77 FR at 48238 ("The buyer of a nonfinancial commodity underlying the agreement, contract or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction, to take delivery of the underlying nonfinancial commodity if *it exercises* the embedded volumetric optionality.") (emphasis added).

¹⁰ *See* 77 FR at 48238-39.

¹¹ *See, e.g.*, Letter from ONEOK, Inc. (July 22, 2011) at 4 (stating that "day-to-day changes in demand" for natural gas "may be caused by variation in weather, operational considerations, or other factors"); Letter from the American Gas Association (Oct. 12, 2012) at 9 (stating that "weather-sensitive demands" for natural gas "cannot be accurately predicted in advance").

¹² *See, e.g.*, Letter from the Commodity Markets Council, the National Corn Growers Association, and the Natural Gas Supply Association (April 17, 2014) at 2 ("Physical end-users need these contracts to address supply input or production output uncertainty associated with the operation of a physical business."); Letter from the Plains All American Pipeline, L.P. (April 17, 2014) at 2 ("Such contracts provide us with the ability to allow our customers flexibility to increase or decrease the amount of purchase or sale of a commodity in response to prevailing market conditions.").

¹³ *See* 77 FR 48228 (describing a forward contract as a "commercial merchandising transaction" in which delivery is delayed for "commercial convenience or necessity").

optionality must primarily be intended as a means of assuring a supply source or providing delivery flexibility in the face of uncertainty regarding the quantity of the nonfinancial commodity that may be needed or produced in the future, consistent with the purposes of a forward contract.¹⁴

In response to commenters, the CFTC is proposing to modify the seventh element to further clarify its interpretation.¹⁵ To begin, the CFTC is proposing to remove reference to the “exercise or non-exercise” of the embedded volumetric optionality. This language was included to embody the longstanding principle, recognized by commenters, that intent may be ascertained by the relevant facts and circumstances surrounding the contract, including the parties’ course of performance thereunder.¹⁶ According to commenters, however, this language has created problems during contract negotiations, because certain parties feel pressure to specify the exact factors that could lead to the

¹⁴ See 77 FR at 48228 (“The primary purpose of a forward contract is to transfer ownership of the commodity and not to transfer solely its price risk.”). See also Letter from the Commodity Markets Council, the National Corn Growers Association, and the Natural Gas Supply Association (April 17, 2014) at 2 (“[Contracts with volumetric optionality] exist to permit end-users to have agreements in place so that they can effectively and economically manage the purchase or sale of commodities related to their commercial businesses, not as a substitute for a financially settled contract or for speculative purposes.”); Letter from ONEOK, Inc. (July 22, 2011) at 7 (“Although the amounts that can be taken on delivery may vary, the primary intent of the contracts is not to provide price protection, which is clearly the intent of the contracts described in the [1985 CFTC] OGC Interpretation as trade options.”).

¹⁵ As stated in the Products Release, the seventh element reads as follows:

The exercise or non-exercise of the embedded volumetric optionality is based primarily on physical factors, or regulatory requirements, that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity.

77 FR at 48238 (footnotes omitted).

¹⁶ See 77 FR 48228 (“In assessing the parties’ expectations or intent regarding delivery, the CFTC consistently has applied a ‘facts and circumstances’ test.”); Letter from ONEOK, Inc. (July 22, 2011) at 6 (“The intent of the parties to defer delivery of a varying amount can be ascertained based on objective criteria, such as the pattern of deliveries in relation to variation in weather, customer demand, or other similar factors.”).

exercise or non-exercise of the volumetric optionality.¹⁷ By removing this language, the CFTC intends to clarify that the focus of the seventh element is intent with respect to the embedded volumetric optionality at the time of contract initiation.¹⁸ The CFTC would further advise commercial parties that they may rely on counterparty representations with respect to the intended purpose for embedding volumetric optionality in the contract, provided they are unaware, and should not reasonably have been aware, of facts indicating a contrary purpose.

The CFTC is also proposing to remove reference to physical factors or regulatory requirements being “outside the control of the parties.” This phrase was taken from commenter letters¹⁹ but has also apparently created problems during contract negotiations, as counterparties often disagree about the degree of control they have over factors influencing their demand for or supply of the nonfinancial commodity.²⁰ By

¹⁷ See, e.g., Letter from the Commodity Markets Council, the National Corn Growers Association, and the Natural Gas Supply Association (April 17, 2014) at 2 & n.3 (stating that commercial parties are “being asked for vague (and, therefore, potentially unenforceable) representations” because “the question of the reason for exercise of volumetric optionality can vary from transaction to transaction and is not known until the time of exercise”); Letter from the American Gas Association (April 17, 2014) at 10 (citing “widespread confusion as to whether counterparties must demonstrate forward contract status as of the time of entering into an agreement, or as of the time of exercise or non-exercise of delivery rights under the agreement.”).

¹⁸ For example, in choosing whether to obtain additional supply by exercising the embedded volumetric optionality under a given contract or turning to another supply source – whether storage, the spot market, or another forward contract with embedded volumetric optionality – commercial parties would be able to consider a variety of factors, including price, provided that the intended purpose for including the embedded volumetric optionality in the contract at contract initiation was to address physical factors or regulatory requirements influencing the demand for or supply of the commodity.

¹⁹ See Letter from BG Americas & Global LNG (July 22, 2011) at 4 (“Variability associated with an energy customer’s physical demand is influenced by factors *outside the control of the energy suppliers (and sometimes the consumers) ...*”); Letter from the Working Group of Commercial Energy Firms (July 22, 2011) at 8 (“Availability of production and requirements for consumption are often influenced by factors *outside the control of the parties* to an energy commodity transaction and can change on an hourly or daily basis.”) (emphasis added).

²⁰ Letter from the Plains All American Pipeline, L.P. (April 17, 2014) at 3 (“[M]any counterparties understand the [seventh element] to have failed when a counterparty has more than one alternative to meet its physical commodity needs, therefore making the choice of supply ‘within its control.’”); Letter from the Commodity Markets Council, the National Corn Growers Association, and the Natural Gas Supply

removing this language, the CFTC intends to clarify that whether the parties have some influence over factors affecting their demand for or supply of the nonfinancial commodity (*e.g.*, the scheduling of plant maintenance, plans for business expansion) would not be inconsistent with the seventh element of the CFTC's interpretation, provided that the embedded volumetric optionality is included in the contract at initiation primarily to address potential variability in a party's supply of or demand for the nonfinancial commodity.

The CFTC is also proposing to clarify that the phrase "physical factors" should be construed broadly to include any fact or circumstance that could reasonably influence supply of or demand for the nonfinancial commodity under the contract. Such facts and circumstances could include not only environmental factors, such as weather or location, but relevant "operational considerations" (*e.g.*, the availability of reliable transportation or technology) and broader social forces, such as changes in demographics or geopolitics.²¹ Concerns that are primarily about price risk (*e.g.*, expectations that the cash market price will increase or decrease), however, would not satisfy the seventh element absent an applicable regulatory requirement to obtain or provide the lowest price (*e.g.*, the buyer is an energy company regulated on a cost-of-service basis).²²

Association (April 17, 2014) at 2-3 (listing as an issue stemming from the ambiguity in the seventh element "uncertainty as to whether end-users with more than one supply choice are always exercising optionality within their control").

²¹ The CFTC reiterates that, as stated in the Products Release, system reliability issues that lead to voluntary supply curtailments would be considered "physical factors" within the scope of the seventh element. *See* 77 FR at 48239 n.345.

²² *See* Letter from the Office of the General Counsel, Federal Energy Regulatory Commission (Oct. 12, 2012) at 4. The CFTC confirms that, as stated in the Products Release, the deliverable quantities allowable under embedded volumetric optionality may be justified by a combination of regulatory requirements and physical factors, such that the quantity provided for by the embedded volumetric optionality may reasonably exceed quantities required by regulation. *See* 77 FR 48238 n.340.

The CFTC understands that in certain retail electric market demand-response programs, electric utilities have the right to interrupt or curtail service to a customer to support system reliability.²³ The CFTC is proposing to clarify that, given that a key function of an electricity system operator is to ensure grid reliability, demand response agreements, even if not specifically mandated by a system operator, may be properly characterized as the product of regulatory requirements within the meaning of the seventh element.²⁴

III. Request for Comment

The CFTC believes that it would benefit from public comment about its proposed interpretation, and therefore requests public comment on all aspects of its proposed interpretation regarding forwards with embedded volumetric optionality, and on the following questions:

1. Market participants have expressed concerns about whether various types of volumetric optionality fit within the CFTC's interpretation. The CFTC recognizes that, since the interpretation is not intended to provide relief for all forms of embedded volumetric optionality, there are likely to remain concerns within the industry about the treatment of embedded volumetric optionality within forward contracts.

²³ See Letter from the National Rural Electric Cooperative Association, the American Public Power Association, the Large Public Power Association, and the Transmission Access Policy Study Group (Oct. 12, 2012) at 9.

²⁴ The CFTC clarifies that its interpretations regarding full requirements and output contracts, as provided in the Products Release, would be unaffected by the discussion herein. See 77 FR at 48239-40. Similarly, the CFTC reiterates that, depending on the relevant facts and circumstances, capacity contracts, transmission (or transportation) service agreements, tolling agreements, and peaking supply contracts, as discussed in the Products Release, may qualify as forward contracts with embedded volumetric optionality provided they meet the elements of the CFTC's proposed interpretation. See 77 FR 48240.

The CFTC notes that, in April, 2012, the CFTC adopted an Interim Final Rule for Commodity Options (the "IFR").²⁵ Even if a contract with volumetric optionality does not fit within the seven elements of the interpretation, the CFTC believes there is widespread agreement that contracts that fail one or more of the seven elements of the CFTC's interpretation would fall within the exemption from most swaps regulation provided by the IFR. Therefore, it appears that the IFR provides a clear and well-understood mechanism through which contracts with volumetric optionality can be exempted that avoids many of the difficulties of determining whether a particular contract with volumetric optionality would satisfy the seven elements of the CFTC's interpretation.

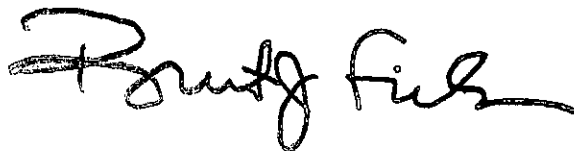
The CFTC invites comment on whether the IFR's approach to defining the universe of swaps subject to its exemption may provide a clearer and easier mechanism for providing relief from swaps requirements than the CFTC's interpretation of forwards with embedded volumetric optionality and whether the IFR currently provides sufficient relief for such contracts.

2. Market participants have argued that the lack of clarity around the seventh element of the CFTC's interpretation has led to costs to end-users. Conceivably, since contracts that fail one or more of the seven elements would be regulated as exempt commodity trade options under the IFR, these costs are attributable to complying with the IFR. The CFTC invites comment on whether or not this is the case, and invites the submission of data quantifying those costs.

²⁵ See 77 FR 25320 (April 27, 2012).

3. What factors should the CFTC consider in determining whether the proposed modifications and clarifications to the CFTC's interpretation are appropriate in view of CFTC precedent regarding the interpretation of the CEA's forward contract exclusion? Do the proposed changes provide sufficient clarity on how contracts with embedded volumetric optionality may satisfy all seven elements of the interpretation, particularly the first and second elements? Are there reasons why trying to provide further relief through the swap definition's forward contract exclusion would not be in the public interest?

By the Securities and Exchange Commission.

A handwritten signature in black ink, appearing to read "Brent J. Fields". The signature is written in a cursive style with a large initial "B" and "F".

Brent J. Fields
Secretary

Date: November 13, 2014

Issued in Washington, DC, on November 13, 2014, by the Commodity Futures Trading Commission.



Christopher J. Kirkpatrick,
Secretary of the Commission.

Commodity Futures Trading Commission (CFTC) Appendices to Forward Contracts With Embedded Volumetric Optionality – Commission Voting Summary, Chairman’s Statement, and Commissioners’ Statements

Appendix 1 – Commodity Futures Trading Commission Voting Summary

On this matter, Chairman Massad and Commissioners Wetjen, Bowen, and Giancarlo voted in the affirmative. No Commissioner voted in the negative.

Appendix 2 – Statement of CFTC Chairman Timothy G. Massad

I support the Staff’s proposed interpretation regarding forward contracts that have what is known as embedded volumetric optionality – generally speaking, contracts to buy or sell a nonfinancial commodity for deferred delivery that provide for variations in delivery amount.

One of my priorities has been to fine-tune our rules to make sure they work as intended and do not impose undue burdens or unintended consequences, particularly for the nonfinancial commercial businesses that use these markets to hedge commercial risks. We must make sure these businesses – whether they are manufacturers, farmers, ranchers or other companies – can continue to use these markets efficiently and effectively.

This proposal is part of that effort. In certain situations, commercial parties are unable to predict at the time a contract is entered into the exact quantities of the commodity that they may need or be able to supply, and the embedded volumetric optionality offers them the flexibility to vary the quantities delivered accordingly. The CFTC put out an interpretation, consisting of seven factors, to provide clarity as to when such contracts would fall within the forward contract exclusion from the swap definition, but some market participants have felt this interpretation, in particular the seventh factor, was hard to apply. In some cases, the two parties would reach different conclusions about the same contract.

Today we are proposing clarifications to the interpretation that I believe will alleviate this ambiguity and allow contracts with volumetric optionality that truly are intended to address uncertainty with respect to the parties' future production capacity or delivery needs, and not for speculative purposes or as a means to obtain one-way price protection, to fall within the exclusion.

Appendix 3 – Statement of CFTC Commissioner Mark P. Wetjen

This proposal further clarifying the definition of forward contracts with embedded volumetric optionality, or EVO, is intended to provide commercial firms the regulatory clarity they have sought since the original release of the seven-part test in August 2012.

The definition of a swap in the Commodity Exchange Act includes commodity options, but excludes from that definition forward contracts.¹ There was a policy reason for this, and at its root was a desire to ensure that Dodd-Frank captured many swaps, and swap-like contracts, that were structured to be similar to options, while also ensuring that

¹ 7 U.S.C. 1a(47).

a new regulatory regime was not inadvertently and inappropriately extended into certain physical markets.

The broad definitional language in question was designed to ensure that financial – as opposed to physical – contracts could not be structured or re-characterized to avoid the new market structure. While the swap definition does not expressly exclude options on energy and agricultural commodities, it does exclude both futures and forwards. I am confident Congress did not intend to pull contracts that historically have been treated as forwards into the new swap regime solely because of optionality in the amount of the physical commodity delivered under the contract.

As a policy matter, Congress surely recognized that the swap definition had to reflect a long-held Commission belief that contracts that are physically settled, and where delivery is required, do not pose the same systemic threats to the financial system as contracts used for speculative purposes. Moreover, Congress expanded the Commission's fraud² and anti-manipulation authority³ over markets where forward contracts are traded, and left intact the Commission's surveillance authority to issue special calls to market participants for all positions and transactions related to a commodity.⁴

² 7 U.S.C. 9(c)(1) ("It shall be unlawful for any person, directly or indirectly, to use or employ, or attempt to use or employ, in connection with . . . a contract of sale of any commodity in interstate commerce . . . any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Commission shall promulgate. . . ."). See also 17 CFR Part 180.

³ 7 U.S.C. 9(c)(3) ("[I]t shall be unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price . . . of any commodity in interstate commerce. . . .").

⁴ 17 CFR 18.05(b) (maintenance of books and records concerning positions and transactions in the cash commodity); 17 CFR 1.31 (pursuant to § 1.31(2), the authority to request information required to be kept in accordance with the Act or Commission regulations); 17 CFR 1.35 (pursuant to § 1.35(3), the authority to request from a futures commission merchant, retail foreign exchange dealer, introducing broker or member of a designated contract market or swap execution facility records required to be kept by § 1.35 in accordance with the requirements of § 1.31); 17 CFR 23.203 (pursuant to § 23.203(a), the authority to request and receive within 72 hours any records required to be kept by a swap dealer or major swap

As mentioned, in resolving to adopt the appropriate regulatory treatment of forward contracts with EVO, the Commission also must weigh the operational and compliance consequences of that treatment. Indeed, the Commission should bring a heightened sensitivity to these considerations in the context of the power sector because affordable electricity and heat are such fundamental needs of modern life.

The Commission's 2012 interpretation, while intended to be helpful, contained certain ambiguities in the seven-part test that created confusion among commercial end-users.

Last spring, the Commission learned at a public roundtable that some market participants may have withdrawn from the market due to those ambiguities, resulting in inferior execution for commercial firms. It is difficult to measure the exact impact of this phenomenon, but apparently it has not been a positive one for consumers of electricity and gas.

A. Ambiguity in the Seven-Part Test

In discussing the seven-part test, commentators zeroed in on two primary issues. First, many of the roundtable participants noted that the exercise or non-exercise of volumetric optionality depends on a number of factors,⁵ some of which will be outside of the control of the parties, and some that will not.

participant by the Act and by Commission regulations and pursuant to § 23.203(2), the authority to request records of any swap or related cash or forward transaction); 17 CFR 23.606 (pursuant to § 23.606(c), the authority to request information that a swap dealer or major swap participant is required to maintain under § 23.606(a)(1)); 17 CFR 45.2 (pursuant to § 45.2(h), the authority to request from swap execution facilities, designated contract markets, derivatives clearing organizations, swap dealers, and major swap participants records required to be kept pursuant to § 45.2.); 17 CFR 46.2 (the authority, pursuant to § 46.2(e), to request records relating to pre-enactment and transition swaps in existence on or after April 25, 2011).

⁵ Letter from The Edison Electric Institute ("EEI") and the Electric Power Supply Association ("EPSA") (April 17, 2014) ("EEI/EP SA Letter") at 3 ("The exercise or non-exercise of volumetric optionality under a forward energy contract depends on a number of factors, including but not limited to, any or all of the following: (1) the level of demand as affected by weather or market conditions; (2) the amount of

Many also noted that parties could reasonably disagree on whether, and the degree to which, a factor is outside of the control of the parties. For example, having choice among more than one source of supply, or selecting from those choices the lowest-priced contract, to some commercial firms caused the contract to fail the seventh prong.

This ambiguity contributed to a second issue – market participants stated that they often do not know the exact reasons that optionality will be exercised until the time of exercise. In other words, parties are uncertain how to characterize contracts at the time of execution, and how intent at the time of exercise or non-exercise might affect that analysis.⁶

The seventh factor's ambiguity has caused a host of problems. For instance, parties have been asked to provide vague and possibly unenforceable representations in agreements.⁷ Parties also often disagree about the proper categorization of a transaction, resulting in them “agreeing to disagree” and considering the same transaction to be, at the same time, a swap, trade option, or a forward with EVO.⁸ This has had the unintended consequence of distorting transaction data reported to the Commission.⁹

unexercised volume remaining under the contract; (3) the time of the change in the level of demand relative to delivery scheduling capabilities; (4) anticipated future weather conditions; (5) the delivery location under the contract relative to the demand location; (6) the price and availability of transportation capacity (e.g. pipeline capacity) to move natural gas; (7) the price of alternative sources of supply; (8) the availability of natural gas or electricity in the spot market; and/or (9) the remaining inventory of the commodity in storage.”)

⁶ Letter from the American Gas Association (April 17, 2014) (“AGA Letter”) at 10 (citing “widespread confusion as to whether counterparties must demonstrate forward contract status as of the time of entering into an agreement, or as of the time of exercise or non-exercise of delivery rights under the agreement.”).

⁷ AGA Letter at 2; EEI/EPISA letter at 3.

⁸ NFP Electric Associations Letter at 3.

⁹ EEI/EPISA letter at 3.

The bottom line is that such uncertainty in the seven-part test increased transaction costs for commercial firms and limited their access to an effective risk-management tool.

B. Proposed Clarifications

This proposal appropriately modifies and clarifies the interpretation of the seventh prong. First, it clarifies that concluding whether the seventh prong is met should be determined by looking to the intent of the parties at the outset of contract initiation.

Second, the new proposal also deletes language referring to physical or regulatory factors being "outside of the control of the parties." Deleting this ambiguous language helps clarify that parties having some influence over factors affecting their demand for a nonfinancial commodity will not per se cause a contract to fail the seventh prong.

In that vein, the proposal also notes that parties may take a variety of factors into consideration when determining whether to exercise volumetric optionality, so long as the intended purpose was to address physical factors or regulatory requirements influencing the demand for, or supply of, the commodity.

Prongs one through six of the test are also appropriately crafted to ensure that the EVO does not undermine the forward contract's overall purpose. Prongs two and three help achieve those purposes by requiring the predominant factor to be actual delivery, and prohibiting the embedded optionality from being severed and marketed separately from the overall agreement.

Prongs four and five also help deter the potential for abuse of these contracts by requiring that the seller under the contract intends to deliver, and the buyer intends to receive, the underlying commodity.

This proposal should go a long way towards providing commercial firms adequate guidance, but I look forward to comments on whether it is adequate enough.

Appendix 4 – Concurring Statement of CFTC Commissioner Sharon Y. Bowen

This is a proposal that, I am concerned, will neither provide the clarity industry is seeking regarding the treatment of embedded volumetric options nor the safeguards that Congress intended when it passed the Dodd-Frank Wall Street Reform and Customer Protection Act.

I do not oppose the Commission's trying to better tailor our regulations to address concerns of end-users. In fact, I commend the Chairman and my fellow Commissioners for trying to address the issues that have arisen from our existing guidance and rules on embedded volumetric options. After many meetings with stakeholders and much analysis of this subject, I am convinced that the Commission should address concerns that industry has raised regarding the treatment of embedded volumetric options.

However, the proposed interpretation may not resolve the issues industry has raised. Options, even physical options, have never been interpreted by the Commission to be forward contracts. They lack the central characteristic that is critical to being a forward contract under the Commodity Exchange Act: a binding obligation to deliver at some time in the future. The history on this is clear, if there is no binding obligation to deliver, there is no forward contract.

The seventh factor was intended, essentially, as a "safe-harbor" provision. Notwithstanding the fact there is no obligation to make or take delivery for the optional portion of the specified commodity, the seventh factor was designed to allow a party's transaction to receive the forward exclusion if that party can demonstrate that it

determined the specified, optional amount was necessary based upon commercial and physical factors, and exercised the option based upon those factors. In other words, this seventh factor was designed to allow embedded volumetric options to receive the forward contract exclusion treatment where their exercise was driven largely by external commercial and physical factors central to the party's commercial business, but largely beyond the control of the party. Through its conduct then, the party was demonstrating its intent to be "bound" to exercise the option if its estimate, based on the factors it used, proved to be accurate.

The Commission was trying to distinguish such a situation from a situation where the party enters into the embedded volumetric option intending to exercise the volumetric option based upon whether, at the time of exercise, it still makes economic sense to use the option. In other words, it was trying to distinguish a situation where the motivation for exercising the option was primarily or substantially based on price. In the latter case, the embedded volumetric option is hard to distinguish, in usage, from any other commodity option. There is no demonstration in the party's course of conduct that it intended to be "bound" to exercise the option at all.

While this test is far from perfect, and I can see the difficulty industry would have in administering it, the Commission was clearly trying to find a rationale for allowing some volumetric optionality that was consistent with the Commission's historic treatment of forward contracts, while avoiding completely erasing the line between options and futures on the one hand, and cash and forward contracts on the other.

This current proposal, however, in possibly broadening the universe of options that would fit within the seventh factor, seems to depart from that rationale, and in doing

so, loses that vital element of demonstrating the parties intended to be "bound" in some sense to exercise the option and consequently that the option was similar, in usage, to a forward contract. Without that, it is not clear to me how such an option can be considered consistent with a forward contract. If it cannot be considered at least similar to a forward contract, I am not sure how a party would determine that embedding such an option in a forward contract would not undermine its nature as a forward contract and thus fail the first factor of the seven-factor test.

There is nothing in the Commodity Exchange Act or Dodd-Frank that contemplates options can be deemed forward contracts simply by being associated with a forward contract. In fact, the opposite seems true: Congress specifically determined that commodity options are swaps and removed the Commission's ability to provide exemptions from the definition of swap.

Interestingly though, Congress did maintain the Commission's authority to determine how swaps that are commodity options should be regulated since Congress did not repeal the Commission's plenary authority over options, including options that are swaps. It was that plenary authority that the Commission utilized to exempt trade options from most of the regulations applicable to swaps in April 2012. It is that authority that the Commission should use here to address embedded volumetric options.

By seeking to broaden an exclusion for volumetric options embedded in forward contracts, the proposed interpretation does try to achieve a goal that industry apparently wants—they would like these options to be outside the Commission's jurisdiction rather than just exempted from regulation. However, history has shown that as the circle of

exclusion widens for industry, too often the circle of protection narrows for investors and consumers.

In 1993, one Commissioner cast the lone dissenting vote against exempting over-the-counter energy derivatives from Commission regulation. She argued that exempting energy derivatives from regulation would set a dangerous precedent and would leave the public unprotected. Today's proposal seems to go farther. It excludes embedded volumetric options from the Commission's authority. Whereas with an exemption, there is the ability to later tailor it to fit the precise needs of the market and the public, there is no turning back from an exclusion.

Congress said, quite clearly, that commodity options are swaps, not forwards. Embedded volumetric options should be exempted as options, not excluded as forwards. I know many in industry have spoken for the need for further clarity regarding the regulation of embedded volumetric options. I don't know what clarity is achieved by trying to call something what it is not. If it looks like an option, is used like an option, and works like an option, it is most likely, an option.

I think the objective of providing for clear regulatory treatment of embedded volumetric options will be far easier to implement, and far more complete, if done through fixing the trade option exemption. Regardless, this proposal is the vehicle before the Commission at present. I want us to get this interpretation right, and therefore support getting public comment on these changes. I do not believe we should contemplate such a significant change to our jurisdiction without receiving the public's views on it first. I invite all interested stakeholders to respond to this proposal and look forward to reviewing their comments.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73591 / November 13, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16273

In the Matter of

**Bluesky Filing Corp.,
Book4Golf.com Corp.,
Casdim International Systems, Inc.,
CBC Bancorp, Inc., and
Centraxx, Inc.,**

Respondents.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
AND NOTICE OF HEARING
PURSUANT TO SECTION 12(j) OF
THE SECURITIES EXCHANGE ACT
OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Bluesky Filing Corp., Book4Golf.com Corp., Casdim International Systems, Inc., CBC Bancorp, Inc., and Centraxx, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Bluesky Filing Corp. (CIK No. 1142381) is a New Jersey corporation located in North Brunswick, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Bluesky Filing is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10 registration statement on June 18, 2001.

2. Book4Golf.com Corp. (CIK No. 1107822) is a Canadian corporation located in Thornhill, Ontario, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Book4Golf.com is delinquent in its periodic

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filings with the Commission, having not filed any periodic reports since it filed a Form 20-F/R registration statement on October 2, 2000, which reported cumulative losses of over \$25.5 million since January 1999.

3. Casdim International Systems, Inc. (CIK No. 847470) is a Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Casdim is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 1998, which reported a net loss of over \$1.49 million for the prior three months.

4. CBC Bancorp, Inc. (CIK No. 779026) is a Connecticut corporation located in Stamford, Connecticut with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CBC Bancorp is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 1997, which reported a net loss of over \$1 million for the prior nine months.

5. Centraxx, Inc. (CIK No. 789747) is a Nevada corporation located in Mississauga, Ontario, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Centraxx is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2001, which reported a net loss of \$753,166 for the prior three months.

B. DELINQUENT PERIODIC FILINGS

6. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

7. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

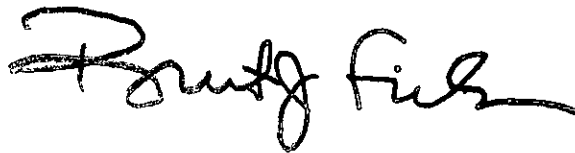
8. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and/or 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

3. What factors should the CFTC consider in determining whether the proposed modifications and clarifications to the CFTC's interpretation are appropriate in view of CFTC precedent regarding the interpretation of the CEA's forward contract exclusion? Do the proposed changes provide sufficient clarity on how contracts with embedded volumetric optionality may satisfy all seven elements of the interpretation, particularly the first and second elements? Are there reasons why trying to provide further relief through the swap definition's forward contract exclusion would not be in the public interest?

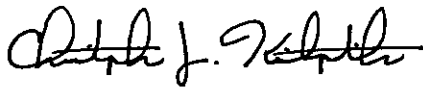
By the Securities and Exchange Commission.

A handwritten signature in black ink, appearing to read "Brent J. Fields". The signature is fluid and cursive, with a long horizontal stroke at the end.

Brent J. Fields
Secretary

Date: November 13, 2014

Issued in Washington, DC, on November 13, 2014, by the Commodity Futures
Trading Commission.



Christopher J. Kirkpatrick,
Secretary of the Commission.

**Commodity Futures Trading Commission (CFTC) Appendices to Forward
Contracts With Embedded Volumetric Optionality – Commission Voting Summary,
Chairman’s Statement, and Commissioners’ Statements**

Appendix 1 – Commodity Futures Trading Commission Voting Summary

On this matter, Chairman Massad and Commissioners Wetjen, Bowen, and
Giancarlo voted in the affirmative. No Commissioner voted in the negative.

Appendix 2 – Statement of CFTC Chairman Timothy G. Massad

I support the Staff’s proposed interpretation regarding forward contracts that have
what is known as embedded volumetric optionality – generally speaking, contracts to buy
or sell a nonfinancial commodity for deferred delivery that provide for variations in
delivery amount.

One of my priorities has been to fine-tune our rules to make sure they work as
intended and do not impose undue burdens or unintended consequences, particularly for
the nonfinancial commercial businesses that use these markets to hedge commercial risks.
We must make sure these businesses – whether they are manufacturers, farmers, ranchers
or other companies – can continue to use these markets efficiently and effectively.

This proposal is part of that effort. In certain situations, commercial parties are unable to predict at the time a contract is entered into the exact quantities of the commodity that they may need or be able to supply, and the embedded volumetric optionality offers them the flexibility to vary the quantities delivered accordingly. The CFTC put out an interpretation, consisting of seven factors, to provide clarity as to when such contracts would fall within the forward contract exclusion from the swap definition, but some market participants have felt this interpretation, in particular the seventh factor, was hard to apply. In some cases, the two parties would reach different conclusions about the same contract.

Today we are proposing clarifications to the interpretation that I believe will alleviate this ambiguity and allow contracts with volumetric optionality that truly are intended to address uncertainty with respect to the parties' future production capacity or delivery needs, and not for speculative purposes or as a means to obtain one-way price protection, to fall within the exclusion.

Appendix 3 – Statement of CFTC Commissioner Mark P. Wetjen

This proposal further clarifying the definition of forward contracts with embedded volumetric optionality, or EVO, is intended to provide commercial firms the regulatory clarity they have sought since the original release of the seven-part test in August 2012.

The definition of a swap in the Commodity Exchange Act includes commodity options, but excludes from that definition forward contracts.¹ There was a policy reason for this, and at its root was a desire to ensure that Dodd-Frank captured many swaps, and swap-like contracts, that were structured to be similar to options, while also ensuring that

¹ 7 U.S.C. 1a(47).

a new regulatory regime was not inadvertently and inappropriately extended into certain physical markets.

The broad definitional language in question was designed to ensure that financial -- as opposed to physical -- contracts could not be structured or re-characterized to avoid the new market structure. While the swap definition does not expressly exclude options on energy and agricultural commodities, it does exclude both futures and forwards. I am confident Congress did not intend to pull contracts that historically have been treated as forwards into the new swap regime solely because of optionality in the amount of the physical commodity delivered under the contract.

As a policy matter, Congress surely recognized that the swap definition had to reflect a long-held Commission belief that contracts that are physically settled, and where delivery is required, do not pose the same systemic threats to the financial system as contracts used for speculative purposes. Moreover, Congress expanded the Commission's fraud² and anti-manipulation authority³ over markets where forward contracts are traded, and left intact the Commission's surveillance authority to issue special calls to market participants for all positions and transactions related to a commodity.⁴

² 7 U.S.C. 9(c)(1) ("It shall be unlawful for any person, directly or indirectly, to use or employ, or attempt to use or employ, in connection with . . . a contract of sale of any commodity in interstate commerce . . . any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Commission shall promulgate. . . ."). See also 17 CFR Part 180.

³ 7 U.S.C. 9(c)(3) ("[I]t shall be unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price . . . of any commodity in interstate commerce. . .").

⁴ 17 CFR 18.05(b) (maintenance of books and records concerning positions and transactions in the cash commodity); 17 CFR 1.31 (pursuant to § 1.31(2), the authority to request information required to be kept in accordance with the Act or Commission regulations); 17 CFR 1.35 (pursuant to § 1.35(3), the authority to request from a futures commission merchant, retail foreign exchange dealer, introducing broker or member of a designated contract market or swap execution facility records required to be kept by § 1.35 in accordance with the requirements of § 1.31); 17 CFR 23.203 (pursuant to § 23.203(a), the authority to request and receive within 72 hours any records required to be kept by a swap dealer or major swap

As mentioned, in resolving to adopt the appropriate regulatory treatment of forward contracts with EVO, the Commission also must weigh the operational and compliance consequences of that treatment. Indeed, the Commission should bring a heightened sensitivity to these considerations in the context of the power sector because affordable electricity and heat are such fundamental needs of modern life.

The Commission's 2012 interpretation, while intended to be helpful, contained certain ambiguities in the seven-part test that created confusion among commercial end-users.

Last spring, the Commission learned at a public roundtable that some market participants may have withdrawn from the market due to those ambiguities, resulting in inferior execution for commercial firms. It is difficult to measure the exact impact of this phenomenon, but apparently it has not been a positive one for consumers of electricity and gas.

A. Ambiguity in the Seven-Part Test

In discussing the seven-part test, commentators zeroed in on two primary issues. First, many of the roundtable participants noted that the exercise or non-exercise of volumetric optionality depends on a number of factors,⁵ some of which will be outside of the control of the parties, and some that will not.

participant by the Act and by Commission regulations and pursuant to § 23.203(2), the authority to request records of any swap or related cash or forward transaction); 17 CFR 23.606 (pursuant to § 23.606(c), the authority to request information that a swap dealer or major swap participant is required to maintain under § 23.606(a)(1)); 17 CFR 45.2 (pursuant to § 45.2(h), the authority to request from swap execution facilities, designated contract markets, derivatives clearing organizations, swap dealers, and major swap participants records required to be kept pursuant to § 45.2.); 17 CFR 46.2 (the authority, pursuant to § 46.2(e), to request records relating to pre-enactment and transition swaps in existence on or after April 25, 2011).

⁵ Letter from The Edison Electric Institute ("EEI") and the Electric Power Supply Association ("EPSA") (April 17, 2014) ("EEI/EP SA Letter") at 3 ("The exercise or non-exercise of volumetric optionality under a forward energy contract depends on a number of factors, including but not limited to, any or all of the following: (1) the level of demand as affected by weather or market conditions; (2) the amount of

Many also noted that parties could reasonably disagree on whether, and the degree to which, a factor is outside of the control of the parties. For example, having choice among more than one source of supply, or selecting from those choices the lowest-priced contract, to some commercial firms caused the contract to fail the seventh prong.

This ambiguity contributed to a second issue – market participants stated that they often do not know the exact reasons that optionality will be exercised until the time of exercise. In other words, parties are uncertain how to characterize contracts at the time of execution, and how intent at the time of exercise or non-exercise might affect that analysis.⁶

The seventh factor's ambiguity has caused a host of problems. For instance, parties have been asked to provide vague and possibly unenforceable representations in agreements.⁷ Parties also often disagree about the proper categorization of a transaction, resulting in them “agreeing to disagree” and considering the same transaction to be, at the same time, a swap, trade option, or a forward with EVO.⁸ This has had the unintended consequence of distorting transaction data reported to the Commission.⁹

unexercised volume remaining under the contract; (3) the time of the change in the level of demand relative to delivery scheduling capabilities, (4) anticipated future weather conditions, (5) the delivery location under the contract relative to the demand location; (6) the price and availability of transportation capacity (e.g. pipeline capacity) to move natural gas; (7) the price of alternative sources of supply; (8) the availability of natural gas or electricity in the spot market; and/or (9) the remaining inventory of the commodity in storage.”).

⁶ Letter from the American Gas Association (April 17, 2014) (“AGA Letter”) at 10 (citing “widespread confusion as to whether counterparties must demonstrate forward contract status as of the time of entering into an agreement, or as of the time of exercise or non-exercise of delivery rights under the agreement.”).

⁷ AGA Letter at 2; EEI/EPSC letter at 3.

⁸ NFP Electric Associations Letter at 3.

⁹ EEI/EPSC letter at 3.

The bottom line is that such uncertainty in the seven-part test increased transaction costs for commercial firms and limited their access to an effective risk-management tool.

B. Proposed Clarifications

This proposal appropriately modifies and clarifies the interpretation of the seventh prong. First, it clarifies that concluding whether the seventh prong is met should be determined by looking to the intent of the parties at the outset of contract initiation.

Second, the new proposal also deletes language referring to physical or regulatory factors being "outside of the control of the parties." Deleting this ambiguous language helps clarify that parties having some influence over factors affecting their demand for a nonfinancial commodity will not per se cause a contract to fail the seventh prong.

In that vein, the proposal also notes that parties may take a variety of factors into consideration when determining whether to exercise volumetric optionality, so long as the intended purpose was to address physical factors or regulatory requirements influencing the demand for, or supply of, the commodity.

Prongs one through six of the test are also appropriately crafted to ensure that the EVO does not undermine the forward contract's overall purpose. Prongs two and three help achieve those purposes by requiring the predominant factor to be actual delivery, and prohibiting the embedded optionality from being severed and marketed separately from the overall agreement.

Prongs four and five also help deter the potential for abuse of these contracts by requiring that the seller under the contract intends to deliver, and the buyer intends to receive, the underlying commodity.

This proposal should go a long way towards providing commercial firms adequate guidance, but I look forward to comments on whether it is adequate enough.

Appendix 4 – Concurring Statement of CFTC Commissioner Sharon Y. Bowen

This is a proposal that, I am concerned, will neither provide the clarity industry is seeking regarding the treatment of embedded volumetric options nor the safeguards that Congress intended when it passed the Dodd-Frank Wall Street Reform and Customer Protection Act.

I do not oppose the Commission's trying to better tailor our regulations to address concerns of end-users. In fact, I commend the Chairman and my fellow Commissioners for trying to address the issues that have arisen from our existing guidance and rules on embedded volumetric options. After many meetings with stakeholders and much analysis of this subject, I am convinced that the Commission should address concerns that industry has raised regarding the treatment of embedded volumetric options.

However, the proposed interpretation may not resolve the issues industry has raised. Options, even physical options, have never been interpreted by the Commission to be forward contracts. They lack the central characteristic that is critical to being a forward contract under the Commodity Exchange Act: a binding obligation to deliver at some time in the future. The history on this is clear, if there is no binding obligation to deliver, there is no forward contract.

The seventh factor was intended, essentially, as a "safe-harbor" provision. Notwithstanding the fact there is no obligation to make or take delivery for the optional portion of the specified commodity, the seventh factor was designed to allow a party's transaction to receive the forward exclusion if that party can demonstrate that it

determined the specified, optional amount was necessary based upon commercial and physical factors, and exercised the option based upon those factors. In other words, this seventh factor was designed to allow embedded volumetric options to receive the forward contract exclusion treatment where their exercise was driven largely by external commercial and physical factors central to the party's commercial business, but largely beyond the control of the party. Through its conduct then, the party was demonstrating its intent to be "bound" to exercise the option if its estimate, based on the factors it used, proved to be accurate.

The Commission was trying to distinguish such a situation from a situation where the party enters into the embedded volumetric option intending to exercise the volumetric option based upon whether, at the time of exercise, it still makes economic sense to use the option. In other words, it was trying to distinguish a situation where the motivation for exercising the option was primarily or substantially based on price. In the latter case, the embedded volumetric option is hard to distinguish, in usage, from any other commodity option. There is no demonstration in the party's course of conduct that it intended to be "bound" to exercise the option at all.

While this test is far from perfect, and I can see the difficulty industry would have in administering it, the Commission was clearly trying to find a rationale for allowing some volumetric optionality that was consistent with the Commission's historic treatment of forward contracts, while avoiding completely erasing the line between options and futures on the one hand, and cash and forward contracts on the other.

This current proposal, however, in possibly broadening the universe of options that would fit within the seventh factor, seems to depart from that rationale, and in doing

so, loses that vital element of demonstrating the parties intended to be “bound” in some sense to exercise the option and consequently that the option was similar, in usage, to a forward contract. Without that, it is not clear to me how such an option can be considered consistent with a forward contract. If it cannot be considered at least similar to a forward contract, I am not sure how a party would determine that embedding such an option in a forward contract would not undermine its nature as a forward contract and thus fail the first factor of the seven-factor test.

There is nothing in the Commodity Exchange Act or Dodd-Frank that contemplates options can be deemed forward contracts simply by being associated with a forward contract. In fact, the opposite seems true: Congress specifically determined that commodity options are swaps and removed the Commission's ability to provide exemptions from the definition of swap.

Interestingly though, Congress did maintain the Commission's authority to determine how swaps that are commodity options should be regulated since Congress did not repeal the Commission's plenary authority over options, including options that are swaps. It was that plenary authority that the Commission utilized to exempt trade options from most of the regulations applicable to swaps in April 2012. It is that authority that the Commission should use here to address embedded volumetric options.

By seeking to broaden an exclusion for volumetric options embedded in forward contracts, the proposed interpretation does try to achieve a goal that industry apparently wants—they would like these options to be outside the Commission's jurisdiction rather than just exempted from regulation. However, history has shown that as the circle of

exclusion widens for industry, too often the circle of protection narrows for investors and consumers.

In 1993, one Commissioner cast the lone dissenting vote against exempting over-the-counter energy derivatives from Commission regulation. She argued that exempting energy derivatives from regulation would set a dangerous precedent and would leave the public unprotected. Today's proposal seems to go farther. It excludes embedded volumetric options from the Commission's authority. Whereas with an exemption, there is the ability to later tailor it to fit the precise needs of the market and the public, there is no turning back from an exclusion.

Congress said, quite clearly, that commodity options are swaps, not forwards. Embedded volumetric options should be exempted as options, not excluded as forwards. I know many in industry have spoken for the need for further clarity regarding the regulation of embedded volumetric options. I don't know what clarity is achieved by trying to call something what it is not. If it looks like an option, is used like an option, and works like an option, it is most likely, an option.

I think the objective of providing for clear regulatory treatment of embedded volumetric options will be far easier to implement, and far more complete, if done through fixing the trade option exemption. Regardless, this proposal is the vehicle before the Commission at present. I want us to get this interpretation right, and therefore support getting public comment on these changes. I do not believe we should contemplate such a significant change to our jurisdiction without receiving the public's views on it first. I invite all interested stakeholders to respond to this proposal and look forward to reviewing their comments.

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 73591 / November 13, 2014

ADMINISTRATIVE PROCEEDING

File No. 3-16273

In the Matter of

**Bluesky Filing Corp.,
Book4Golf.com Corp.,
Casdim International Systems, Inc.,
CBC Bancorp, Inc., and
Centraxx, Inc.,**

Respondents.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
AND NOTICE OF HEARING
PURSUANT TO SECTION 12(j) OF
THE SECURITIES EXCHANGE ACT
OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Bluesky Filing Corp., Book4Golf.com Corp., Casdim International Systems, Inc., CBC Bancorp, Inc., and Centraxx, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Bluesky Filing Corp. (CIK No. 1142381) is a New Jersey corporation located in North Brunswick, New Jersey with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Bluesky Filing is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10 registration statement on June 18, 2001.

2. Book4Golf.com Corp. (CIK No. 1107822) is a Canadian corporation located in Thornhill, Ontario, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Book4Golf.com is delinquent in its periodic

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filings with the Commission, having not filed any periodic reports since it filed a Form 20-F/R registration statement on October 2, 2000, which reported cumulative losses of over \$25.5 million since January 1999.

3. Casdim International Systems, Inc. (CIK No. 847470) is a Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Casdim is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 1998, which reported a net loss of over \$1.49 million for the prior three months.

4. CBC Bancorp, Inc. (CIK No. 779026) is a Connecticut corporation located in Stamford, Connecticut with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CBC Bancorp is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 1997, which reported a net loss of over \$1 million for the prior nine months.

5. Centraxx, Inc. (CIK No. 789747) is a Nevada corporation located in Mississauga, Ontario, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Centraxx is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2001, which reported a net loss of \$753,166 for the prior three months.

B. DELINQUENT PERIODIC FILINGS

6. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

7. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

8. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and/or 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to

notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Brent J. Fields
Secretary

Kevin M. O'Neill

By: **Kevin M. O'Neill**
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3967 / November 13, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16274

In the Matter of

GREGORY VIOLA,

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 203(f) OF THE
INVESTMENT ADVISERS ACT OF 1940
AND NOTICE OF HEARING**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Gregory Viola ("Respondent" or "Viola").

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. From at least approximately 1999 to July 2011, Viola, age 62, worked as a tax return preparer and conducted an investment business out of his home in Orange, Connecticut. He never registered with the State of Connecticut as an investment adviser and has never been registered with the Commission as an investment adviser or in any other capacity. From at least 2007 through July 2011, Viola acted as an unregistered investment adviser in connection with his investment business.

B. RESPONDENT'S CRIMINAL CONVICTION

2. On February 1, 2012, Viola pleaded guilty to two counts of mail fraud in violation of Title 18 United States Code, Section 1341 before the United States District Court for

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the District of Connecticut, United States v. Gregory Viola, Case No. 12-CV-10873-DJC. On October 5, 2012, he was sentenced to 100 months of imprisonment, followed by three years of supervised release, and was ordered to pay restitution in the amount of \$6,872,633.97.

3. The counts of the criminal information to which Viola pleaded guilty alleged, inter alia, that: From approximately 2007 through July, 2011, Viola, while conducting an investment business, knowingly and willfully devised a fraudulent scheme and artifice whereby he obtained funds from investors by means of materially false and fraudulent pretenses, representations and promises that included telling investors he would invest their funds and help generate significant returns on their investments, and, in some cases, promising that he would also provide dividend or interest payments. Viola did not invest or maintain investor funds as he represented and commingled them with funds in his own personal bank accounts and used them to pay personal expenses. In an effort to keep the fraudulent scheme going, Viola also routinely used new investors' fund to pay dividends and redemptions to earlier investors. Viola created, and used the United States mails to transmit, fraudulent account statements that falsely portrayed the value of investment accounts and charged investors fees based on those inflated principal balances. When pleading guilty to mail fraud before the Court on February 1, 2012, Viola admitted he told investors he would manage their funds entrusted to him, charged them asset-based fees, and gave them false brokerage account statements showing their funds invested in stocks.

4. Viola's conviction for mail fraud was for a felony or misdemeanor involving (i) the purchase or sale of a security and (ii) the theft or misappropriation of funds or securities. His misconduct occurred while he was, for compensation, engaged in the business of advising others as to the value of securities or as to the advisability of investing in, purchasing or selling securities.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest that public administrative proceedings be instituted to determine:

A. Whether the allegations set forth in Section II hereof are true and, in connection therewith, to afford Respondent an opportunity to establish any defenses to such allegations; and

B. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 203(f) of the Advisers Act.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If Respondent fails to file the directed answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default, and the proceedings may be determined against him upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon Respondent as provided for in the Commission's Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 210 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Brent J. Fields
Secretary

Kevin M. O'Neill
By: **Kevin M. O'Neill**
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73606 / November 14, 2014

INVESTMENT ADVISERS ACT OF 1940
Release No. 3968 / November 14, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16156

In the Matter of

BLAKE RICHARDS,

Respondent.

**CORRECTED ORDER MAKING
FINDINGS AND IMPOSING REMEDIAL
SANCTIONS PURSUANT TO SECTION
15(b) OF THE SECURITIES EXCHANGE
ACT OF 1934 AND SECTION 203(f) OF
THE INVESTMENT ADVISERS ACT OF
1940**

I.

On September 23, 2014, the Securities and Exchange Commission ("Commission") instituted public administrative proceedings pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Blake Richards ("Richards" or "Respondent").

II.

In response to these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent consents to the Commission's jurisdiction over him and the subject matter of these proceedings and to the entry of this Order Making Findings and Imposing Remedial Sanctions Pursuant to Section 15(b) of the Securities Exchange Act of 1934 And Section 203(f) of the Investment Advisers Act of 1940 ("Order") as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Richards (CRD #4051402), 36 years of age, was a registered representative and investment adviser representative associated with LPL, a registered broker-dealer and investment adviser. He holds the Series 7, 63 and 65 securities licenses and resides in Buford, GA. Richards utilizes two d/b/a names, Blake Richards Investments and BMO Investments. Richards was associated with Edward Jones from October 1999 until August 2004, with A.G. Edwards & Sons, Inc. from August 2004 to February 2007, with H&R Block Financial Advisors, Inc. (later acquired by Ameriprise Advisor Services, Inc.) from February 2007 to May 2009, and with LPL from May 2009 until May 3, 2013, when he was terminated by LPL.

2. On August 26, 2014, a final judgment was entered against Richards. The final judgment incorporated an earlier order of August 20, 2013, which by consent permanently enjoined Richards from future violations of Sections 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act, in the civil action entitled Securities and Exchange Commission v. Blake B. Richards, Civil Action Number 1:13-cv-1729, in the United States District Court for the Northern District of Georgia.

3. The Commission's complaint alleged that, since approximately 2008, Richards misappropriated approximately \$2 million from at least six individuals who were his broker-dealer and investment advisor clients. At least two of the investors were elderly, and the majority of the misappropriated funds constituted retirement savings and/or life insurance proceeds from deceased spouses. When his clients informed Richards they had funds available to invest he instructed the investors to write out checks to one of two entities called "Blake Richards Investments" or "BMO Investments," both d/b/a entities used by Richards. Richards represented to the investors that he would invest their funds through his investment vehicle in life insurance, fixed income assets, variable annuities, or household-name stocks. After the transfers were made, Richards misappropriated the funds.

IV.

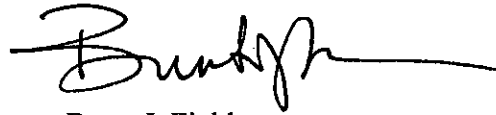
In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Richards's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b) of the Exchange Act and Section 203(f) of the Advisers Act, that Respondent Richards be, and hereby is:

barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

A handwritten signature in black ink, appearing to read "Brent J. Fields", with a long horizontal flourish extending to the right.

Brent J. Fields
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73606 / November 14, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16156

In the Matter of

BLAKE RICHARDS,

Respondent.

**ORDER MAKING FINDINGS AND
IMPOSING REMEDIAL SANCTIONS
PURSUANT TO SECTION 15(b) OF THE
SECURITIES EXCHANGE ACT OF 1934
AND SECTION 203(f) OF THE
INVESTMENT ADVISERS ACT OF 1940**

I.

On September 23, 2014, the Securities and Exchange Commission ("Commission") instituted public administrative proceedings pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Blake Richards ("Richards" or "Respondent").

II.

In response to these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent consents to the Commission's jurisdiction over him and the subject matter of these proceedings and to the entry of this Order Making Findings and Imposing Remedial Sanctions Pursuant to Section 15(b) of the Securities Exchange Act of 1934 And Section 203(f) of the Investment Advisers Act of 1940 ("Order") as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

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1. Richards (CRD #4051402), 36 years of age, was a registered representative and investment adviser representative associated with LPL, a registered broker-dealer and investment adviser. He holds the Series 7, 63 and 65 securities licenses and resides in Buford, GA. Richards utilizes two d/b/a names, Blake Richards Investments and BMO Investments. Richards was associated with Edward Jones from October 1999 until August 2004, with A.G. Edwards & Sons, Inc. from August 2004 to February 2007, with H&R Block Financial Advisors, Inc. (later acquired by Ameriprise Advisor Services, Inc.) from February 2007 to May 2009, and with LPL from May 2009 until May 3, 2013, when he was terminated by LPL.

2. On August 26, 2014, a final judgment was entered against Richards. The final judgment incorporated an earlier order of August 20, 2013, which by consent permanently enjoined Richards from future violations of Sections 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act, in the civil action entitled Securities and Exchange Commission v. Blake B. Richards, Civil Action Number 1:13-cv-1729, in the United States District Court for the Northern District of Georgia.

3. The Commission's complaint alleged that, since approximately 2008, Richards misappropriated approximately \$2 million from at least six individuals who were his broker-dealer and investment adviser clients. At least two of the investors were elderly, and the majority of the misappropriated funds constituted retirement savings and/or life insurance proceeds from deceased spouses. When his clients informed Richards they had funds available to invest he instructed the investors to write out checks to one of two entities called "Blake Richards Investments" or "BMO Investments," both d/b/a entities used by Richards. Richards represented to the investors that he would invest their funds through his investment vehicle in life insurance, fixed income assets, variable annuities, or household-name stocks. After the transfers were made, Richards misappropriated the funds.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Richards's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b) of the Exchange Act and Section 203(f) of the Advisers Act, that Respondent Richards be, and hereby is:

barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served

as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

A handwritten signature in black ink, appearing to read "Brent J. Fields", with a long horizontal flourish extending to the right.

Brent J. Fields
Secretary

*Commissioner Gallagher
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73603 / November 14, 2014

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3597 / November 14, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16275

In the Matter of

LINDEN BOYNE,

Respondent.

ORDER INSTITUTING PUBLIC
ADMINISTRATIVE PROCEEDINGS AND
IMPOSING TEMPORARY SUSPENSION
PURSUANT TO RULE 102(e)(3) OF THE
COMMISSION'S RULES OF PRACTICE

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Rule 102(e)(3)¹ of the Commission's Rules of Practice against Linden Boyne ("Respondent" or "Boyne").

II.

The Commission finds that:

A. RESPONDENT

1. Linden Boyne, age 71, is a British citizen and resident of Surrey, England. Beginning in 2003, he served as the chief financial officer ("CFO"), secretary, and director of Electronic Game Card, Inc. ("EGMI"), a company that purported to be a seller of credit-card sized

¹ Rule 102(e)(3)(i) provides, in relevant part, that:

The Commission, with due regard to the public interest and without preliminary hearing, may, by order, temporarily suspend from appearing or practicing before it any attorney, accountant, engineer, or other professional or expert who has been by name . . . [p]ermanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

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electronic games and that had common stock registered with the Commission pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act") during the relevant period. On September 1, 2009, Boyne was replaced as CFO and secretary. Between October 2009 and March 25, 2010, he served as EGMI's interim CFO and secretary.

2. As EGMI's CFO, Boyne oversaw the company's financial operations, participated in the preparation of its financial statements and the filing of its annual and quarterly reports with the Commission, and certified the accuracy of those reports. Boyne is not licensed as a certified public accountant and is not registered with the Commission in any capacity.

B. CIVIL INJUNCTION

3. On October 8, 2014, the U.S. District Court for the Southern District of New York entered a final judgment against Boyne, permanently enjoining him from future violations, direct or indirect, of Sections 5 and 17(a) of the Securities Act of 1933, Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(5), 13(d), and 16(a) of the Exchange Act, Exchange Act Rules 10b-5, 12b-20, 13a-1, 13a-13, 13a-14, 13b2-1, 13b2-2, 13d-1, 13d-2, 16a-2, and 16a-3, and Section 304 of the Sarbanes-Oxley Act of 2002. Securities and Exchange Commission v. Cole et al., Civil Action Number 12-CV-8167 (RJS), Doc. No. 141.

4. The Commission's complaint alleged that Boyne and others engaged in a fraudulent scheme through EGMI to reap approximately \$12 million in unlawful gains between 2006 and 2009. Throughout that period, Boyne – while serving as EGMI's chief financial officer – repeatedly misled the investing public about the company's operations and financial status. For example, he artificially inflated EGMI's stock price by preparing and certifying materially false quarterly and annual financial statements that were filed with the Commission and distributed to the investing public. Those filings overstated the value of, or omitted material facts concerning, EGMI's assets, revenues, and investments and understated the number of common shares the company had outstanding. While in control of EGMI's business and financial records, Boyne repeatedly provided false information and falsified documents to EGMI's outside auditors.

5. The Commission's complaint further alleges that, while Boyne and EGMI's chief executive officer were making material misstatements to elevate EGMI's stock price, they were also secretly and improperly funneling millions of shares of EGMI stock to Gibraltar-based entities they controlled. While he was a director and officer of EGMI who controlled more than 5% of the company's common stock, Boyne failed to file Schedules 13D and Forms 4 with the Commission that accurately reported his holdings and transactions in EGMI securities.

III.

Based upon the foregoing, the Commission finds that a court of competent jurisdiction has permanently enjoined Boyne from violating the Federal securities laws within the meaning of Rule 102(e)(3)(i)(A) of the Commission's Rules of Practice. In view of these findings, the Commission deems it appropriate and in the public interest that Boyne be temporarily suspended from appearing or practicing before the Commission.

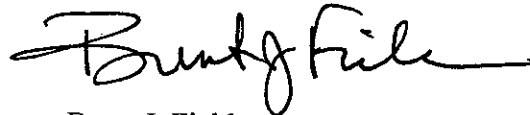
IT IS HEREBY ORDERED that Boyne be, and hereby is, temporarily suspended from appearing or practicing before the Commission. This Order shall be effective upon service on the Respondent.

IT IS FURTHER ORDERED that Boyne may within thirty days after service of this Order file a petition with the Commission to lift the temporary suspension. If the Commission within thirty days after service of the Order receives no petition, the suspension shall become permanent pursuant to Rule 102(e)(3)(ii).

If a petition is received within thirty days after service of this Order, the Commission shall, within thirty days after the filing of the petition, either lift the temporary suspension, or set the matter down for hearing at a time and place to be designated by the Commission, or both. If a hearing is ordered, following the hearing, the Commission may lift the suspension, censure the petitioner, or disqualify the petitioner from appearing or practicing before the Commission for a period of time, or permanently, pursuant to Rule 102(e)(3)(iii).

This Order shall be served upon Boyne personally, by certified mail at his last known address, or, if in a foreign country, by any other method reasonably calculated to give notice, provided that the method of service used is not prohibited by the law of the foreign country.

By the Commission.



Brent J. Fields
Secretary

Commissioner Gallagher
Not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73604 / November 14, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16276

In the Matter of
MARK A. ELLISON, ESQ.,
Respondent.

ORDER OF SUSPENSION PURSUANT
TO RULE 102(e)(2) OF THE
COMMISSION'S RULES OF PRACTICE

I.

The Securities and Exchange Commission deems it appropriate to issue an order of forthwith suspension of Mark A. Ellison ("Ellison") pursuant to Rule 102(e)(2) of the Commission's Rules of Practice [17 C.F.R. 201.102(e)(2)].¹

II.

The Commission finds that:

1. Ellison is an attorney, whom the State of Idaho admitted to practice law in 1976.
2. On August 25, 2014, a judgment in a criminal case was entered against Ellison in *United States v. Swenson, et al*, No. 1:13-CR-00091, in the United States District Court for the District of Idaho, finding him guilty of forty-four (44) counts of securities fraud in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.
3. As a result of this conviction, Ellison was sentenced to five years in prison and

¹ Rule 102(e)(2) provides in pertinent part: "Any attorney who has been suspended or disbarred by a court of the United States or of any State; . . . or any person who has been convicted of a felony or a misdemeanor involving moral turpitude shall be forthwith suspended from appearing or practicing before the Commission." See 17 C.F.R. 201.102(e)(2).

three years of supervised release with restitution to be determined at a later date.

III.

In view of the foregoing, the Commission finds that Ellison has been convicted of a felony within the meaning of Rule 102(e)(2) of the Commission's Rules of Practice.

Accordingly, it is ORDERED, that Mark A. Ellison is forthwith suspended from appearing or practicing before the Commission pursuant to Rule 102(e)(2) of the Commission's Rules of Practice.

By the Commission.

A handwritten signature in cursive script, appearing to read "Brent J. Fields".

Brent J. Fields
Secretary

*Commissioner Gallagher
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73605 / November 14, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16277

In the Matter of
DOUGLAS L. SWENSON, CPA
Respondent.

ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND NOTICE OF HEARING AND ORDER OF SUSPENSION PURSUANT TO RULE 102(e)(2) OF THE COMMISSION'S RULES OF PRACTICE

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Douglas L. Swenson ("Respondent" or "Swenson") and also deems it appropriate to issue an order of forthwith suspension of Swenson pursuant to Rule 102(e)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.102(e)(2)].¹

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. Swenson was the president of DBSI and the founder and president of numerous entities related to the DBSI group of companies. Swenson signed at least two Forms D filed with the Commission by a DBSI-related company. From August 1979 until March 2009, Swenson was associated with various broker-dealers registered with the Commission, including DBSI Securities Corporation. Swenson was a licensed Certified Public Accountant ("CPA") in Idaho from March 1981 until June 1995.

¹ Rule 102(e)(2) provides in pertinent part: "any person who has been convicted of a felony or a misdemeanor involving moral turpitude shall be forthwith suspended from appearing or practicing before the Commission." See 17 C.F.R. 201.102(e)(2).

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B. RESPONDENT'S CRIMINAL CONVICTION

2. On April 14, 2014, a jury convicted Swenson of forty-four (44) counts of securities fraud in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and thirty-four (34) counts of wire fraud in violation of 18 U.S.C. § 1343, before the United States District Court for the District of Idaho, in United States v. Swenson et al, Case. No. 1:13-CR-00091. Swenson was sentenced to twenty years in prison and three years of supervised release with restitution to be determined at a later date.

3. The counts of the criminal indictment for which Swenson was found guilty alleged, among other things, that during 2008, Swenson, in connection with the sale of securities, used a device or scheme to defraud; made an untrue statement of a material fact or failed to disclose a material fact that resulted in making his statement misleading; and engaged in acts, practices, or courses of business that operated as a fraud or deceit upon any person.

III.

In view of the foregoing, the Commission finds that Swenson has been convicted of a felony within the meaning of Rule 102(e)(2) of the Commission's Rules of Practice.

Accordingly, it is ORDERED that Douglas L. Swenson is forthwith suspended from appearing or practicing before the Commission pursuant to Rule 102(e)(2) of the Commission's Rules of Practice.

IV.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest that public administrative proceedings be instituted to determine:

A. Whether the allegations set forth in Section II hereof are true and, in connection therewith, to afford Respondent an opportunity to establish any defenses to such allegations; and

B. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 15(b) of the Exchange Act.

V.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section IV hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If Respondent fails to file the directed answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against him upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon Respondent as provided for in the Commission's Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 210 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.



Brent J. Fields
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73609 / November 14, 2014

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3598 / November 14, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16278

In the Matter of

CHARLES ELLIOT SMITH, CPA

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 15(b) OF THE
SECURITIES EXCHANGE ACT OF 1934
AND RULE 102(e) OF THE
COMMISSION'S RULES OF PRACTICE,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §§ 78o(b)] and Rule 102(e)(3) of the Commission's Rules of Practice [17 C.F.R. § 201.102(e)(3)]¹ against Charles Elliot Smith ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the

¹ Rule 102(e)(3)(i) provides, in relevant part, that:

The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . accountant . . . who has been by name . . . permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

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purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Exchange Act and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Smith, 57 years old, is a resident of Rockwall, Texas. He is the founder and co-principal of Yorkdale Capital, LLC ("Yorkdale"), along with his brother Mark Smith. From 1983 to the present, Smith has also been a self-employed accountant, doing business as Charles E. Smith, CPA. Smith obtained his CPA certificate in Massachusetts. He transferred it to Texas in 1982. Smith previously held securities licenses, which are now expired. Smith has also served as an officer and/or director of various penny stock issuers, and has participated in offerings of penny stocks.

2. On October 31, 2014, the Commission filed a complaint against Smith and his brother Mark Smith in Securities and Exchange Commission v. Charles Elliot Smith, et al., Civil Action Number 3:14-cv-03874-D in the United States District Court for the Northern District of Texas. On October 31, 2014, the court entered an order permanently enjoining Smith, by consent, from future violations of Section 17(a) of the Securities Act of 1933 ("Securities Act") [15 U.S.C. §§ 77q(a)] and Sections 10(b), 13(b)(5), and 15(a) of the Exchange Act [15 U.S.C. §§ 78j(b), 78m(b)(5), and 78o(a)] and Rules 10b-5 and 13b2-1 thereunder [17 C.F.R. §§ 240.10b-1 and 240.13b2-1], and from aiding and abetting violations of Sections 13(a), 13(b)(2)(A), and 15(d) of the Exchange Act [15 U.S.C. §§ 78m(a), 78m(b)(2)(A), and 78o(d)] and Rules 12b-20, 13a-1, 13a-11, 13a-13, 13b2-2, 15d-1, and 15d-13 thereunder [17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-11, 240.13a-13, 240.13b2-2, 240.15d-1, and 240.15d-13], ordering him to pay, jointly and severally with Mark Smith, disgorgement with prejudgment interest of \$78,750.52, to pay a civil penalty of \$150,000, and imposing five-year penny stock and officer and director bars.

3. The Commission's complaint alleged that, among other things, since at least 2006, Smith, along with his brother Mark Smith, Yorkdale and other affiliates, formed and operated at least eight publicly-traded shell companies, caused four of those shell companies to make offerings of penny stocks, and caused each of the shell companies to be sold through reverse merger transactions, all without complying with the Commission's rules and regulations applicable to shell company registration and reporting. The complaint further alleged that in connection with the offer, purchase and sale of securities of the shell companies, Smith engaged in a fraudulent scheme and made and caused to be made various materially false and misleading statements that, among other things, hid his, his brother Mark Smith's, Yorkdale's and/or various affiliates' control of the shell companies, misstated the intended uses of proceeds from the securities offerings, misstated the role of the named officers and directors of the companies and failed to disclose various

compensation to be paid to Smith, Mark Smith, Yorkdale and their affiliates. The complaint further alleged that Charles Smith falsely applied the signature of one of the shell companies' chief executive officers to two Commission filings, without that officer's consent or knowledge. The complaint further alleged that, in connection with the offer and sale of the shell companies' securities, Smith acted as an unregistered broker and as an unregistered dealer.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Smith's Offer.

A. Accordingly, it is hereby ORDERED pursuant Section 15(b)(6) of the Exchange Act, Respondent Smith be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization with the right to apply for reentry after five years to the appropriate self-regulatory organization, or if there is none, to the Commission.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

B. It is further ORDERED pursuant to Rule 102(e)(3) of the Commission's Rules of Practice,

1. Respondent is suspended from appearing or practicing before the Commission as an accountant.
2. After five years from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:
 - a. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent's work in his/her practice before the Commission will be reviewed either by the independent audit committee of the public company for which he/she works or in some other acceptable manner, as long as he/she practices before the Commission in this capacity; and/or

b. an independent accountant. Such an application must satisfy the Commission that:

i. Respondent, or the public accounting firm with which he/she is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

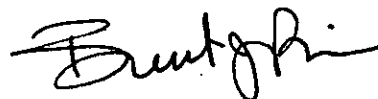
ii. Respondent, or the registered public accounting firm with which he/she is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in the respondent's or the firm's quality control system that would indicate that the respondent will not receive appropriate supervision;

iii. Respondent has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

iv. Respondent acknowledges his/her responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that his/her state CPA license is current and he/she has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.



Brent J. Fields
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73610 / November 14, 2014

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3599 / November 14, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16279

In the Matter of

MARK SMITH, CPA

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO RULE 102(e) OF THE
COMMISSION'S RULES OF PRACTICE,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Rule 102(e)(3) of the Commission's Rules of Practice [17 C.F.R. § 201.102(e)(3)]¹ against Mark Smith ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these

¹ Rule 102(e)(3)(i) provides, in relevant part, that:

The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . accountant . . . who has been by name . . . permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

proceedings and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Smith, 50 years old, is a resident of Allen, Texas. Since 2006, he has been a co-principal of Yorkdale Capital, LLC ("Yorkdale") with his brother Charles Elliot Smith. From at least 2006 to the present, Smith has also been a self-employed accountant, doing business under the name AM Group. Smith obtained his CPA certificate in Massachusetts in 1989, which he kept current until 1991. He does not hold a CPA certificate or license in Texas.

2. On October 31, 2014, the Commission filed a complaint against Smith and his brother in Securities and Exchange Commission v. Charles Elliot Smith, et al., Civil Action Number 3:14-cv-03874-D, in the United States District Court for the Northern District of Texas. On October 31, 2014, the court entered an order permanently enjoining Smith, by consent, from future violations of Section 17(a)(2) and (3) of the Securities Act of 1933 ("Securities Act") [15 U.S.C. §§ 77q(a)(2) and (3)] and Rule 13b2-1 under the Securities Exchange Act of 1934 ("Exchange Act") [17 C.F.R. § 240.13b2-1], and from aiding and abetting violations of Sections 13(a), 13(b)(2)(A) and 15(d) of the Exchange Act [15 U.S.C. §§ 78m(a), 78m(b)(2)(A) and 78o(d)] and Rules 12b-20, 13a-1, 13a-11, 13a-13, 13b2-2, 15d-1, and 15d-13 thereunder [17 C.F.R. §§ 240.12b-20, 240.13a-1, 240.13a-11, 240.13a-13, 240.13b2-2, 240.15d-1, and 240.15d-13], ordering him to pay, jointly and severally with Charles Smith, disgorgement with prejudgment interest of \$78,750.52, to pay a civil penalty of \$50,000, and imposing a three-year penny stock bar.

3. The Commission's complaint alleged that, among other things, since at least 2006, Smith, along with his brother Charles Smith, Yorkdale and other affiliates, formed and operated at least eight publicly-traded shell companies and caused four of the shell companies to be sold through reverse merger transactions, all without complying with the Commission's rules and regulations applicable to shell company registration and reporting. The complaint further alleged that Smith prepared filings with the Commission, financial statements and communications to auditors that contained materially false or misleading statements or omissions, including, among other things, fraudulent statements or omissions concerning control of the shell companies by Smith, his brother Charles Smith, Yorkdale and/or their affiliates, misstatements about the intended uses of proceeds from the securities offerings, misstatements about the role of the named officers and directors of the companies, and omissions concerning the compensation to be paid to Smith, Charles Smith, Yorkdale and their affiliates.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Smith's Offer.

Accordingly, it is hereby ORDERED pursuant to Rule 102(e)(3) of the Commission's Rules of Practice,

A. Respondent is suspended from appearing or practicing before the Commission as an accountant.

B. After three years from the date of this order, Respondent may request that the Commission consider his reinstatement by submitting an application (attention: Office of the Chief Accountant) to resume appearing or practicing before the Commission as:

1. a preparer or reviewer, or a person responsible for the preparation or review, of any public company's financial statements that are filed with the Commission. Such an application must satisfy the Commission that Respondent's work in his/her practice before the Commission will be reviewed either by the independent audit committee of the public company for which he/she works or in some other acceptable manner, as long as he/she practices before the Commission in this capacity; and/or

2. an independent accountant. Such an application must satisfy the Commission that:

a. Respondent, or the public accounting firm with which he/she is associated, is registered with the Public Company Accounting Oversight Board ("Board") in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

b. Respondent, or the registered public accounting firm with which he/she is associated, has been inspected by the Board and that inspection did not identify any criticisms of or potential defects in the respondent's or the firm's quality control system that would indicate that the respondent will not receive appropriate supervision;

c. Respondent has resolved all disciplinary issues with the Board, and has complied with all terms and conditions of any sanctions imposed by the Board (other than reinstatement by the Commission); and

d. Respondent acknowledges his/her responsibility, as long as Respondent appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the

Board, including, but not limited to, all requirements relating to registration, inspections, concurring partner reviews and quality control standards.

The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that his/her state CPA license is current and he/she has resolved all other disciplinary issues with the applicable state boards of accountancy. However, if state licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its other merits. The Commission's review may include consideration of, in addition to the matters referenced above, any other matters relating to Respondent's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

By the Commission.



Brent J. Fields
Secretary

*Commissioner Aguilar
Commissioner Gallagher
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

November 17, 2014

In the Matter of

YesDTC Holdings, Inc.

File No. 500-1

ORDER OF SUSPENSION OF
TRADING

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of YesDTC Holdings, Inc. ("YesDTC") because it has not filed a periodic report since its Form 10-Q for the period ending June 30, 2011. YesDTC is a Nevada corporation and is currently quoted on OTC Link operated by OTC Markets Group Inc. under the ticker symbol YESD.

The Commission is of the opinion that the public interest and the protection of investors require a suspension of trading in the securities of YesDTC. Therefore, it is ordered, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of YesDTC is suspended for the period from 9:30 a.m. EST on November 17, 2014, through 11:59 p.m. EST on December 1, 2014.

By the Commission.



Brent J. Fields
Secretary

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*Commissioner Aguilar
Commissioner Gallagher
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 73612 / November 17, 2014

ADMINISTRATIVE PROCEEDING

File No. 3-16280

In the Matter of

YesDTC Holdings, Inc.,

Respondent.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
AND NOTICE OF HEARING
PURSUANT TO SECTION 12(j) OF
THE SECURITIES EXCHANGE ACT
OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent YesDTC Holdings, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. Respondent YesDTC Holdings, Inc. (CIK No. 1449527) is a Nevada corporation located in San Francisco, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). YesDTC Holdings, Inc. is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ending June 30, 2011. As of August 15, 2014, Respondent's stock (symbol "YESD") was quoted on OTC Link operated by OTC Markets Group Inc. had six market makers and was eligible for the "piggyback" exception of Exchange Act rule 15c2-11(f)(3).

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B. DELINQUENT PERIODIC FILINGS

2. As discussed in more detail above, Respondent is delinquent in its periodic filings with the Commission and has repeatedly failed to meet its obligations to file timely periodic reports.

3. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

4. As a result of the foregoing, Respondent failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondent an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of, each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondent identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of Respondent.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of Respondent, may be deemed in default and the proceedings may be determined against it upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f),

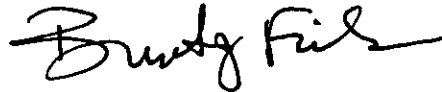
221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondent personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.



Brent J. Fields
Secretary

*Chair White
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 73616 / November 17, 2014

ADMINISTRATIVE PROCEEDING

File No. 3-16281

In the Matter of

STEPHEN TIMMS and
YASSER RAMAHI,

Respondents.

ORDER INSTITUTING CEASE-AND-
DESIST PROCEEDINGS PURSUANT
TO SECTION 21C OF THE
SECURITIES EXCHANGE ACT OF
1934, MAKING FINDINGS, AND
IMPOSING A CEASE-AND-DESIST
ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Stephen Timms ("Timms") and Yasser Ramahi ("Ramahi") (collectively "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, and except as provided herein in Section V, Respondents consent to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

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III.

On the basis of this Order and Respondents' Offers, the Commission finds¹ that:

Summary

1. During 2009, Stephen Timms and Yasser Ramahi arranged expensive travel, entertainment, and personal items for foreign government officials in the Kingdom of Saudi Arabia in order to influence the officials to obtain new business for their employer, FLIR Systems, Inc. and to retain existing business for FLIR with the Saudi Arabia Ministry of Interior (the "MOI"). Timms and Ramahi subsequently provided false explanations for the gifts to FLIR and attempted to conceal the gifts' true value by submitting false documentation to the company.

Respondents

2. **Stephen Timms**, age 51, is a United States citizen who resides in Thailand. FLIR hired Timms in November 2001. He was promoted to Middle East Business Development Director for FLIR'S Government Systems division in September 2007. Timms was the head of FLIR's Middle East office in Dubai during the relevant time period, and was one of the company executives responsible for obtaining business for FLIR's Government Systems division from the MOI.

3. **Yasser Ramahi**, age 53, is a United States citizen who resides in the United Arab Emirates. Ramahi was hired by FLIR in late 2005 and worked in business development in Dubai. During the relevant period, Ramahi's manager was Timms, the head of FLIR's Middle East office.

Other Relevant Entity

4. **FLIR Systems, Inc.** is an Oregon-based defense contractor whose common stock is registered under Section 12(b) of the Exchange Act and is listed on the NASDAQ Global Select Market. FLIR, founded in 1978, makes thermal imaging and other sensing products and systems, night vision, and infrared camera systems.

FLIR's Business with the Saudi Ministry of Interior

5. In November 2008, FLIR entered into a contract with the MOI to sell thermal binoculars for approximately \$12.9 million. Ramahi and Timms were the primary sales employees responsible for the contract on behalf of FLIR. In the contract, FLIR agreed to conduct a "Factory Acceptance Test," attended by MOI officials, prior to delivery of the binoculars to Saudi Arabia. The Factory Acceptance Test was a key condition to the fulfillment of the contract. FLIR anticipated that a successful delivery of

¹ The findings herein are made pursuant to Respondents' Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

the binoculars, along with the creation of a FLIR service center, would lead to an additional order in 2009 or 2010.

6. At the same time, Ramahi and Timms were also involved in FLIR's negotiations to sell security cameras to the MOI. In May 2009, FLIR signed an agreement for the integration of its cameras into another company's products for use by the MOI. The contract was valued at approximately \$17.4 million and FLIR hoped to win additional future business with the MOI under this agreement.

"World Tour" for Saudi Officials

7. In February 2009, Ramahi and Timms began preparing for the Factory Acceptance Test, which was scheduled to occur in July 2009 in Billerica, Massachusetts. Timms requested the names of the MOI officials who would attend the test so that travel arrangements could be made for them by FLIR's travel agent in Dubai, UAE. Timms subsequently contacted the United States Embassy in Riyadh, Saudi Arabia, for assistance to obtain visas for the MOI officials to attend the Factory Acceptance Test.

8. Ramahi and Timms then sent MOI officials on what Timms later referred to as a "world tour" before and after the Factory Acceptance Test. Among the MOI officials for whom Ramahi and Timms provided the "world tour" were the head of the MOI's technical committee and a senior engineer on the committee, who played a key role in the decision to award FLIR the business.

9. In June 2009, Ramahi made arrangements for himself and MOI officials to travel from Riyadh to Casablanca, where they would stay for several nights at FLIR's expense. The MOI officials then traveled to Paris with FLIR's third-party agent, where they would also stay for several nights at a luxury hotel, also paid for by FLIR. Ramahi met the MOI officials and FLIR's third-party agent in Boston for the equipment inspection at FLIR's nearby facilities. On the way back from Boston, Ramahi traveled with most of the MOI officials to Dubai and arranged airfare and hotel accommodations for one MOI official to travel to Beirut before returning to Riyadh, all at FLIR's expense. Timms received the travel itinerary ahead of the officials' departure on the "world tour."

10. The trip proceeded as planned. In total, the MOI officials traveled for 20 nights on their "world tour," with airfare and hotel accommodations paid for by FLIR. In addition, while the MOI officials were in Boston, Ramahi and the third-party agent also took the MOI officials on a weekend trip to New York City at FLIR's expense. There was no business purpose for the stops outside of Boston.

11. While in the Boston area, the MOI officials spent a single 5-hour day at FLIR's Boston facility completing the equipment inspection. The agenda for their remaining 7 days in Boston included just three other 1-2 hour visits to FLIR's Boston facility, some additional meetings with FLIR personnel at their hotel, and other leisure activities, all at FLIR's expense.

12. Timms approved expenses incurred by Ramahi and the MOI officials in connection with the extended travel, and Timms' manager approved the expenses for the

air travel provided to the MOI officials in connection with their "world tour." FLIR's finance department processed and paid the approved air expenses the next day.

Expensive Watches for Saudi Officials

13. In March 2009, while Ramahi was present, Timms provided expensive gifts to five MOI officials. At Timms' and Ramahi's instruction, in February 2009, FLIR's third-party agent purchased five watches in Riyadh, paying approximately 26,000 Saudi Riyal (about U.S. \$7,000).

14. In mid-March 2009, Ramahi and Timms traveled to Saudi Arabia for a nine-day business trip to discuss several business opportunities with MOI officials. According to Timms' expense report, the purpose of the trip was to meet with MOI officials regarding FLIR's efforts to sell its security cameras. During the trip, Timms, with Ramahi's knowledge, gave the five watches to MOI officials. Ramahi and Timms believed the MOI officials to be important to sales of both the binoculars and the security cameras. The MOI officials who received the watches included two of the MOI officials who subsequently went on the "world tour" travel.

15. Within weeks of his visit to Saudi Arabia, Timms submitted an expense report to FLIR for reimbursement of the watches. At the time of his submittal, Timms confirmed that each watch cost \$1,425 and was for "Executive Gifts." Shortly thereafter, Timms identified the names of the MOI officials who received the watches. The reimbursement was approved by Timms' manager and paid out to Timms.

The Cover Up

16. In July 2009, in connection with an unrelated review of expenses in the Dubai office, FLIR's finance department flagged Timms' reimbursement request for the watches. In response to their questions, Timms claimed that he had made a mistake and falsely stated that the expense report should have reflected a total of 7,000 Saudi Riyal (about \$1,900) rather than \$7,000 as submitted.

17. At his supervisors' request, Ramahi secured a second, fabricated invoice reflecting that the watches cost 7,000 Saudi Riyal, which Timms submitted to FLIR finance in August 2009. Ramahi also told FLIR investigators that the watches were each purchased for approximately 1,300-1,400 Saudi Riyal (approximately \$377) by FLIR's third-party agent.

18. In September 2009, the FLIR finance department attempted to contact FLIR's third-party agent. In e-mail correspondence, the FLIR finance department asked the agent a series of questions about the watches. Unknown to the finance department, Timms drafted responses to the questions on behalf of the agent. At Timms' direction, the agent maintained the false cover story: that the watches cost a total of 7,000 Saudi Riyal, not U.S. \$7,000.

19. In July 2009, Ramahi and Timms claimed that the MOI's luxury travel and "world tour" had been a mistake. They told the FLIR finance department that the

MOI had used FLIR's travel agent in Dubai to book their own travel and that it had been mistakenly charged to FLIR. They promised to send an invoice to the MOI to pay for the "world tour" travel. Instead, however, Ramahi and Timms used FLIR's agent to give the appearance that the MOI paid for their travel. Timms also oversaw the preparation of false and misleading documentation of the MOI travel expenses that was submitted to FLIR's finance department. For example, Timms obtained an invoice from the Dubai travel agency showing direct flights from Boston to Riyadh—a route not taken by the MOI officials on their "world tour." Timms submitted the false invoice to FLIR finance as the "corrected" travel documentation.

FLIR Profits from Sales to the Saudi Ministry of Interior

20. Following the equipment inspection in Boston, the MOI gave its permission for FLIR to ship the thermal binoculars. The MOI later placed an order for additional binoculars for an approximate price of \$1.2 million. In total, FLIR received payments from the MOI for the binoculars that exceeded \$10 million.

21. From September 2009 through August 2012, FLIR also shipped the security cameras and related accessories to the MOI. FLIR received payments for the cameras exceeding \$18 million. FLIR subsequently submitted a bid to sell additional security cameras to the MOI. The bid expired before the contract was awarded by the MOI.

FLIR's FCPA-Related Policies and Training

22. At all relevant times, FLIR had in place a code of conduct which prohibited FLIR employees from violating the FCPA. The policy required employees to record information "accurately and honestly" in FLIR's books and records, with "no materiality requirement or threshold for a violation."

23. Both Ramahi and Timms received training on their obligations under the FCPA and FLIR's policy prior to the provision of expensive gifts of travel, entertainment, and personal items to the MOI. On or around May 13, 2007 and on or around December 2, 2008, Timms completed FLIR's two-part FCPA-specific online training courses, including courses focused on "Understanding the Law" and "Dealing with Third Parties." Ramahi only completed part one of the two-part series in May 2007. The training course completed by both Ramahi and Timms, entitled "Understanding the Law," gave examples of prohibited gifts under the FCPA and specifically identified gifts of luxury watches, vacations and side trips during official business travel.

Legal Standards and FCPA Violations

A. Under Section 21C(a) of the Exchange Act, the Commission may impose a cease-and-desist order upon any person who is violating, has violated, or is about to violate any provision of the Exchange Act or any rule or regulation thereunder, and upon any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation.

B. Section 30A of the Exchange Act prohibits any officer, director, employee, or agent acting on behalf of an issuer with a class of securities registered pursuant to Section 12 of the Exchange Act, in order to obtain or retain business, from corruptly giving or authorizing the giving of, anything of value to any foreign official for the purposes of influencing the official or inducing the official to act in violation of his or her lawful duties, or to secure any improper advantage, or to induce a foreign official to use his influence with a foreign governmental instrumentality to influence any act or decision of such government or instrumentality. [15 U.S.C. § 78dd-1].

C. Section 13(b)(5) of the Exchange Act prohibits any person from knowingly falsifying any book, record, or account required to be kept by a reporting company under Section 13(b)(2) of the Exchange Act, or from knowingly circumventing a system of internal accounting controls or knowingly failing to implement a system of internal accounting controls. [15 U.S.C. § 78m(b)(5)]. Rule 13b2-1 thereunder prohibits any person from directly or indirectly falsifying any book, record, or account required to be kept by a reporting company under Section 13(b)(2)(A) of the Exchange Act. [17 C.F.R. § 240.13b2-1].

D. Under Section 13(b)(2)(A) of the Exchange Act issuers are required to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and disposition of the assets of the issuer. [15 U.S.C. § 78m(b)(2)(A)].

E. As described above, Respondents violated Section 30A of the Exchange Act by corruptly providing expensive gifts of travel, entertainment, and personal items to the MOI officials to retain and obtain business for FLIR. Respondents also violated Section 13(b)(5) of the Exchange Act, and Rule 13b2-1 thereunder, by knowingly circumventing FLIR's existing policies and controls, placing a fabricated invoice for the watches into FLIR's books and records and falsifying FLIR's records regarding the MOI officials' extended personal travel paid by FLIR. As a result of this same conduct, Respondents caused FLIR's books and records to be not accurately maintained in violation of Section 13(b)(2)(A) of the Exchange Act.

Undertakings

In connection with this action and any related judicial or administrative proceeding or investigation commenced by the Commission or to which the Commission is a party, Respondents (i) agree to appear and be interviewed by Commission staff at such times and places as the staff requests upon reasonable notice; (ii) will accept service by mail or facsimile transmission of notices or subpoenas issued by the Commission for documents or testimony at depositions, hearings, or trials, or in connection with any related investigation by Commission staff; (iii) appoint Respondents' attorneys as agents to receive service of such notices and subpoenas; (iv) with respect to such notices and subpoenas, waive the territorial limits on service contained in Rule 45 of the Federal Rules of Civil Procedure and any applicable local rules, provided that the party requesting the testimony reimburses Respondents' travel, lodging, and subsistence expenses at the then-prevailing U.S. Government per diem rates; and (v) consent to

personal jurisdiction over Respondents in any United States District Court for purposes of enforcing any such subpoena.

In determining whether to accept the Offers, the Commission has considered these Undertakings.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondents' Offers.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondents cease and desist from committing or causing any violations and any future violations of Sections 13(b)(2)(A), 13(b)(5), and 30A of the Exchange Act [15 U.S.C. §§ 78m(b)(2)(A), 78m(b)(5), and 78dd-1] and Rule 13b2-1 thereunder [17 C.F.R. § 240.13b2-1].

B. Pursuant to Section 21B(a)(2) of the Exchange Act, Respondent Stephen Timms shall pay a civil money penalty in the amount of \$50,000 to the Securities and Exchange Commission. Payment shall be made in the following installments: (i) \$30,000 within 10 days of the entry of the Order; (ii) \$5,000 within 90 days of entry of the Order; (iii) \$5,000 within 180 days of entry of the Order; (iv) \$5,000 within 270 days of entry of the Order; and (v) the final \$5,000 payment within 360 days of entry of the Order. If any payment is not made by the date the payment is required by the Order, the entire outstanding balance, plus any additional interest accrued pursuant to 31 U.S.C. § 3717, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the Commission Web site at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Stephen Timms as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Tracy L. Davis, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 44 Montgomery Street, Suite 2800, San Francisco, CA 94104.

C. Pursuant to Section 21B(a)(2) of the Exchange Act, Respondent Yasser Ramahi shall pay a civil money penalty in the amount of \$20,000 to the Securities and Exchange Commission. Payment shall be made within 14 days of the entry of the Order. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in one of the following ways:

- (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondent may make direct payment from a bank account via Pay.gov through the Commission Web site at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Yasser Ramahi as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Tracy L. Davis, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 44 Montgomery Street, Suite 2800, San Francisco, CA 94104.

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V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, the findings in this Order are true and admitted by Respondents, and further, any debt for civil penalty or other amounts due by Respondents under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondents of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. § 523(a)(19).

By the Commission.

Brent J. Fields
Secretary

Kevin M. O'Neill

By: Kevin M. O'Neill
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 73618 / November 18, 2014

ADMINISTRATIVE PROCEEDING

File No. 3-16282

In the Matter of

**All-American Care Centers, Inc.,
FDH, Inc.,
Stirrup Creek Gold Ltd., and
USN Communications, Inc. (n/k/a CTBB
Holdings, Inc.),**

Respondents.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
AND NOTICE OF HEARING
PURSUANT TO SECTION 12(j) OF
THE SECURITIES EXCHANGE ACT
OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents All-American Care Centers, Inc., FDH, Inc., Stirrup Creek Gold Ltd., and USN Communications, Inc. (n/k/a CTBB Holdings, Inc.).

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. All-American Care Centers, Inc. (CIK No. 1231073) is a dissolved Florida corporation located in Oak Brook, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). All-American is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2007, which reported a net loss of \$7,750 for the prior nine months.

2. FDH, Inc. (CIK No. 946459) is a dissolved Colorado corporation located in Denver, Colorado with a class of securities registered with the Commission pursuant to

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Exchange Act Section 12(g). FDH is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended July 31, 1998, which reported a net loss of \$3,148 from the company's February 10, 1992 inception to July 31, 1998.

3. Stirrup Creek Gold Ltd. (CIK No. 894157) is a British Columbia corporation located in Surrey, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Stirrup Creek is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F/R on March 24, 1997, which reported a deficit of \$370,029 (Canadian) for the year ended April 30, 1996.

4. USN Communications, Inc. (n/k/a CTBB Holdings, Inc.) (CIK No. 926134) is a merged Delaware corporation located in Chicago, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). USN is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended September 30, 1998, which reported a net loss of over \$67 million for the prior three months.

B. DELINQUENT PERIODIC FILINGS

5. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

6. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

7. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and/or 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Brent J. Fields
Secretary

Kevin M. O'Neill
By: **Kevin M. O'Neill**
Deputy Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73634 / November 18, 2014

Admin. Proc. File No. 3-15755

In the Matter of
MARK FEATHERS

ORDER SUMMARILY AFFIRMING
INITIAL DECISION IN PART AND
IMPOSING REMEDIAL SANCTIONS

Mark Feathers, formerly the chief executive officer and a director of Small Business Capital Corp. ("SBCC"), a privately-held California corporation, appeals from the initial decision of an administrative law judge. The law judge found that a district court permanently enjoined Feathers from future violations of the antifraud and registration provisions of the federal securities laws and that the injunction served as a basis to consider imposing a sanction. The law judge determined that it was in the public interest to bar Feathers from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization ("NRSRO") and from participating in an offering of penny stock.

Feathers filed a petition for review by the Commission, and the Division of Enforcement filed a motion for summary affirmance of the initial decision. We have reviewed the record of action before the law judge *de novo*, as well as the documents filed on appeal.

I. We summarily affirm the law judge's findings regarding the injunction.

The law judge found that Feathers had been permanently enjoined by a district court "from engaging in or continuing any conduct or practice . . . in connection with the purchase or sale of any security" within the meaning of Exchange Act Sections 15(b)(4) and 15(b)(6).¹

¹ *Mark Feathers*, Initial Decision Release No. 605, 2014 WL 2418472, at *3 (May 30, 2014). The district court found that Feathers was an associated person of an unregistered broker. Exchange Act Sections 15(b)(4) and 15(b)(6), 15 U.S.C. §§ 78o(b)(4) and (6), authorize the Commission to sanction an unregistered associated person of an unregistered broker. *See, e.g., Vladislav Steven Zubkis*, Exchange Act Release No. 52876, 2005 WL 3299148, at *6 (Dec. 2, 2005) (barring, pursuant to Exchange Act § 15(b)(6)(A), an associated person of an unregistered broker-dealer from associating with any broker-dealer and from participating in any penny stock offering, based on injunction prohibiting securities laws violations).

Pursuant to Commission Rule of Practice 411, we may summarily affirm an initial decision, in whole or in part, if we find that no issue raised in the initial decision warrants consideration by us of further oral or written argument, that no prejudicial error was committed in the conduct of the proceeding, and that the decision embodies no exercise of discretion or decision of law or policy that is important and that we should review.² We find that the standard for granting summary affirmance has been met regarding the law judge's findings as to the injunction. We therefore adopt the initial decision's factual and legal findings on this point.

II. We find, based on our independent review, that it is in the public interest to impose an industry-wide bar on Feathers.

The law judge found that an industry-wide bar was appropriate based on an examination of the relevant public interest factors. Under Rule 411(e)(2), we will decline to grant summary affirmance upon a reasonable showing that "the decision embodies an exercise of discretion that is important and that the Commission should review."³ Such is the case here. In order for us to summarily affirm the law judge's sanctioning determination, the law judge's analysis must explain, based on the facts and circumstances presented in a case, why an industry-wide bar is in the public interest.⁴ Although the law judge's analysis need not include a "ritualistic incantation" regarding [the] remedial effect" of the industry-wide bar, it should make specific "findings regarding the protective interests to be served" by such a bar and the "risk of future misconduct."⁵ In this case, although the initial decision discussed the public interest factors in general, it did not specifically articulate why the facts and circumstances of the case warrant an industry-wide bar or how such a bar will protect the interests of the investing public.⁶ We have an interest in further explaining why an industry-wide bar serves the public interest.

² See 17 C.F.R. § 201.411(e)(2); *Joseph Contorinis*, Exchange Act Release No. 72031, 2014 WL 1665995, at *2 & n.5 (Apr. 25, 2014) (citing *Eric S. Butler*, Exchange Act Release No. 64204, 2011 WL 3792730, at *1 n.2 (Aug. 26, 2011) (noting in a follow-on proceeding based on a criminal conviction that the Commission may apply the summary affirmance rule "in the future where, as here, the relevant facts are undisputed and the initial decision does not embody an important question of law or policy warranting further review by the Commission"))).

³ 17 C.F.R. § 201.411(e)(2).

⁴ *Ross Mandell*, Exchange Act Release No. 71688, 2014 WL 907416, at *2 (Mar. 7, 2014).

⁵ *Id.* at *2 & n.11 (citations omitted).

⁶ *Id.* at *2 (finding that the initial decision did not sufficiently articulate why the facts and circumstances of the case warranted an industry-wide bar or how the bar protected the trading public from further harm and determining, as an exercise of discretion, to explain why the bar served the public interest). Compare *Anthony Chiasson*, Initial Decision Release No. 589, 2014 WL 1512024, at *4-8 (Apr. 18, 2014) (acknowledging the Commission's directive in *Mandell* and engaging in extensive analysis of facts and circumstances regarding an industry-wide bar), *appeal filed*, Admin. Proc. File No. 3-15580 (May 9, 2014).

In analyzing the public interest, we consider, among other things: the egregiousness of the respondent's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his conduct, and the likelihood that the respondent's occupation could present opportunities for future violations.⁷ Our "inquiry into ... the public interest is a flexible one, and no one factor is dispositive."⁸

The district court's findings underscore the egregiousness of Feathers's actions. Feathers violated the antifraud provisions by offering and selling, through SBCC, securities in two mortgage investments funds and causing those funds to make material misrepresentations to investors about the funds' management, capitalization, and returns.⁹ For example, the funds represented to investors that the funds would not grant loans to SBCC—other than loans secured by real property—when, in fact, Feathers caused the funds to transfer over \$7 million in cash to SBCC using sham accounting entries in the funds' financial statements. The funds also represented in offering documents that they adhered to conservative lending standards by only making secured loans. But the funds actually made unsecured loans to SBCC, which had no ability to repay the loans. The funds further represented in offering documents that member returns would be paid from profits generated by the funds' investments when, in reality, the funds were not profitable and Feathers used investors' money to make "Ponzi-like payments" of returns to other investors.

During the time that Feathers engaged in this misconduct, he committed another violation by failing to register with the Commission as an associated person of a broker. The district court found that Feathers also was liable for SBCC's failure to register with the Commission as a broker. The district court ordered Feathers to disgorge ill-gotten gains of \$7,497,402.51 and to pay a second-tier civil money penalty of \$10,000, sanctions that reflect the district court's view of the seriousness of Feathers's actions.

Feathers's conduct was recurrent, having begun in early 2009 and ended in the middle of 2012. As to scienter, the court found that the Division of Enforcement "presented abundant evidence demonstrating that Feathers acted intentionally or recklessly in carrying out the misrepresentations and misstatements . . ." Among other things, the court found that Feathers intended to deceive investors by manipulating the funds' financial statements and multiple investor communications in order to conceal the fact that the funds engaged in risky transactions

⁷ *Mandell*, 2014 WL 907416, at *4 (citing *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981)).

⁸ *David Henry Disraeli*, Exchange Act Release No. 57027, 2007 WL 4481515, at *15 (Dec. 21, 1007), *petition denied*, 334 F. App'x 334 (D.C. Cir. 2009) (per curiam).

⁹ *SEC v. Small Bus. Capital Corp., et al.*, Civil Action No. 5:12 CV 03237-EJD, 2013 WL 4455850, at *14 (Aug. 16, 2013) (finding violations of Securities Act Section 17(a), 15 U.S.C. § 77q(a); Exchange Act Section 10(b), 15 U.S.C. § 78j(b); and Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5).

and were not financially sound.¹⁰ Moreover, Feathers disregarded advice from the funds' auditors and attorneys to stop selling loans between the funds and to readjust misleading entries in the funds' financial statements.

The court found that Feathers presented "no evidence" that he recognized the wrongful nature of his conduct. In fact, Feathers argued before the court that he did not commit fraud and that he would continue to follow rules in the future, as he had done in the past. The court also found that "Feathers did not show that he would not re-enter the brokerage industry if he were able." To the contrary, Feathers suggested that he intended to re-enter the securities industry when he indicated that he would hire a securities attorney to avoid violating the securities laws in the future.¹¹

On appeal, Feathers asserts that he was "denied an opportunity for public hearings and any level of discovery" during the proceeding before the law judge. Rule of Practice 250(b) provides that a hearing officer may grant a motion for summary disposition without an in-person hearing if "there is no genuine issue with regard to any material fact and the party making the motion is entitled to a summary disposition as a matter of law."¹² Once the Division showed that it had satisfied the criteria for summary disposition, Feathers had the opportunity to produce documents, affidavits, or some other evidence to demonstrate that there was a genuine and material factual dispute that the law judge could not resolve without a hearing. Feathers did not raise "the existence of a genuine issue of material fact," and therefore the law judge was not required to conduct an in-person hearing.¹³

¹⁰ See *Tzernach David Netzer Korem*, Exchange Act Release No. 70044, 2013 WL 3864511, at *6 & n.48 (July 26, 2013) (citation omitted) (finding that respondent's efforts to conceal misconduct further demonstrated scienter).

¹¹ At the time the court issued its order imposing sanctions in November 2013, it found that Feathers was employed at a printing company without elaborating on the nature of Feathers's role or responsibilities.


¹² 17 C.F.R. § 201.250(b).

¹³ *Michael C. Pattison, CPA*, Exchange Act Release No. 67900, 2012 WL 4320146, at *11 & n.62 (Sept. 20, 2012) (quoting *Gary M. Kornman*, Exchange Act Rel. No. 59403, 2009 WL 367635, at *11 (Feb. 13, 2009)). On September 30, 2014 Feathers sent a letter to the Office of the Secretary stating that the Division "failed to turn over enforcement files which it was required to turn over." At a March 24, 2014 prehearing conference, the Division represented that it produced its investigative file, and Feathers did not challenge that representation. We find nothing in the record that suggests that the Division has failed to comply with its document production requirements. The other arguments that Feathers raises on appeal were properly addressed and rejected by the law judge in the initial decision. We therefore do not repeat those arguments here, and we summarily affirm that part of the initial decision and adopt the law judge's findings with respect to those arguments as our own.

Despite Feathers's assurances against future violations, we find that he poses too great of a risk to the investing public to be permitted to re-enter the industry. We conclude that an industry-wide bar is appropriate.¹⁴ We have repeatedly held that "antifraud injunctions merit the most stringent sanctions and that our 'foremost consideration must . . . be whether [the] sanction protects the trading public from further harm.'"¹⁵ As we have stated, "[t]he securities industry presents continual opportunities for dishonesty and abuse, and depends heavily on the integrity of its participants and on investors' confidence."¹⁶ Feathers acted with a complete lack of integrity when he deceived investors about fundamental information involving their investments. His repeated dishonesty and callous disregard for the funds' investors combined with his contempt for, or at the very least his misunderstanding of, his responsibilities as a securities professional demonstrate his unfitness to remain in the securities industry in any capacity.¹⁷ We find that a bar from associating with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or NRSRO and from participating in any offering of penny stock will prevent Feathers from putting investors at further risk and serve as a deterrent to others from engaging in similar misconduct.¹⁸

Accordingly, IT IS ORDERED that the Division of Enforcement's motion for summary affirmance is granted.

By the Commission.


By: **Lynn M. Powalski**
Deputy Secretary

Brent J. Fields
Secretary

¹⁴ See *Korem*, 2013 WL 3864511, at *5 & n.42 (finding that, in the absence of evidence to the contrary, it is ordinarily in the public interest to bar a respondent who is enjoined from violating the antifraud provisions and imposing industry-wide bar) (citing *Marshall E. Melton*, Advisers Act Release No. 2151, 2003 WL 21729839, at *9 (July 25, 2003)).

¹⁵ E.g., *Korem*, 2013 WL 3864511, at *5 & n.40 (citation omitted); *Sherwin Brown & Jamerica Fin., Inc.*, Advisers Act Release No. 3217, 2011 WL 2433279, at *6 & n.18 (June 17, 2011) (citing *James C. Dawson*, Advisers Act Release No. 3057, 2010 WL 2886183, at *6 (July 23, 2010)).

¹⁶ *Korem*, 2013 WL 3864511, at *6 & n.53 (citing *Conrad P. Seghers*, Advisers Act Release No. 2656, 2007 WL 2790633, at *7 (Sept. 26, 2007)).

¹⁷ See *Korem*, 2013 WL 3864511, at *7 (finding that the antifraud provisions that the respondent violated apply broadly to the conduct of all participants in the securities industry).

¹⁸ In support of his appeal, Feathers includes in, or attaches to, his petition for review and his reply to the Division's opposition to the petition for review various documents and excerpts of documents. But he has not shown "with particularity that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence previously" as required by Rule of Practice 452(a). 17 C.F.R. § 201.452(a). Accordingly, we will not admit this additional evidence.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73637 / November 19, 2014

INVESTMENT ADVISERS ACT OF 1940
Release No. 3970 / November 19, 2014

Admin. Proc. File No. 3-15928

In the Matter of

SIMING YANG

ORDER GRANTING
MOTION TO AMEND ORDER
INSTITUTING PROCEEDINGS

The Division of Enforcement requests that we amend the order instituting these proceedings ("OIP") to take account of developments that have occurred since it was issued. The request is unopposed and, for the reasons discussed below, we have determined to grant it.

I. BACKGROUND

On May 27, 2014, following a jury verdict, a district court entered a final judgment¹ against Siming Yang, permanently enjoining him from future violations of Sections 10(b) and 13(d) of the Securities Exchange Act of 1934 and Rules 10b-5, 13d-1, and 13d-2 thereunder and Sections 206(1) and 206(2) of the Investment Advisers Act of 1940.² The complaint alleged, among other things, that Yang, a Chinese citizen who was acting as an investment adviser to a start-up investment firm, Prestige Trade Investments Limited, engaged in a fraudulent "front-running"³ scheme and caused Prestige to file false Schedules 13D with the Commission. After a

¹ The district court also ordered Yang to pay \$150,000 in civil money penalties.

² 15 U.S.C. §§ 78j(b), 78m(d), 80b-6(1) & (2); 17 C.F.R. §§ 240.10b-5, 13d-1, 13d-2. See *SEC v. Siming Yang*, Civil Action No. 12-cv-2473 (N.D. Ill. May 27, 2014), 2014 WL 2198323.

³ "'Front-running' refers to a situation where one buyer intentionally trades in front of another, larger, buyer in order to take advantage of any benefit the larger buyer's purchase generates in the market." *In re State Street Bank & Trust Co. Fixed Income Funds Inv. Litig.*, 842 F. Supp. 2d 614, 640 n.18 (S.D.N.Y. 2012).

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six-day trial, the jury found Yang liable on the charges of front-running and filing false Schedules 13D.⁴

On June 12, 2014, we instituted this follow-on proceeding against Yang pursuant to Advisers Act Section 203(f).⁵ In the OIP, the Division alleged that, from 2008 until March 30, 2012, Yang was employed as a research analyst by BAMCO, Inc., a New York-based registered broker-dealer and investment adviser. In his answer to the OIP, however, Yang denied that he was employed by BAMCO.

On September 5, 2014, a law judge held a prehearing conference at which Yang's counsel again denied Yang's association with BAMCO (or any registered investment adviser), although he admitted that Yang was employed by one of two affiliated subsidiaries of Baron Capital Group, Inc., an investment management holding company.⁶ The law judge stated that Yang's denial could create a disputed issue of material fact precluding summary disposition "because without [Yang] being associated with an investment adviser, there cannot be any sanctions or action taken under Section 203(f)."⁷ The law judge suggested that the Division consider moving to amend the OIP to address Yang's associational status and thereby obviate the need for a hearing on this issue.

II. Amending the OIP is appropriate

On September 18, 2014, the Division filed a motion to amend the OIP. The Division states that the purpose of the amendment is to address Yang's "equivocation on his employment status and negate the need for a hearing." According to the Division, regardless of which subsidiary Yang may claim as his employer, he nonetheless was associated with a registered broker-dealer and/or registered investment adviser. The amendment identifies BAMCO and the two subsidiaries of Baron Capital Group, Inc. as alternative employers, identifies their registration status, and includes Exchange Act Section 15(b) as an alternative statutory basis for

⁴ The jury did not find Yang liable on the charge that he engaged in insider trading in the stock of Zhongpin Inc.

⁵ 15 U.S.C. § 80b-3(f).

⁶ At trial, Yang admitted that he worked for an entity affiliated with "Baron Capital." Baron Capital Group, Inc.'s affiliated subsidiaries are Baron Capital, Inc., a registered broker-dealer, and Baron Capital Management, Inc., a registered investment adviser. It is not clear from the motion papers what the relationship is between BAMCO and Baron Capital Group, Inc. or its subsidiaries.

⁷ Pursuant to the Commission's Rule of Practice 250, a law judge may grant a motion for summary disposition only if there is no genuine issue with regard to any material fact and the movant is entitled to summary disposition as a matter of law. 17 C.F.R. § 201.250.

the OIP. The amendment also clarifies that Yang acted as an unregistered investment adviser to Prestige.

Under Rule of Practice 200(d)(1), we may, at any time, upon motion by a party, amend an OIP to include new matters of fact or law.⁸ We have stated that amendments of OIPs to reflect "subsequent developments"⁹ "should be freely granted, subject only to the consideration that other parties should not be surprised nor their rights prejudiced."¹⁰ The Division's proposed amendment to the OIP meets these standards. It reflects "subsequent developments," *i.e.*, Yang's denial of his employment with BAMCO in his answer to the OIP and at the pretrial hearing, and his admission at that hearing that he was employed by one of two affiliated subsidiaries of Baron Capital Group, Inc. In addition, it can neither surprise nor prejudice Yang. It is therefore appropriate, under the circumstances, to grant the Division's motion to amend the OIP to clarify Yang's employment status and to add Section 15(b) of the Securities Exchange Act of 1934 as an alternative statutory basis for this proceeding.¹¹

Accordingly, IT IS ORDERED that the Division of Enforcement's motion to amend the Order Instituting Proceedings issued on June 12, 2014 against Siming Yang is GRANTED; and it is further

ORDERED that Section I of the Order Instituting Proceedings issued on June 12, 2014, is amended to add that proceedings be "instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934"; and it is further

ORDERED that Section II Paragraph 1 of the Order Instituting Proceedings issued on June 12, 2014, is amended to allege that Siming Yang "was employed as a research analyst with New York-based registered investment adviser, BAMCO, Inc. ("BAMCO"), and/or registered broker-dealer Baron Capital, Inc. and/or registered investment adviser Baron Capital Management, Inc., all affiliated subsidiaries of investment management holding company, Baron Capital Group, Inc."; and it is further

⁸ 17 C.F.R. § 201.200(d)(1).

⁹ *Carl L. Shipley*, Securities Exchange Act Release No. 10870, 1974 WL 161761, at *4 (June 21, 1974).

¹⁰ *Robert David Beauchene*, Exchange Act Release No. 68974, 2013 WL 661619, at *2 (Feb. 25, 2013) (quoting *Charles K. Seavey*, Investment Advisers Act Release No. 1925A, 2001 WL 228030, at *2 (Mar. 9, 2001)).

¹¹ *See, e.g., Seavey*, 2001 WL 228030, at *1-2 (granting motion to amend order instituting proceedings to include Respondent's subsequent guilty plea and sentence to federal money laundering and add Advisers Act Section 203(f) as an alternative statutory basis).


ORDERED that Section II Paragraph 1 of the Order Instituting Proceedings issued on June 12, 2014, is amended to allege that "Yang also acted as the investment adviser to his own investment firm, Prestige Trade Investments Limited ("Prestige")"; and it is further

ORDERED that Section III of the Order Instituting Proceedings issued on June 12, 2014, is amended to institute public administrative proceedings to determine "what, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 15(b) of the Exchange Act."; and it is further

ORDERED that Respondent shall file an amended answer to the allegations contained in the Order Instituting Proceedings, as amended herein, within twenty days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice.¹²

By the Commission.

Brent J. Fields
Secretary


By: Lynn M. Powalski
Deputy Secretary

¹² 17 C.F.R. § 201.220.

SECURITIES AND EXCHANGE COMMISSION

[Release No. PA- 52; File No. S7-11-14]

Privacy Act of 1974: Systems of Records.

AGENCY: Securities and Exchange Commission.

ACTION: Notice to revise two existing systems of records.

SUMMARY: In accordance with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C § 552a, the Securities and Exchange Commission ("Commission" or "SEC") proposes to revise two existing systems of records, "Administrative Proceeding Files (SEC-36)", last published in the Federal Register Volume 62 FR 47884 (September 11, 1997) and "Information Pertaining or Relevant to SEC Regulated Entities and Their Activities" (SEC-55), last published in the Federal Register Volume 75 FR 35853(June 23, 2010).

DATES: The proposed system will become effective [insert date that is 40 days after publication in the Federal Register] unless further notice is given. The Commission will publish a new notice if the effective date is delayed to review comments or if changes are made based on comments received. To be assured of consideration, comments should be received on or before [insert date that is 30 days after publication in the Federal Register].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/other.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-11-14 on the subject line.

Paper Comments:

Send paper comments in triplicate to Brent J. Fields, Secretary, U.S. Securities and Exchange

Commission, 100 F Street, NE, Washington, DC 20549-1090. All submissions should refer to File Number S7 -11-14. This file number should be included on the subject line if e-mail is used. To help process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/other.shtml>). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Todd Scharf, Acting Chief Privacy Officer, Office of Information Technology, 202-551-8800.

SUPPLEMENTARY INFORMATION:

The Commission proposes to revise two existing systems of records, "Administrative Proceeding Files (SEC-36)," and "Information Pertaining or Relevant to SEC Regulated Entities and Their Activities (SEC-55)."

The Administrative Proceedings Files (SEC-36) records are used in any proceeding where the federal securities laws are in issue or in which the Commission, or past or present members of its staff, is a party or otherwise involved in an official capacity. The SEC-36 system of records contains records on individuals that are involved in administrative proceedings before the SEC, including participants, witnesses, attorneys, and SEC employees. Substantive changes to SEC-36 have been made to the following sections: (1) Categories of Individuals, to clarify specific individuals covered in the records; (2) Categories of Records, to add specific data elements collected on individuals, to include, names, addresses, email addresses, telephone

numbers, and fax numbers; (3) Purpose, to state the purpose of the system, which was omitted in the last publication; (4) Authority for Maintenance of the System, to add additional regulatory authority authorizing the collection of information; (5) Routine Uses, to clarify categories of users in two routine uses located at numbers 2 and 13, to delete one routine use previously located at number 2, and to expand by seven routine uses located at numbers 1, 4, and 19-23; and (6) Storage, to expand to include electronic media. Additional minor administrative changes have been made to the Record Source Categories, Retrievability and Safeguards sections, to clarify internal handling practices for the records; and to the Notification, Access and Contesting Procedures sections, to update the Commission's current address.

The Information Pertaining or Relevant to SEC Regulated Entities and Their Activities (SEC-55) records are used by SEC personnel in connection with their official functions, including but not limited to, conducting examinations for compliance with federal securities law, investigating possible violations of federal securities laws, and other matters relating to SEC regulatory and law enforcement functions. Substantive changes to SEC-55 have been made to the following sections: (1) Name, to clarify the type of records in the system; (2) Categories of Individuals, to clarify the specific individuals covered in the system of records; (3) Categories of Records, modified to include specific data elements collected on individuals, name, address, telephone number, and email address; and (4) Routine Uses, to expand by one new routine use located at number 22. Additional minor administrative changes have been made to the Safeguards section, to clarify internal handling practices for the records; and to the System Manager(s) and Address Section, to update the Commission's current address.

The Commission has submitted a report of the revised systems of records to the appropriate Congressional Committees and to the Director of the Office of Management and

Budget ("OMB") as required by 5 U.S.C. § 552a(r) (Privacy Act of 1974) and guidelines issued by OMB on December 12, 2000 (65 FR 77677).

Accordingly, the Commission is proposing to revise two existing systems of records to read as follows:

SEC-36

SYSTEM NAME:

Administrative Proceeding Files.

SYSTEM LOCATION:

Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

CATEGORIES OF INDIVIDUALS COVERED BY THE SYSTEM:

Records are maintained on all individuals that are involved in administrative proceedings before the SEC, including, participants, witnesses, attorneys, SEC employees, contractors, students, interns, volunteers, affiliates, and others working on behalf of the SEC.

CATEGORIES OF RECORDS IN THE SYSTEM:

Records may include the names, addresses, email addresses, telephone numbers, and fax numbers of individuals named as participants; witnesses; attorneys; SEC employees and others working on behalf of the SEC. Additionally, records include orders for proceedings, answers, motions, responses, orders, offers of settlement and other pleadings, transcripts of all hearings and documents introduced as evidence therein; other relevant documents; and correspondence relating to proceedings.

PURPOSE(S):

The records in this system may be utilized in any proceeding where the Federal securities laws are in issue or in which the Commission or past or present members of its staff is a party or otherwise involved in an official capacity.

AUTHORITY FOR MAINTENANCE OF THE SYSTEM:

15 U.S.C. 77h(e), 77u, 78v, 78o(b), 80a-40, and 80b-12; the Commission's Rules of Practice, 17 CFR 201.100-900 and the Commission's Rules of Fair Fund and Disgorgement Plans, 17 CFR 201.1100-1106.

ROUTINE USES OF RECORDS MAINTAINED IN THE SYSTEM, INCLUDING CATEGORIES OF USERS AND THE PURPOSES OF SUCH USES:

In addition to those disclosures generally permitted under 5 U.S.C. 552a(b) of the Privacy Act, these records or information contained therein may specifically be disclosed outside the Commission as a routine use pursuant to 5 U.S.C. 552 a(b)(3) as follows:

1. To appropriate agencies, entities, and persons when (a) it is suspected or confirmed that the security or confidentiality of information in the system of records has been compromised; (b) the SEC has determined that, as a result of the suspected or confirmed compromise, there is a risk of harm to economic or property interests, identity theft or fraud, or harm to the security or integrity of this system or other systems or programs (whether maintained by the SEC or another agency or entity) that rely upon the compromised information; and (c) the disclosure made to such agencies, entities, and persons is reasonably necessary to assist in connection with the SEC's efforts to respond to the suspected or confirmed compromise and prevent, minimize, or remedy such harm.

2. To other federal, state, local, or foreign law enforcement agencies; securities self-regulatory organizations; and foreign financial regulatory authorities to assist in or coordinate regulatory or law enforcement activities with the SEC.
3. To national securities exchanges and national securities associations that are registered with the SEC, the Municipal Securities Rulemaking Board; the Securities Investor Protection Corporation; the Public Company Accounting Oversight Board; the federal banking authorities, including, but not limited to, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation; state securities regulatory agencies or organizations; or regulatory authorities of a foreign government in connection with their regulatory or enforcement responsibilities.
4. By SEC personnel for purposes of investigating possible violations of, or to conduct investigations authorized by, the federal securities laws.
5. In any proceeding where the federal securities laws are in issue or in which the Commission, or past or present members of its staff, is a party or otherwise involved in an official capacity.
6. In connection with proceedings by the Commission pursuant to Rule 102(e) of its Rules of Practice, 17 CFR 201.102(e).
7. To a bar association, state accountancy board, or other federal, state, local, or foreign licensing or oversight authority; or professional association or self-regulatory authority to the extent that it performs similar functions (including the Public Company Accounting Oversight Board) for investigations or possible disciplinary action.
8. To a federal, state, local, tribal, foreign, or international agency, if necessary to obtain information relevant to the SEC's decision concerning the hiring or retention of an employee;

the issuance of a security clearance; the letting of a contract; or the issuance of a license, grant, or other benefit.

9. To a federal, state, local, tribal, foreign, or international agency in response to its request for information concerning the hiring or retention of an employee; the issuance of a security clearance; the reporting of an investigation of an employee; the letting of a contract; or the issuance of a license, grant, or other benefit by the requesting agency, to the extent that the information is relevant and necessary to the requesting agency's decision on the matter.
10. To produce summary descriptive statistics and analytical studies, as a data source for management information, in support of the function for which the records are collected and maintained or for related personnel management functions or manpower studies; may also be used to respond to general requests for statistical information (without personal identification of individuals) under the Freedom of Information Act.
11. To any trustee, receiver, master, special counsel, or other individual or entity that is appointed by a court of competent jurisdiction, or as a result of an agreement between the parties in connection with litigation or administrative proceedings involving allegations of violations of the federal securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(47)) or pursuant to the Commission's Rules of Practice, 17 CFR 201.100 - 900 or the Commission's Rules of Fair Fund and Disgorgement Plans, 17 CFR 201.1100-1106, or otherwise, where such trustee, receiver, master, special counsel, or other individual or entity is specifically designated to perform particular functions with respect to, or as a result of, the pending action or proceeding or in connection with the administration and enforcement by the Commission of the federal securities laws or the Commission's Rules of Practice or the Rules of Fair Fund and Disgorgement Plans.

12. To any persons during the course of any inquiry, examination, or investigation conducted by the SEC's staff, or in connection with civil litigation, if the staff has reason to believe that the person to whom the record is disclosed may have further information about the matters related therein, and those matters appeared to be relevant at the time to the subject matter of the inquiry.
13. To interns, grantees, experts, contractors, and others who have been engaged by the Commission to assist in the performance of a service related to this system of records and who need access to the records for the purpose of assisting the Commission in the efficient administration of its programs, including by performing clerical, stenographic, or data analysis functions, or by reproduction of records by electronic or other means. Recipients of these records shall be required to comply with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. 552a.
14. In reports published by the Commission pursuant to authority granted in the federal securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(47)), which authority shall include, but not be limited to, section 21(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78u(a)).
15. To members of advisory committees that are created by the Commission or by Congress to render advice and recommendations to the Commission or to Congress, to be used solely in connection with their official designated functions.
16. To any person who is or has agreed to be subject to the Commission's Rules of Conduct, 17 CFR 200.735-1 to 200.735-18, and who assists in the investigation by the Commission of possible violations of the federal securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(47)), in the preparation or conduct

of enforcement actions brought by the Commission for such violations, or otherwise in connection with the Commission's enforcement or regulatory functions under the federal securities laws.

17. To a Congressional office from the record of an individual in response to an inquiry from the Congressional office made at the request of that individual.
18. To members of Congress, the press and the public in response to inquiries relating to particular Registrants and their activities, and other matters under the Commission's jurisdiction. In matters involving public proceedings, most of the records are available to the public.
19. To prepare and publish information relating to violations of the federal securities laws as provided in 15 U.S.C. 78c(a)(47)), as amended.
20. To respond to subpoenas in any litigation or other proceeding.
21. To a trustee in bankruptcy.
22. To members of Congress, the General Accountability Office, or others charged with monitoring the work of the Commission or conducting records management inspections.
23. To any governmental agency, governmental or private collection agent, consumer reporting agency or commercial reporting agency, governmental or private employer of a debtor, or any other person, for collection, including collection by administrative offset, federal salary offset, tax refund offset, or administrative wage garnishment, of amounts owed as a result of Commission civil or administrative proceedings.

**POLICIES AND PRACTICES FOR STORING, RETRIEVING, ACCESSING,
RETAINING, AND DISPOSING OF RECORDS IN THE SYSTEM:**

STORAGE:

Records are maintained in electronic and paper format. Electronic records are stored in computerized databases and/or electronic storage devices. Paper records and records on electronic storage devices may be stored in locked file rooms and/or file cabinets and/or secured buildings.

RETRIEVABILITY:

Records are retrievable by party name, case name and/or commission file number through searchable databases. In some instances records may be retrieved by email address.

SAFEGUARDS:

Access to SEC facilities, data centers, and information or information systems is limited to authorized personnel with official duties requiring access. SEC facilities are equipped with security cameras and 24-hour security guard service. The records are kept in limited access areas during duty hours and secured areas at all other times. Computerized records are safeguarded in secured, encrypted environment. Security protocols meet the promulgating guidance as established by the National Institute of Standards and Technology (NIST) Security Standards from Access Control to Data Encryption, and Security Assessment & Authorization (SA&A). Records will be maintained in a secure, password-protected electronic system that will utilize commensurate safeguards that may include: firewalls, intrusion detection and prevention systems, and role-based access controls. Additional safeguards will vary by program. All records are protected from unauthorized access through appropriate administrative, operational, and technical safeguards. These safeguards include: restricting access to authorized personnel who have a "need to know"; using locks; and password protection identification features.

Contractors and other recipients providing services to the Commission shall be required to maintain equivalent safeguards.

RETENTION AND DISPOSAL:

These records will be maintained until they become inactive, at which time they will be retired or destroyed in accordance with records schedules of the United States Securities and Exchange Commission and as approved by the National Archives and Records Administration

SYSTEM MANAGER(S) AND ADDRESS:

Secretary, Office of the Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1091.

NOTIFICATION PROCEDURE:

All requests to determine whether this system of records contains a record pertaining to the requesting individual may be directed to the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2736.

RECORD ACCESS PROCEDURES:

Persons wishing to obtain information on the procedures for gaining access to or contesting the contents of these records may contact the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2736.

CONTESTING RECORD PROCEDURES:

See Record access procedures above.

RECORD SOURCE CATEGORIES:

Records are obtained from any person named as a respondent in an order instituting proceedings, any applicant named in the caption of any order, persons entitled to notice in any proceeding, any person seeking Commission review of a decision, any person representing a party in a

proceeding and/or SEC personnel from a division or office assigned primary responsibility by the Commission to participate in a particular proceeding. Additionally, information may be obtained from any papers filed with the Commission in connection with a proceeding and internal Commission files.

EXEMPTIONS CLAIMED FOR THE SYSTEM:

None.

SEC-55

SYSTEM NAME:

Information Pertaining or Relevant to SEC Regulated Entities and Their Activities.

SYSTEM LOCATION:

Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549. Records also are maintained in the SEC Regional Offices.

CATEGORIES OF INDIVIDUALS COVERED BY THE SYSTEM:

Records concern individuals associated with entities or persons that are regulated by the SEC to include broker-dealers, investment advisers, investment companies, self-regulatory organizations, clearing agencies, nationally recognized statistical rating organizations, transfer agents, municipal securities dealers, municipal advisors, security-based swap dealers, security-based swap data repositories, major security-based swap participants, security-based swap execution facilities, and funding portals (individually, a "Regulated Entity;" collectively, "Regulated Entities"). Records may also concern persons, directly or indirectly, with whom Regulated Entities or their affiliates have client relations or business arrangements.

CATEGORIES OF RECORDS IN THE SYSTEM:

Records may contain Regulated Entities' and their associated persons' names, addresses, telephone numbers and email addresses. Additionally, there may be information relating to the business activities and transactions of Regulated Entities and their associated persons, as well as their compliance with provisions of the federal securities laws and with other applicable rules.

AUTHORITY FOR MAINTENANCE OF THE SYSTEM:

15 U.S.C. 78a et seq., 80a-1 et seq., and 80b-1 et seq.

PURPOSE(S):

1. For use by authorized SEC personnel in connection with their official functions including, but not limited to, conducting examinations for compliance with federal securities laws, investigations into possible violations of the federal securities laws, and other matters relating to the SEC's regulatory and law enforcement functions.
2. To maintain continuity within the SEC as to each Regulated Entity and to provide SEC staff with the background and results of earlier examinations of Regulated Entities, as well as an insight into current industry practices or possible regulatory compliance issues.
3. To conduct lawful relational searches or analysis or filtering of data in matters relating to the SEC's examination, regulatory or law enforcement functions.

ROUTINE USES OF RECORDS MAINTAINED IN THE SYSTEM, INCLUDING CATEGORIES OF USERS AND THE PURPOSES OF SUCH USES:

In addition to those disclosures generally permitted under 5 U.S.C. 552a(b) of the Privacy Act, these records or information contained therein may specifically be disclosed outside the Commission as a routine use pursuant to 5 U.S.C. 552a(b)(3) as follows:

1. To appropriate agencies, entities, and persons when (a) it is suspected or confirmed that the security or confidentiality of information in the system of records has been compromised; (b) the SEC has determined that, as a result of the suspected or confirmed compromise, there is a risk of harm to economic or property interests, identity theft or fraud, or harm to the security or integrity of this system or other systems or programs (whether maintained by the SEC or another agency or entity) that rely upon the compromised information; and (c) the disclosure made to such agencies, entities, and persons is reasonably necessary to assist in connection with the SEC's efforts to respond to the suspected or confirmed compromise and prevent, minimize, or remedy such harm.
2. To other federal, state, local, or foreign law enforcement agencies; securities self-regulatory organizations; and foreign financial regulatory authorities to assist in or coordinate regulatory or law enforcement activities with the SEC.
3. To national securities exchanges and national securities associations that are registered with the SEC, the Municipal Securities Rulemaking Board; the Securities Investor Protection Corporation; the Public Company Accounting Oversight Board; the federal banking authorities, including, but not limited to, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation; state securities regulatory agencies or organizations; or regulatory authorities of a foreign government in connection with their regulatory or enforcement responsibilities.
4. By SEC personnel for purposes of investigating possible violations of, or to conduct investigations authorized by, the federal securities laws.
5. In any proceeding where the federal securities laws are in issue or in which the Commission, or past or present members of its staff, is a party or otherwise involved in an official capacity.

6. In connection with proceedings by the Commission pursuant to Rule 102(e) of its Rules of Practice, 17 CFR 201.102(e).
7. To a bar association, state accountancy board, or other federal, state, local, or foreign licensing or oversight authority; or professional association or self-regulatory authority to the extent that it performs similar functions (including the Public Company Accounting Oversight Board) for investigations or possible disciplinary action.
8. To a federal, state, local, tribal, foreign, or international agency, if necessary to obtain information relevant to the SEC's decision concerning the hiring or retention of an employee; the issuance of a security clearance; the letting of a contract; or the issuance of a license, grant, or other benefit.
9. To a federal, state, local, tribal, foreign, or international agency in response to its request for information concerning the hiring or retention of an employee; the issuance of a security clearance; the reporting of an investigation of an employee; the letting of a contract; or the issuance of a license, grant, or other benefit by the requesting agency, to the extent that the information is relevant and necessary to the requesting agency's decision on the matter.
10. To produce summary descriptive statistics and analytical studies, as a data source for management information, in support of the function for which the records are collected and maintained or for related personnel management functions or manpower studies; may also be used to respond to general requests for statistical information (without personal identification of individuals) under the Freedom of Information Act.
11. To any trustee, receiver, master, special counsel, or other individual or entity that is appointed by a court of competent jurisdiction, or as a result of an agreement between the parties in connection with litigation or administrative proceedings involving allegations of

violations of the federal securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(47)) or pursuant to the Commission's Rules of Practice, 17 CFR 201.100 – 900 or the Commission's Rules of Fair Fund and Disgorgement Plans, 17 CFR 201.1100-1106, or otherwise, where such trustee, receiver, master, special counsel, or other individual or entity is specifically designated to perform particular functions with respect to, or as a result of, the pending action or proceeding or in connection with the administration and enforcement by the Commission of the federal securities laws or the Commission's Rules of Practice or the Rules of Fair Fund and Disgorgement Plans.

12. To any persons during the course of any inquiry, examination, or investigation conducted by the SEC's staff, or in connection with civil litigation, if the staff has reason to believe that the person to whom the record is disclosed may have further information about the matters related therein, and those matters appeared to be relevant at the time to the subject matter of the inquiry.
13. To interns, grantees, experts, contractors, and others who have been engaged by the Commission to assist in the performance of a service related to this system of records and who need access to the records for the purpose of assisting the Commission in the efficient administration of its programs, including by performing clerical, stenographic, or data analysis functions, or by reproduction of records by electronic or other means. Recipients of these records shall be required to comply with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. 552a.
14. In reports published by the Commission pursuant to authority granted in the federal securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934, 15

- U.S.C. 78c(a)(47)), which authority shall include, but not be limited to, section 21(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78u(a)).
15. To members of advisory committees that are created by the Commission or by Congress to render advice and recommendations to the Commission or to Congress, to be used solely in connection with their official designated functions.
 16. To any person who is or has agreed to be subject to the Commission's Rules of Conduct, 17 CFR 200.735-1 to 200.735-18, and who assists in the investigation by the Commission of possible violations of the federal securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(47)), in the preparation or conduct of enforcement actions brought by the Commission for such violations, or otherwise in connection with the Commission's enforcement or regulatory functions under the federal securities laws.
 17. To a Congressional office from the record of an individual in response to an inquiry from the Congressional office made at the request of that individual.
 18. To members of Congress, the press, and the public in response to inquiries relating to particular Registrants and their activities, and other matters under the Commission's jurisdiction.
 19. To prepare and publish information relating to violations of the federal securities laws as provided in 15 U.S.C. 78c(a)(47)), as amended.
 20. To respond to subpoenas in any litigation or other proceeding.
 21. To a trustee in bankruptcy.
 22. To any governmental agency, governmental or private collection agent, consumer reporting agency or commercial reporting agency, governmental or private employer of a debtor, or

any other person, for collection, including collection by administrative offset, federal salary offset, tax refund offset, or administrative wage garnishment, of amounts owed as a result of Commission civil or administrative proceedings.

23. To members of Congress, the Government Accountability Office, or others charged with monitoring the work of the Commission or conducting records management inspections.

POLICIES AND PRACTICES FOR STORING, RETRIEVING, ACCESSING, RETAINING, AND DISPOSING OF RECORDS IN THE SYSTEM:

STORAGE:

Records are maintained in electronic and paper format. Electronic records are stored in computerized databases and/or electronic storage devices. Paper records and records on electronic storage devices may be stored in locked file rooms and/or file cabinets and/or secured buildings.

RETRIEVABILITY:

Information is indexed by name of the Regulated Entity or by certain SEC identification numbers. Information regarding individuals may be obtained through the use of cross-reference methodology or some form of personal identifier. Access for inquiry purposes is via a computer terminal.

SAFEGUARDS:

Access to SEC facilities, data centers, and information or information systems is limited to authorized personnel with official duties requiring access. SEC facilities are equipped with security cameras and 24-hour security guard service. The records are kept in limited access areas during duty hours and secured areas at all other times. Computerized records are safeguarded in secured, encrypted environment. Security protocols meet the promulgating guidance as

established by the National Institute of Standards and Technology (NIST) Security Standards from Access Control to Data Encryption, and Security Assessment & Authorization (SA&A). Records will be maintained in a secure, password-protected electronic system that will utilize commensurate safeguards that may include: firewalls, intrusion detection and prevention systems, and role-based access controls. Additional safeguards will vary by program. All records are protected from unauthorized access through appropriate administrative, operational, and technical safeguards. These safeguards include: restricting access to authorized personnel who have a "need to know"; using locks; and password protection identification features. Contractors and other recipients providing services to the Commission shall be required to maintain equivalent safeguards.

RETENTION AND DISPOSAL:

These records will be maintained until they become inactive, at which time they will be retired or destroyed in accordance with records schedules of the United States Securities and Exchange Commission and as approved by the National Archives and Records Administration.

SYSTEM MANAGER(S) AND ADDRESS:

Chief Information Officer, Office of Information Technology, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-4949.

NOTIFICATION PROCEDURE:

All requests to determine whether this system of records contains a record pertaining to the requesting individual may be directed to the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2736.

RECORD ACCESS PROCEDURES:

Persons wishing to obtain information on the procedures for gaining access to or contesting the contents of these records may contact the FOIA/PA Officer, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-2736.

CONTESTING RECORD PROCEDURES:

See Record Access Procedures above.

RECORD SOURCE CATEGORIES:

Record sources include filings made by Regulated Entities; information obtained through examinations or investigations of Regulated Entities and their activities; information contained in SEC correspondence with Regulated Entities; information received from other federal, state, local, foreign or other regulatory organizations or law enforcement agencies; complaint information received by the SEC via letters, telephone calls, emails or any other form of communication; and data obtained from third-party sources.

EXEMPTIONS CLAIMED FOR THE SYSTEM:

None.

By the Commission.



Brent J. Fields

Secretary

Date: November 19, 2014

REPORT OF NOTICE TO REVISE A SYSTEM OF RECORDS

System Name: Administrative Proceeding Files (SEC- 36)

Introduction: In accordance with the requirements of the Privacy Act of 1974, 5 U.S.C. § 552a, the Securities and Exchange Commission ("Commission" or "SEC") proposes to revise the system of records titled "Administrative Proceeding Files (SEC-36)." Administrative Proceeding Files (SEC-36) records are used by SEC personnel in connection with any proceeding where the federal securities laws are in issue or in which the Commission or past or present members of its staff is a party or otherwise involved in an official capacity. Substantive changes to SEC-36 have been made to the following sections: (1) Categories of Individuals, to clarify specific individuals covered in the records; (2) Categories of Records, to add specific data elements collected on individuals, to include, names, addresses, email addresses, telephone numbers, and fax numbers; (3) Purpose, to state the purpose of the system, which was omitted in the last publication; (4) Authority for Maintenance of the System, to add additional regulatory authority authorizing the collection of information; (5) Routine Uses, to clarify categories of users in two routines uses located at numbers 2 and 13, to delete one routine use previously located at number 2, and to expand by seven routine uses located at numbers 1, 4, and 19-23; and (6) Storage, to expand to include electronic media. Additional minor administrative changes have been made to the Record Source Categories, Retrievability and Safeguards sections, to clarify internal handling practices for the records; and to the Notification, Access and Contesting Procedures sections, to update the Commission's current address.

Purpose: The records are used in any proceeding where the federal securities laws are in issue or in which the Commission, or past or present members of its staff is a party or otherwise involved in an official capacity.

Authority: 15 U.S.C. 77h(e), 77u, 78v, 78o(b), 80a-40, and 80b-12; the Commission's Rules of Practice, 17 CFR 201.100-900 and the Commission's Rules of Fair Fund and Disgorgement Plans, 17 CFR 201.1100-1106.

Probable effect on individual privacy or other rights: The records in this system may reveal personal information about individuals. We will disclose information under the routine uses only as necessary to accomplish the stated purpose. We do not anticipate that the routine use disclosures will have an unwarranted adverse effect on the rights of the individuals to whom the records pertain.

Security provided for this system: Access to SEC facilities, data centers, and information or information systems is limited to authorized personnel with official duties requiring access. SEC facilities are equipped with security cameras and 24-hour security guard service. The records are kept in limited access areas during duty hours and secured areas at all other times. Computerized records are safeguarded in secured, encrypted environment. Security protocols meet the promulgating guidance as established by the National Institute of Standards and Technology (NIST) Security Standards from Access Control to Data Encryption, and Security Assessment & Authorization (SA&A). Records will be maintained in a secure, password-protected electronic system that will utilize commensurate safeguards that may include: firewalls, intrusion detection and prevention systems, and role-based access controls. Additional safeguards will vary by program. All records are protected from unauthorized access through appropriate administrative, operational, and technical safeguards. These safeguards include: restricting access to authorized personnel who have a "need to know"; using locks; and password protection identification features. Contractors and other recipients providing services to the Commission shall be required to maintain equivalent safeguards.

Compatibility of routine uses: The Privacy Act (5 U.S.C. § 552a(a)(7) and (b)(3)) and SEC disclosure regulation (17 CFR 200, Subpart H) permit disclosure of information under a published routine use for a purpose that is compatible with the purpose for which the information was collected. The routine uses are appropriate and meet the relevant statutory and regulatory criteria; are compatible with the purposes of this system; and will ensure efficient administration of the records contained in the system.

OMB Requirements: A report of this revised system of records must be transmitted to OMB.

OPM Requirements: None

REPORT OF NOTICE TO REVISE A SYSTEM OF RECORDS

System Name: Information Pertaining or Relevant to SEC Regulated Entities and Their Activities (SEC-55)

Introduction: In accordance with the requirements of the Privacy Act of 1974, 5 U.S.C. § 552a, the Securities and Exchange Commission ("Commission" or "SEC") proposes to revise the system of records titled "Information Pertaining or Relevant to SEC Regulated Entities and Their Activities (SEC-55). The Information Pertaining or Relevant to SEC Regulated Entities and Their Activities (SEC-55) records are used by SEC personnel in connection with their official functions, including but not limited to, conducting examinations for compliance with federal securities law, investigating possible violations of federal securities laws, and other matters relating to SEC regulatory and law enforcement functions. Substantive changes to SEC-55 have been made to the following sections: (1) Name, to clarify the type of records in the system; (2) Categories of Individuals, to clarify the specific individuals covered in the system of records; (3) Categories of Records, modified to include specific data elements collected on individuals, name, address, telephone number, and email address; and (4) Routine Uses, to expand by one new routine use located at number 22. Additional minor administrative changes have been made to the Safeguards section, to clarify internal handling practices for the records; and to the System Manager(s) and Address Section, to update the Commission's current address.

Purpose: The records are used by SEC personnel in connection with their official functions including but not limited to, conducting examinations for compliance with federal securities law, investigating possible violations of federal securities laws, and other matters relating to SEC regulatory and law enforcement functions.

Authority: 15 U.S.C. 78a et seq., 80a-1 et seq., and 80b-1 et seq.

Probable effect on individual privacy or other rights: The records in this system may reveal personal information about individuals. We will disclose information under the routine uses only as necessary to accomplish the stated purpose. We do not anticipate that the routine use disclosures will have an unwarranted adverse effect on the rights of the individuals to whom the records pertain.

Security provided for this system: Access to SEC facilities, data centers, and information or information systems is limited to authorized personnel with official duties requiring access. SEC facilities are equipped with security cameras and 24-hour security guard service. The records are kept in limited access areas during duty hours and secured areas at all other times. Computerized records are safeguarded in secured, encrypted environment. Security protocols meet the promulgating guidance as established by the National Institute of Standards and Technology (NIST) Security Standards from Access Control to Data Encryption, and Security Assessment & Authorization (SA&A). Records will be maintained in a secure, password-protected electronic system that will utilize commensurate safeguards that may include: firewalls, intrusion detection and prevention systems, and role-based access controls. Additional safeguards will vary by program. All records are protected from unauthorized access through appropriate administrative, operational, and technical safeguards. These safeguards include: restricting access to authorized personnel who have a "need to know"; using locks; and password protection identification features. Contractors and other recipients providing services to the Commission shall be required to maintain equivalent safeguards.

Compatibility of routine uses: The Privacy Act (5 U.S.C. § 552a(a)(7) and (b)(3)) and SEC disclosure regulation (17 CFR 200, Subpart H) permit disclosure of information under a published routine use for a purpose that is compatible with the purpose for which the information

was collected. The routine uses are appropriate and meet the relevant statutory and regulatory criteria; are compatible with the purposes of this system; and will ensure efficient administration of the records contained in the system.

OMB Requirements: A report of this revised system of records must be transmitted to OMB.

OPM Requirements: None

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240, 242, and 249

[Release No. 34-73639; File No. S7-01-13]

RIN 3235-AL43

Regulation Systems Compliance and Integrity

AGENCY: Securities and Exchange Commission.

ACTION: Final rule and form; final rule amendment; technical amendment.

SUMMARY: The Securities and Exchange Commission ("Commission") is adopting new Regulation Systems Compliance and Integrity ("Regulation SCI") under the Securities Exchange Act of 1934 ("Exchange Act") and conforming amendments to Regulation ATS under the Exchange Act. Regulation SCI will apply to certain self-regulatory organizations (including registered clearing agencies), alternative trading systems ("ATSS"), plan processors, and exempt clearing agencies (collectively, "SCI entities"), and will require these SCI entities to comply with requirements with respect to the automated systems central to the performance of their regulated activities.

DATES: Effective Date: [Insert date 60 days after date of publication in Federal Register].

Compliance Date: The applicable compliance dates are discussed in Section IV.F of this release.

FOR FURTHER INFORMATION CONTACT: David Liu, Senior Special Counsel, Office of Market Supervision, at (312) 353-6265, Heidi Pilpel, Senior Special Counsel, Office of Market Supervision, at (202) 551-5666, Sara Hawkins, Special Counsel, Office of Market Supervision, at (202) 551-5523, Yue Ding, Special Counsel, Office of Market Supervision, at (202) 551-5842, David Garcia, Special Counsel, Office of Market Supervision, at (202) 551-

5681, and Elizabeth C. Badawy, Senior Accountant, Office of Market Supervision, at (202) 551-5612, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010.

SUPPLEMENTARY INFORMATION: Regulation SCI will, with regard to SCI entities, supersede and replace the Commission's current Automation Review Policy ("ARP"), established by the Commission's two policy statements, each titled "Automated Systems of Self-Regulatory Organizations," issued in 1989 and 1991.¹ Regulation SCI also will supersede and replace aspects of those policy statements codified in Rule 301(b)(6) under the Exchange Act, applicable to significant-volume ATSS that trade NMS stocks and non-NMS stocks.² Regulation SCI will require SCI entities to establish written policies and procedures reasonably designed to ensure that their systems have levels of capacity, integrity, resiliency, availability, and security adequate to maintain their operational capability and promote the maintenance of fair and orderly markets, and that they operate in a manner that complies with the Exchange Act. It will also require SCI entities to mandate participation by designated members or participants in scheduled testing of the operation of their business continuity and disaster recovery plans, including backup systems, and to coordinate such testing on an industry- or sector-wide basis with other SCI entities. In addition, Regulation SCI will require SCI entities to take corrective action with respect to SCI events (defined to include systems disruptions, systems compliance issues, and systems intrusions), and notify the Commission of such events. Regulation SCI will further

¹ See Securities Exchange Act Release Nos. 27445 (November 16, 1989), 54 FR 48703 (November 24, 1989) ("ARP I Release" or "ARP I") and 29185 (May 9, 1991), 56 FR 22490 (May 15, 1991) ("ARP II Release" or "ARP II" and, together with ARP I, the "ARP Policy Statements").

² See 17 CFR 242.301(b)(6). See also Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) ("ATS Release").

require SCI entities to disseminate information about certain SCI events to affected members or participants and, for certain major SCI events, to all members or participants of the SCI entity. In addition, Regulation SCI will require SCI entities to conduct a review of their systems by objective, qualified personnel at least annually, submit quarterly reports regarding completed, ongoing, and planned material changes to their SCI systems to the Commission, and maintain certain books and records. Finally, the Commission also is adopting modifications to the volume thresholds in Regulation ATS³ for significant-volume ATSS that trade NMS stocks and non-NMS stocks, applying them to SCI ATSS (as defined below), and moving this standard from Regulation ATS to adopted Regulation SCI for these asset classes.

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³ 17 CFR 242.300-303 (“Regulation ATS”).

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I. Introduction

The U.S. securities markets attract a wide variety of issuers and broad investor participation, and are essential for capital formation, job creation, and economic growth, both domestically and across the globe. The U.S. securities markets have been transformed by regulatory and related technological developments in recent years. They have, among other things, substantially enhanced the speed, capacity, efficiency, and sophistication of the trading functions that are available to market participants.⁴ At the same time, these technological advances have generated an increasing risk of operational problems with automated systems,

⁴ See Securities Exchange Act Release No. 61358 (January 14, 2010), 75 FR 3594, 3598 (January 21, 2010) (Concept Release on Equity Market Structure).

including failures, disruptions, delays, and intrusions. Given the speed and interconnected nature of the U.S. securities markets, a seemingly minor systems problem at a single entity can quickly create losses and liability for market participants, and spread rapidly across the national market system, potentially creating widespread damage and harm to market participants, including investors.

This transformation of the U.S. securities markets has occurred in the absence of a formal regulatory structure governing the automated systems of key market participants. Instead, for over two decades, Commission oversight of the technology of the U.S. securities markets has been conducted primarily pursuant to a voluntary set of principles articulated in the Commission's ARP Policy Statements,⁵ applied through the Commission's Automation Review Policy inspection program ("ARP Inspection Program").⁶

Section 11A(a)(2) of the Exchange Act,⁷ enacted as part of the Securities Acts Amendments of 1975 ("1975 Amendments"),⁸ directs the Commission, having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets, to

⁵ While participation in the ARP Inspection Program is voluntary, the underpinnings of ARP I and ARP II are rooted in Exchange Act requirements. See infra notes 7-12 and accompanying text.

⁶ See infra Section II.A (discussing the ARP Inspection Program). See also supra note 1. The ARP Inspection Program has historically been administered by the Commission's Division of Trading and Markets. In February 2014, to consolidate the inspection function of the group with the Commission's Office of Compliance Inspections and Examinations ("OCIE"), the ARP Inspection Program was transitioned to OCIE and has been renamed the Technology Controls Program ("TCP"). However, for ease of reference to the historical ARP Inspection Program, relevant portions of the SCI Proposal, and references in comment letters, this Release will continue to use the terms ARP, ARP Inspection Program, and ARP staff, unless the context otherwise requires.

⁷ 15 U.S.C. 78k-1(a)(2).

⁸ Pub. L. 94-29, 89 Stat. 97 (1975).

use its authority under the Exchange Act to facilitate the establishment of a national market system for securities in accordance with the Congressional findings and objectives set forth in Section 11A(a)(1) of the Exchange Act.⁹ Among the findings and objectives in Section 11A(a)(1) is that “[n]ew data processing and communications techniques create the opportunity for more efficient and effective market operations”¹⁰ 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.”¹¹ In addition, Sections 6(b), 15A, and 17A(b)(3) of the Exchange Act impose obligations on national securities exchanges, national securities associations, and clearing agencies, respectively, to be “so organized” and “[have] the capacity to...carry out the purposes of [the Exchange Act].”¹²

In March 2013, the Commission proposed Regulation Systems Compliance and Integrity (“Regulation SCI”)¹³ to require certain key market participants to, among other things: (1) have comprehensive policies and procedures in place to help ensure the robustness and resiliency of their technological systems, and also that their technological systems operate in compliance with the federal securities laws and with their own rules; and (2) provide certain notices and reports to the Commission to improve Commission oversight of securities market infrastructure. As discussed in further detail below and in the SCI Proposal, Regulation SCI was proposed to

⁹ 15 U.S.C. 78k-1(a)(1).

¹⁰ Section 11A(a)(1)(B) of the Exchange Act, 15 U.S.C. 78k-1(a)(1)(B).

¹¹ Section 11A(a)(1)(C)(i) of the Exchange Act, 15 U.S.C. 78k-1(a)(1)(C)(i).

¹² See Sections 6(b)(1), 15A(b)(2), and 17A(b)(3) of the Exchange Act, 15 U.S.C. 78f(b)(1), 78q-3(b)(2), 78q-1(b)(3), respectively. See also Section 2 of the Exchange Act, 15 U.S.C. 78b, and Section 19 of the Exchange Act, 15 U.S.C. 78s.

¹³ Securities Exchange Act Release No. 69077 (March 8, 2013), 78 FR 18083 (March 25, 2013) (“Proposing Release” or “SCI Proposal”).

update, formalize, and expand the Commission's ARP Inspection Program, and, with respect to SCI entities, to supersede and replace the Commission's ARP Policy Statements and rules regarding systems capacity, integrity and security in Rule 301(b)(6) of Regulation ATS.¹⁴

A confluence of factors contributed to the Commission's proposal of Regulation SCI and to the Commission's current determination that it is necessary and appropriate at this time to address the technological vulnerabilities, and improve Commission oversight, of the core technology of key U.S. securities markets entities, including national securities exchanges and associations, significant alternative trading systems, clearing agencies, and plan processors.

These considerations include: the evolution of the markets to become significantly more dependent upon sophisticated, complex and interconnected technology; the current successes and limitations of the ARP Inspection Program; a significant number of, and lessons learned from, recent systems issues at exchanges and other trading venues,¹⁵ increased concerns over "single

¹⁴ See 17 CFR 242.301(b)(6) and ATS Release, *supra* note 2.

¹⁵ See Proposing Release, *supra* note 13, at 18085-91 for a further discussion of these developments and *infra* Section II.B (discussing recent events related to technology issues). In addition, prior to issuing the Proposing Release, in October 2012 the Commission convened a roundtable entitled "Technology and Trading: Promoting Stability in Today's Markets" ("Technology Roundtable"). The Technology Roundtable examined the relationship between the operational stability and integrity of the securities market and the ways in which market participants design, implement, and manage complex and interconnected trading technologies. See Securities Exchange Act Release No. 67802 (September 7, 2012), 77 FR 56697 (September 13, 2012) (File No. 4-652) and Technology Roundtable Transcript, available at: <http://www.sec.gov/news/otherwebcasts/2012/ttr100212-transcript.pdf>. A webcast of the Roundtable is available at: www.sec.gov/news/otherwebcasts/2012/ttr100212.shtml. As noted in the Proposing Release, the Commission believes that the information presented at the Technology Roundtable further highlighted that quality standards, testing, and improved response mechanisms are among the issues needing very thoughtful and focused attention in today's securities markets. See Proposing Release, *supra* note 13, at 18090-91 for further discussion of the Technology Roundtable.

points of failure” in the securities markets;¹⁶ and the views of a wide variety of commenters received in response to the SCI Proposal.

The Commission received 60 comment letters on the proposal from national securities exchanges, registered securities associations, registered clearing agencies, ATSS, broker-dealers, institutional and individual investors, industry trade groups, software and technology vendors, and academics.¹⁷ Commenters generally supported the goals of the proposal, but as further discussed below, some expressed concern about various specific elements of the proposal, and recommended certain modifications or clarifications.

After careful review and consideration of the comment letters, the Commission is adopting Regulation SCI (“Rule”) and Form SCI (“Form”) with certain modifications from the SCI Proposal, as discussed below, to respond to concerns expressed by commenters and upon further consideration by the Commission of the more appropriate approach to further the goals of the national market system by strengthening the technology infrastructure of the U.S. securities markets.

II. Background

A. Automation Review Policy Inspection Program

¹⁶ See *infra* Section IV.A.2.c (discussing single points of failure in the securities markets in conjunction with the adopted term “critical SCI system”).

¹⁷ Comments received on the proposal are available on the Commission’s website, available at: <http://www.sec.gov/comments/s7-01-13/s70113.shtml>. See Exhibit A for a citation key to the comment letters cited in this release.

Upon request from some commenters, the Commission extended the comment period for an additional 45 days in order to give the public additional time to comment on the matters addressed by the SCI Proposal. See Securities Exchange Act Release No. 69606 (May 20, 2013), 78 FR 30803 (May 23, 2013).

For over two decades, the Commission's ARP Inspection Program has helped the Commission oversee the technology infrastructure of the U.S. securities markets. This voluntary information technology review program was developed by staff of the Commission to implement the Commission's ARP Policy Statements issued in 1989 and 1991.¹⁸ Through these Policy Statements, the Commission articulated its views on the steps that SROs should take with regard to their automated systems, set forth recommendations for how SROs should conduct independent reviews, and provided that SROs should notify the Commission of material systems changes and significant systems problems.¹⁹ In 1998, the Commission adopted Regulation ATS which, among other things, imposed by rule certain aspects of the ARP Policy Statements on significant-volume ATSS.²⁰ Further, Commission staff subsequently provided additional guidance regarding various aspects of the ARP Inspection Program through letters to ARP entities, including recommendations regarding reporting planned systems changes and systems issues to the Commission.²¹

Under the ARP Inspection Program, Commission staff ("ARP staff") conducts inspections of the trading and related systems of national securities exchanges and associations, certain ATSS, clearing agencies, and plan processors (collectively "ARP entities"), attends periodic technology briefings by ARP entities, monitors planned significant system changes, and

¹⁸ See ARP Policy Statements, *supra* note 1. For a detailed discussion of the ARP Policy Statements, see Proposing Release, *supra* note 13, at 18085-86.

¹⁹ See ARP Policy Statements, *supra* note 1.

²⁰ See 17 CFR 242.301(b)(6) and ATS Release, *supra* note 2.

²¹ In June 2001, staff from the Division of Market Regulation sent a letter to the SROs and other participants in the ARP Inspection Program regarding Guidance for Systems Outage and System Change Notifications ("2001 Staff ARP Interpretive Letter"). See Proposing Release, *supra* note 13, at 18087, n. 35. The 2001 Staff ARP Interpretive Letter is available at: <http://www.sec.gov/divisions/marketreg/sroautomation.shtml>.

responds to reports of system failures, disruptions, and other systems problems of ARP entities. The goal of the ARP inspections is to evaluate whether an ARP entity's controls over its information technology resources in nine general areas, or information technology "domains,"²² is consistent with ARP and industry guidelines. Such guidelines are identified by ARP staff from a variety of information technology publications that ARP staff believes reflects industry standards for securities market participants.²³ At the conclusion of an ARP inspection, ARP staff typically issues a report to the ARP entity with an assessment of the ARP entity's information technology program for its key systems, including any recommendations for improvement.²⁴

Because the ARP Inspection Program was established pursuant to Commission policy statements rather than Commission rules, participation in and compliance with the ARP Inspection Program by ARP entities is voluntary. As such, despite its general success in working with SROs to improve their automated systems, there are certain limitations with the ARP Inspection Program. In particular, because of the voluntary nature of the ARP Inspection Program, the Commission is constrained in its ability to assure compliance with ARP standards.

²² These information technology "domains" include: application controls; capacity planning; computer operations and production environment controls; contingency planning; information security and networking; audit; outsourcing; physical security; and systems development methodology. Each domain itself contains subcategories. For example, "contingency planning" includes business continuity, disaster recovery, and pandemic planning, among other things. See id. at 18086.

²³ See id. at 18086-87.

²⁴ In addition, Commission staff conducts inspections of SROs, as part of the Commission's oversight of them. Unlike ARP inspections, however, which focus on information technology controls, such Commission staff primarily conducts risk-based examinations of securities exchanges, FINRA, and other SROs to evaluate whether they and their member firms are complying with the Exchange Act, the rules thereunder, and SRO rules, as applicable. As part of the Commission's oversight of the SROs, Commission staff also reviews systems compliance issues reported to Commission staff. The information gained from the Commission staff review of reported systems compliance issues helps to inform its examination risk-assessments for SROs. See id. at 18087.

The Government Accountability Office (“GAO”) has identified the voluntary nature of the ARP Inspection Program as a limitation and recommended that the Commission make compliance with ARP guidelines mandatory.²⁵ In addition, as more fully discussed in the SCI Proposal, the evolution of the U.S. securities markets in recent years to become almost entirely electronic and highly dependent on sophisticated trading and other technology, including complex and interconnected routing, market data, regulatory, surveillance and other systems, has posed challenges for the ARP Inspection Program.²⁶

B. Recent Events

A series of high-profile recent events involving systems-related issues further highlights the need for market participants to bolster the operational integrity of their automated systems in this area. In the SCI Proposal, the Commission identified several systems problems experienced by SROs and ATSS that garnered significant public attention and illustrated the types and risks of systems issues affecting today’s markets.²⁷ Since Regulation SCI’s proposal in March 2013, additional systems problems among market participants have occurred, further underscoring the importance of bolstering the robustness of U.S. market infrastructure to help ensure its stability, integrity, and resiliency.

²⁵ See GAO, Financial Market Preparedness: Improvements Made, but More Action Needed to Prepare for Wide-Scale Disasters, Report No. GAO-04-984 (September 27, 2004). GAO cited instances in which the GAO believed that entities participating in the ARP Inspection Program failed to adequately address or implement ARP staff recommendations as the reasoning behind its recommendation to make compliance with ARP guidelines mandatory.

²⁶ See Proposing Release, *supra* note 13, at 18087-89.

²⁷ See *id.* at 18089-90. The Proposing Release also discussed the effects of Superstorm Sandy on the U.S. securities exchanges, noting certain weaknesses in business continuity and disaster recovery planning that were highlighted by the event. See *id.* at 18091.

In particular, since Regulation SCI's proposal, disruptions have continued to occur across a variety of market participants. For example, with respect to the options markets, some exchanges have delayed the opening of trading,²⁸ halted trading,²⁹ or experienced other errors as a result of systems issues,³⁰ and trading in options was halted due to a systems issue with the

²⁸ On April 25, 2013, the Chicago Board Options Exchange, Inc. ("CBOE") delayed the opening of trading on its exchange for over three hours due to what CBOE described as an internal "software bug." See CBOE Information Circular IC13-036, April 29, 2013, available at: <http://www.cboe.com/publish/InfoCir/IC13-036.pdf>. During this time, while trading in many products was able to continue on the other options exchanges, trading was completely halted for those products that are singly-listed on CBOE, including options on the S&P 500 Index and the CBOE Volatility Index ("VIX"). Trading was able to resume by approximately 1:00 p.m. ET, though some residual systems problems continued. Specifically, certain auction mechanisms were unavailable for the remainder of the day and some of the trade data from April 25 was erroneously re-transmitted to OCC on April 26. See *id.* and CBOE System Status notifications for April 25, 2013, available at: <http://www.cboe.com/aboutcboe/systemstatus/search.aspx>. CBOE subsequently reported that preliminary staging work related to a planned reconfiguration of CBOE's systems in preparation for extended trading hours on the CBOE Futures Exchange and CBOE options exchange "exposed and triggered a design flaw in the existing messaging infrastructure configuration." See CBOE Information Circular IC13-036, April 29, 2013, available at: <http://www.cboe.com/publish/InfoCir/IC13-036.pdf>.

²⁹ On November 1, 2013, Nasdaq halted trading on the Nasdaq Options Market ("NOM") for more than five hours through the close of the trading day. Nasdaq stated that the halt was a result of "a significant increase in order entries which inhibited the system's ability to accept orders and disseminate quotes on a subset of symbols." As Nasdaq stated, Nasdaq determined that it was in the best interest of market participants and investors to cancel all orders on the NOM book and continue the market halt through the close. See Nasdaq Market System Status Updates for November 1, 2013, available at: <https://www.nasdaqtrader.com/Trader.aspx?id=MarketSystemStatusSearch>.

³⁰ On April 29, 2014, NYSE Arca and NYSE Amex Options experienced a systems issue that resulted in numerous complex orders booking at incorrect prices. In some cases, this resulted in erroneous fill reports, all of which were subsequently nullified. See Trader Update to All NYSE Amex Options and NYSE Arca Options Participants, "Erroneous Complex Order Executions," dated April 29, 2014, available at: http://www1.nyse.com/pdfs/2014_04_29_NYSE_Amex_and_Arca_Options_Erroneous_Complex_Order_Executions.pdf.

securities information processor for options market information.³¹ Systems issues have also impacted consolidated market data in the equities markets, including one incident that led to a trading halt in all securities listed on a particular exchange.³² Systems issues have also affected

³¹ On September 16, 2013, options market trading was halted for approximately 20 minutes due to a systems issue with the Options Price Reporting Authority (“OPRA”), the securities information processor for options market information that disseminates option quotation and last sale information to market data vendors. OPRA reported that it experienced problems processing quotes as a result of a software issue originating from a limited rollout of certain software upgrades. See Notice to All OPRA Market Data Recipients from OPRA, LLC, dated September 18, 2013, available at: <http://www.opradata.com/specs/16-sept-2013-opra-outage.pdf>.

³² On August 22, 2013, the NASDAQ Stock Market LLC (“Nasdaq”) halted trading in all Nasdaq-listed securities for more than three hours after the Nasdaq UTP Securities Information Processor (“SIP”), the single source of consolidated market data for Nasdaq-listed securities, was unable to process quotes from exchanges for dissemination to the public. According to Nasdaq, a sequence of events created a spike in message traffic volume into the SIP exceeding the SIP’s capacity and causing the system to fail. Nasdaq cited “more than 20 connect and disconnect sequences from NYSE Arca” and a “stream of quotes for inaccurate symbols from NYSE Arca” as events contributing to the systems problem. Nasdaq noted that the stream of messages, which was 26 times greater than usual activity, degraded the system and exceeded its capacity, ultimately resulting in the failure. Nasdaq stated that these events exposed a flaw in the SIP’s software code which prevented a successful failover to the backup system. See “NASDAQ OMX Provides Updates on Events of August 22, 2013,” by NASDAQ OMX (August 29, 2013), available at: <http://www.nasdaqomx.com/newsroom/pressreleases/pressrelease?messageId=1204807&displayLanguage=en>; and Nasdaq Market System Status notifications for August 22, 2013, available at: <https://www.nasdaqtrader.com/Trader.aspx?id=MarketSystemStatusSearch>.

Nasdaq experienced another outage related to the SIP on September 4, 2013. This incident lasted only several minutes and affected only a subset of Nasdaq-listed securities. See “NASDAQ OMX Issues Statement on the Securities Information Processor,” by NASDAQ OMX (September 4, 2013), available at: <http://ir.nasdaqomx.com/releasedetail.cfm?ReleaseID=788700>.

The SIP consolidates quotation information and transaction reports from market centers and disseminates such consolidated information to market participants pursuant to the Commission-approved Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privilege

trading off of national securities exchanges, including an incident where FINRA halted trading in all OTC equity securities due to a lack of availability of quotation information resulting from a connectivity issue experienced by an ATS.³³ Systems issues during this time have not been limited to systems disruptions, but have also included allegations of systems compliance issues.³⁴

Basis, available at: <http://www.utpplan.com/>. See generally Rule 608 of Regulation NMS, 17 CFR 242.608 (“Filing and amendment of national market system plans”).

More recently, on October 30, 2014, according to the NYSE, a network hardware failure impacted the Consolidated Tape System, Consolidated Quote System, and Options Price Reporting Authority data feeds at the primary data center. Exchanges experienced issues publishing and receiving trades and quotes as a result. After investigation of the issue, the Securities Industry Automation Corporation (“SIAC”) (the processor for the affected data feeds) switched over to the secondary data center for these data feeds and normal processing subsequently resumed. The exchanges then connected to the secondary data center as provided for in SIAC’s business continuity plan. See “Service Advisory – CTA Update,” by NYSE (October 30, 2014), available at: <https://markets.nyx.com/nyse/market-status/view/13467> and “NMS SIP market wide issue,” by NYSE (October 30, 2014), available at: <https://markets.nyx.com/nyse/market-status/view/13465>.

³³ On November 7, 2013, FINRA halted trading for over 3 ½ hours in all OTC equity securities due to a lack of availability of quotation information resulting from a connectivity issue experienced by OTC Markets Group Inc.’s OTC Link ATS. See “Market-Wide Quotation and Trading Halt for all OTC Equity Securities,” FINRA Uniform Practice Advisory, UPC #47-13, November 7, 2013, available at: <http://www.finra.org/web/groups/industry/@ip/@comp/@mt/documents/upcnotices/p381590.pdf>; “Quotation and Trading Halt for OTC Equity Securities,” FINRA Uniform Practice Advisory, UPC #48-13, November 7, 2013, available at: <http://www.finra.org/web/groups/industry/@ip/@comp/@mt/documents/upcnotices/p381593.pdf>; “OTC Markets Group Issues Statement on OTC Link® ATS Trading on November 7, 2013,” OTC Disclosure & News Service, November 7, 2013, available at: <http://www.otcmarkets.com/stock/OTCM/news/OTC-Markets-Group-Issues-Statement-on-OTC-Linkreg-ATS-Trading-on-November-7-2013?id=71144>. OTC Markets Group subsequently reported that a network outage at one of its core network providers caused the lack of connectivity to its primary data center in New Jersey. See “OTC Markets Group Issues Statement on OTC Link® ATS Trading on November 7, 2013,” OTC Disclosure & News Service, November 7, 2013, available at: <http://www.otcmarkets.com/stock/OTCM/news/OTC-Markets-Group-Issues-Statement-on-OTC-Linkreg-ATS-Trading-on-November-7-2013?id=71144>.

³⁴ For example, in June 2013, the Commission charged CBOE and its affiliate (C2 Options Exchange, Incorporated (“C2”)) for various systemic breakdowns in their regulatory and

Systems issues are not unique to the U.S. securities markets, with similar incidents occurring in the U.S. commodities markets as well as foreign markets.³⁵ However, the

compliance responsibilities as self-regulatory organizations, including failure to enforce the federal securities laws and Commission rules. See Securities Exchange Act Release No. 69726, In the Matter of Chicago Board Options Exchange, Incorporated and C2 Options Exchange, Incorporated (settled action: June 11, 2013), available at: <http://www.sec.gov/litigation/admin/2013/34-69726.pdf> (“CBOE Order”). CBOE and C2 consented to an Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 19(h) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Sanctions and a Cease-and-Desist Order. In the CBOE Order, among other charges, the Commission stated that “CBOE’s automated surveillance programs for manually handled trades were ineffective” and that “CBOE failed to maintain a reliable or accurate audit trail of orders” on its trading facility. See *id.* at 11, 13.

In addition, in May 2014, the Commission sanctioned the New York Stock Exchange LLC (“NYSE”) and two of its affiliated exchanges (NYSE Arca, Inc. (“NYSE Arca”), NYSE MKT LLC (“NYSE MKT”)) for alleged failure to comply with their responsibilities as self-regulatory organizations to conduct their business operations in accordance with Commission-approved exchange rules and the federal securities laws. See Securities Exchange Act Release No. 72065, In the Matter of New York Stock Exchange LLC, NYSE Arca, Inc., NYSE MKT LLC, and Archipelago Securities, L.L.C. (settled action: May 1, 2014), available at: <http://www.sec.gov/litigation/admin/2014/34-72065.pdf> (“NYSE Order”). NYSE, NYSE Arca, NYSE MKT, and Archipelago Securities consented to an Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 19(h) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Sanctions and a Cease-and-Desist Order. In the NYSE Order, the Commission cited various instances of NYSE systems not operating in compliance with their effective rules, such as NYSE’s block trading facility not functioning in accordance with applicable rules; NYSE distributing an automated feed of closing order imbalance information to its floor brokers at an earlier time than specified in NYSE rules; and NYSE failing to execute certain orders in locked markets contrary to exchange rules. See *id.* In the NYSE Order, the Commission stated that the exchanges “lacked comprehensive and consistently-applied policies and procedures for...evaluating whether business operations were being conducted fully in accordance with existing exchange rules and the federal securities laws.” *Id.* at 3.

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See, e.g., Jacob Bunge, Bradley Hope, and Leslie Josephs, “Technical Glitch Hits CME Trading,” *Wall St. J.*, April 8, 2014; Jeremy Grant, “Glitch Delays Singapore Derivative Trade,” *Fin. Times*, April 9, 2013; Tamsyn Parker, “NZX Trading Resumes After Technical Glitch,” *The New Zealand Herald*, July 1, 2013; Matt Clinch, “Flash Crash: Israel Stocks Hit by Typo,” *CNBC.com*, available at:

Commission believes that it is critical that key U.S. securities market participants bolster their operational integrity to prevent, to the extent reasonably possible, these types of events, which can not only lead to tangible monetary losses,³⁶ but which commenters believe to have the potential to reduce investor confidence in the U.S. markets.³⁷

The SCI Proposal also noted that the risks associated with cybersecurity, and how to protect against systems intrusions, are increasingly of concern to all types of entities.³⁸ On March 27, 2014, the Commission conducted a Cybersecurity Roundtable (“Cybersecurity Roundtable”).³⁹ The Cybersecurity Roundtable addressed the cybersecurity landscape and cybersecurity issues faced by participants in the financial markets today, including exchanges,

<http://www.cnbc.com/id/100986999>; and Ksenia Galouchko, “Moscow Exchange Halts Derivatives Trading for Almost an Hour,” Bloomberg, November 13, 2013.

³⁶ See, e.g., Proposing Release, *supra* note 13 (discussing systems issues affecting the initial public offerings (“IPO”) of BATS Global Markets, Inc. and Facebook, Inc.). In a rule change approved by the Commission in March 2013, Nasdaq implemented a \$62 million accommodation program to compensate certain members for their losses in connection with the Facebook IPO. Securities Exchange Act Release No. 69216 (March 22, 2013), 78 FR 19040 (March 28, 2013). In its quarterly earnings announcement for the second quarter of 2013, UBS reported a \$356 million loss tied to Facebook’s IPO, while The Knight Capital Group and Citadel Investment Group claimed losses of \$30 million to \$35 million and Citigroup cited losses close to \$20 million. See Michael J. De La Merced, “Behind the Huge Facebook Loss at UBS,” N.Y. Times, July 21, 2012. See also Angel Letter at 15 (stating that catastrophic failures in exchange systems are extremely costly in terms of direct losses to participants and result in reduced investor confidence in markets); and Better Markets Letter at 2 (citing to the systems related problems at Knight Capital, Direct Edge, BATS, and during the Facebook IPO that resulted in investor or company losses).

³⁷ See, e.g., Angel2 Letter at 2; Sungard Letter at 2; Better Markets Letter at 2; Leuchtkafer Letter at 3; FSI Letter at 3; and Angel Letter at 10, 15.

³⁸ See Proposing Release, *supra* note 13, at 18089-90.

³⁹ See Securities Exchange Act Release No. 71742 (March 19, 2014), 79 FR 16071 (March 24, 2014) (File No. 4-673). A webcast of the Cybersecurity Roundtable is available at: <http://www.sec.gov/news/otherwebcasts/2014/cybersecurity-roundtable-032614.shtml>.

broker-dealers, investment advisers, transfer agents and public companies.⁴⁰ Panelists discussed, among other topics, the scope and nature of cybersecurity threats to the financial industry; how

⁴⁰ The first panel discussed the cybersecurity landscape, and panelists included: Cyrus Amir-Mokri, Assistant Secretary for Financial Institutions, Department of the Treasury; Mary E. Galligan, Director, Cyber Risk Services, Deloitte and Touche LLP; Craig Mundie, Member, President's Council of Advisors on Science and Technology; Senior Advisor to the Chief Executive Officer, Microsoft Corporation; Javier Ortiz, Vice President, Strategy and Global Head of Government Affairs, TaaSera, Inc.; Andy Roth, Partner and Co-Chair, Global Privacy and Security Group, Dentons US LLP; Ari Schwartz, Acting Senior Director for Cybersecurity Programs, National Security Council, The White House; Adam Sedgewick, Senior Information Technology Policy Advisor, national Institute of Standards and Technology; and Larry Zelvin, Director, National Cybersecurity and Communications Integration Center, U.S. Department of Homeland Security.

The second panel discussed public company disclosure of cybersecurity risks and incidents, and panelists included: Peter Beshar, Executive Vice President and General Counsel, Marsh & McLennan Companies, Inc.; David Burg, Global and U.S. Advisor Cyber Security Leader, PricewaterhouseCoopers LLP; Roberta Karmel, Centennial Professor of Law, Brooklyn Law School; Jonas Kron, Senior Vice President, Director of Shareholder Advocacy, Trillum Asset Management LLC; Douglas Meal, Partner, Ropes & Gray LLP; and Leslie T. Thornton, Vice President and General Counsel, WGL Holdings, Inc. and Washington Gas Light Company.

The third panel addressed cybersecurity issues faced by the securities markets, and panelists included: Mark G. Clancy, Managing Director and Corporate Information Security Officer, The Depository Trust and Clearing Corporation; Mark Graff, Chief Information Security Officer, Nasdaq OMX; Todd Furney, Vice President, Systems Security, Chicago Board Options Exchange; Katheryn Rosen, Deputy Assistant Secretary, Office of Financial Institutions Policy, Department of the Treasury; Thomas Sinnott, Managing Director, Global Information Security, CME Group; and Aaron Weissenfluh, Chief Information Security Officer, BATS Global Markets, Inc.

The final panel discussed how broker-dealers, investment advisers, and transfer agents address cybersecurity issues, and panelists included: John Denning, Senior Vice President, Operational Policy Integration, Development and Strategy, Bank of America/Merrill Lynch; Jimmie H. Lenz, Senior Vice President, Chief Risk and Credit Officer, Wells Fargo Advisors LLC; Mark R. Manley, Senior Vice President, Deputy General Counsel and Chief Compliance Officer, AllianceBernstein L.P.; Marcus Prendergast, Director and Corporate Information Security Officer, ITG; Karl Schimmeck, Managing Director, Financial Services Operations, Securities Industry and Financial Markets Association; Daniel M. Sibears, Executive Vice President, Regulatory Operations/Shared Services, FINRA; John Reed Stark, Managing Director, Stroz Friedberg; Craig Thomas, Chief Information Security Officer, Computershare; and David

market participants can effectively manage cybersecurity threats, including public and private sector coordination efforts and information sharing; the role that government should play to promote cybersecurity in the financial markets and market infrastructure; cybersecurity disclosure issues faced by public companies; and the identification of appropriate best practices and standards with regard to cybersecurity. Although the views of panelists varied, many emphasized the significant risk that cybersecurity attacks pose to the financial markets and market infrastructure today and the need to effectively manage that risk through measures such as testing, risk assessments, adoption of consistent best practices and standards, and information sharing.

III. Overview

The Commission acknowledges that the nature of technology and the level of sophistication and automation of current market systems prevent any measure, regulatory or otherwise, from completely eliminating all systems disruptions, intrusions, or other systems issues.⁴¹ However, given the issues outlined above, the Commission believes that the adoption of, and compliance by SCI entities with Regulation SCI, with the modifications from the SCI Proposal as discussed below, will advance the goals of the national market system by enhancing the capacity, integrity, resiliency, availability, and security of the automated systems of entities important to the functioning of the U.S. securities markets, as well as reinforce the requirement

G. Tittsworth, Executive Director and Executive Vice President, Investment Adviser Association.

⁴¹ See, e.g., October 2, 2012 remarks by Dr. Nancy Leveson, Professor of Aeronautics and Astronautics and Professor of Engineering Systems, MIT, Technology Roundtable (stating, for example, that “it is impossible to build totally secure software systems” and “we’ve learned that we cannot build an unsinkable ship and cannot build unfailable software”), available at: <http://www.sec.gov/news/otherwebcasts/2012/ttr100212-transcript.pdf>.

that such systems operate in compliance with the Exchange Act and rules and regulations thereunder, thus strengthening the infrastructure of the U.S. securities markets and improving its resilience when technological issues arise. In this respect, Regulation SCI establishes an updated and formalized regulatory framework, thereby helping to ensure more effective Commission oversight of such systems.

As proposed, Regulation SCI would have applied to “SCI entities” (estimated in the SCI Proposal to be 44 entities), a term which would have included all self-regulatory organizations (excluding security futures exchanges), ATSS that exceed specified volume thresholds, plan processors for market data NMS plans, and certain exempt clearing agencies. The most significant elements of the SCI Proposal⁴² would have required each SCI entity to:

- Implement policies and procedures reasonably designed to ensure that its “SCI systems” and “SCI security systems” have levels of capacity, integrity, resiliency, availability, and security, adequate to maintain the SCI entity’s operational capability and promote the maintenance of fair and orderly markets, with deemed compliance for policies and procedures that are consistent with current SCI industry standards, including identified information technology publications listed on proposed Table A;
- Implement policies and procedures reasonably designed to ensure that its systems operate in the manner intended, including in compliance with the federal securities laws and rules, and the entity’s rules and governing documents, with safe harbors from liability for SCI entities and individuals;

⁴² Each provision of the SCI Proposal is described in further detail below in Section IV. See also Proposing Release, supra note 13, at Section III.

- Upon any “responsible SCI personnel” becoming aware of the occurrence of an “SCI event” (defined to include systems disruptions, systems compliance issues, and systems intrusions), begin to take appropriate corrective action, including mitigating potential harm to investors and market integrity and devoting adequate resources to remedy the SCI event as soon as practicable;
- Report to the Commission the occurrence of any SCI event; and notify its members or participants of certain types of SCI events;
- Notify the Commission 30 days in advance of “material systems changes” (subject to an exception for exigent circumstances) and provide semi-annual summary progress reports on such material systems changes;
- Conduct an annual review, to be performed by objective, qualified personnel, of its compliance with Regulation SCI and submit a report of such annual review to its senior management and to the Commission;
- Designate those of its members or participants that would be required to participate in the testing (to occur at least annually) of its business continuity and disaster recovery plans, and coordinate such testing with other SCI entities on an industry- or sector-wide basis; and
- Meet certain other requirements, including maintaining records related to compliance with Regulation SCI and providing Commission representatives reasonable access to its systems to assess compliance with the rule.

The Commission received substantial comment on the SCI Proposal from a wide range of entities. Commenters generally expressed support for the goals of the rule, but many suggested that the SCI Proposal’s scope was unnecessarily broad and could be more tailored to lower

compliance costs and still achieve the goal of reducing significant technology risk in the markets. Broadly speaking, the areas of concern garnering the greatest comment included the: (i) breadth of certain key proposed definitions; (ii) costs associated with the scope of the proposed rule, including its reporting obligations; (iii) publications designated on Table A as proposed examples of “current SCI industry standards;” (iv) proposed entity safe harbor for systems compliance policies and procedures; (v) breadth of the proposed mandatory testing requirements; and (vi) proposed access provision.⁴³

The Commission has carefully considered the views of commenters in crafting Regulation SCI to meet its goals to strengthen the technology infrastructure of the securities markets and improve its resilience when technology falls short. Many of these modifications are intended to further focus the scope of the requirements from the proposal and to lessen the costs and burdens on SCI entities, while still allowing the Commission to achieve its goals. While Section IV below provides a detailed discussion of the changes the Commission has made to the SCI Proposal in adopting Regulation SCI today,⁴⁴ broadly speaking, the key changes include:

- Refining the scope of the proposal by, among other things, revising certain key definitions (including the definition of SCI systems and the definition of SCI ATS to exclude ATSs that trade only municipal securities or corporate debt securities (together, “fixed-income ATSs”)), refining the reporting framework for SCI events, and replacing the proposed 30-day advanced reporting requirement for material systems changes with a quarterly reporting requirement;

⁴³ A more detailed discussion of commenters’ views can be found below in Section IV.

⁴⁴ The Economic Analysis, *infra* Section VI, discusses the economic effects, including the costs and benefits, of the provisions of Regulation SCI, as adopted.

- Modifying the proposal to differentiate certain obligations and requirements, including tailoring certain obligations based on the criticality of a system (by, for example, adopting a new defined term “critical SCI system” for which heightened requirements will apply), and based on the significance of an event (such as adopting a new defined term “major SCI event” for purposes of the dissemination requirements, and establishing differing reporting obligations for SCI events that have had no or a de minimis impact on the SCI entity’s operations or on market participants);
- Modifying the proposed policies and procedures requirements relating to both operational capability and the maintenance of fair and orderly markets, as well as systems compliance;
- Refining the scope of SCI entity members and participants that would be required to participate in mandatory business continuity/disaster recovery plan testing; and
- Eliminating the proposed requirement that SCI entities provide Commission representatives reasonable access to their systems because the Commission can adequately assess an SCI entity’s compliance with Regulation SCI through existing recordkeeping requirements and examination authority, as well as through the new recordkeeping requirement in Rule 1005 of Regulation SCI.

In addition, the Commission notes that proposed Regulation SCI consisted of a single rule (Rule 1000) that included subparagraphs ((a) through (f)) addressing the various obligations of the rule. However, for clarity and simplification, adopted Regulation SCI is renumbered as Rules 1000 through 1007, as follows:

- Adopted Rule 1000 (which corresponds to proposed Rule 1000(a)) contains definitions for terms used in Regulation SCI;

- Adopted Rule 1001 (proposed Rules 1000(b)(1)-(2)) contains the policies and procedures requirements for SCI entities relating to both operational capability and the maintenance of fair and orderly markets, as well as systems compliance;
- Adopted Rule 1002 (proposed Rules 1000(b)(3)-(5)) contains the obligations of SCI entities with respect to SCI events, which include corrective action, Commission notification, and information dissemination;
- Adopted Rule 1003 (proposed Rules 1000(b)(6)-(8)) contains requirements relating to material systems changes and SCI reviews;
- Adopted Rule 1004 (proposed Rule 1000(b)(9)) contains requirements relating to business continuity and disaster recovery testing;
- Adopted Rule 1005 (proposed Rule 1000(c)) contains requirements relating to recordkeeping;
- Adopted Rule 1006 (proposed Rule 1000(d)) contains requirements relating to electronic filing and submission;
- Adopted Rule 1007 (proposed Rule 1000(e)) contains requirements for service bureaus.

IV. Description of Adopted Regulation SCI and Form SCI

A. Definitions Establishing the Scope of Regulation SCI – Rule 1000

A series of definitions set forth in Rule 1000 relate to the scope of Regulation SCI. These include the definitions for “SCI entity” (as well as the types of entities that are SCI entities, namely “SCI SRO,” “SCI ATS,” “plan processor,” and “exempt clearing agency subject to ARP”), “SCI systems” (and related definitions for “indirect SCI systems” and “critical SCI

systems”), and “SCI event” (as well as the types of events that constitute SCI events, namely “systems disruption,” “systems compliance issue,” and “systems intrusion”).⁴⁵

1. SCI Entities

Regulation SCI imposes requirements on entities meeting the definition of “SCI entity” under the rule. Proposed Rule 1000(a) defined “SCI entity” as an “SCI self-regulatory organization, SCI alternative trading system, plan processor, or exempt clearing agency subject to ARP.”⁴⁶ The Commission is adopting the definition of “SCI entity” in Rule 1000 as proposed.⁴⁷

Some commenters discussed the definition of SCI entity generally and advocated for an expansion of the proposed definition, asserting that additional categories of market participants may have the potential to impact the market in the event of a systems issue.⁴⁸ For example, one

⁴⁵ Rule 1000 contains additional defined terms that are discussed in subsequent sections below. See *infra* Section IV.B.3 (discussing the definition of “responsible SCI personnel”), Section IV.B.3.d (discussing “major SCI event” and deletion of the proposed definition of “dissemination SCI event”), Section IV.B.4 (discussing deletion of the proposed definition for “material systems change”), Section IV.B.5 (discussing “SCI review” and “senior management”), and Section IV.C.2 (discussing “electronic signature”).

⁴⁶ See proposed Rule 1000(a) and Proposing Release *supra* note 13, at Section III.B.1.

⁴⁷ Proposed Rule 1000(a) also defined each of the terms within the definition of SCI entity for the purpose of designating specifically the entities that would be subject to Regulation SCI. As described in the Sections IV.A.1.a-d below, the Commission is also adopting these terms as proposed and without modification, with the exception of the definition of “SCI ATS,” which is being revised to exclude ATSS that trade only municipal securities or corporate debt securities.

⁴⁸ See, e.g., NYSE Letter at 8-9 and Liquidnet Letter at 2-3. See also BlackRock Letter at 4 (stating, among other things, that Regulation SCI should extend to any trading platforms that transact significant volume because these venues have a meaningful role and impact on the equity market). See also *infra* Section IV.E (discussing comments regarding the potential inclusion of other types of entities, such as broker-dealers generally, within the scope of Regulation SCI).

commenter suggested that the definition of “SCI entity” be extended to include the ATS and broker-dealer entities covered by the Regulation NMS definition of a “trading center.”⁴⁹

Another commenter stated that the Commission should potentially expand the definition of SCI entity to also include dark pools if they met the volume thresholds of ATSS.⁵⁰

Other commenters believed that the scope of the definition should be more limited.⁵¹ For example, one commenter suggested that the definition should only include those entities that are systemically important to the functioning of the U.S. securities markets and should utilize volume thresholds for exchanges and ATSS to make this determination.⁵²

Several commenters advocated the adoption of a “risk-based” approach, which would entail categorizing market participants based on the criticality of the functions performed rather than applying Regulation SCI to all “SCI entities” equally.⁵³ Some commenters suggested replacing the term “SCI entity” with categories of participants based on potential market impact

⁴⁹ Specifically, Section 600(b)(78) of Regulation NMS includes within the definition of a “trading center” “an ATS, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.” 17 CFR 242.600(b)(68). See NYSE Letter at 8-9.

⁵⁰ See CoreOne Letter at 7-9. CoreOne recommended that the Commission require dark pools to publicly disclose their aggregate volume in a manner similar to disclosures made by exchanges and ATSS. CoreOne stated that, once dark pools publicly disclose their volumes, it would be easier to evaluate whether dark pools should be included as SCI entities. Id.

⁵¹ See, e.g., KCG Letter at 6-8; ITG Letter at 2-4; and CME Letter at 2-5.

⁵² See ITG Letter at 2-4, 7. This commenter argued that, alternatively, the Commission could impose a lower set of obligations on “lesser” SCI entities. See id., at 9-11. See also infra notes 81-82 (discussing this commenter’s suggested thresholds for exchanges) and note 131 (discussing this commenter’s recommended thresholds for ATSS). See discussion in Sections IV.A.1.a and IV.A.1.b (relating to SCI SROs and SCI ATSS, respectively).

⁵³ See, e.g., BIDS Letter at 5-6; SIFMA Letter at 4-5; KCG Letter at 2-3, 6-8; Fidelity Letter at 2-4; UBS Letter at 2-4; and LiquidPoint Letter at 2-3.

or including in the definition only those participants that are essential to continuous market-wide operation or that are the sole providers of a service in the securities markets.⁵⁴ Other commenters agreed with the proposed scope of the term “SCI entity,” but believed that the various requirements under the rule should be tiered based on risk profiles.⁵⁵ Several commenters identified various factors that should be considered in conducting a risk-assessment such as whether an entity is a primary listing market, is the sole market where the security is traded, or performs a monopoly or utility type role where there is no redundancy built into the marketplace, among others.⁵⁶ Some commenters identified specific functions that they believed to be highly critical to the functioning of the securities markets and thus pose the greatest risk to the markets in the event of a systems issue, including securities information processing, clearance and settlement systems, and trading of exclusively listed securities, among others.⁵⁷

After careful consideration of the comments, the Commission has determined to adopt the overall scope of entities covered by Regulation SCI as proposed.⁵⁸ As discussed below, the Commission continues to believe that it is appropriate and would further the goals of the national market system to subject all SROs (excluding securities futures exchanges), ATSS meeting certain volume thresholds with respect to NMS stocks and non-NMS stocks (discussed further below), plan processors, and certain exempt clearing agencies to the requirements of Regulation

⁵⁴ See, e.g., BIDS Letter at 3-6; Direct Edge Letter at 1-2; and KCG Letter at 2-3, 6-8. Specifically, Direct Edge stated that SCI entities should include Commission-registered exchanges, securities information processors under approved NMS plans for market data, and clearance and settlement systems.

⁵⁵ See, e.g., SIFMA Letter at 4 and Fidelity Letter at 3-4.

⁵⁶ See, e.g., SIFMA Letter at 4 and Fidelity Letter at 3-4.

⁵⁷ See, e.g., SIFMA Letter at 4; Direct Edge Letter at 1-2; and KCG Letter at 2-3.

⁵⁸ But see *infra* Section IV.A.1.b (discussing revisions to the definition of “SCI ATS”).

SCI. The Commission believes that this definition appropriately includes those entities that play a significant role in the U.S. securities markets and/or have the potential to impact investors, the overall market, or the trading of individual securities.⁵⁹

While some commenters supported expanding the definition of SCI entity to encompass various other types of entities, the Commission has determined not to expand the scope of entities subject to Regulation SCI at this time. As noted in the SCI Proposal, Regulation SCI is based, in part, on the ARP Inspection Program, which has included the voluntary participation of all active registered clearing agencies, all registered national securities exchanges, the only registered national securities association—Financial Industry Regulatory Authority (“FINRA”), one exempt clearing agency, and one ATS.⁶⁰ The ARP Inspection Program has also included the systems of entities that process and disseminate quotation and transaction data on behalf of the Consolidated Tape Association System (“CTA Plan”), Consolidated Quotation System (“CQS Plan”), Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation, and Dissemination of Quotation and Transaction Information for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privileges Basis (“Nasdaq UTP Plan”), and Options Price Reporting Authority (“OPRA Plan”).⁶¹ Significant-volume ATSS have also been subject to certain aspects of the ARP Policy Statements pursuant to Regulation ATS.⁶² In addition, one entity that has been granted an exemption from registration as a clearing agency has been subject to the ARP Inspection Program pursuant to the conditions of the exemption order issued by the

⁵⁹ See *infra* Sections IV.A.1.a-d (discussing more specifically each category of entity included within the definition of “SCI entity”).

⁶⁰ See Proposing Release, *supra* note 13, at 18086.

⁶¹ See *infra* note 196 and accompanying text.

⁶² See Rule 301(b)(6) of Regulation ATS, 17 CFR 242.301(b)(6).

Commission.⁶³ The scope of the definition of SCI entity is intended to largely reflect the historical reach of the ARP Inspection Program and existing Rule 301 of Regulation ATS, while also expanding the coverage to certain additional entities that the Commission believes play a significant role in the U.S. securities markets and/or have the potential to impact investors, the overall market, or the trading of individual securities. The Commission acknowledged in the SCI Proposal that there may be other categories of entities not included within the definition of SCI entity that, given their increasing size and importance, could pose risks to the market should an SCI event occur.⁶⁴ However, as discussed in further detail below,⁶⁵ the Commission believes that, at this time, the entities included within the definition of SCI entity, because of their current role in the U.S. securities markets and/or their level of trading activity, have the potential to pose the most significant risk in the event of a systems issue. Although some commenters suggested that Regulation SCI should cover a greater range of market participants,⁶⁶ the Commission believes that it is important to move forward now on rules that will meaningfully enhance the technology standards and oversight of key markets and market infrastructure. Further, the Commission believes that a measured approach that takes an incremental expansion from the entities covered under the ARP Inspection Program is an appropriate method for imposing the mandatory requirements of Regulation SCI at this time given the potential costs of compliance. This approach will enable the Commission to monitor and evaluate the implementation of

⁶³ See Proposing Release, supra note 13, at 18096-97. See also infra Section IV.A.1.d (discussing the inclusion in Regulation SCI of exempt clearing agencies subject to ARP).

⁶⁴ See Proposing Release, supra note 13, at 18138-39.

⁶⁵ See infra Sections IV.A.1.a-d (discussing more specifically each category of entity included within the definition of "SCI entity").

⁶⁶ See supra notes 48-50 and accompanying text.

Regulation SCI, the risks posed by the systems of other market participants, and the continued evolution of the securities markets, such that it may consider, in the future, extending the types of requirements in Regulation SCI to additional categories of market participants, such as non-ATS broker-dealers, security-based swap dealers, investment advisers, investment companies, transfer agents, and other key market participants. As noted in the SCI Proposal, should the Commission decide to propose to apply some or all of the requirements of Regulation SCI to additional types of entities, the Commission will issue a separate release discussing such a proposal and seeking public comment.⁶⁷

With respect to another commenter's recommendation regarding dark pools, to the extent that this commenter intended its comment to refer to ATSS, ATSS would be included within the scope of Regulation SCI if they met the applicable volume thresholds discussed below.⁶⁸ To the extent that this commenter intended its comment to refer to other types of non-ATS dark venues where broker-dealers internalize order flow, the Commission notes that it has determined not to

⁶⁷ See Proposing Release, *supra* note 13, at 18138.

⁶⁸ See *infra* Section IV.A.1.b (discussing definition of "SCI ATS"). This commenter also recommended that the Commission require dark pools to publicly disclose their aggregate volume to make it easier to evaluate whether dark pools should be included as SCI entities, and supported FINRA's plans to require such trading volume disclosures. The Commission notes that FINRA recently adopted new Rule 4552, which requires each ATS to report to FINRA weekly volume information regarding transactions in NMS stocks and OTC equity securities, and FINRA makes such information publicly available on its website. See Securities Exchange Act Release No. 71341 (January 17, 2014), 79 FR 4213 (January 24, 2014) (approving FINRA Rule 4552 requiring each ATS to report to FINRA weekly volume information and number of securities transactions). The Commission also notes that all ATSS (including dark pool ATSS) are required under Regulation ATS to provide the Commission with quarterly trading volume information. See Rule 301(b)(9) of Regulation ATS, 17 CFR 242.301(b)(9).

extend the scope of Regulation SCI to other types of broker-dealers at this time for the reasons discussed below.⁶⁹

The Commission has also determined not to further limit the scope of entities subject to Regulation SCI as suggested by some commenters. As discussed in more detail below, the Commission continues to believe that each of the identified categories of entities plays a significant role in the U.S. securities markets and/or has the potential to impact investors, the overall market, or the trading of individual securities, and thus should be subject to the requirements of Regulation SCI. Accordingly, the Commission does not agree that it should adopt a “risk-based” approach to further limit the categories of market participants subject to Regulation SCI. The Commission believes that limiting the applicability of Regulation SCI to only the most systemically important entities posing the highest risk to the markets is too limited of a category of market participants, as it would exclude certain entities that, in the Commission’s view, have the potential to pose significant risks to the securities markets should an SCI event occur. However, the Commission believes it is appropriate to incorporate risk-based considerations in various other aspects of Regulation SCI. Consistent with the views of some commenters advocating that the requirements of Regulation SCI should be tailored to the specific risk-profile of a particular entity or particular system,⁷⁰ the Commission notes that Regulation SCI, as proposed, was intended to incorporate a consideration of risk within its requirements and believes it is appropriate to more explicitly incorporate risk considerations in various provisions of adopted Regulation SCI. For example, as discussed in further detail below, the requirement to have reasonably designed policies and procedures relating to operational

⁶⁹ See infra text accompanying notes 121-125.

⁷⁰ See supra note 55 and accompanying text.

capability was designed to permit SCI entities to take a risk-based approach in developing their policies and procedures based on the criticality of a particular system.⁷¹ In addition, the Commission believes that it is appropriate to further incorporate a risk-based approach into other aspects of the regulation; and thus, as discussed below, is adopting a new term—“critical SCI systems”—to identify systems that the Commission believes should be subject to heightened requirements in certain areas.⁷² Further, the Commission has determined that certain other definitions (such as the definition of “SCI systems”), and certain requirements of the rule (such as Commission notification for SCI events and material systems changes), should be scaled back and refined consistent with a risk-based approach, as discussed below. The Commission believes that these modifications, further incorporating risk-based considerations in the requirements and scaling back certain requirements, provide the proper balance between requiring that the appropriate entities are subject to baseline standards for systems capacity, integrity, resiliency, availability, security, and compliance, while reducing the overall burden of the rule for all SCI entities, which is consistent with, and responsive to, the views of those commenters that the Commission take a more risk-based approach to SCI entities.

a. SCI Self-Regulatory Organization or SCI SRO

Proposed Rule 1000(a) defined “SCI self-regulatory organization,” or “SCI SRO,” to be consistent with the definition of “self-regulatory organization” set forth in Section 3(a)(26) of the Exchange Act.⁷³ This definition covered all national securities exchanges registered under

⁷¹ See *infra* Section IV.B.1 (discussing the policies and procedures requirement under adopted Rule 1001(a)).

⁷² See *infra* Section IV.A.2.c (discussing the definition of “critical SCI systems”).

⁷³ See 15 U.S.C. 78c(a)(26): “The term ‘self-regulatory organization’ means any national securities exchange, registered securities association, or registered clearing agency, or

Section 6(b) of the Exchange Act,⁷⁴ registered securities associations,⁷⁵ registered clearing agencies,⁷⁶ and the Municipal Securities Rulemaking Board (“MSRB”).⁷⁷ The definition,

(solely for purposes of sections 19(b), 19(c), and 23(b) of this title) the Municipal Securities Rulemaking Board established by section 15B of this title.”

⁷⁴ Currently, these registered national securities exchanges are: (1) BATS Exchange, Inc. (“BATS”); (2) BATS Y-Exchange, Inc. (“BATS-Y”); (3) Boston Options Exchange LLC (“BOX”); (4) CBOE; (5) C2; (6) Chicago Stock Exchange, Inc. (“CHX”); (7) EDGA Exchange, Inc. (“EDGA”); (8) EDGX Exchange, Inc. (“EDGX”); (9) International Securities Exchange, LLC (“ISE”); (10) Miami International Securities Exchange, LLC (“MIAX”); (11) NASDAQ OMX BX, Inc. (“Nasdaq OMX BX”); (12) NASDAQ OMX PHLX LLC (“Nasdaq OMX Phlx”); (13) Nasdaq; (14) National Stock Exchange, Inc. (“NSX”); (15) NYSE; (16) NYSE MKT; (17) NYSE Arca; and (18) ISE Gemini, LLC (“ISE Gemini”).

⁷⁵ FINRA is the only registered national securities association.

⁷⁶ Currently, there are seven clearing agencies (Depository Trust Company (“DTC”); Fixed Income Clearing Corporation (“FICC”); National Securities Clearing Corporation (“NSCC”); Options Clearing Corporation (“OCC”); ICE Clear Credit; ICE Clear Europe; and CME) with active operations that are registered with the Commission. The Commission notes that in 2012 it adopted Rule 17Ad-22, which requires registered clearing agencies to have effective risk management policies and procedures in place. See Securities Exchange Act Release No. 68080 (October 22, 2012), 77 FR 66220 (November 2, 2012) (“Clearing Agency Standards Release”). The Commission believes that Regulation SCI, to the extent it addresses areas of risk management similar to those addressed by Rule 17Ad-22(d)(4), complements Rule 17Ad-22(d)(4).

Additionally, on March 12, 2014, the Commission proposed rules that would apply to SEC-registered clearing agencies that have been designated as systemically important by the Financial Stability Oversight Council or that are involved in activities with a more complex risk profile, such as clearing security-based swaps. See Securities Exchange Act Release No. 71699 (Mar. 12, 2014), 79 FR 16865 (March 26, 2014) (“Covered Clearing Agencies Proposal”). Regulation SCI and proposed Rule 17Ad-22(e)(17) are intended to be consistent and complementary. See also Covered Clearing Agencies Proposal, 79 FR at 16866, n.1 and accompanying text (discussing the Commission’s consideration of the relevant international standards).

⁷⁷ 15 U.S.C. 78c(a)(26). As noted in the Proposing Release, historically, the ARP Inspection Program did not include the MSRB, but instead focused on entities having trading, quotation and transaction reporting, and clearance and settlement systems more closely connected to the equities and options markets. The Commission believes that it is appropriate to apply Regulation SCI to the MSRB, particularly given the fact that the MSRB is the only SRO relating to municipal securities and is a key provider of consolidated market data for the municipal securities market. Accordingly, as proposed,

however, excluded an exchange that lists or trades security futures products that is notice-registered with the Commission as a national securities exchange pursuant to Section 6(g) of the Exchange Act, as well as any limited purpose national securities association registered with the Commission pursuant to Exchange Act Section 15A(k).⁷⁸ Accordingly, the proposed definition of SCI SRO in Rule 1000(a) included all national securities exchanges registered under Section 6(b) of the Exchange Act, all registered securities associations, all registered clearing agencies,

the term "SCI SRO" included the MSRB. In 2008, the Commission amended Rule 15c2-12 to designate the MSRB as the single centralized disclosure repository for continuing municipal securities disclosure. In 2009, the MSRB established the Electronic Municipal Market Access system ("EMMA"). EMMA now serves as the official repository of municipal securities disclosure, providing the public with free access to relevant municipal securities data, and is the central database for information about municipal securities offerings, issuers, and obligors. Additionally, the MSRB's Real-Time Transaction Reporting System ("RTRS"), with limited exceptions, requires municipal bond dealers to submit transaction data to the MSRB within 15 minutes of trade execution, and such near real-time post-trade transaction data can be accessed through the MSRB's EMMA website. While pre-trade price information is not as readily available in the municipal securities market, the Commission's Report on the Municipal Securities Market also recommended that the Commission and MSRB explore the feasibility of enhancing EMMA to collect best bids and offers from material ATs and make them publicly available on fair and reasonable terms. See Report on the Municipal Securities Market (July 31, 2012), available at: <http://www.sec.gov/news/studies/2012/munireport073112.pdf>. The Commission believes that the MSRB's SCI systems currently are limited to those operated by or on behalf of the MSRB that directly support market data (i.e., currently limited to the EMMA, RTRS, and SHORT systems). As discussed more fully below, the EMMA, RTRS, and SHORT systems referenced by the MSRB in its comment letter would be market data systems within the definition of SCI systems because they provide or directly support price transparency. See infra note 253 and accompanying text.

⁷⁸ See 15 U.S.C. 78f(g); 15 U.S.C. 78o-3(k). These entities are security futures exchanges and the National Futures Association, for which the CFTC serves as their primary regulator. See generally CFTC Concept Release on Risk Controls and System Safeguards for Automated Trading Environments, 78 FR 56542 (September 12, 2013) ("CFTC Concept Release") (describing the CFTC's regulatory scheme for addressing risk controls relating to automated systems).

and the MSRB.⁷⁹ The definition of “SCI self-regulatory organization” or “SCI SRO” is being adopted in Rule 1000 as proposed.⁸⁰

One commenter suggested that the rule should include volume thresholds for exchanges.⁸¹ Specifically, this commenter recommended that, with regard to exchanges, the definition should include only those exchanges that have five percent or more of average daily dollar volume in at least five NMS stocks for four of the previous six months.⁸² Another commenter asked the Commission to adopt certain specific exceptions to the definition of SCI SRO and SCI entity for entities that are dually registered with the CFTC and Commission where the CFTC is the entity’s “primary regulator” and for any entity that does not play a “significant

⁷⁹ For any SCI SRO that is a national securities exchange, any facility of such national securities exchange, as defined in Section 3(a)(2) of the Exchange Act, 15 U.S.C. 78c(a)(2), also is covered because such facilities are included within the definition of “exchange” in Section 3(a)(1) of the Exchange Act, 15 U.S.C. 78c(a)(1).

⁸⁰ The Commission notes that NSX ceased trading as of the close of business on May 30, 2014. See Securities Exchange Act Release No. 72107 (May 2, 2014), 79 FR 27017 (May 12, 2014) (Notice of Filing and Immediate Effectiveness of Proposed Rule Change To Cease Trading on Its Trading System) (“NSX Trading Cessation Notice”). In the NSX Trading Cessation Notice, NSX stated: “[T]he Exchange will continue to be registered as a national securities exchange and will continue to retain its status as a self-regulatory organization[;]” and further, that it “shall file a proposed rule change pursuant to Rule 19b-4 of the Exchange Act prior to any resumption of trading on the Exchange pursuant to Chapter XI (Trading Rules).” Because NSX remains a national securities exchange registered under Section 6(b) of the Exchange Act, it continues to meet the definition of SCI entity, and is counted as an SCI entity for purposes of this release.

⁸¹ See ITG Letter at 10. This commenter also suggested similar revised thresholds for SCI ATSS. See also *infra* note 131 and accompanying text. Although only one commenter specifically commented on the proposed inclusion of SCI SROs within the scope of Regulation SCI, as discussed above, some commenters believed that Regulation SCI should generally take a more risk-based or tiered approach generally which, in some cases, would affect which entities (including SCI SROs) would be subject to Regulation SCI. See *supra* notes 53-56 and accompanying text.

⁸² See ITG Letter at 10.

role” in the markets subject to the Commission’s jurisdiction and that cannot have a “significant impact” on the markets subject to the Commission’s jurisdiction.⁸³

The Commission does not believe that a trading volume threshold is appropriate for SCI SROs that are exchanges, but instead believes that Regulation SCI should apply to all SCI SROs. The threshold suggested by the commenter would exclude from Regulation SCI those exchanges with volumes below the suggested threshold; however, the Commission believes that all exchanges play a significant role in our securities markets. For example, all stock exchanges are subject to a variety of specific public obligations under the Exchange Act, including the requirements of Regulation NMS which, among other things, designates the best bid or offer of such exchanges to be protected quotations.⁸⁴ Accordingly, every exchange may have a protected quotation that can obligate market participants to send orders to that exchange. Among other reasons, given that market participants may be required to send orders to any one of the exchanges at any given time if such exchange is displaying the best bid or offer, the Commission believes that it is important that the safeguards of Regulation SCI apply equally to all exchanges irrespective of trading volume.

⁸³ See CME Letter at 2.

⁸⁴ See generally 17 CFR 242.600-612. In addition, as the commenter’s suggested thresholds would apply only with respect to exchanges that trade NMS stocks, national securities exchanges that do not trade NMS stocks (i.e., options exchanges) would also be excluded from Regulation SCI under the commenter’s suggestion. The Commission believes that it would be inappropriate to exclude options exchanges from the requirements of Regulation SCI, because technology risks are equally applicable to such exchanges, as evidenced by recent significant technology incidents affecting the options markets. See *supra* notes 28-31 and accompanying text. As such, systems issues at options exchanges can pose significant risks to the markets, and the Commission believes that the inclusion of options exchanges within the scope of Regulation SCI is necessary to achieve the goals of Regulation SCI.

With regard to one commenter's suggestion to except from the definition of SCI SRO those entities dually registered with the CFTC and Commission where the CFTC is the entity's "primary regulator,"⁸⁵ the Commission disagrees that such entities should be relieved from the requirements of Regulation SCI solely because they are dually registered.⁸⁶ While the CFTC is responsible for overseeing such an entity with regard to its futures activities, it does not have oversight responsibility for the entity's securities-related activities and systems. While the commenter stated that it (as a dual registrant) is already subject to similar requirements to adopt controls and procedures with regard to operational risk and reliability, security, and capacity of its systems pursuant to CFTC regulations, the Commission again notes that such requirements do

⁸⁵ See supra note 83 and accompanying text.

⁸⁶ The commenter notes that the Commission has proposed to exclude from the definition of SCI SRO those exchanges that list or trade security futures products that are notice-registered with the Commission pursuant to Section 6(g), as well as limited purpose national securities associations registered with the Commission pursuant to Exchange Act Section 15A(k). See Proposing Release, supra note 13, at 18093, n. 97 and accompanying text. The Commission notes that such entities are subject to the joint jurisdiction of the Commission and the CFTC. To avoid duplicative regulation, however, the CFMA established a system of notice registration under which trading facilities and intermediaries that are already registered with either the Commission or the CFTC may register with the other agency on an expedited basis for the limited purpose of trading security futures products. A "notice registrant" is then subject to primary oversight by one agency, and is exempted under the CFMA from all but certain specified provisions of the laws administered by the other agency. See Section 6(g)(4) and Section 15A(k)(3)-(4) (enumerating the provisions of the Exchange Act from which a notice-registered exchange and limited purpose national securities association, respectively, are exempted). Given this, the Commission believes that it is appropriate to defer to the CFTC regarding the systems integrity of these entities). See also generally CFTC Concept Release, supra note 78. This regulatory scheme does not apply outside of the specific contexts of security futures exchanges and associations. In contrast, entities that are registered with both the Commission and the CFTC in other capacities, such as clearing agencies, are subject to a full set of regulations by each regulator. The Exchange Act and Commodity Exchange Act do not exempt these entities, due to any dual regulatory scheme, from any provisions of the laws administered by the Commission and, as discussed further below, the Commission believes they should not be afforded an exclusion from Regulation SCI.

not apply to such an entity's securities-related systems as such systems are outside of the CFTC's jurisdiction and, as such, such systems would not be subject to inspection and examination by the CFTC for compliance with such requirements.⁸⁷ Further, Regulation SCI imposes a notification framework to inform the Commission of SCI events and material systems changes, as well as other requirements unique to Regulation SCI. Accordingly, the Commission believes that such entities should be subject to the requirements of Regulation SCI. In addition, as noted above, this commenter also asked the Commission to create an exception for any entity that does not play a "significant role" in the markets subject to the Commission's jurisdiction and that cannot have a "significant impact" on the markets subject to the Commission's jurisdiction.⁸⁸ While the Commission disagrees with excluding SROs from coverage as discussed above, the Commission notes that it is revising the proposed definition of SCI systems to clarify that the term SCI systems encompasses only those systems that, with respect to securities, directly support trading, clearance and settlement, order routing, market data, market regulation, or market surveillance, as discussed below.⁸⁹ Accordingly, the Commission believes this change should address the commenter's concerns about the requirements applying to entities

⁸⁷ The Commission notes that, to the extent that such an entity's systems for its functions that fall in the purview of the Commission (relating to securities and securities-based swaps) and that fall in the purview of the CFTC (relating to futures and swaps) are integrated, it believes that the focus of the CFTC's exams and inspections of such systems would be on such systems' functionality related to non-securities-related activities, such as swaps or futures, and not those related to securities activities. Thus, the Commission believes that the potential examination and inspection of such integrated systems by both the CFTC and SEC does not support the exclusion of the SCI entities operating such systems, or the systems themselves, from the scope of Regulation SCI.

⁸⁸ See supra note 83 and accompanying text.

⁸⁹ See adopted Rule 1000 (emphasis added). See also infra Section IV.A.2.b (discussing the definition of "SCI systems").

whose systems cannot affect the markets subject to the Commission's jurisdiction, i.e., the U.S. securities markets.

b. SCI Alternative Trading System

Proposed Rule 1000(a) defined the term "SCI alternative trading system," or "SCI ATS," as an alternative trading system, as defined in § 242.300(a), which during at least four of the preceding six calendar months, had: (1) with respect to NMS stocks – (i) five percent or more in any single NMS stock, and 0.25 percent or more in all NMS stocks, of the average daily dollar volume reported by an effective transaction reporting plan, or (ii) one percent or more, in all NMS stocks, of the average daily dollar volume reported by an effective transaction reporting plan; (2) with respect to equity securities that are not NMS stocks and for which transactions are reported to a self-regulatory organization, five percent or more of the average daily dollar volume as calculated by the self-regulatory organization to which such transactions are reported; or (3) with respect to municipal securities or corporate debt securities, five percent or more of either – (i) the average daily dollar volume traded in the United States, or (ii) the average daily transaction volume traded in the United States.⁹⁰

The proposed definition would have modified the thresholds currently appearing in Rule 301(b)(6) of Regulation ATS that apply to significant-volume ATSs.⁹¹ Specifically, the proposed definition would have: used average daily dollar volume thresholds, instead of an average daily share volume threshold, for ATSs that trade NMS stocks or equity securities that are not NMS stocks ("non-NMS stocks"); used alternative average daily dollar and transaction volume-based tests for ATSs that trade municipal securities or corporate debt securities; lowered

⁹⁰ See proposed Rule 1000(a) and Proposing Release, supra note 13, at Section III.B.1.

⁹¹ 17 CFR 242.301(b)(6).

the volume thresholds applicable to ATSS for each category of asset class; and moved the proposed thresholds to Regulation SCI. In particular, with respect to NMS stocks, the Commission proposed to change the volume threshold from 20 percent of average daily volume in any NMS stock such that an ATS that traded NMS stocks that met either of the following two alternative threshold tests would be subject to the requirements of proposed Regulation SCI: (i) five percent or more in any NMS stock, and 0.25 percent or more in all NMS stocks, of the average daily dollar volume reported by an effective transaction reporting plan; or (ii) one percent or more, in all NMS stocks, of the average daily dollar volume reported by an effective transaction reporting plan. With respect to non-NMS stocks, municipal securities, and corporate debt securities, the Commission proposed to reduce the standard from 20 percent to five percent for these types of securities,⁹² the same percentage threshold for such types of securities that triggers the fair access provisions of Rule 301(b)(5) of Regulation ATS.⁹³

The proposed definition of "SCI ATS" is being adopted substantially as proposed with regard to ATSS trading NMS stocks and ATSS trading non-NMS stocks, with the addition of a six-month compliance period for entities satisfying the thresholds in the definition for the first time, as discussed in more detail below. However, for the reasons discussed below, the Commission has determined to exclude from the definition of "SCI ATS" ATSS that trade only municipal securities or corporate debt securities and accordingly, such ATSS will not be subject to the requirements of Regulation SCI.

⁹² See proposed Rule 1000(a).

⁹³ See Rule 301(b)(5) of Regulation ATS under the Exchange Act. 17 CFR 242.301(b)(5). In addition, as noted above, the proposed rule used alternative average daily dollar and transaction volume-based tests for ATSS that trade municipal securities or corporate debt securities.

Inclusion of ATSS Generally

Many commenters provided comment on the inclusion of ATSS within the scope of Regulation SCI. Some commenters believed that more ATSS should be covered by Regulation SCI.⁹⁴ For example, some commenters suggested that the term "SCI ATS" should include all ATSS, because these commenters believed that they have the potential to negatively impact the market in the event of a systems issue.⁹⁵ Moreover, one commenter stated that the Commission should not distinguish between ATSS based on calculated thresholds because an ATS might limit trading on its system so as to avoid being subject to the requirements of Regulation SCI.⁹⁶

Conversely, other commenters stated that fewer, or even no, ATSS should be covered.⁹⁷ Such commenters generally argued that there are key differences between ATSS and exchanges, and thus, ATSS should be regulated differently from exchanges and not be included in Regulation SCI with exchanges.⁹⁸ The differences identified by commenters included: ATSS' relative market shares and sizes; the fact that ATSS are already subject to various regulations as broker-dealers (including Rule 15c3-5 under the Exchange Act, various FINRA rules, and Regulation ATS); and certain fundamental economic differences between the two types of entities (including that exchanges can gain revenue from listing and market data, have self-clearing, and have a protected quote).⁹⁹ One commenter argued that, if the Commission were to

⁹⁴ See, e.g., NYSE Letter at 9-10; Lauer Letter at 4; and CoreOne Letter at 7-8.

⁹⁵ See, e.g., NYSE Letter at 9-10; and Lauer Letter at 4.

⁹⁶ See, e.g., NYSE Letter at 9-10.

⁹⁷ See, e.g., BIDS Letter at 3; ITG Letter at 3; KCG Letter at 8; and OTC Markets Letter at 9.

⁹⁸ See, e.g., BIDS Letter at 3; ITG Letter at 3; KCG Letter at 9, 14-17; TMC Letter at 2; and OTC Markets Letter at 9.

⁹⁹ Id.

include ATSS in Regulation SCI, it should treat ATSS and SROs equally by allowing ATSS to have the same benefits of SROs, including allowing ATSS to derive an income stream from contributions to the SIP, have access to clearing, and have immunity from lawsuits.¹⁰⁰ Other commenters also noted that, although ATSS have an increasingly large, collective market share, ATSS have not contributed to any of the recent major systems issues that have impacted the market.¹⁰¹

Another commenter stated that the SCI Proposal unfairly discriminated against ATSS by including them within the definition of SCI entity.¹⁰² Specifically, although this commenter did not believe that Regulation SCI should be expanded to include more entities, it stated that the SCI Proposal's failure to capture certain entities (such as clearing firms, market makers, block positioners, and order routing firms) that it believed could have a greater impact on market stability in the event of a systems issue, while including ATSS, demonstrates that the proposal is arbitrary, capricious, and unfairly discriminatory in nature.¹⁰³

After careful consideration of the comment letters, the Commission continues to believe that the inclusion of ATSS that trade NMS stocks and non-NMS stocks in Regulation SCI is appropriate.¹⁰⁴ The Commission believes that certain of those ATSS play an important role in

¹⁰⁰ See OTC Markets Letter at 9.

¹⁰¹ See ITG Letter at 4; and BIDS Letter at 3.

¹⁰² See ITG Letter at 9.

¹⁰³ See *id.*

¹⁰⁴ Given the inclusion of ATSS that trade NMS stocks and non-NMS stocks within the scope of Regulation SCI, Regulation ATS is also being amended to remove paragraphs (b)(6)(i)(A) and (b)(6)(i)(B) of Rule 301 so that Rule 301(b)(6) will no longer apply to ATSS trading NMS stocks and non-NMS stocks. However, as described below, the Commission has determined to exclude ATSS that trade only municipal securities or corporate debt securities from the scope of Regulation SCI, and such ATSS will remain

today's securities markets, and thus should be subject to the safeguards and obligations of Regulation SCI. As noted in the SCI Proposal, the equity markets have evolved significantly over recent years, resulting in an increase in the number of trading centers and a reduction in the concentration of trading activity.¹⁰⁵ As such, even smaller trading centers, such as certain higher-volume ATSS, now collectively represent a significant source of liquidity for NMS stocks and some ATSS have similar and, in some cases, greater trading volume than some national securities exchanges, with no single national securities exchange executing more than approximately 19 percent of volume in NMS stocks in today's securities markets.¹⁰⁶ Accordingly, the Commission believes that ATSS meeting certain volume thresholds can play a significant role in the securities markets and, given their heavy reliance on automated systems, have the potential to significantly impact investors, the overall market, and the trading of individual securities should an SCI event occur.

Commenters identified certain differences between exchanges and ATSS, which commenters argued justified different treatment under Regulation SCI for ATSS or exclusion of ATSS from the regulation completely.¹⁰⁷ While the Commission recognizes that there are some fundamental differences between ATSS and exchanges, including certain of those identified by

subject to the requirements of Rule 301(b)(6) if they meet the volume thresholds therein. 17 CFR 242.301(b)(6). See supra notes 14 and 20 and accompanying text.

¹⁰⁵ See Proposing Release, supra note 13, at 18094.

¹⁰⁶ See market volume statistics reported by BATS, available at: http://www.batstrading.com/market_summary/ (no single stock exchange executed more than approximately 19 percent during the second quarter of 2014, with Nasdaq having the highest market share of 18.6 percent). In comparison, according to data from Form ATS-R for the second quarter of 2014, approximately 18 percent of consolidated NMS stocks dollar volume took place on ATSS.

¹⁰⁷ See supra notes 98-99 and accompanying text.

commenters, the Commission does not agree that all ATSS should be excluded from Regulation SCI because, as discussed above, it believes that there are certain significant-volume ATSS that have the potential to significantly impact investors, the overall market, or the trading of individual securities should an SCI event occur. At the same time, the risk-based considerations permitted in adopted Regulation SCI may result in the systems of those ATSS that are subject to Regulation SCI (i.e., SCI ATSS) being subject to less stringent requirements than the systems of SROs or other SCI entities in certain areas. For example, as discussed in further detail below, the Commission is adopting a definition of "critical SCI systems," which are a subset of SCI systems that are subject to certain heightened requirements under Regulation SCI. This definition is intended to capture those systems that are core to the functioning of the securities markets or that represent "single points of failure" and thus, pose the greatest risk to the markets. The Commission believes that, as currently constituted, relative to the systems of SCI SROs, the systems of SCI ATSS generally would not fall within this category of critical SCI systems, and thus such SCI ATSS would not be subject to the more stringent requirements that would be applicable to the critical SCI systems of other SCI entities. The Commission also notes that other requirements under Regulation SCI are designed to be consistent with a risk-based approach. The Commission believes that this approach recognizes the different roles played by different SCI systems at various SCI entities and, where permitted, allows each SCI entity, including SCI ATSS, to tailor the applicable requirements accordingly.

While some commenters noted that ATSS have not contributed to any of the recent high-profile systems issues,¹⁰⁸ the Commission does not believe that the relative lack of high-profile

¹⁰⁸ See supra note 101 and accompanying text.

systems issues at ATSs to date is an indication that ATSs do not have the potential to have a significant impact on the market in the event of a future systems issue.¹⁰⁹

Other commenters noted the competitive environment of ATSs and argued that, if one ATS experiences a systems issue and becomes temporarily unavailable, trading can be easily rerouted to other venues.¹¹⁰ The Commission acknowledges that a temporary outage at an ATS (or at a SCI SRO, for that matter) may not lead to a widespread systemic disruption. However, the Commission notes that Regulation SCI is not designed to solely address system issues that cause widespread systemic disruption, but also to address more limited systems malfunctions and other issues that can harm market participants or create compliance issues.¹¹¹

Some commenters also stated that inclusion of ATSs is not necessary because ATSs are already subject to sufficient regulations as broker-dealers, citing Rule 15c3-5 under the Exchange Act, various FINRA rules, and Regulation ATS.¹¹² While the Commission acknowledges that these rules similarly impose requirements related to the capacity, integrity and/or security of a broker-dealer's systems and are designed to address some of the same concerns that Regulation SCI is intended to address, the Commission notes that these rules generally take a different approach than Regulation SCI. For example, the obligations of an ATS under Rule 15c3-5 address vulnerability in the national market system that relate specifically to

¹⁰⁹ The Commission also notes that, as discussed above, in November 2013, a systems issue at OTC Link ATS led FINRA to halt trading in all OTC securities for over three hours. See supra note 33 and accompanying text.

¹¹⁰ See ITG Letter at 3; and KCG Letter at 9.

¹¹¹ The Commission notes that each ATS provides different services in terms of, among other things, pricing, latency, and order fills to meet investors' specific needs. Thus, for example, an ATS outage could interfere with the supply of certain services that investors demand and, thus, could impose costs on investors.

¹¹² See supra notes 98-99 and accompanying text.

market access,¹¹³ whereas Regulation SCI is designed to further the goals of the national market system more broadly by helping to ensure the capacity, integrity, resiliency, availability, and security of the automated systems of entities important to the functioning of the U.S. securities markets.¹¹⁴ Thus, the Commission has determined to include ATSS within the scope of Regulation SCI because of their role as markets and a potential significant source of liquidity. With regard to the FINRA rules identified by commenters, the Commission does not believe that these rules, even when considered in combination with Rule 15c3-5, are an appropriate substitute for the comprehensive approach in Regulation SCI for ATSS in their role as markets.¹¹⁵ Finally,

¹¹³ See Securities Exchange Act Release No. 63241 (November 3, 2010), 75 FR 69792 (November 15, 2010) (“Market Access Release”).

¹¹⁴ The Commission notes that Rule 15c3-5 focuses on addressing the particular risks that arise when broker-dealers provide electronic access to exchanges or ATSS and therefore does not address the same range of technology-related issues as Regulation SCI is designed to address. Both Rule 15c3-5 and Regulation SCI are policies and procedures-based rules that are designed to address the risks presented by the pervasive use of technology in today’s markets. The policies and procedures required by Regulation SCI apply broadly to technology that supports trading, clearance and settlement, order routing, market data, market regulation, and market surveillance and, among other things, address their overall capacity, integrity, resilience, availability, and security. Rule 15c3-5, by contrast, is more narrowly focused on those technology and other errors that can create some of the more significant risks to broker-dealers and the markets, namely those that arise when a broker-dealer enters orders into an exchange or ATS, including when it provides sponsored or direct market access to customers or other persons, where the consequences of such an error can rapidly magnify and spread throughout the markets. See also *infra* note 115 (discussing FINRA rules applicable to broker-dealers). The Commission will continue to monitor and evaluate the risks posed by broker-dealer systems to the market and the implementation of the Market Access Rule, and may consider extending the types of requirements in Regulation SCI to additional market participants in the future.

¹¹⁵ For example, 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 relates to policies and procedures to achieve compliance with applicable securities laws and regulations, and thus the Commission

as noted above, Rule 301(b)(6) of Regulation ATS imposed by rule certain aspects of the ARP Policy Statements on significant-volume ATSS. As described in detail herein, Regulation SCI seeks to expand upon, update, and modernize the requirements of the ARP Policy Statements and Rule 301(b)(6), by, for example, expanding the requirements to a broader set of systems,

believes that this requirement is broadly related to adopted Rule 1001(b) regarding policies and procedures to ensure systems compliance. However, the Commission notes that, unlike adopted Rule 1001(b), which focuses on ensuring that an entity's systems operate in compliance with the Exchange Act, the rules and regulations thereunder and the entity's rules and governing documents, this NASD rule does not specifically address compliance of the systems of FINRA members. Further, the Commission does not believe this provision covers more broadly policies and procedures akin to those in adopted Rule 1001(a) that are designed to ensure that SCI systems have levels of capacity, integrity, resiliency, availability, and security adequate to maintain the SCI entity's operation capability and promote fair and orderly markets. Similarly, while FINRA Rule 3130 relates to adopted Rule 1001(b) regarding policies and procedures to ensure systems compliance in that it requires a member's chief compliance officer to certify that the member has in place written policies and procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules, and federal securities laws and regulations, it does not specifically address compliance of the systems of FINRA members, and does not require similar policies and procedures to those in adopted Rule 1001(a) regarding operational capability of SCI entities. Further, while FINRA Rule 4530 imposes a reporting regime for, among other things, compliance issues and other events where a member has concluded or should have reasonably concluded that a violation of securities or other enumerated law, rule, or regulation of any domestic or foreign regulatory body or SRO has occurred, the Commission notes that these reporting requirements are different in several respects from the Commission notification requirements relating to systems compliance issues (e.g., scope, timing, content, the recipient of the reports) and, importantly, would not cover reporting of systems disruptions or systems intrusions that did not also involve a violation of a securities law, rule, or regulation. In addition, FINRA Rule 4370 generally requires that a member maintain a written continuity plan identifying procedures relating to an emergency or significant business disruption, which is akin to adopted Rule 1001(a)(2)(v) requiring policies and procedures for business continuity and disaster recovery plans. Unlike Regulation SCI, however, the FINRA rule does not include the requirement that the business continuity and disaster recovery plans be reasonably designed to achieve next business day resumption of trading and two-hour resumption of critical SCI systems following a wide-scale disruption, nor does it require the functional and performance testing and coordination of industry or sector-testing of such plans, which the Commission believes to be instrumental in achieving the goals of Regulation SCI with respect to SCI entities.

imposing new requirements for information dissemination regarding SCI events, and requiring Commission notification for additional types of events, among others. Accordingly, the Commission believes that, for SCI ATSS, the existing broker-dealer rules and regulations identified by commenters are complemented by the requirements of Regulation SCI (other than Rule 301(b)(6), which will no longer apply to ATSS that trade NMS stocks and non-NMS stocks), and do not serve as substitutes for the regulatory framework being adopted today.

The Commission also believes that, unlike with respect to exchanges, it is appropriate that Regulation SCI not apply to all ATSS. Exchanges, as self-regulatory organizations, play a special role in the U.S. securities markets, and as such, are subject to certain requirements under the Exchange Act and are able to enjoy certain unique benefits.¹¹⁶ Accordingly, as discussed above, the Commission believes it is appropriate to subject all national securities exchanges to the requirements of Regulation SCI regardless of trading volume.¹¹⁷ In contrast, in recognition of the more limited role that certain ATSS may play in the securities markets and the costs that will result from compliance with the requirements of the regulation, the Commission believes that it is appropriate to adopt volume thresholds, as discussed below, to identify those ATSS that have the potential to significantly impact the market should an SCI event occur, therefore warranting inclusion within the scope of the regulation. One commenter, in advocating for the application of the regulation to all ATSS, stated that the Commission should not adopt volume

¹¹⁶ See supra Section IV.A.1.a (discussing the definition of "SCI SRO") and infra notes 120-121 and accompanying text. As identified by one commenter, benefits afforded to SROs include, among others, the ability to receive market data revenue and immunity from private liability for regulatory activities. See supra note 100. See also ATSS Release, supra note 2, at 70902-03 (discussing generally some of the obligations and benefits to be considered when determining whether to register as a national securities exchange or as a broker-dealer acting as an ATSS).

¹¹⁷ See supra notes 81-83 and accompanying text.

thresholds because ATSS may limit trading so as to avoid being subject to the requirements of Regulation SCI.¹¹⁸ The Commission does not believe that the possibility of some ATSS structuring their business to fall below the thresholds of the rule is a sufficient justification for applying the rule to all ATSS. The Commission notes that, to the extent that an ATSS limits its trading so as not to reach the volume thresholds for SCI ATSS, it would have less potential to impact investors and the market and may appropriately not be subject to the requirements of the rules. As discussed further below, the Commission believes that the dual dollar volume threshold for NMS stocks being adopted today is appropriately designed to ensure that ATSS that have either the potential to significantly impact the market as a whole or the potential to significantly impact the market for a single NMS stock (and have some impact on the market as a whole at the same time) will be subject to the requirements of Regulation SCI. Thus, only those ATSS that limit their trading so as to fall below both the single NMS stock threshold and the broad NMS stocks threshold will not be subject to the requirements of Regulation SCI.

As noted above, one commenter asserted that, if ATSS are subject to the same requirements of Regulation SCI as exchanges, they similarly should be entitled to the benefits afforded to SROs.¹¹⁹ The Commission notes that, as discussed above, SROs are subject to a variety of obligations as self-regulatory organizations under the Exchange Act—including filing proposed rules with the Commission and enforcing those rules and the federal securities laws with respect to their members—that do not apply to other market participants, including

¹¹⁸ See supra notes 95-96 and accompanying text.

¹¹⁹ See supra note 100 and accompanying text.

ATs.¹²⁰ Although SRO and non-SRO markets are subject to different regulatory regimes, with a different mix of benefits and obligations, the Commission believes it is appropriate to subject them to comparable requirements for purposes of Regulation SCI given the importance of assuring that the technology of key trading centers, regardless of regulatory status, is reliable, secure, and functions in compliance with the law.¹²¹ At the same time, while questions have been raised as to whether the broader regulatory regimes for exchanges and ATs should be harmonized, the Commission does not believe it appropriate to delay implementing Regulation SCI or necessary to resolve these issues before proceeding with Regulation SCI. The Commission notes that ATs have the ability to apply for registration as a SRO should they so wish and, if such application were to be approved by the Commission, such entities could assume the additional responsibilities that are imposed on SROs, as well as avail themselves of the same benefits.

As noted above, one commenter objected to the regulation's inclusion of ATs while excluding certain other entities that the commenter believed similarly had the potential to impact the market, concluding that the proposal was therefore arbitrary, capricious, and unfairly discriminatory in nature.¹²² At the same time, this commenter stated that it did not recommend

¹²⁰ See supra Section IV.A.1.a (discussing the definition of "SCI SRO"); see also Section 19(b) of the Exchange Act, 15 U.S.C. 78s(b)(1), and Section 6(b) of the Exchange Act, 15 U.S.C. 78f(b). Because these important regulatory responsibilities are imposed upon SROs, SROs also are afforded certain unique benefits, such as immunity from private liability with respect to their regulatory functions and the ability to receive market data revenue. See supra note 116 and accompanying text.

¹²¹ But see discussion supra regarding potentially different requirements for ATs and exchanges, including those relating to SCI ATs and critical SCI systems.

¹²² See supra note 103 and accompanying text.

that additional entities be included within the scope of the regulation.¹²³ First, as noted above, the Commission has determined to include ATSS meeting the adopted volume thresholds within the scope of Regulation SCI because of their unique role as markets rather than because of their role as traditional broker-dealers. All broker-dealers are subject to Rule 15c3-5 and other FINRA rules as noted by some commenters, which impose certain requirements related to the capacity, integrity and/or security of a broker-dealer's systems appropriately tailored to their role as broker-dealers. Further, as noted above, the scope of Regulation SCI is rooted in the historical reach of the ARP Inspection Program and Rule 301 of Regulation ATS (which applies to significant-volume ATSS).¹²⁴ The Commission acknowledged in the SCI Proposal that there may be other categories of broker-dealers not included within the definition of SCI entity that, given their increasing size and importance, could pose a significant risk to the market should an SCI event occur.¹²⁵ The Commission solicited comment on whether there are additional categories of market participants that should be subject to all or some of the requirements of Regulation SCI and noted that, were the Commission to decide to apply the requirements of Regulation SCI to such additional entities, it would issue a separate release outlining such a proposal and the rationale therefor.¹²⁶ As discussed above, the Commission believes that, at this time, the entities included within the scope of Regulation SCI, because of their current role in the U.S. securities markets and/or their level of trading activity, have the potential to pose the most significant risk in the event of a systems issue. Further, the Commission believes that a

¹²³ See supra note 103 and accompanying text.

¹²⁴ See supra notes 60-67 and accompanying text.

¹²⁵ See Proposing Release, supra note 13, at 18138-39.

¹²⁶ See id.

measured approach that takes an incremental expansion from the entities covered under the ARP Inspection Program is an appropriate method for imposing the mandatory requirements of Regulation SCI at this time. As such, while the Commission believes that the types of entities subject to Regulation SCI as adopted are appropriate, the Commission may consider extending the types of requirements in Regulation SCI to additional market participants in the future.

SCI ATS Thresholds

Several commenters discussed the specific proposed volume thresholds for SCI ATSS, and many offered what they believed to be more appropriate alternative methods for including ATSS within Regulation SCI.¹²⁷ For example, some commenters urged the Commission to retain the existing 20 percent threshold under Regulation ATS for purposes of Regulation SCI or asked the Commission to provide further explanation as to why the current threshold under Regulation ATS should be altered.¹²⁸ One commenter agreed with the Commission that the 20 percent threshold currently in Regulation ATS might be too high, and suggested using a threshold for ATSS trading NMS stocks of five percent or more of the volume in all NMS stocks during a 12-month period, to be determined once a year in the same given month.¹²⁹ Another commenter suggested that the Commission apply its ATS threshold for NMS stocks to only the 500 most active securities.¹³⁰ An additional recommendation by one commenter with regard to NMS stocks was to include only those ATSS with five percent or more of at least five NMS stocks with

¹²⁷ See, e.g., Direct Edge Letter at 2; SIFMA Letter at 6-7; BIDS Letter at 6; ITG Letter at 10; and OTC Markets Letter at 11. But see BlackRock Letter at 4 (agreeing with the Commission's approach in the SCI Proposal of lowering the thresholds for SCI ATSS from the thresholds in Rule 301(b)(6) of Regulation ATS).

¹²⁸ See, e.g., Direct Edge Letter at 2; and KCG Letter at 10-11.

¹²⁹ See SIFMA Letter at 6.

¹³⁰ See BIDS Letter at 6.

an aggregate average daily share volume greater than 500,000 shares and 0.25 percent or more of all NMS stocks for four of the previous six months, or those ATSs that have three percent or more of all NMS stocks in four of the previous six months.¹³¹ Another commenter suggested retaining Rule 301(b)(6) as part of Regulation ATS, but amending the rule by lowering the average daily volume threshold to 2.5 percent.¹³²

One commenter requested clarification on the phrase “0.25 percent or more in all NMS stocks, of the average daily dollar volume reported by an effective transaction reporting plan.”¹³³ Because there is more than one transaction reporting plan, this commenter asked whether the proposed volume thresholds would be calculated per plan or calculated based on all NMS volume.¹³⁴

Some commenters provided suggestions with regard to the proposed measurement methodology for the thresholds.¹³⁵ A few commenters argued that the proposed time period measurement of “at least four of the preceding six calendar months” is cumbersome to apply in practice and believed that the time period should be over a longer term.¹³⁶ For example, two commenters stated that the rule should utilize a 12-month measurement period.¹³⁷ Conversely, another commenter generally opposed the thresholds stating that all ATSs should be subject to

¹³¹ See ITG Letter at 10.

¹³² See OTC Markets Letter at 11. This commenter also suggested leaving in place the existing five percent average daily share volume threshold for the display requirement of Rule 301(b)(3) under Regulation ATS.

¹³³ See SIFMA Letter at 6-7.

¹³⁴ See SIFMA Letter at 6-7.

¹³⁵ See, e.g., BIDS Letter at 6; KCG Letter at 19; SIFMA Letter at 7; and Lauer Letter at 4-5.

¹³⁶ See, e.g., BIDS Letter at 6; and KCG Letter at 19.

¹³⁷ See BIDS Letter at 6; and KCG Letter at 19.

the rule, but noted that if the rule includes a trading volume metric, the measurement period should be much shorter (such as two to four weeks).¹³⁸ In addition, one commenter stated that the measurement should be based on number of shares traded rather than dollar value.¹³⁹

Two commenters also suggested that ATSS should be given six months after meeting the given threshold in the definition of SCI ATS to come into compliance with Regulation SCI.¹⁴⁰

The Commission is adopting the thresholds for ATSS that trade NMS stocks and non-NMSs stock as proposed. In setting the thresholds for Regulation SCI, the Commission believes it is establishing an appropriate and reasonable scope for the application of the regulation. Although commenters provided various suggestions for different thresholds, nothing persuaded the Commission that these suggestions would better accomplish the goals of Regulation SCI than the thresholds the Commission is adopting. As discussed below, the Commission has analyzed the number of entities it believes are likely to be covered by the thresholds it is establishing. The Commission recognizes that these thresholds ultimately represent a matter of judgment by the Commission as it takes the step of promulgating Regulation SCI, and the Commission intends to monitor these thresholds to determine whether they continue to be appropriate.

With regard to the threshold for ATSS trading NMS stocks, the Commission has determined to adopt this threshold as proposed. After careful consideration of the comments, the Commission continues to believe that this threshold is an appropriate measure of when a market is of sufficient significance so as to warrant the protections and requirements of Regulation

¹³⁸ See Lauer Letter at 4-5.

¹³⁹ See BIDS Letter at 6.

¹⁴⁰ See KCG Letter at 19; and SIFMA Letter at 7.

SCI.¹⁴¹ The Commission is, however, making one technical modification in response to a commenter to clarify that the threshold will be calculated based on all NMS volume, rather than on a per plan basis.¹⁴² The Commission agrees with the commenter that the proposed language should be clarified and, as such, the threshold language within the definition of “SCI ATS” in Rule 1000 is being revised to refer to “applicable effective transaction reporting plans,” rather than “an effective transaction reporting plan.”¹⁴³

Under the adopted definition of SCI ATS, with regard to NMS stocks, an ATS will be subject to Regulation SCI if, during at least four of the preceding six calendar months, it had: (i) five percent or more in any single NMS stock, and 0.25 percent or more in all NMS stocks, of the average daily dollar volume reported by applicable effective transaction reporting plans, or (ii) one percent or more, in all NMS stocks, of the average daily dollar volume reported by

¹⁴¹ The numerical thresholds in the definition of SCI ATS reflect an informed assessment by the Commission, based on qualitative and quantitative analysis, of the likely economic consequences of the specific numerical thresholds included in the definition. In making such assessment and, in turn, selecting the numerical thresholds, in addition to considering the views of commenters, the Commission has reviewed relevant data. See infra notes 150 and 175 and accompanying text.

¹⁴² See supra note 134 and accompanying text. As noted above, this commenter asked the Commission for clarification on this aspect of the rule.

¹⁴³ Because the threshold has two prongs, one of which is based on all NMS volume, it is necessary to specify that there is more than one transaction reporting plan that would be applicable in calculating all NMS stock trading volume. At the same time, since the other prong of the threshold is based on the trading volume of single NMS stocks, it is necessary to also add the term “applicable” before the term “transaction reporting plans” as only one transaction reporting plan would be applicable per security. The definition of “eligible securities” in each of the transaction reporting plans are mutually exclusive, ensuring that each security is subject to only one transaction reporting plan. See CTA Plan, available at: <http://www.nyxdata.com/cta>; and Nasdaq UTP Plan, available at: <http://www.utpplan.com>.

applicable effective transaction reporting plans.¹⁴⁴ The Commission continues to believe that this threshold will identify those ATSS that could have a significant impact on the overall market or that could have a significant impact on a single NMS stock and some impact on the market as a whole at the same time.¹⁴⁵

While some commenters advocated for thresholds higher than those proposed and/or retaining the 20 percent threshold in Regulation ATS,¹⁴⁶ as the Commission discussed in the SCI Proposal, the securities markets have significantly evolved since the time of the adoption of Regulation ATS, resulting in trading activity in stocks being more dispersed among a variety of trading centers. For example, in today's markets, national securities exchanges, once the predominant type of venue for trading stocks, each account for no more than approximately 19 percent of volume in NMS stocks.¹⁴⁷ By way of contrast, based on data collected from ATSS pursuant to FINRA Rule 4552 for 18 weeks of trading in 2014, the trading volume of ATSS accounted for approximately 18 percent of the total dollar volume in NMS stocks, with no individual ATS executing more than five percent.¹⁴⁸ Given this dispersal of trading volume among an increasing number of trading venues, the increasingly interconnected nature of the markets, and the increasing reliance on a variety of automated systems, the Commission believes that there is a heightened potential for systems issues originating from a number of sources to

¹⁴⁴ But see infra notes 169-170 and accompanying text (discussing a six-month compliance period for SCI entities satisfying the thresholds for the first time).

¹⁴⁵ Under the adopted thresholds, because of the requirement to meet the threshold for at least four of the preceding six calendar months, inactive and newly operating ATSS would not be included in the definition of SCI ATS. See infra note 152.

¹⁴⁶ See supra note 128 and accompanying text.

¹⁴⁷ See supra note 106.

¹⁴⁸ See infra note 150.

significantly affect the market. Due to these developments, the Commission believes that the 20 percent threshold as adopted in Regulation ATS is no longer an appropriate measure for determining those entities that can have a significant impact on the market and thus should be subject to the protections of Regulation SCI. Rather, the Commission believes that lower volume thresholds are appropriate, and as noted in the SCI Proposal, the Commission believes that the adopted thresholds would include ATSS having NMS stock dollar volume comparable to or in excess of the NMS stock dollar volume of certain national securities exchanges subject to Regulation SCI.¹⁴⁹

Based on data collected from ATSS pursuant to FINRA Rule 4552 for 18 weeks of trading in 2014,¹⁵⁰ the Commission believes that approximately 12 ATSS trading NMS stocks would exceed the adopted thresholds and fall within the definition of SCI entity, accounting for approximately 66 percent of the dollar volume market share of all ATSS trading NMS stocks.¹⁵¹

¹⁴⁹ See Proposing Release, supra note 13, at 18094.

¹⁵⁰ See Securities Exchange Act Release No. 71341 (January 17, 2014), 79 FR 4213 (January 24, 2014) (approving FINRA Rule 4552 requiring each ATS to report to FINRA weekly volume information and number of securities transactions). Commission staff analyzed FINRA ATS data for the period of May 19, 2014 through September 19, 2014. The recently available FINRA ATS data is consistent with the OATS data used in the SCI Proposal. In addition, the analysis of FINRA ATS data examines a threshold of trading volume over four out of six time periods, each period defined as a period of three consecutive weeks as a rough approximation of the threshold test on four out of the preceding six calendar months as prescribed in the definition of SCI ATS. The Commission noted in the SCI Proposal that the staff analysis of OATS data may overestimate the number of ATSS that may meet the proposed thresholds. While the calculation based on FINRA ATS data may not overestimate the number of ATSS as much as the data analysis in the proposal, it could still overestimate the number of ATSS that would meet the thresholds. Nevertheless, the Commission believes the analysis of FINRA ATS data offers useful insights. See Proposing Release, supra note 13, at 18094.

¹⁵¹ According to the FINRA ATS data, during this time period, a total of 44 ATSS traded NMS stocks. The Commission notes that the number of ATSS exceeding the adopted

The Commission acknowledges that its analysis of the FINRA ATS data did not reveal an obvious threshold level above which a particular subset of ATSs may be considered to have a significant impact on individual NMS stocks or the overall market, as compared to another subset of ATSs. However, for the following reasons, the Commission continues to believe that the adopted thresholds for ATSs trading NMS stock are an appropriate measure to identify those ATSs that should be subject to the requirements of Regulation SCI. First, by imposing both a single NMS stock threshold and an all NMS stocks threshold in the first prong of the definition, the thresholds will help to ensure that Regulation SCI will not apply to an ATS that has a large volume in a small NMS stock and little volume in all other NMS stocks. At the same time, the Commission believes that inclusion of the dual-prong dollar volume thresholds is appropriate. Specifically, it will require not only that ATSs that have significant trading volume in all NMS stocks are subject to the requirements of Regulation SCI, but also that ATSs that have large trading volume in a single NMS stock and could significantly affect the market for that stock are also covered by the safeguards of Regulation SCI provided they have levels of trading in all NMS stocks that could allow such ATSs to also have some impact on the market as a whole. The Commission also believes that, as discussed further below, the adopted thresholds will also appropriately capture not only ATSs that have significant trading volume in active stocks, but also those that have significant trading volume in less active stocks. The Commission believes that a systems issue at an ATS that is a significant market for the trading of a less actively traded stock could similarly impose significant risks to the market for such securities, because a systems outage at such a venue could significantly impede the ability to trade such securities, thereby

thresholds, and the percentage of volume of trading in NMS stocks that they represent, may change over time in response to market and competitive forces.

having a significant impact on the market for such less-actively traded securities. In addition, the Commission continues to believe that thresholds that account for 66 percent of the dollar volume market share of all ATSS trading NMS stocks is a reasonable level that would not exclude new entrants to the ATS market.¹⁵² Further, as noted above, the thresholds would include ATSS having NMS stock dollar value comparable to the NMS stock dollar volume of the equity exchanges subject to Regulation SCI. Finally, the Commission believes that the adopted thresholds are appropriate to help ensure that entities that have determined to participate (in more

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Consistent with the Commission's statement in the SCI Proposal, the Commission has considered barriers to entry and the promotion of competition in setting the threshold such that new ATSS trading NMS stocks would be able to commence operations without, at least initially, being required to comply with – and thereby not incurring the costs associated with – Regulation SCI. See Proposing Release, *supra* note 13, at n. 102. In particular, a new ATS could engage in limited trading in any one NMS stock or all NMS stocks, until it reached an average daily dollar volume of five percent or more in any one NMS stock and 0.25 percent or more in all NMS stocks, or one percent in all NMS stocks, over four of the preceding six months. Because a new ATS could begin trading in NMS stocks for at least three months (*i.e.*, less than four of the preceding six months), and conduct such trading at any dollar volume level without being subject to Regulation SCI, and would have to exceed the specified volume levels for the requisite period to become so subject, the Commission believes that these thresholds should not prevent a new ATS entrant from having the opportunity to initiate and develop its business. Further, the Commission notes that, as discussed below, it is adopting an additional six-month compliance period (in addition to the general nine-month compliance period from the Effective Date of Regulation SCI afforded to all SCI entities) for ATSS newly meeting the thresholds, so that once an ATS meets the threshold, it will have six months from that time to become fully compliant with Regulation SCI. See *infra* Section IV.F (discussing effective dates and compliance periods). The Commission believes that, for ATSS that have newly entered the market, this additional compliance period will give such ATSS additional opportunity to develop and grow their business without incurring the costs of compliance with Regulation SCI during this time. This additional compliance period should also provide such ATSS with time to plan on how they would meet the requirements of Regulation SCI, and could also potentially allow SCI ATSS to become more equipped to bear the cost of Regulation SCI once compliance is required, and thus not significantly discourage new ATSS from entering the market and growing. See *infra* Section VI.C.1.c (discussing further barriers to entry and the potential effects on competition of the adopted thresholds).

than a limited manner) in the national market system as markets that bring buyers and sellers together, are subject to the requirements of Regulation SCI.

As noted above, several commenters provided specific suggestions for alternative standards for determining which ATSS should be included within the scope of Regulation SCI.¹⁵³ While the Commission recognizes that some of the suggested alternatives could have certain benefits, it also believes that each recommended standard also has corresponding limitations, and thus believes that the adopted thresholds are an appropriate measure for identifying those ATSS that should be subject to Regulation SCI. First, as described above, the Commission believes that adopting a two-prong standard is necessary to identify those ATSS that, in the event of a systems issue, could have a significant impact on the overall market or that could have a significant impact on a single NMS stock and some impact on the market as a whole at the same time. The Commission notes that several of the thresholds suggested by commenters lacked such a dual-prong standard (and, in particular, the prong relating to individual NMS stocks) and thus do not provide the advantages associated with the adopted threshold in protecting the trading venues for a single NMS stock. With regard to one commenter's suggestion that the first prong of the threshold should, among other things, consider five NMS stocks, rather than a single stock, the Commission does not believe the commenter has provided any clear rationale for this standard.¹⁵⁴ As discussed, the purpose of the first prong is to identify significant trading venues (or markets) for a single security where a systems disruption could have a significant effect on

¹⁵³ See supra notes 127-132 and accompanying text.

¹⁵⁴ See supra note 131 and accompanying text. This commenter argued generally that the thresholds should be revised so as to only include those entities that would have an "immediate and substantial impairment of a functioning marketplace." However, the commenter did not explain why it advocated the use of five NMS stocks, rather than a single NMS stock. See ITG Letter at 9.

the market for that security, and setting the threshold to consider five NMS securities could potentially exclude trading venues that host large trading activity for a single NMS security. Additionally, the Commission notes that the suggested alternative approach would be unlikely to have any significant practical effect when used in conjunction with the second prong of the threshold, which looks at trading across all NMS stocks, because the second prong would likely capture an ATS with five percent or more volume in five NMS stocks. With regard to one commenter's suggestion to apply the threshold to only the 500 most active NMS stocks¹⁵⁵ and another commenter's suggestion to include only stocks with an aggregate average daily share volume greater than 500,000,¹⁵⁶ the Commission disagrees that the threshold should be structured to capture only ATSS that have significant trading volume in active stocks. Rather, the first prong of the adopted threshold is designed to capture any ATS that has five percent or more of the trading volume of any NMS stock, irrespective of how actively traded it is, so that Regulation SCI can effectively address risks relating to the trading of all NMS stocks, and not only the most active of NMS stocks. If the Commission were to apply the threshold only to the 500 most active NMS stocks or stocks only with average daily share volumes greater than 500,000, an ATS that, for example, served as the primary venue for the trading of less actively traded NMS stocks, but had negligible market share for more actively traded NMS stocks, would not be subject to Regulation SCI. However, an SCI event that resulted in an outage of such an ATS could have a significant impact on the market for such less actively traded NMS stocks. As such, failure to include such an ATS within the scope of Regulation SCI would be contrary to the goals of the regulation. Finally, with regard to one commenter's suggestion to retain Rule

¹⁵⁵ See supra note 130 and accompanying text.

¹⁵⁶ See supra note 131 and accompanying text.

301(b)(6) as part of Regulation ATS and amend the threshold to 2.5 percent,¹⁵⁷ as discussed throughout this release, Regulation SCI is intended to expand upon the requirements of Rule 301(b)(6) and to supersede and replace such requirements for ATSS that trade NMS stocks.¹⁵⁸ For the reasons noted above, the Commission believes it is appropriate to include ATSS meeting the adopted volume thresholds within the scope of Regulation SCI, and the Commission does not believe it is appropriate to retain Rule 301(b)(6) as part of Regulation ATS, thereby subjecting ATSS to a separate and differing set of regulatory requirements than other SCI entities with regard to systems capacity, integrity, resiliency, availability, security, and compliance.¹⁵⁹ For all of the reasons discussed above, the Commission does not believe that any of the alternative standards suggested by commenters would better capture those entities that have the potential to pose significant risk to the market.

One commenter urged the Commission to utilize number of shares traded rather than dollar value, stating that while most of the world uses value traded, available data for the U.S. equity markets is share-based.¹⁶⁰ The Commission disagrees with this commenter and notes that daily dollar volume is readily available from a number of sources, including the SIPs.¹⁶¹

¹⁵⁷ See supra note 132 and accompanying text.

¹⁵⁸ But see infra notes 189-192 and accompanying text (discussing the Commission's determination to retain the applicability of Rule 301(b)(6) to fixed-income ATSS).

¹⁵⁹ The Commission notes that, with regard to the specific threshold level suggested by this commenter (2.5%), the Commission believes the adopted thresholds to be an appropriate measure to identify those ATSS that should be subject to the requirements of Regulations SCI for the reasons discussed above. See supra note 141.

¹⁶⁰ See supra note 139 and accompanying text.

¹⁶¹ See also Proposing Release, supra note 13, at 18094 (stating that the use of dollar thresholds may better reflect the economic impact of trading activity).

The time measurement period for ATSS that trade NMS stocks and non-NMS stocks is also being adopted as proposed. Thus, ATSS will be subject to Regulation SCI only if they meet the numerical thresholds for at least four of the preceding six months.¹⁶² The Commission notes that the adopted time measurement period is consistent with the current standard in Rule 301(b)(6) of Regulation ATS.¹⁶³ The Commission believes that this time measurement period is an appropriate time period over which to evaluate the trading volume of an ATS and should help to ensure that it does not capture ATSS with relatively low trading volume that may have had an anomalous increase in trading on a given day or few days. Contrary to concerns raised by some commenters,¹⁶⁴ under this time measurement methodology, an ATS would not qualify as an SCI entity simply by trading a single large block of an illiquid security during one month (or even two or three months). While one commenter suggested that the time measurement period be shorter and recommended a period of two to four weeks,¹⁶⁵ the Commission believes that this could cause ATSS to fall within the scope of the definition solely as a result of an atypical, short-term increase in trading or a small number of large block trades that is not reflective of ATSS' general level of trading. Specifically, with such a short period of measurement, a short-term spike in trading volume uncharacteristic of an ATS's overall trading volume history could (and if large enough, likely would) skew the overall trading volume for that time period, causing an

¹⁶² See adopted Rule 1000 (definition of "SCI ATS"). The Commission notes that if an ATS that was not previously subject to Regulation SCI meets the SCI ATS volume threshold for four consecutive months, it would become subject to Regulation SCI at the end that four-month period. However, as discussed further below, such an ATS would have an additional six months from that time to comply with the requirements of Regulation SCI. See *infra* text accompanying notes 169-170.

¹⁶³ 17 CFR 242.301(b)(6).

¹⁶⁴ See, e.g., BIDS Letter at 6.

¹⁶⁵ See *supra* note 138 and accompanying text.

ATS to meet the volume thresholds and thus become subject to Regulation SCI even though the overall risk posed by the ATS does not warrant it. Further, the Commission believes that such a shorter time measurement period could provide more barriers to entry for ATSs, because new ATSs would not have as long of a time period to develop their business prior to having to incur the costs of compliance associated with being subject to the requirements of Regulation SCI.¹⁶⁶ This potential to incur such costs almost immediately after the initial start of operations could act as a barrier to entry for some new ATSs.

Other commenters recommended a longer measurement period, such as 12 months.¹⁶⁷ The Commission does not believe, however, that a longer time period is necessary or more appropriate to identify those entities that play a significant role in the market for a particular asset class and/or that have the potential to significantly impact investors or the market, warranting inclusion in the scope of Regulation SCI. The Commission believes that the adopted time measurement period provides sufficient trading history data so as to indicate an ATS's significance to the market, and that the structure of the test (i.e., requiring an ATS to meet the threshold for four out of six months) ensures sustainability of such trading levels. In addition, modifying the time measurement period to 12 months (and thus eliminating the four out of six

¹⁶⁶ See supra note 152 and accompanying text. See also infra Section VI.C.1.c (discussing barriers to entry and the effects on competition of the adopted thresholds and time measurement period for SCI ATSs).

¹⁶⁷ See supra notes 136-137 and accompanying text. One of these commenters noted that the "four out of the preceding six months" measurement is cumbersome to apply in practice. See KCG Letter at 19. The Commission does not believe this measurement period to be overly cumbersome to apply in practice, as it would require only that an ATS undertake an assessment once at the end of each month as to whether the ATSs had exceeded the volume thresholds set forth in the rule and then make a determination at the end of a six month period whether the ATS met this threshold for four out of the six preceding months.

month measurement period) would make such a measure more susceptible to capturing ATSs that have a major but isolated spike in trading during a single month. Specifically, as noted above, a single anomalous large increase in trading volume during one month (or such a spike in two or three months) could never result in an ATS becoming subject to Regulation SCI solely as a result of such a spike in trading, because the ATS would meet the threshold only for one month, rather than the four months required by the rule. On the other hand, a threshold based on an average over 12 months could be skewed by the occurrence of one large spike in trading that results in the overall average for the 12-month period being increased to such a level that it meets the volume threshold levels. Thus, contrary to one commenter's suggestion that a 12-month period would require "a sustained trading level at the threshold,"¹⁶⁸ the Commission believes that the structure of the adopted measurement period test (i.e., four out of six months) may be a better indicator of actual sustained trading levels at the threshold warranting the protections of the rule. Further, the Commission believes that 12 months is a less appropriate time measurement period than the period adopted because, for example, an ATS could have significant trading volume early on during such a time period such that it may pose significant risk to the markets in the event of a systems issue at such an ATS without being subject to Regulation SCI for a significant period of time. The Commission believes that the adopted time period strikes an appropriate balance between being a long enough period so as to not be triggered by atypical periods of increased trading or a few occurrences of very large trades, while also not causing unnecessary delay in requiring that ATSs playing an important role in the market are subject to Regulation SCI.

¹⁶⁸ See KCG Letter at 19. See also supra notes 136-137 and accompanying text.

Finally, as discussed further in Section IV.F, the Commission agrees with commenters that it is appropriate to provide ATSS meeting the volume thresholds in the definition of SCI ATS for the first time a period of time before they are required to comply with Regulation SCI.¹⁶⁹ Thus, consistent with the recommendation of these commenters, the Commission is revising the definition of SCI ATS to provide that an SCI ATS will not be required to comply with the requirements of Regulation SCI until six months after satisfying any of the applicable thresholds in the definition of SCI ATS for the first time.¹⁷⁰

ATSS Trading Non-NMS Stocks

Some commenters addressed whether Regulation SCI should apply to ATSS trading non-NMS stocks.¹⁷¹ Specifically, one commenter stated that the rules should apply only to trading in NMS securities because non-NMS stock trading—which is dispersed among broker-dealers—does not have a single point of failure and is therefore less susceptible to rapid, widespread issues that occur as a result of a high degree of linkage or inter-dependency.¹⁷² Another commenter stated that, with respect to non-NMS stocks (as well as municipal securities and corporate debt securities), the proposed five percent threshold was too low and would unnecessarily include ATSS for these product types that are “not systemic to maintaining fair,

¹⁶⁹ See *supra* note 140 and accompanying text.

¹⁷⁰ See Rule 1000 (definition of SCI ATS, paragraph (c)).

¹⁷¹ See, e.g., OTC Markets Letter at 7; SIFMA Letter at 7; TMC Letter at 1-3 (asserting that retail fixed-income ATSS should not be subject to Regulation SCI); and KCG Letter at 3, 10-11.

¹⁷² See OTC Markets Letter at 7.

orderly, and efficient markets” and asked the Commission to further study the appropriate threshold for these ATSS.¹⁷³

With regard to equity securities that are not NMS stocks and for which transactions are reported to a self-regulatory organization, the adopted thresholds remain unchanged from the SCI Proposal. Thus, for such securities, an ATS will be subject to the requirements of Regulation SCI if, during four of the preceding six calendar months, it had five percent or more of the average daily dollar volume as calculated by the self-regulatory organization to which such transactions are reported.¹⁷⁴ The Commission continues to believe that this threshold will appropriately identify ATSS that play a significant role in the market for those securities and, thus, should be subject to the requirements of Regulation SCI.

Using data from the second quarter of 2014, an ATS executing transactions in non-NMS stocks at a level exceeding five percent of the average daily dollar volume traded in the United States would be executing trades at a level exceeding \$45.2 million daily.¹⁷⁵ Based on data collected from Form ATS-R for the second quarter of 2014, the Commission estimates that two ATSS would exceed this threshold and fall within the definition of SCI entity, accounting for approximately 99 percent of the dollar volume market share of all ATSS trading non-NMS

¹⁷³ See SIFMA Letter at 7.

¹⁷⁴ However, as noted above, an ATS meeting the definition of SCI ATS for the first time will be afforded a six-month compliance period. See supra notes 169-170 and accompanying text.

¹⁷⁵ In the Proposing Release, the Commission used data from the first six months of 2012 to estimate that an ATS executing transactions in non-NMS stocks at a level exceeding five percent of the average daily volume traded in the United States would be executed trades at a level exceeding \$31 million daily. See Proposing Release, supra note 13, at n.111 and accompanying text. The Commission has updated this estimate using over-the-counter reporting facility data available from FINRA.

stocks.¹⁷⁶ These thresholds reflect an assessment by the Commission, based on qualitative and quantitative analysis, of the likely consequences of the specific quantitative thresholds included in the definition. From this analysis and in conjunction with considering the views of commenters, the Commission has derived what it believes to be an appropriate threshold to identify those ATs that should be subject to the requirements of Regulation SCI.

As discussed above, one commenter objected to the inclusion of ATs trading non-NMS stocks within the scope of Regulation SCI.¹⁷⁷ This commenter argued that non-NMS trading is not susceptible to the issues that Regulation SCI is designed to address because such trading is dispersed among broker-dealers and does not create the types of single points of failure that pose widespread systemic risk.¹⁷⁸ First, as noted above, while the Commission is particularly concerned with systems issues that pose the greatest risk to our markets and have the potential to cause the most widespread effects and damage (such as those that are single points of failure), Regulation SCI is intended to address a broader set of risks of systems issues. Accordingly, the adopted threshold for non-NMS stock ATs is designed to identify those ATs that play a significant role in the market for such securities. Further, the Commission disagrees with the commenter's assertion that trading in non-NMS stocks cannot result in widespread disruptions.¹⁷⁹

¹⁷⁶ The Commission notes that the number of ATs exceeding the adopted threshold, and the percentage of volume of trading in non-NMS stocks that they represent, may change over time in response to market and competitive forces.

¹⁷⁷ See supra note 172 and accompanying text.

¹⁷⁸ See id.

¹⁷⁹ See supra note 33 and accompanying text.

While one commenter stated that the five percent threshold was too low, this commenter did not provide an alternative threshold but rather asked the Commission to further study this issue.¹⁸⁰ As noted above, based on qualitative and quantitative analysis, the Commission believes the five percent threshold to be an appropriate measure to determine which ATs are of sufficient significance in the current market for non-NMS stocks to warrant their inclusion within the scope of Regulation SCI. The Commission notes that it intends to monitor the level of this threshold, and other thresholds being adopted today, to ensure that they continue to be appropriate.

The Commission notes that adoption of a higher threshold for non-NMS stocks than for NMS stocks reflects the Commission's acknowledgement of certain differences between the two markets. In particular, as noted in the SCI Proposal, while the Commission believes that similar concerns about the trading of NMS stocks on ATs apply to the trading of non-NMS stocks, the Commission also believes that certain characteristics of the market for non-NMS stocks, such as the lower degree of automation, electronic trading, and interconnectedness, generally result in an overall lower risk to the market in the event of a systems issue.¹⁸¹ In particular, the Commission believes that a systems issue at an SCI entity that trades non-NMS stocks would not be as likely to have as significant or widespread an impact as readily as a systems issue at an SCI entity that trades NMS stocks. Therefore, the Commission believes that there is less risk of market impact in the markets for those securities at this time. As such, the Commission has determined not to adopt the same, more stringent, thresholds that would trigger the requirements of Regulation SCI that the Commission is adopting for ATs trading NMS stocks. The Commission also believes

¹⁸⁰ See supra note 173.

¹⁸¹ See Proposing Release, supra note 13, at 18096.

that imposition of a threshold that is set too low in markets that lack automation could have the unintended effects of discouraging automation in these markets and discouraging new entrants into these markets. Specifically, it could increase the cost of automation in relation to other methods of executing trades, and thus market participants might make a determination that the costs associated with becoming subject to Regulation SCI preclude a shift to automated trading or the development of a new automated trading system, particularly given the expected lower trading volume when beginning operations. Further, the Commission notes that it has traditionally provided special safeguards with regard to NMS stocks in its rulemaking efforts relating to market structure.¹⁸² For these reasons, the Commission believes that it is appropriate at this time to apply a different threshold to ATSS trading NMS stocks than those ATSS trading non-NMS stocks.

ATSS Trading Fixed-Income Securities

Several commenters specifically addressed the inclusion of municipal security and corporate debt security ATSS within the scope of Regulation SCI, stating that these ATSS should not be subject to Regulation SCI or that the proposed thresholds should be modified.¹⁸³ These commenters identified differences in the nature of fixed-income trading as compared to the markets for NMS securities and concluded that the thresholds were inappropriate and would be detrimental to the market for these types of securities.¹⁸⁴ In particular, commenters stated that inclusion of fixed-income ATSS and/or the adoption of the proposed thresholds would impose

¹⁸² See, e.g., Regulation NMS, 17 CFR 242.600-612; Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 27496 (June 29, 2005) (Regulation NMS Adopting Release).

¹⁸³ See, e.g., SIFMA Letter at 7; TMC Letter at 1-3; and KCG Letter at 2-3, 10-11.

¹⁸⁴ See, e.g., SIFMA Letter at 7; TMC Letter at 1-3; and KCG Letter at 2-3, 10-11.

unduly high costs on these entities given their size, scope of operations, lack of automation, low speed, and resulting low potential to pose risk to systems.¹⁸⁵ Further, one commenter noted that the cost of compliance for these types of entities would discourage the shift from manual fixed-income trading in the OTC markets to more transparent and efficient automated trading venues.¹⁸⁶

In addition, one commenter stated that if retail fixed-income ATSS are included in the final rule, a better measurement would be to look at par amount traded rather than volume.¹⁸⁷ Finally, one commenter requested that the Commission clarify that ATSS relating to listed-options are not subject to the obligations of proposed Regulation SCI.¹⁸⁸

While the adopted definition of SCI ATS remains unchanged from the proposal for NMS stocks and non-NMS stocks, the Commission, after considering the views of commenters, has determined to exclude ATSS that trade only municipal securities or corporate debt securities from the definition of SCI ATS at this time.¹⁸⁹ Accordingly, such fixed-income ATSS will not be subject to the requirements of Regulation SCI. Rather, fixed-income ATSS will continue to be subject to the existing requirements in Rule 301(b)(6) of Regulation ATS regarding systems capacity, integrity and security if they meet the twenty percent threshold for municipal securities or corporate debt securities provided by that rule.¹⁹⁰ The Commission believes that this change

¹⁸⁵ See, e.g., SIFMA Letter at 7; TMC Letter at 1-3; and KCG Letter at 2-3, 10-11.

¹⁸⁶ See KCG Letter at 3, 10-11 (noting that the vast majority of fixed-income trades are done in the OTC markets and only a few ATSS for the fixed-income market have emerged in recent years).

¹⁸⁷ See TMC Letter at 1-3.

¹⁸⁸ See LiquidPoint Letter at 2-3.

¹⁸⁹ See *supra* notes 183-186.

¹⁹⁰ See 17 CFR 242.301(b)(6).

is warranted given the unique nature of the current fixed-income markets, as noted by several commenters. In particular, fixed-income markets currently rely much less on automation and electronic trading than markets that trade NMS stocks or non-NMS stocks.¹⁹¹ In addition, the municipal and corporate fixed-income markets tend to be less liquid than the equity markets, with slower execution times and less complex routing strategies.¹⁹² As such, the Commission believes that a systems issue at a fixed-income ATS would not have as significant or widespread an impact as in other markets. Thus, while ensuring the capacity, integrity and security of the systems of fixed-income ATSs is important, the benefits of lowering the threshold applicable to fixed-income ATSs from the current twenty percent threshold in Regulation ATS and subjecting such ATSs to the safeguards of Regulation SCI would not be as great as for ATSs that trade NMS stock or non-NMS stock. As commenters pointed out, the cost of the requirements of Regulation SCI could be significant for fixed-income ATSs relative to their size, scope of operations, and more limited potential for systems risk. The Commission is cognizant that lowering the current threshold applicable to fixed-income ATSs in Regulation ATS and subjecting such ATSs to the requirements of Regulation SCI could have the unintended effect of discouraging automation in these markets and discouraging the entry of new fixed-income ATSs

¹⁹¹ See, e.g., *supra* notes 183-186 and accompanying text (discussing the unique nature of fixed-income trading). See also Tracy Alloway and Michael Mackenzie, "Goldman Retreats from Bond Platform," *Fin. Times*, February 17, 2014 (noting that, despite efforts to make the market for bond trades more electronic, large bond trading continues to occur overwhelmingly by 'voice-brokered' transactions); and Lisa Abramowicz, "Humans Beat Machines as Electronic Trading Slows: Credit Markets," *Bloomberg*, February 19, 2014 (stating that a shift in corporate bond transactions to electronic systems is failing to keep up with total volume).

¹⁹² See, e.g., TMC Bonds Letter at 1 (stating that fixed-income markets have significantly lower volumes and slower execution times than equity markets and have no meaningful connectivity between fixed-income ATS participants).

into the market, which could impede the evolving transparency and efficiency of these markets and negatively impact liquidity in these markets.

For these reasons, the Commission believes that it is appropriate to continue to apply the requirements in Rule 301(b)(6) of Regulation ATS to fixed-income ATSs that meet the volume thresholds of that rule and to exclude ATSs that trade only municipal securities or corporate debt securities from the scope of Regulation SCI at this time.

c. Plan Processor

Under Proposed Rule 1000(a), the term “plan processor” had the meaning set forth in Rule 600(b)(55) of Regulation NMS, which defines “plan processor” as “any self-regulatory organization or securities information processor acting as an exclusive processor in connection with the development, implementation and/or operation of any facility contemplated by an effective national market system plan.”¹⁹³ The Commission is adopting the definition of “plan processor” as proposed.¹⁹⁴

The Commission received no comments on the proposed definition of “plan processor.”¹⁹⁵ As noted in the SCI Proposal, the ARP Inspection Program included the systems of the plan processors of four national market system plans—the CTA Plan, CQS Plan, Nasdaq

¹⁹³ See 17 CFR 242.600(b)(55).

¹⁹⁴ See proposed Rule 1000(a) and Proposing Release supra note 13, at Section III.B.1.

¹⁹⁵ However, some commenters did support the overall scope of the term “SCI entity” or agreed specifically that plan processors should be included within the definition of that term. See, e.g., Lauer Letter at 3 (urging the Commission to expand the scope of entities covered) and KCG Letter at 5-6 (recommending that Regulation SCI be targeted to services offered by only one or a few entities, such as plan processors). In addition, one commenter, although commenting specifically on the definition of “SCI system,” stated that Regulation SCI should be tailored to focus only on systems impacting the core functions of the overall market, which should include the exclusive SIPs that transmit market data. See OTC Markets Letter at 12-13.

UTP Plan, and OPRA Plan.¹⁹⁶ Although an entity selected as the processor of an SCI Plan acts on behalf of a committee of SROs, such entity is not required to be an SRO, nor is it required to be owned or operated by an SRO.¹⁹⁷ The Commission believes, however, that the systems of

¹⁹⁶

See ARP I Release, *supra* note 1, at n. 8 and n. 17. Each of the CTA Plan, CQS Plan, Nasdaq UTP Plan, and OPRA Plan, is a "national market system plan" ("NMS Plan") as defined under Rule 600(a)(43) of Regulation NMS under the Exchange Act, 17 CFR 242.600(a)(43). Rule 600(a)(55) of Regulation NMS under the Exchange Act, 17 CFR 242.600(a)(55), defines a "plan processor" as "any self-regulatory organization or securities information processor acting as an exclusive processor in connection with the development, implementation and/or operation of any facility contemplated by an effective national market system plan." Section 3(a)(22)(B) of the Exchange Act, 15 U.S.C. 78c(22)(B), defines "exclusive processor" to mean "any securities information processor or self-regulatory organization which, directly or indirectly, engages on an exclusive basis on behalf of any national securities exchange or registered securities association, or any national securities exchange or registered securities association which engages on an exclusive basis on its own behalf, in collecting, processing, or preparing for distribution or publication any information with respect to (i) transactions or quotations on or effected or made by means of any facility of such exchange or (ii) quotations distributed or published by means of any electronic system operated or controlled by such association."

As a processor involved in collecting, processing, and preparing for distribution transaction and quotation information, the processor of each of the CTA Plan, CQS Plan, Nasdaq UTP Plan, and OPRA Plan meets the definition of "exclusive processor;" and because each acts as an exclusive processor in connection with an NMS Plan, each also meets the definition of "plan processor" under Rule 600(a)(55) of Regulation NMS, as well as Rule 1000(a) of Regulation SCI. For ease of reference, an NMS Plan having a current or future "plan processor" is referred to herein as an "SCI Plan." The Commission notes that not every processor of an NMS Plan would be a "plan processor" under Rule 1000, and therefore not every processor of an NMS Plan would be an SCI entity subject to the requirements of Regulation SCI. For example, the processor of the Symbol Reservation System associated with the National Market System Plan for the Selection and Reservation of Securities Symbols (File No. 4-533) would not be a "plan processor" subject to Regulation SCI because it does not meet the "exclusive processor" statutory definition, as it is not involved in collecting, processing, and preparing for distribution transaction and quotation information.

¹⁹⁷

Pursuant to Section 11A of the Exchange Act (15 U.S.C. 78k-1), and Rule 609 of Regulation NMS thereunder (17 CFR 242.609), such entities, as "exclusive processors," are required to register with the Commission as securities information processors on Form SIP. See 17 CFR 249.1001 (Form SIP, application for registration as a securities information processor or to amend such an application or registration).

such entities, because they deal with key market data, are central features of the national market system¹⁹⁸ and should be subject to the same systems standards as SCI SROs. The inclusion of plan processors in the definition of SCI entity is designed to ensure that the processor for an SCI Plan, regardless of its identity, is independently subject to the requirements of Regulation SCI. The Commission believes that it is important for such plan processors to be subject to the requirements of Regulation SCI because of the important role they serve in the national market system: operating and maintaining computer and communications facilities for the receipt, processing, validating, and dissemination of quotation and/or last sale price information generated by the members of the plan.

Recent SIP incidents further highlighted the importance of plan processors to the U.S. securities markets and the necessity of including such processors within the scope of Regulation SCI.¹⁹⁹ As evidenced by the incidents, the availability of consolidated market data is central to the functioning of the securities markets. The unavailability of a system, such as a plan processor, that is a single point of failure with no backups or alternatives can result in a significant impact on the entire national market system. Accordingly, the Commission believes that that it is essential to ensure that the automated systems of the entities responsible for the

¹⁹⁸ See Concept Release on Equity Market Structure, supra note 4, at 3594-95.

¹⁹⁹ As noted above, a disruption of the Nasdaq SIP on August 22, 2013 resulted in a three hour halt in trading in all Nasdaq-listed securities because of the SIP's inability to process quotes. See supra note 32 and accompanying text. Also as noted above, on October 30, 2014, according to the NYSE, a network hardware failure impacted the Consolidated Tape System, Consolidated Quote System, and Options Price Reporting Authority data feeds at the primary data center, and SIAC switched over to the secondary data center for these data feeds. See id.

consolidation and processing of important market data, namely, plan processors, have adequate levels of capacity, integrity, resiliency, availability, and security.²⁰⁰

Further, pursuant to its terms, each SCI Plan is required to periodically review its selection of its processor, and may in the future select a different processor for the SCI Plan than its current processor.²⁰¹ Thus, the definition of “plan processor” covers any entity selected as the processor for a current or future SCI Plan.²⁰²

d. Exempt Clearing Agency Subject to ARP

Proposed Rule 1000(a) defined the term “exempt clearing agency subject to ARP” to mean “an entity that has received from the Commission an exemption from registration as a clearing agency under Section 17A of the Act, and whose exemption contains conditions that relate to the Commission’s Automation Review Policies, or any Commission regulation that supersedes or replaces such policies.” This definition is being adopted as proposed.

As noted in the SCI Proposal, this definition of “exempt clearing agency subject to ARP” currently covers one entity, Omgeo Matching Services – US, LLC (“Omgeo”).²⁰³ In its

²⁰⁰ Systems directly supporting functionality relating to the provision of consolidated market data are included within the definition of “critical SCI systems,” for which heightened obligations under Regulation SCI will apply. See adopted Rule 1000. See also *supra* Section IV.A.2.c (discussing the definition of “critical SCI systems”).

²⁰¹ See CTA Plan Section V(d) and CQS Plan Section V(d), available at: <http://www.nyxdata.com/cta>; OPRA Plan Section V, available at: http://www.opradata.com/pdf/opra_plan.pdf; and Nasdaq UTP Plan Section V, available at: <http://www.utpplan.com>.

²⁰² Currently, SIAC is the processor for the CTA Plan, CQS Plan, and OPRA Plan, and Nasdaq is the processor for the Nasdaq UTP Plan. SIAC is wholly owned by NYSE Euronext. Both SIAC and Nasdaq are registered with the Commission as securities information processors, as required by Section 11A(b)(1) of the Exchange Act, 15 U.S.C. 78k-1(b)(1), and in accordance with Rule 609 of Regulation NMS, 17 CFR 242.609.

²⁰³ On April 17, 2001, the Commission issued an order granting Omgeo an exemption from registration as a clearing agency subject to certain conditions and limitations in order that

comment letter, Omgeo stated that it believed its inclusion as an SCI entity was reasonable because clearing agencies that provide matching services, such as Omgeo, perform a critical role in the infrastructure of the U.S. financial markets in handling large amounts of highly confidential proprietary trade data.²⁰⁴ Omgeo requested, however, that the Commission clarify that other similarly situated clearing agencies would also be subject to the requirements of Regulation SCI, and further requested that the Commission expand the definition of SCI entity, as applied to clearing agencies, to include, without limitation, any entity providing either matching services or confirmation/affirmation services for depository eligible securities that settle in the United States, as contemplated by FINRA Rule 11860.²⁰⁵

The Commission notes that the adopted definition of “exempt clearing agency subject to ARP” does provide that any entity that receives from the Commission an exemption from registration as a clearing agency under Section 17A of the Act, and whose exemption contains conditions that relate to the Automation Review Policies or any Commission regulation that supersedes or replaces the Commission’s Automation Review Policies (such as Regulation SCI) would be included within the scope of Regulation SCI. Therefore, clearing agencies that are similarly situated as Omgeo (*i.e.*, those that are subject to an exemption that contains the relevant

Omgeo might offer electronic trade confirmation and central matching services. See Global Joint Venture Matching Services – US, LLC; Order Granting Exemption from Registration as a Clearing Agency, Securities Exchange Act Release No. 44188 (April 17, 2001), 66 FR 20494 (April 23, 2001) (File No. 600-32) (“Omgeo Exemption Order”). Because the Commission granted it an exemption from clearing agency registration, Omgeo is not a self-regulatory organization.

²⁰⁴ See Omgeo Letter at 2-3.

²⁰⁵ See id.

conditions) will be subject to Regulation SCI.²⁰⁶ The Commission does not believe, therefore, that an expansion of the definition as suggested by Omgeo is necessary to further clarify that similarly situated entities will be subject to the requirements of Regulation SCI.

Among the operational conditions required by the Commission in the Omgeo Exemption Order were several that directly related to the ARP policy statements.²⁰⁷ For the same reasons that it required Omgeo to abide by the conditions relating to the ARP policy statements set forth in the Omgeo Exemption Order, the Commission believes it is appropriate that Omgeo (or any similarly situated exempt clearing agency) should be subject to the requirements of Regulation SCI, and thus is including any "exempt clearing agency subject to ARP" within the definition of SCI entity.

2. SCI Systems, Critical SCI Systems, and Indirect SCI Systems

a. Overview

Regulation SCI, as adopted, distinguishes three categories of systems of an SCI entity: "SCI systems," "critical SCI systems," and "indirect SCI systems." The SCI Proposal broadly defined SCI systems to mean "all computer, network, electronic, technical, automated, or similar systems of, or operated by or on behalf of, an SCI entity, whether in production, development, or

²⁰⁶ Any entity seeking an exemption from registration as a clearing agency is responsible for requesting and obtaining such an exemption from the Commission.

²⁰⁷ These conditions require Omgeo to, among other things: provide the Commission with an audit report addressing all areas discussed in the Commission ARP policy statements; provide annual reports prepared by competent, independent audit personnel in accordance with the annual risk assessment of the areas set forth in the ARP policy statements; report all significant systems outages to the Commission; provide advance notice of any material changes made to its electronic trade confirmation and central matching services; and respond and require its service providers to respond to requests from the Commission for additional information relating to its electronic trade confirmation and central matching services, and provide access to the Commission to conduct inspections of its facilities, records and personnel related to such services. See *supra* note 203.

testing, that directly support trading, clearance and settlement, order routing, market data, regulation, or surveillance.” The SCI Proposal also defined the term SCI security systems (to which only the provisions of Regulation SCI relating to security and intrusions would apply) as: “any systems that share network resources with SCI systems that, if breached, would be reasonably likely to pose a security threat to SCI systems.”²⁰⁸

Many commenters stated that the proposed definitions of SCI systems and SCI security systems were too broad and urged the Commission to target systems that pose the greatest risk to the market if they malfunction.²⁰⁹ After careful consideration of the comments, and as discussed more fully below, the Commission agrees that certain types of systems included in the proposed definition of SCI systems may be appropriately excluded from the adopted definition. However, because U.S. securities market infrastructure is highly interconnected and seemingly minor systems problem at a single entity can spread rapidly across the national market system, the Commission does not believe it is appropriate to apply Regulation SCI only to the most critical SCI systems, as some commenters suggested. Instead, the adopted regulation applies to a broader set of systems than urged by some commenters, but a more targeted set of systems than proposed. In addition, the adopted approach recognizes that some systems pose greater risk than others to the maintenance of fair and orderly markets if they malfunction. To this end, adopted Regulation SCI identifies three broad categories of systems of SCI entities that are subject to the regulation: “SCI systems,” “critical SCI systems,” and “indirect SCI systems,” with each category subject to differing requirements under Regulation SCI.

²⁰⁸ See proposed Rule 1000(a) and Proposing Release, supra note 13, at Section III.B.2.

²⁰⁹ See, e.g., NYSE Letter at 10; Joint SROs Letter at 5; Omgeo Letter at 4; KCG Letter at 3; DTCC Letter at 4; FIF Letter at 3; Liquidnet Letter at 3; and OTC Markets Letter at 12-13.

As discussed more fully below, the adopted definition of "SCI systems" includes those systems that directly support six areas that have traditionally been considered to be central to the functioning of the U.S. securities markets, namely trading, clearance and settlement, order routing, market data, market regulation, and market surveillance. SCI systems are subject to all provisions of Regulation SCI, except for certain requirements applicable only to critical SCI systems.

In addition, the Commission is adopting a definition of "critical SCI systems," a subset of SCI systems that are subject to certain heightened resilience and information dissemination provisions of Regulation SCI. Guided significantly by commenters' views on those systems that are most critical, the Commission is defining the term "critical SCI systems" as SCI systems that: (1) directly support functionality relating to: (i) clearance and settlement systems of clearing agencies; (ii) openings, reopenings, and closings on primary trading markets; (iii) trading halts; (iv) initial public offerings; (v) the provision of consolidated market data (i.e., SIPs); or (vi) exclusively-listed securities; or (2) provide functionality to the securities markets for which the availability of alternatives is significantly limited or nonexistent and without which there would be a material impact on fair and orderly markets.²¹⁰ As more fully discussed below, systems in this category are those that, if they were to experience systems issues, the Commission believes would be most likely to have a widespread and significant impact on the securities markets.

In addition, the Commission is adopting a definition of "indirect SCI systems," in place of the proposed definition of "SCI security systems." "Indirect SCI systems" are subject only to the provisions of Regulation SCI relating to security and intrusions. The term "indirect SCI systems" is defined to mean "any systems of, or operated by or on behalf of, an SCI entity that, if

²¹⁰ See Rule 1000(a).

breached, would be reasonably likely to pose a security threat to SCI systems” and, if an SCI entity puts in place appropriate security measures, is intended to refer to few, if any, systems of the SCI entity.

b. SCI Systems

SCI systems generally

Proposed Rule 1000(a) defined the term “SCI systems” to mean “all computer, network, electronic, technical, automated, or similar systems of, or operated by or on behalf of, an SCI entity, whether in production, development, or testing, that directly support trading, clearance and settlement, order routing, market data, regulation, or surveillance.”²¹¹ After careful consideration of the comments, the Commission is refining the scope of the systems covered by the definition of “SCI systems.” As adopted, the term “SCI systems” in Rule 1000 means “all computer, network, electronic, technical, automated, or similar systems of, or operated by or on behalf of, an SCI entity that, with respect to securities, directly support trading, clearance and settlement, order routing, market data, market regulation, or market surveillance.”

One commenter generally supported the proposed definition of SCI systems, and stated that the definition should be expanded to include any technology system that has direct market access.²¹² In response to this comment, the Commission believes that many systems with direct market access are captured by the adopted definition. However, as discussed above, the

²¹¹ See proposed Rule 1000(a) and Proposing Release, supra note 13, at Section III.B.2.

²¹² See Lauer Letter at 5.

Commission has determined not to propose to expand the scope of Regulation SCI to include other broker-dealer entities and their systems at this time.²¹³

Contrary to the commenter who urged expansion of the proposed definition, many commenters believed the term to be too broad and recommended that it be revised in various ways.²¹⁴ These commenters argued that the definition was over-inclusive, with some believing that it could potentially apply to all systems of an SCI entity.

Specifically, several commenters recommended that the definition of SCI systems be revised to include a more limited set of systems than proposed.²¹⁵ Commenters advocating this general approach provided various suggestions for the specific standard that they believed should apply. For example, among commenters' recommendations were suggestions that the definition of SCI systems should include only those systems: whose failure or degradation would reasonably be expected to have an adverse material impact on the sound operation of financial markets;²¹⁶ that are highly critical to functioning as an SCI entity;²¹⁷ that have the potential to

²¹³ See supra Section IV.A.1 (discussing scope of SCI entities covered by Regulation SCI) and infra Section IV.E (discussing comments on the inclusion of broker-dealers generally within the scope of Regulation SCI).

²¹⁴ See, e.g., NYSE Letter at 10-11; Omgeo Letter at 3-6; MSRB Letter at 7-9; FIF Letter at 3; ICI Letter at 4; BIDS Letter at 15-16; ITG Letter at 5; Liquidnet Letter at 3; CME Letter at 5; DTCC Letter at 3-5; OCC Letter at 3-4; Joint SROs Letter at 5; FINRA Letter at 5-10; SIFMA Letter at 8; Oppenheimer Letter at 3; OTC Markets Letter at 12; and Direct Edge Letter at 2.

²¹⁵ See, e.g., NYSE Letter at 10; Joint SROs Letter at 5; Omgeo Letter at 4; KCG Letter at 3; DTCC Letter at 4; FIF Letter at 3; Liquidnet Letter at 3; and OTC Markets Letter at 12-13. See infra text accompanying notes 216-225.

²¹⁶ See Omgeo Letter at 4.

²¹⁷ See KCG Letter at 3. See also ICI Letter at 3 and Oppenheimer Letter at 3 (stating generally that the proposed definitions should be revised to more specifically focus on system events that are truly disruptive to the markets and the systems themselves that are

impact the protection of securities investors and the maintenance of fair and orderly markets;²¹⁸ that directly support trading, clearance and settlement, order routing, market data, regulation, or surveillance in real-time;²¹⁹ that support the SCI entity's "core functions...which the SCI entity performs pursuant to applicable Commission regulations;"²²⁰ that are reasonably likely to pose a plausible risk to the markets (namely, systems that route or execute orders, clear and settle trades, or transmit required market data);²²¹ or that impact the core functions of the overall market, which, according to the commenter, would include exclusive SIPs that transmit market data and systems responsible for primary NMS auction markets that set daily opening and closing prices.²²² In addition, one commenter suggested that the term should be defined as a production system that connects to and is part of the electronic network that comprises the market.²²³ This commenter also noted that the definition should distinguish between systems that connect to the markets and those that are used to run a business.²²⁴ Another commenter suggested that, if Regulation SCI were to apply only to exchanges and ATSS, the term should be

likely to pose a risk to the fair and orderly operation of the markets or participants in the markets).

²¹⁸ See CME Letter at 5.

²¹⁹ See Joint SROs Letter at 5. This group of commenters further stated that non-real-time systems should not be included, as they do not warrant the level of oversight and added costs that the regulation imposes.

²²⁰ See DTCC Letter at 4.

²²¹ See NYSE Letter at 3, 10. In addition, this commenter added that the key to whether a proposed "supporting" function should be included is whether or not it is critical to the proper operation of a core functionality.

²²² See OTC Markets Letter at 13.

²²³ See BIDS Letter at 15-16. Thus, this commenter argued that, for a venue that does not route orders, the reporting of trade executions to the tape should not be enough to qualify such a system as an "SCI system."

²²⁴ See *id.*

limited to exchange and ATS systems operated by the entity and should not include, for example, brokerage systems.²²⁵

The Commission is further focusing the scope of the definition of SCI systems in response to these comments.²²⁶ The Commission is replacing the proposed language referring to “systems...whether in production, development, or testing that directly support trading, clearance and settlement, order routing, market data, regulation, or surveillance” with the following language: “systems, with respect to securities, that directly support trading, clearance and settlement, order routing, market data, market regulation, or market surveillance.” As such, the adopted definition has been limited to apply to production systems that relate to securities market functions, and in particular to those six functions—trading, clearance and settlement, order routing, market data, market regulation, or market surveillance—that traditionally have been considered to be central to the functioning of the U.S. securities markets, as urged by several commenters.²²⁷ The Commission believes that systems providing these six functions may pose a significant risk to the maintenance of fair and orderly markets if their capacity,

²²⁵ See Liquidnet Letter at 3.

²²⁶ See supra notes 215-218, 220-222, and 224-225, and accompanying text. The definition is not limited strictly to real-time systems, however, or those that “connect to” and are “part of the electronic network that comprises the market,” because those limitations could exclude relevant systems, such as certain market regulation or market surveillance systems operated by or on behalf of an SCI entity, which the Commission views as integral to one or more of the six functions identified in the definition. In response to the commenter requesting that “brokerage” systems be excluded from the definition of SCI systems, the Commission notes that the adopted definition of SCI systems applies to systems that directly support the enumerated six functions, operated by or on behalf of an SCI entity. The definition therefore would exclude systems, including brokerage systems, that are not operated by or on behalf of an SCI entity. See, respectively, supra notes 219 and 223 and accompanying text.

²²⁷ See supra notes 219-221 and accompanying text.

integrity, reliability, availability or security is compromised, and therefore that they should be covered by the definition of “SCI systems.”

Although some commenters pointed to the phrase “directly support” in the proposed rule as vague and overbroad,²²⁸ the Commission has retained this phrase in the adopted definition. The term “directly support,” is retained to acknowledge that systems of SCI entities are complex and highly interconnected and that the definition of SCI systems should not exclude functionality or supporting systems on which the six identified categories of systems rely to remain operational.²²⁹ In response to comment that the definition of SCI systems should distinguish between systems that connect to the markets and those that are used to run a business,²³⁰ the Commission notes that the adopted definition would not include systems “used to run a business” if they are not within the six identified categories of market-related production systems and not necessary to their continued functioning. Further, the adopted definition clarifies that SCI systems encompass only those systems that, with respect to securities, directly support trading, clearance and settlement, order routing, market data, market regulation, or market surveillance. The Commission believes that this change appropriately responds to one commenter’s concerns that the proposed definition would capture systems operated by an SCI entity that have “practically no relevance or relation to SEC markets” and suggested that the definition should be revised to include only those systems that would directly impact a market that was subject to the

²²⁸ See OCC Letter at 3; and NYSE Letter at 10.

²²⁹ The Commission notes that it believes that specifying that the definition applies to those systems that “directly support” these core functions is necessary so as to not result in a definition that is overly broad and would capture systems that only peripherally or indirectly support these functions. See generally supra notes 214-225 and accompanying text (discussing comments that urged revisions to the definition of SCI systems). See also infra Section IV.A.2.d (discussing the definition of “indirect SCI systems”).

²³⁰ See supra note 224 and accompanying text.

Commission's jurisdiction.²³¹ As a result of this modification, if an SCI SRO does not use its systems to conduct business with respect to securities, its systems would not fall within the definition of "SCI systems." Further, if an SCI entity operates systems for the trading of both futures and securities, only its trading systems for securities would be subject to the requirements of Regulation SCI.²³²

In addition, one commenter urged that the Commission should initially limit the scope of SCI systems to those systems covered by the ARP Policy Statements (trading, clearance and settlement, and order routing) and phase in other types of systems later.²³³ The Commission believes that the adopted definition of SCI systems obviates the need for such an approach, as many systems for which the commenter urged a delay in compliance will not be covered by the regulation, as adopted.

SCI Systems: Inclusions and Exclusions

Various commenters objected to specific categories proposed to be included in the definition of SCI systems. First, many commenters opposed the proposed inclusion of development and testing systems in the definition, noting that issues in development and testing systems would have little or no impact on the operations of SCI entities and that such systems are designed to identify and address problems before they are introduced into production

²³¹ See CME Letter at 5.

²³² However, the Commission notes that, if an SCI entity has systems that do not relate to securities, and that have not been properly walled off from its SCI systems for securities, they may be captured by the definition of "indirect SCI systems" (as discussed below) and subject to certain requirements of the rule including those relating to security and intrusions standards. See *infra* Section IV.A.2.d (discussing definition of "indirect SCI systems").

²³³ See MSRB Letter at 9.

systems.²³⁴ Some commenters argued that inclusion of development and testing systems in the definition of SCI systems would subject such systems to more requirements under Regulation SCI than was necessary and noted that certain other provisions of Regulation SCI would necessarily include reporting information to the Commission on such systems, even without their inclusion in the definition of SCI systems.²³⁵ For example, one commenter stated that application of most provisions of Regulation SCI to testing and development systems would provide little benefit, and noted that updates regarding systems in development and material new features of existing systems could instead be done through the semi-annual reports to the Commission under proposed Rule 1000(b)(8).²³⁶ Similarly, one commenter noted that information regarding the status of systems that are in development and testing would be captured in the notices regarding material systems changes under proposed Rule 1000(b)(6) and in the updates under proposed Rule 1000(b)(8).²³⁷ Alternatively, this commenter suggested that the Commission could require that any testing errors be corrected (and such corrections be retested) prior to implementation of those changes in production.²³⁸

The Commission believes that certain modifications to the elements of the proposed definition of SCI systems are appropriate. First, in response to comments, the reference to

²³⁴ See NYSE Letter at 11; FINRA Letter at 10-11; Omgeo Letter at 5; DTCC Letter at 4; SIFMA Letter at 8; BIDS Letter at 16; MSRB Letter at 7-8; OCC Letter at 5; CME Letter at 6; Joint SROs Letter at 5; and Direct Edge Letter at 2. One commenter qualified this position by stating that, to the extent that a systems issue in a development and testing environment were to give rise to an issue affecting an SCI system, the proposal should apply to that development and testing environment. See OCC Letter at 5.

²³⁵ See MSRB Letter at 7; and DTCC Letter at 4.

²³⁶ See MSRB Letter at 7.

²³⁷ See DTCC Letter at 4.

²³⁸ See *id.*

development and testing systems in the proposed definition of SCI systems has been deleted.²³⁹ As commenters pointed out, development and testing systems are generally designed to identify and address problems before new systems or systems changes are introduced into production systems and, by their nature, can often experience issues, both intentional and unplanned, during the testing process. The Commission believes that systems issues that occur with respect to such systems are less likely to have a significant impact on the operations of an SCI entity or on the securities markets as a whole than issues occurring with respect to production systems. Further, subjecting these systems to the Commission notification requirements in adopted Rule 1002(b) could have the unintended effect of deterring SCI entities from fully utilizing the testing and development processes to test new systems and systems changes and develop solutions to issues prior to implementation of such systems or changes in production. At the same time, the Commission notes that, in order to have policies and procedures reasonably designed to achieve capacity, integrity, resiliency, availability, and security for SCI systems in accordance with adopted Rule 1001(a), an SCI entity will be required to have policies and procedures that include a program to review and keep current systems development and testing methodology for SCI systems.²⁴⁰ Accordingly, review of programs relating to systems development and testing for SCI systems is within the scope of Regulation SCI, and an SCI entity should reasonably expect Commission staff to review such processes and systems during the course of its exams and

²³⁹ Because the Commission is removing development and testing systems from the definition of SCI systems, the reference to production systems in the definition of SCI systems is also being deleted as it is unnecessary to distinguish between development, testing and production systems within the definition. See adopted Rule 1000 (definition of "SCI systems").

²⁴⁰ See adopted Rule 1001(a) and discussion in *infra* Section IV.B.1 (discussing the policies and procedures requirement under adopted Rule 1001(a)).

inspections. In addition, the Commission notes that the definition of SCI review in adopted Rule 1000 and corresponding requirements for an annual SCI review in adopted Rule 1003(b) require an assessment of internal control design and effectiveness, which includes development processes.²⁴¹ Further, if development and testing systems are not appropriately walled off from production systems, such systems could be captured under the definition of indirect SCI systems as discussed below and be subject to the requirements of Regulation SCI. If an SCI entity's development and testing systems are not walled off from production systems, the SCI entity should consider whether its policies and procedures should specify safeguards to ensure that its personnel can clearly distinguish the development and testing systems from the production systems, in order to avoid inadvertent errors that may result in an SCI event.

Some commenters also opposed the proposed inclusion of regulatory and surveillance systems within the definition of SCI systems or suggested that the Commission refine or clarify the scope of such systems.²⁴² Some of these commenters argued that inclusion of such systems was not necessary because these systems do not operate on a real-time basis or have a real-time impact on trading.²⁴³ Further, one commenter suggested that periodic reporting of material outages or delays in the operation of regulatory and surveillance systems, pursuant to appropriate policies and procedures, would support the goals of Regulation SCI without imposing undue burdens on SCI entities or raising the risk that market participants would purposefully direct

²⁴¹ See adopted Rule 1000 and 1003(b) and discussion in infra Section IV.B.5 (discussing the SCI review requirement). The Commission also notes that development processes include testing processes.

²⁴² See NYSE Letter at 11; BATS Letter at 5; MSRB Letter at 8-9; and FINRA Letter at 7-8.

²⁴³ See NYSE Letter at 11; and Joint SROs Letter at 5.

order flow to SCI entities experiencing regulatory or surveillance systems issues.²⁴⁴ Another commenter advocated for replacing the terms “regulation” and “surveillance” with “market regulation” and “market surveillance,” respectively, and asked the Commission to clarify the difference between “regulatory” and “surveillance” systems.²⁴⁵

In consideration of these comments, the Commission has determined to limit SCI systems to those systems relating to market regulation and market surveillance rather than including all regulation and surveillance systems. As proposed, the definition contained no such limitations and could potentially be interpreted to cover systems used for member regulation and member surveillance. The Commission does not believe that inclusion of member regulation or member surveillance systems such as those, for example, relating to member registration, capital requirements, or dispute resolution, would advance the goals of Regulation SCI. Issues relating to such systems are unlikely to have the same level of impact on the maintenance of fair and orderly markets or an SCI entity’s operational capability as those systems identified in the definition of SCI systems. The Commission believes that this change will more appropriately capture only those regulatory and surveillance systems that are related to core market functions, such as trading, clearance and settlement, order routing, and market data.²⁴⁶ Another element of

²⁴⁴ See NYSE Letter at 11 (citing concerns regarding the potential that dissemination of information regarding issues with regulatory or surveillance systems to members or participants could provide a “roadmap for violative market behavior”).

²⁴⁵ See FINRA Letter at 7-8.

²⁴⁶ The Commission notes that Rule 613 of Regulation NMS requires the creation of an NMS plan to govern the creation, implementation, and maintenance of a consolidated audit trail and central repository. See 17 CFR 242.613. See also Securities Exchange Act Release No. 67457 (July 18, 2012), 77 FR 45722 (August 1, 2012) (“Consolidated Audit Trail Adopting Release”). Although the consolidated audit trail central repository has not yet been created, the Commission believes that the consolidated audit trail repository will be a market regulation system that falls within the definition of SCI

the proposed definition of "SCI systems" that some commenters addressed was the inclusion of market data systems. Specifically, one commenter believed that the inclusion of all market data systems was too broad, and argued that only "systems that directly support 'the transmission of market data as required by the Exchange Act'" should be included, thus limiting the types of market data systems to those relating to consolidated data and excluding those that transmit proprietary market data.²⁴⁷ Although the term "market data" is not defined in Regulation SCI, that term generally refers to price information for securities, both pre-trade and post-trade, such as quotations and transaction reports.²⁴⁸ In response to the commenter urging that only market data systems relating to consolidated data be included, the term "market data" does not refer exclusively to consolidated market data, but includes proprietary market data generated by SCI entities as well. The Commission notes that both consolidated and proprietary market data systems are widely used and relied upon by a broad array of market participants, including institutional investors, to make trading decisions, and that if a consolidated or a proprietary market data feed became unavailable or otherwise unreliable, it could have a significant impact

systems, and further that it will be an SCI system of each SCI SRO that is a member of an approved NMS plan under Rule 613, because it will be a facility of each SCI SRO that is a member of such plan. See Consolidated Audit Trail Adopting Release, 77 FR at 45774 (stating, "[T]he central repository will be jointly owned by, and be a facility of, each SRO that is a sponsor of the NMS plan."). See also SCI Proposing Release, supra note 13, at 18099 (contemplating inclusion of the consolidated audit trail central repository as an SCI system).

²⁴⁷ See NYSE Letter at 10-11.

²⁴⁸ See Exchange Act Section 11A (15 U.S.C. 78K-1(a)(1)(C)(iii)), granting the Commission authority to assure the availability to brokers, dealers, and investors of "information with respect to quotations for and transactions in securities". See also *Regulation of Market Information Fees and Revenues*, Securities Exchange Act Release No. 42208, 64 FR 70613 (December 17, 1999) (describing "market information" as information concerning quotations for and transactions in equity securities and options that are actively traded in the U.S. markets).

on the trading of the securities to which it pertains, and could interfere with the maintenance of fair and orderly markets. Therefore, systems of an SCI entity directly supporting proprietary market data or consolidated market data are both within the scope of the definition of SCI systems and subject to Regulation SCI. However, the Commission has repeatedly emphasized the importance of consolidated market data to the national market system and the protection of investors²⁴⁹ and the severe impact of its unavailability was evidenced by the SIP outage in August 2013.²⁵⁰ Thus, as discussed below, systems directly supporting functionality related to the provision of consolidated market data are distinguished by their inclusion in the definition of “critical SCI systems.”²⁵¹

Further, one commenter questioned whether the phrase “market data systems” was intended to be limited to data-driven systems devoted to price transparency or whether the Commission also intended to include document-based systems devoted to public disclosure.²⁵² In response to this comment, the Commission notes that systems providing or directly supporting price transparency are within the scope of SCI systems.²⁵³ However, systems solely providing or directly supporting other types of data, such as systems used by market participants to submit disclosure documents, or systems used by SCI entities to make disclosure documents publicly

²⁴⁹ See, e.g., Concept Release on Equity Market Structure, supra note 198; and Regulation NMS Adopting Release, supra note 182, at 37503-04.

²⁵⁰ See supra note 32 and accompanying text.

²⁵¹ See infra Section IV.A.2.c (discussing definition of “critical SCI systems”).

²⁵² See MSRB Letter at 8-9 (citing its EMMA Primary Market Disclosure Service and EMMA Continuing Disclosure Service system as an example of a document-based system devoted to public disclosure).

²⁵³ With regard to this particular comment, the Commission notes that the specific systems referenced – the RTRS, EMMA Primary Market Disclosure Service, EMMA Continuing Disclosure Service and SHORT System – all include pricing information for securities, and thus would fall within the definition of “SCI systems.”

available, are not within the scope of SCI systems, so long as they do not also directly support price transparency.

Several commenters also argued that the term SCI systems should not include systems operated on behalf of an SCI entity by a third party.²⁵⁴ Some of these commenters pointed to potential difficulties with meeting the requirements of Regulation SCI with regard to third party systems.²⁵⁵ One commenter specifically suggested that the proposal should be limited to those systems under the control of the SCI entity.²⁵⁶ Another commenter noted that the SCI entity should instead be responsible for managing these relationships through due diligence, contract terms, and monitoring of third party performance.²⁵⁷ One commenter also requested that the Commission clarify how SCI entities should comply with the oversight of vendor systems as part of Regulation SCI.²⁵⁸

Although several commenters argued that the term SCI systems should not include third-party systems, the Commission continues to believe that, if a system is operated on behalf of an SCI entity and directly supports one of the six key functions listed within the definition of SCI system, it should be included as an SCI system subject to the requirements of Regulation SCI. The Commission believes that any system that directly supports one of the six functions

²⁵⁴ See Omgeo Letter at 5-6; DTCC Letter at 4; SIFMA Letter at 8-9; BIDS Letter at 16; and BATS Letter at 4. See also ITG Letter at 5 (expressing concern about the inclusion of systems of third parties operated on behalf of an SCI entity and systems that are unrelated to the trading operations of an ATS.).

²⁵⁵ See, e.g., Omgeo Letter at 5-6; and BATS Letter at 4 (arguing that it would be difficult for SCI entities to ensure compliance by third party vendors absent their willingness to disclose to SCI entities highly detailed information about their intellectual property and proprietary systems).

²⁵⁶ See SIFMA Letter at 9.

²⁵⁷ See BIDS Letter at 16.

²⁵⁸ See FIF Letter at 3.

enumerated in the definition of SCI system is important to the functioning of the U.S. securities markets, regardless of whether it is operated by the SCI entity directly or by a third party. The Commission believes that permitting such systems to be excluded from the requirements of Regulation SCI would significantly reduce the effectiveness of the regulation in promoting the national market system by ensuring the capacity, integrity, resiliency, availability, and security of those systems important to the functioning of the U.S. securities markets. Further, if the definition did not include systems operated on behalf of an SCI entity, the Commission is concerned that some SCI entities might be inclined to outsource certain of their systems solely to avoid the requirements of Regulation SCI, which would further undermine the goals of Regulation SCI. The Commission agrees with the comment that an SCI entity should be responsible for managing its relationship with third parties operating systems on behalf of the SCI entity through due diligence, contract terms, and monitoring of third party performance. However, the Commission believes that these methods may not be sufficient in all cases to ensure that the requirements of Regulation SCI are met for SCI systems operated by third parties. The fact that they might be sufficient some of the time is therefore not a basis for excluding these systems from the definition of SCI systems. Instead, if an SCI entity determines to utilize a third party for an applicable system, it is responsible for having in place processes and requirements to ensure that it is able to satisfy the requirements of Regulation SCI for systems operated on behalf of the SCI entity by a third party. The Commission believes that it would be appropriate for an SCI entity to evaluate the challenges associated with oversight of third-party vendors that provide or support its applicable systems subject to Regulation SCI. If an SCI entity is uncertain of its ability to manage a third-party relationship (whether through due diligence, contract terms,

monitoring, or other methods) to satisfy the requirements of Regulation SCI,²⁵⁹ then it would need to reassess its decision to outsource the applicable system to such third party.²⁶⁰ For example, if a third-party vendor is unwilling to disclose to an SCI entity information regarding the vendor's intellectual property or proprietary system that the SCI entity believes it needs to satisfy the requirements of Regulation SCI, as some commenters suggested might be the case, an SCI entity will need to reassess its relationship with that vendor, because the vendor's unwillingness to provide necessary information or other assurances would not exclude the outsourced system from the definition of SCI systems. Accordingly, the definition of SCI system, as adopted in Rule 1000, retains the reference to systems operated "on behalf of" SCI entities.

Finally, some commenters asked for clarification on miscellaneous aspects of the definition. For example, one commenter requested that the Commission clarify that the definition of SCI system for purposes of Regulation SCI is separate and distinct from the definition of a facility set forth in Section 3(a)(2) of the Exchange Act.²⁶¹ The Commission notes that the term "SCI system" under Regulation SCI is distinct from the term "facility" in Section 3(a)(2) of the Exchange Act.²⁶² Because a facility of an exchange would only fall

²⁵⁹ See BIDS Letter at 16 (suggesting these methods of managing third-party relationships to comply with the proposed rule).

²⁶⁰ See FIF Letter at 3 and FINRA Letter at 22-23 (requesting Commission guidance on how an SCI entity should manage third-party relationships in the context of adopted Regulation SCI). See also *infra* notes 851-852 and accompanying text (discussing comments on the risk of noncompliance by an SCI entity in connection with reporting SCI events and material systems changes due to challenges posed by third-party systems).

²⁶¹ See NYSE Letter at 10.

²⁶² See 15 U.S.C. 78c3(a)(2).

within the definition of "SCI systems" if it is a system that directly supports any one of the six functions provided in the definition of "SCI systems," not all systems that are facilities of an exchange will be SCI systems. For example, as noted in the SCI Proposal, the definition of SCI systems would apply to systems of exchange-affiliated routing brokers that are facilities of national securities exchanges.²⁶³ But a system used for member regulation that may meet the definition of a facility under the Exchange Act, would not be within the scope of the definition of "SCI systems."

Another commenter requested confirmation that internal systems are excluded from the definition of SCI system.²⁶⁴ The Commission notes that the definition of "SCI system" does not differentiate between "internal systems" and those systems accessed by market participants or other outside parties.²⁶⁵ The Commission notes that, while some internal systems of an SCI entity may not meet the definition of SCI system, it does not believe that that all internal systems (as described by this commenter) would be outside of the scope of the definition of SCI system.²⁶⁶

²⁶³ See Proposing Release, supra note 13, at 18099.

²⁶⁴ See FINRA Letter at 10.

²⁶⁵ See adopted Rule 1000 (definition of SCI systems).

²⁶⁶ In addition, the Commission notes that, while certain internal systems may not be "SCI systems," they may instead meet the definition of "indirect SCI systems" under adopted Rule 1000, if they are not properly walled off from SCI systems. However, as discussed below, the Commission is clarifying the meaning of this defined term to note that systems that are effectively physically or logically separated from SCI systems would be outside of the definition of indirect SCI systems and thus outside of the scope of Regulation SCI. See infra Section IV.A.2.d (discussing the definition of "indirect SCI systems").

Other commenters advocated that SCI entities should be permitted to conduct their own risk-based assessment to determine which of their systems should be considered SCI systems.²⁶⁷ One commenter noted that SCI entities should be required to develop and maintain an established methodology for identifying which systems qualify as SCI systems,²⁶⁸ while other commenters advocated for coordination with the Commission in establishing criteria to be used in conducting such risk-based assessments or review by the Commission of an SCI entity's own risk-based assessment.²⁶⁹ The Commission has carefully considered these comments and generally agrees that certain systems pose greater risk to the markets in the event of a systems issue and are of paramount importance to the functioning of the U.S. securities markets. Rather than include only those in the definition of SCI systems, the Commission believes that it is more prudent to instead identify these systems as "critical SCI systems" subject to certain heightened obligations. Further, adopted Rule 1001(a) requiring SCI entities to have policies and procedures reasonably designed to ensure that their systems have adequate levels of capacity, integrity, resiliency, availability, and security is consistent with a risk-based approach.²⁷⁰ Specifically, as discussed in further detail below, an SCI entity may tailor its policies and procedures based on the relative criticality of a given SCI system to the SCI entity and to the securities markets generally.²⁷¹

c. Critical SCI Systems

²⁶⁷ See DTCC Letter at 3-5; Omgeo Letter at 5-6; and OCC Letter at 3-4.

²⁶⁸ See Omgeo Letter at 5.

²⁶⁹ See OCC Letter at 3-4; and DTCC Letter at 3-4.

²⁷⁰ See adopted Rule 1001(a). See also *infra* Section IV.B.1 (discussing policies and procedures for operational capability).

²⁷¹ See *infra* Section IV.B.1.a-b (discussing the use of risk-based considerations to tailor policies and procedures for operational capability).

As discussed above, in response to comments, the Commission is incorporating a risk-based approach in certain aspects of Regulation SCI.²⁷² To that end, the Commission is adopting a definition of “critical SCI systems” to designate SCI systems that the Commission believes should be subject to the highest level of requirements. As a subset of “SCI systems,” “critical SCI systems” are subject to the same provisions as “SCI systems,” except that critical SCI systems are subject to certain heightened resilience and information dissemination provisions of Regulation SCI. In these respects, critical SCI systems are subject to an increased level of obligation as compared to other SCI systems.²⁷³

Rule 1000 defines “critical SCI systems” as “any SCI systems of, or operated by or on behalf of, an SCI entity that: (a) directly support functionality relating to: (1) clearance and settlement systems of clearing agencies;²⁷⁴ (2) openings, reopenings, and closings on the primary listing market; (3) trading halts; (4) initial public offerings; (5) the provision of consolidated market data; or (6) exclusively-listed securities; or (b) provide functionality to the securities markets for which the availability of alternatives is significantly limited or nonexistent and without which there would be a material impact on fair and orderly markets.”

As noted above, many commenters advocated for a risk-based approach to Regulation SCI and

²⁷² See supra notes 53-56 and accompanying text (discussing comments on a risk-based approach).

²⁷³ See infra Sections IV.B.1.b and IV.B.3.d (discussing the two-hour resumption goal for “critical SCI systems” and information dissemination requirement for “major SCI events,” respectively).

²⁷⁴ “Clearance and settlement systems of clearing agencies” includes systems of registered clearing agencies and exempt clearing agencies subject to ARP. See Rule 1000 (definition of “exempt clearing agency subject to ARP,” which by its terms would also include an entity that has received from the Commission an exemption from registration as a clearing agency under Section 17A of the Act, and whose exemption contains conditions that relate to ARP, or any Commission regulation that supersedes or replaces such policies, including Regulation SCI).

either suggested that only the entities or systems that pose the greatest risk to the markets should be within the scope of the regulation or, alternatively, that the requirements of Regulation SCI be tailored to the specific risk-profile of a particular entity or particular system.²⁷⁵ While the Commission disagrees with commenters who suggested that Regulation SCI should apply only to “critical systems,” as it believes that these are not the only systems that could pose a significant risk to the securities markets, the Commission believes that it is appropriate to hold systems that pose the greatest risk to the markets if they malfunction to higher standards and more stringent requirements under Regulation SCI. Recent events have also demonstrated the importance of certain critical systems functionality, including those that represent “single points of failure” to the securities markets, and the need for more robust market infrastructure, particularly with regard to critical market systems.²⁷⁶

The Commission believes that the adoption of the definition of “critical SCI systems” and heightened requirements for such systems recognizes that some systems are critical to the continuous and orderly functioning of the securities markets more broadly and, as such, ensuring their capacity, integrity, resiliency, availability, and security is of the utmost importance. Therefore, as discussed further below, the Commission believes that it is appropriate for such critical SCI systems to be held to heightened requirements (as compared to those for SCI systems) related to capacity, integrity, resiliency, availability, and security generally; rapid

²⁷⁵ See supra notes 53-56 and 216-222 and accompanying text (discussing comments on a risk-based approach and limiting SCI systems to only core or critical systems).

²⁷⁶ See supra Section II.B (describing recent events involving systems-related issues). In particular, the Nasdaq SIP incident, which caused a disruption in the dissemination of consolidated market data in the equity markets and led to a trading halt in all Nasdaq-listed stocks for several hours, confirmed that disruptions in systems that represent single points of failure can have a major and detrimental impact across an entire national market system.

recovery following wide-scale disruptions; and disclosure of SCI events. The Commission believes that the definition of critical SCI systems is appropriately designed to identify those SCI systems whose functions are critical to the operation of the markets, including those systems that represent potential single points of failure in the securities markets. Systems in this category are those that, if they were to experience systems issues, the Commission believes would be most likely to have a widespread and significant impact on the securities markets.

The first prong of the definition identifies six specific categories of systems that the Commission believes are the most critical to the securities markets, and the most likely to have widespread and significant market impact should a systems issue occur. These are: clearance and settlement systems of clearing agencies; openings, reopenings, and closings on the primary listing market; trading halts; initial public offerings; the provision of consolidated market data (i.e., SIPs); and exclusively-listed securities.

In the context of suggesting the adoption of a risk-based approach for Regulation SCI, some commenters identified those functions that they believed were most critical to the functioning of the markets. Among those identified were clearance and settlement, opening and closing auctions, IPO auctions, the provision of consolidated market data by the SIPs; and trading of exclusively-listed securities.²⁷⁷ The Commission agrees with commenters who

²⁷⁷ See, e.g., Direct Edge Letter at 2 (citing, among others, SIPs and clearance and settlement systems as essential to continuous market-wide operation); KCG Letter at 2-3 (identifying opening and closing auctions, IPO auctions, trading of exclusively-listed options, market data consolidators, and settlement and central clearing as "single points of failure" that should be subject to heightened regulatory requirements); and SIFMA Letter at 4 (stating that highly critical functions should include primary listing exchanges, trading exclusively listed securities, SIPs, clearance and settlement, distribution of unique post-trade transparency information, and real-time market surveillance). Although these commenters were urging that Regulation SCI apply only to these critical systems, as explained above, the Commission believes that such an approach would be too limited.

characterized these categories of systems as critical. In addition, as discussed below, the Commission believes that systems that directly support functionality relating to trading halts should be included in the definition of critical SCI systems.

With respect to “clearance and settlement systems of clearing agencies,” the clearance and settlement of securities is fundamental to securities market activity.²⁷⁸ Clearing agencies perform a variety of services that help ensure that trades settle on time and at the agreed upon terms. For example, clearing agencies compare transaction information (or report to members the results of exchange comparison operations), calculate settlement obligations (including net settlement), collect margin (such as initial and variation margin), and serve as a depository to hold securities as certificates or in dematerialized form to facilitate automated settlement. Because of their role, clearing agencies are critical central points in the financial system. A significant portion of securities activity flows through one or more clearing agencies. Clearing agencies have direct links to participants and indirect links to the customers of participants. Clearing agencies are also linked to each other through common participants and, in some cases, by operational processes. Safe and reliable clearing agencies are essential not only to the stability of the securities markets they serve but often also to payment systems, which may be used by a clearing agency or may themselves use a clearing agency to transfer collateral.²⁷⁹ The safety of securities settlement arrangements and post-trade custody arrangements is also critical to the goal of protecting the assets of investors from claims by creditors of intermediaries and other entities that perform various functions in the operation of the clearing agency.²⁸⁰ Investors

²⁷⁸ See Clearing Agency Standards Release, supra note 76, at 66220, 66264.

²⁷⁹ See Clearing Agency Standards Release, supra note 76, at 66264.

²⁸⁰ See id.

are more likely to participate in markets when they have confidence in the safety and reliability of clearing agencies as well as settlement systems.²⁸¹ Accordingly, the Commission believes “clearance and settlement systems of clearing agencies” are appropriate for inclusion in the definition of critical SCI systems.²⁸²

Similarly, reliable openings, reopenings, and closings on primary listing markets are key to the establishment and maintenance of fair and orderly markets. NYSE and Nasdaq, for example, each have an opening cross for their listed securities that solicits trading interest and generates a single auction price that attracts widespread participation and is relied upon as a benchmark by other markets and market participants.²⁸³ Similar processes are used, and heavy levels of participation typically are generated, at the primary listing markets in the reopening cross that follows a trading halt.²⁸⁴ Closing auctions at the primary listing markets also attract widespread participation, and the closing prices they establish are commonly used as benchmarks, such as to value derivative contracts and generate mutual fund net asset values. As such, during these critical trading periods, market participants rely on the processes of the primary listing markets to effect transactions, and establish benchmark prices that are used in a

²⁸¹ See id.

²⁸² The Commission notes that systems of SCI entities other than clearing agencies that are used in connection with the clearance and settlement of trades are not captured by the definition of “critical SCI systems,” but rather would fall within the definition of “SCI systems,” as discussed above. See supra Section IV.2. The Commission believes that such systems of other SCI entities, such as SROs and ATSS, do not provide the same critical functions or pose the same level of risk to the market as the clearance and settlement systems of clearing agencies as discussed above.

²⁸³ See Nasdaq Rule 4752 (Opening Process) and NYSE Rules 115A (Orders at the Opening) and 123D (Openings and Halts in Trading).

²⁸⁴ See, e.g., Nasdaq Rule 4753 (Nasdaq Halt and Imbalance Crosses) and NYSE Rules 115A (Orders at the Opening) and 123D (Openings and Halts in Trading).

wide variety of contexts so that the unavailability or disruption of systems directly supporting the opening, reopening and closing processes on the primary listing markets could have widespread detrimental effects.²⁸⁵

In addition, the Commission believes that systems directly supporting functionality relating to trading halts²⁸⁶ are essential to the orderly functioning of the securities markets, and therefore should be included in the definition of critical SCI systems. In the event a trading halt is necessary, it is essential that the systems responsible for communicating the trading halt—typically maintained by the primary listing market—are robust and reliable so that the trading halt is effective across the U.S. securities markets. For example, when there is material “news pending” with respect to an issuer, it is the responsibility of the primary listing market to call a regulatory halt by generating a halt message which, when received by other trading centers, requires them to cease trading the security.²⁸⁷ Similar responsibilities are placed on the primary

²⁸⁵ For example, press reports indicated that the decision to close the New York Stock Exchange in the wake of Superstorm Sandy, and the resulting lack of availability of the NYSE opening and closing prices, was a significant contributing cause of the unscheduled closure of the U.S. national securities exchanges. See, e.g., Jenny Strasburg, Jonathan Cheng, and Jacob Bunge, “Behind Decision to Close Markets,” *Wall St. J.*, October 29, 2012. See also Proposing Release, supra note 13, at 18091 (discussing the effects of Superstorm Sandy on the securities markets). While other exchanges outside of the path of Superstorm Sandy did not experience the same risks to their electronic trading systems as the NYSE and could have otherwise opened for business, the risk that opening and closing prices might not be set by NYSE for its listed securities contributed to the consensus recommendation of market participants that the markets remain closed. See Jenny Strasburg, Jonathan Cheng, and Jacob Bunge, “Behind Decision to Close Markets,” *Wall St. J.*, October 29, 2012.

²⁸⁶ For purposes of clarity, the Commission notes that the term “trading halts” as used in this context is intended to capture market-wide halts, such as regulatory halts, rather than a halt to trading for securities on a particular market (for example, caused by a systems issue specific to that market).

²⁸⁷ See, e.g., CTA Plan Section IX(a), available at: <http://www.nyxdata.com/cta>; National Market System Plan To Address Extraordinary Market Volatility, Section VII (“Limit

listing market with respect to calling trading halts under the National Market System Plan to Address Extraordinary Market Volatility, as well as on plan processors to disseminate this information to the public.²⁸⁸ Thus, systems which communicate information regarding trading halts provide an essential service in the U.S. markets and, should a systems issue occur affecting the ability of an SCI entity to provide such notifications, the fair and orderly functioning of the securities markets may be significantly impacted.

Companies offer shares of capital stock to the general public for the first time through the IPO process, in which the primary listing market initiates public trading in a company's shares. The IPO is conducted exclusively on that exchange, and secondary market trading cannot commence on any other exchange until the opening trade is printed on the primary listing market.²⁸⁹ As such, the Commission believes that an exchange's systems that directly support the IPO process and the initiation of secondary market trading are a critical element of the capital formation process and the effective functioning of the securities markets. The Commission believes that these systems, which are the sole responsibility of the primary listing market, can adversely affect not only the IPO of a particular issuer, but may also result in significant

Up/Limit Down Plan"); NYSE Arca Rule 7.12, BATS Rule 11.18, and EDGA Rule 11.14. See also Securities Exchange Act Release No. 67091 (May 31, 2012), 77 FR 33498 (June 6, 2012) (File No. 4-631) (Order Approving, on a Pilot Basis, the National Market System Plan To Address Extraordinary Market Volatility) ("Limit Up/Limit Down Plan Approval Order").

²⁸⁸ See Limit Up/Limit Down Plan, supra note 287 and Limit Up/Limit Down Plan Approval Order, supra note 287.

²⁸⁹ See Rule 12f-2 under the Exchange Act, 17 CFR 240.12f-2 (providing that a national securities exchange may extend unlisted trading privileges to a security when at least one transaction in the security has been effected on the national securities exchange upon which the security is listed and the transaction has been reported pursuant to an effective transaction reporting plan).

monetary losses and harm to investors if they fail.²⁹⁰ As noted in the SCI Proposal, systems issues affecting the two recent high-profile IPOs highlighted how disruptions in IPO systems can have a significant impact on the market.²⁹¹

Systems directly supporting the provision of consolidated market data are also critical to the functioning of U.S. securities markets and represent potential single points of failure in the delivery of important market information. When Congress mandated a national market system in 1975, it emphasized that the systems for collecting and distributing consolidated market data would be central features of the national market system.²⁹² Further, one of the findings of the recent report by the staffs of the Commission and the CFTC on the market events of May 6, 2010 was that “fair and orderly markets require that the standards for robust, accessible, and timely market data be set quite high.”²⁹³ Accurate, timely, and efficient collection, processing, and dissemination of consolidated market data provides the public with ready access to a

²⁹⁰ See, e.g., supra note 36 (discussing the losses associated with Nasdaq’s Facebook IPO).

²⁹¹ Specifically, in March 2012, BATS announced that a “software bug” caused BATS to shut down the IPO of its own stock, and in May 2012, issues with Nasdaq’s trading systems delayed the start of trading in the IPO of Facebook, Inc. and some market participants experienced delays in notifications of whether orders had been filled. See Proposing Release, supra note 13, at 18089; and Securities Exchange Act Release No. 69655, In the Matter of The NASDAQ Stock Market, LLC and NASDAQ Execution Services, LLC (settled action: May 29, 2013), available at: <http://www.sec.gov/litigation/admin/2013/34-69655.pdf>. Nasdaq and Nasdaq Execution Services, LLC consented to an Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 19(h)(1) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Sanctions and a Cease-and-Desist Order.

²⁹² See H.R. Rep. No. 94-229, 94th Cong., 1st Sess. 93 (1975). See also Concept Release on Equity Market Structure, supra note 4, at 3600, and Proposing Release, supra note 13, at 18108 (each discussing the importance of consolidated market data).

²⁹³ See Findings Regarding The Market Events Of May 6, 2010, Report Of The Staffs Of The CFTC And SEC To The Joint Advisory Committee On Emerging Regulatory Issues, September 30, 2010, at 8 (“May 6 Staff Report”).

comprehensive and reliable source of information for the prices and volume of any NMS stock at any time during the trading day.²⁹⁴ This information helps to ensure that the public is aware of the best displayed prices for a stock, no matter where they may arise in the national market system.²⁹⁵ It also enables investors to monitor the prices at which their orders are executed and serves as a data point that helps them to assess whether their orders received best execution.²⁹⁶

Finally, systems directly supporting functionality relating to exclusively-listed securities represent single points of failure in the securities markets, because exclusively-listed securities, by definition, are listed and traded solely on one exchange.²⁹⁷ As such, a trading disruption on the exclusive listing market necessarily will disrupt trading by all market participants in those securities.²⁹⁸

The second prong of the definition is a broader catch-all provision intended to capture any SCI systems, beyond those specifically identified within the first prong of the definition, that provide functionality to the securities markets for which the availability of alternatives is significantly limited or nonexistent and without which there would be a material impact on fair

²⁹⁴ See id.

²⁹⁵ See id.

²⁹⁶ See id. Also, as discussed above, the recent Nasdaq SIP disruption demonstrated that the availability, accuracy, and reliability of consolidated market data is currently central to the functioning of the securities markets, and systems issues affecting such systems can result in major disruptions to the national market system, undermining the maintenance of fair and orderly markets.

²⁹⁷ As noted above, commenters identified the systems supporting the trading of exclusively-listed securities as representing critical points of failure or critical functionality in the securities markets. See, e.g., KCG Letter at 2-3; and SIFMA Letter at 4.

²⁹⁸ For example, as noted above, in April 2013, CBOE delayed the opening of trading on its exchange for over three hours due to an internal "software bug," preventing investors from trading in those products that are singly-listed on CBOE, including options on the S&P 500 Index and the VIX. See supra note 28 and accompanying text.

and orderly markets. The Commission is not aware of any SCI systems that would fall under this prong of the critical SCI systems definition at this time, and notes that this prong of the definition is intended to account for further technology advancements and the continual evolution of the securities markets, in recognition that such developments could result in additional or new types of systems that would, similar to the enumerated categories of systems in the first prong of the definition, become so critical to the continuous and orderly functioning of the securities markets such that they should be subject to the requirements of Regulation SCI imposed on those systems specifically enumerated in the first prong of the definition.

The Commission also notes that the definition applies to those systems “of, or operated by or on behalf of, an SCI entity.” This language mirrors the language in the definitions of SCI system and indirect SCI system, and as discussed above, is intended to cover systems that are third-party systems operated on behalf of SCI entities.²⁹⁹

d. Indirect SCI Systems (Proposed as “SCI Security Systems”)

Proposed Rule 1000 defined the term “SCI security systems” to mean “any systems that share network resources with SCI systems that, if breached, would be reasonably likely to pose a security threat to SCI systems.”³⁰⁰ As adopted, Regulation SCI includes the new term “indirect SCI systems,” in place of the proposed term “SCI security systems.” The term “indirect SCI systems” is defined to mean “any systems of, or operated by or on behalf of, an SCI entity that, if breached, would be reasonably likely to pose a security threat to SCI systems.”

As an initial matter, the Commission has determined to replace the proposed term “SCI security systems” with the adopted term “indirect SCI systems” because it believes that the latter

²⁹⁹ See supra notes 254-260 and accompanying text.

³⁰⁰ See proposed Rule 1000(a) and Proposing Release, supra note 13, at Section III.B.2.

term, in using the word “indirect,” better reflects that it is intended to cover non-SCI systems only if they are not appropriately secured and segregated from SCI systems, and therefore could indirectly pose risk to SCI systems.³⁰¹ The adopted definition of indirect SCI systems includes systems “of, or operated by or on behalf of” of an SCI entity that, “if breached, would be reasonably likely to pose a security threat to SCI systems.” As discussed below, in response to comment that the proposed term would cover too many systems unrelated to SCI systems, the adopted term excludes the phrase “share network resources.”

One commenter expressly supported the definition of SCI security systems and urged that it be expanded to include any technology system that has direct market access.³⁰² In response to this comment, the Commission notes that the adopted definition includes any technology system of, or operated by or on behalf of an SCI entity, that has direct market access if that system meets the definition’s test: whether a breach of that system would be reasonably likely to pose a security threat to SCI systems.

This commenter also suggested that the Commission additionally require SCI entities to have independent security audits performed and allow the auditor to have the ability to define which systems should be included and which can be safely excluded.³⁰³ The Commission is not requiring “independent security audits” to determine which systems would fall within the definition of indirect SCI system as suggested by this commenter,³⁰⁴ because the Commission

³⁰¹ The Commission also believes that eliminating the word “security” from the defined term will help clarify that the term is not limited to systems relating only to security of the SCI entity and its systems (e.g., firewalls, VPNs).

³⁰² See Lauer Letter at 5.

³⁰³ See *id.*

³⁰⁴ See adopted Rule 1000 (definition of “SCI review”) and *infra* Section IV.B.5 (discussing the SCI review requirement).

believes its adopted rule requiring an annual SCI review addresses the commenter's request. The Commission notes that the adopted annual SCI review requirement requires that such review be performed by objective, qualified personnel, and that it include an assessment of logical and physical security controls for SCI systems and indirect SCI systems. The Commission believes that an SCI entity is generally in the best position to assess in the first instance which of its systems may fall within the definition of indirect SCI systems, and that having an independent third party audit to make that determination should be optional rather than required at this time.

Contrary to the commenter urging expansion of the proposed definition of SCI security systems, many commenters argued that the proposed definition was overbroad,³⁰⁵ with several of these same commenters suggesting that the term be deleted from the rule entirely.³⁰⁶ The Commission believes that Regulation SCI warrants inclusion of a definition of indirect SCI systems because an issue or systems intrusion with respect to a non-SCI system still could cause or increase the likelihood of an SCI event with respect to an SCI entity's SCI systems.³⁰⁷ In particular, because systems that are not adequately walled off from SCI systems may present potential entry points to an SCI entity's network and thus represent potential vulnerabilities to SCI systems, the Commission believes that it is important that the provisions of Regulation SCI

³⁰⁵ See, e.g., NYSE Letter at 11; Omgeo Letter at 6; MFA Letter at 6 (noting specifically that the definition could be read to extend to broker-dealers or other third parties); SIFMA Letter at 8; ITG Letter at 5, 12; BIDS Letter at 16-17; MSRB Letter at 7; OCC Letter at 4; FINRA Letter at 12-13; CME Letter at 6; DTCC Letter at 5; Oppenheimer Letter at 3; and Direct Edge Letter at 3.

³⁰⁶ See, e.g., NYSE Letter at 11; Omgeo Letter at 6; MFA Letter at 6; SIFMA Letter at 2; FIF Letter at 3; LiquidPoint Letter at 3; KCG Letter at 18; OCC Letter at 3; and Joint SROs Letter at 5.

³⁰⁷ See Proposing Release, supra note 13, at 18099.

relating to security standards and systems intrusions apply to such systems (i.e., indirect SCI systems).

Many commenters objecting to the proposed definition as too broad addressed particular elements of the proposed definition of SCI security systems or provided specific recommendations for modifications or limitations to the definition.³⁰⁸ For example, some commenters criticized the use of the phrase “share network resources,” noting that it was vague and too broad, potentially encompassing almost any system of an SCI entity.³⁰⁹ Similarly, one commenter stated that the definition of SCI security system should include only systems that “directly” share network resources with an SCI system.³¹⁰ One commenter argued that the definition should only include those systems that are materially and directly connected to the trading operations of an SCI entity.³¹¹ Several commenters recommended that systems that are logically and/or physically separated from SCI systems should be excluded from the definition.³¹² Some commenters qualified this position by stating that such systems should be excluded, for example, as long as SCI entities monitor those systems for security breaches and

³⁰⁸ See NYSE Letter at 12; BATS Letter at 5-6; ISE Letter at 7-8; BIDS Letter at 16-17; SROs Letter at 15; Direct Edge Letter at 3; FINRA Letter at 13; ISE Letter at 8; and DTCC Letter at 5; and ITG Letter at 12.

³⁰⁹ See NYSE Letter at 12; BATS Letter at 5; and ISE Letter at 7-8.

³¹⁰ See BIDS Letter at 16-17.

³¹¹ See ITG Letter at 12 (stating that its suggested approach would, in its case, cover systems for order handling and execution, processing of market data, transaction reporting, and clearing and settlement of trades).

³¹² See, e.g., Joint SROs Letter at 15 (stating that the term “SCI security systems” should be deleted, but if retained, should exclude those systems that are physically and logically separated); BATS Letter at 5-6; Direct Edge Letter at 3; FINRA Letter at 13; ISE Letter at 8; and DTCC Letter at 5.

have the ability to shut the system off if they detect a security breach;³¹³ or provided that the separation is routinely monitored and has appropriate risk controls in place and the system is “air gapped” (i.e., has no point of entry) from the public internet.³¹⁴ One commenter believed that the definition should exclude any system with “compensatory controls in place,” which it stated would protect and secure SCI systems from vulnerabilities that could arise from shared network links.³¹⁵ Another commenter asked for greater clarity on the extent to which SCI security systems that are isolated from production, such as email and intranet sites, raise security issues that are within the scope of the proposal.³¹⁶

After careful consideration of these comments, the Commission believes that inclusion of the phrase “share network resources” in the proposed definition could be interpreted in a manner that would include almost any system that is part of an SCI entity’s network. In response to commenters who expressed concern about the breadth of the proposed definition, the Commission has determined to eliminate the phrase “share network resources” from the definition, so that the adopted result-oriented test depends on whether a system “if breached, would be reasonably likely to pose a security threat to SCI systems.” As a result, the inquiry into whether any system is an indirect SCI system will depend on whether it is effectively physically or logically separated from SCI systems. Systems that are adequately physically or logically separated (i.e., isolated from SCI systems, such that they do not provide vulnerable points of entry into SCI systems) will not fall within the definition of indirect SCI systems.

³¹³ See BATS Letter at 5-6.

³¹⁴ See Direct Edge Letter at 3.

³¹⁵ See FINRA Letter at 13.

³¹⁶ See ISE Letter at 8.

The Commission believes that having adequate separation and security controls should protect SCI systems from vulnerabilities caused by other systems. To the extent that non-SCI systems are sufficiently walled off from SCI systems using appropriate security measures, and thus are not reasonably likely to pose a security threat to SCI systems if breached, they would not be included in the definition of indirect SCI systems, and thus would be outside of the scope of Regulation SCI.

The Commission notes that the definition of indirect SCI systems will not include any systems of an SCI entity for which the SCI entity establishes reasonably designed and effective controls that result in SCI systems being logically or physically separated from such non-SCI systems. Thus, the universe of an SCI entity's indirect SCI systems is in the control of each SCI entity, and SCI entities should reasonably expect Commission staff to assess its security controls around SCI systems in connection with an inspection or examination for compliance with Regulation SCI. If these controls are not present or are not reasonably designed, the applicable non-SCI systems would be within the scope of the definition of indirect SCI systems and subject to the security standards and systems intrusions provisions of Regulation SCI.

Some commenters recommended that, rather than including SCI security systems in the scope of the regulation, the Commission should instead require SCI entities to establish policies and procedures designed to ensure the security of their systems.³¹⁷ According to these commenters, such an approach would require an evaluation of the risks posed to SCI systems by non-SCI systems. As noted, the Commission believes that the adopted definition of "indirect SCI systems" will effectively require SCI entities to evaluate the risks posed to SCI systems by

³¹⁷ See, e.g., NYSE Letter at 12; MFA Letter at 6; SIFMA Letter at 2; FIF Letter at 3; LiquidPoint Letter at 3; KCG Letter at 18; OCC Letter at 3; and Joint SROs Letter at 5.

non-SCI systems. However, the Commission believes that the adopted approach will incentivize SCI entities to seek to have in place strong security controls around SCI systems. As noted, if an SCI entity designs and implements security controls so that none of its non-SCI systems would be reasonably likely to pose a security threat to SCI systems, then it will have no indirect SCI systems. If, however, an SCI entity does have indirect SCI systems, then certain provisions of Regulation SCI will apply to those indirect SCI systems.³¹⁸ The Commission believes this approach to indirect SCI systems is more appropriate than the policies and procedures approach suggested by some commenters because the Commission believes that its approach is more comprehensive as it includes, for example, the requirements to take corrective action, provide notifications to the Commission, and disseminate information for certain SCI events relating to indirect SCI systems which, by definition, if breached, would be reasonably likely to pose a security threat to SCI systems. Another commenter stated that a more precise definition of SCI security systems is important and that it would be valuable for the Commission to work with representatives within the securities industry to collectively craft the most appropriate definition that will ensure that critical security systems are captured.³¹⁹ In crafting the definition, the Commission has taken into account comments received, with such commenters representing a wide variety of types of participants in the securities markets, and believes the adopted definition of indirect SCI systems, along with the definition of SCI systems, is responsive to a broad range of commenters' concerns.³²⁰

³¹⁸ See infra notes 323-328 (discussing the provisions of Regulation SCI applicable to indirect SCI systems).

³¹⁹ See DTCC Letter at 5.

³²⁰ See supra note 17 and accompanying text.

Another commenter suggested that the definition be limited to systems “of, or operated by, or on behalf of, an SCI entity,” noting that the definition of SCI security systems should have parallel construction to the definition of “SCI systems” and without this phrase, SCI entities would be tasked inappropriately with controlling for systems outside of their effective control.³²¹ As noted, the adopted definition of “indirect SCI systems” applies to those systems “of, or operated by or on behalf of, an SCI entity.” As a result, the adopted definition of indirect SCI systems provides (as is the case for SCI systems) that systems “of, or operated by or on behalf of” an SCI entity, are included in the definition of indirect SCI systems if their breach would be reasonably likely to pose a security threat to SCI systems.³²² The Commission believes that the addition of this language is warranted to make clear that security of SCI systems is not limited solely to threats from systems operated directly by the SCI entity. If it were, outsourced systems of SCI entities would not be subject to the requirements of Regulation SCI, which would undermine the goals of Regulation SCI.

As discussed in further detail below, unlike SCI systems, those systems meeting the definition of “indirect SCI systems” will only be subject to certain provisions of Regulation SCI. Specifically, references to “indirect SCI systems” are included in the definitions of “responsible SCI personnel,” “SCI review,” and “systems intrusion” in adopted Rule 1000.³²³ Rule 1001(a), requiring reasonably designed policies and procedures to ensure operational capability, will

³²¹ See MSRB Letter at 7.

³²² See *supra* Section IV.A.2.b (discussing the inclusion of third party systems in the definition of “SCI systems”).

³²³ See adopted Rule 1000.

apply to indirect SCI systems only for purposes of security standards.³²⁴ In addition, Rule 1002, which relates to an SCI entity's obligations with regard to SCI events, will apply to indirect SCI systems only with respect to systems intrusions.³²⁵ Further, pursuant to Rule 1003(a), the obligations related to systems changes will apply to material changes to the security of indirect SCI systems.³²⁶ In addition, the requirements regarding an SCI review will apply to indirect SCI systems.³²⁷ Finally, Rules 1005 through 1007, relating to recordkeeping and electronic filing and submission of Form SCI, respectively, will also apply to indirect SCI systems.³²⁸ The Commission believes that it is appropriate to subject indirect SCI systems to only these specified provisions because the Commission believes that the primary risk posed by indirect SCI systems is that they may serve as vulnerable entry points to SCI systems. The Commission's objective with respect to indirect SCI systems is to guard against a non-SCI system being breached in a manner that threatens the security of any SCI system. The Commission believes that its approach to defining indirect SCI systems, and requiring SCI entities to consider, address, and report on security changes and intrusions into systems where vulnerabilities have been identified, is tailored to meet this objective.

³²⁴ See adopted Rule 1001(a) and supra Section IV.B.1 (discussing the policies and procedures requirement under Rule 1001(a)).

³²⁵ See adopted Rule 1000 (definitions of system compliance and systems disruption, which do not include indirect SCI systems, and the definition of systems intrusion, which includes indirect SCI systems) and supra Section IV.B.3 (discussing an SCI entity's obligations with respect to SCI events).

³²⁶ See adopted Rule 1003(a)(i) and Section IV.B.4 (discussing requirements relating to material systems changes).

³²⁷ See adopted Rule 1003(b) and Section IV.B.5 (discussing the SCI review requirement).

³²⁸ See adopted Rules 1005-1007 and Section IV.C (discussing the recordkeeping and electronic filing of Form SCI).

3. SCI Events

Regulation SCI specifies the types of events—i.e., SCI events—that give rise to certain obligations under the rule, including taking corrective action, reporting to the Commission, and disseminating information about such SCI events.³²⁹ Proposed Rule 1000(a) defined the term “SCI event” as “an event at an SCI entity that constitutes: (1) a systems disruption; (2) a systems compliance issue; or (3) a systems intrusion.”³³⁰ The Commission is adopting the definition of “SCI event” as proposed.

Many commenters believed that the proposed definition of “SCI event” was vague³³¹ or overly broad because it was not limited to capturing material SCI events³³² or events that the commenters believed are truly disruptive and pose a risk to the market.³³³ Specifically, several commenters recommended that the definition of SCI event include a materiality threshold, so that only events determined by the SCI entity to be material would trigger certain obligations under the rule.³³⁴ One commenter stated that the definition of SCI event could be interpreted to

³²⁹ See *infra* Section IV.B.3 (discussing an SCI entity’s obligations with respect to SCI events).

³³⁰ See proposed Rule 1000(a) and Proposing Release, *supra* note 13, at Section III.B.3.

³³¹ See ITG Letter at 12; and OTC Markets Letter at 16.

³³² See FIF Letter at 2; ITG Letter at 12; DTCC Letter at 5; and OTC Markets Letter at 16.

³³³ See NYSE Letter at 3; ICI Letter at 4; Oppenheimer Letter at 3. See also *supra* note 231 and accompanying text (discussing comment that the definition of SCI systems should be revised to cover only those systems where a disruption, compliance issue, intrusion or material systems change would impact investors and markets that are subject to the Commission’s jurisdiction).

³³⁴ See, e.g., FIF Letter at 2 (suggesting factors for determining what is a material SCI event, and urging that only material SCI events be subject to notification requirements); ITG Letter at 12 (suggesting that a Commission notification requirement apply only to those events that have a material impact on the ongoing maintenance of fair and orderly markets in an NMS security); and DTCC Letter at 5 (recommending that each component of the term SCI event be limited by a materiality threshold and be “risk-based” so that the

include trivial events, and therefore believed that the definition needed clarity.³³⁵ Finally, one commenter suggested that SCI event be defined as outlined in Rule 301(b)(6)(ii)(G) under Regulation ATS,³³⁶ which requires a qualifying ATS to notify the Commission of material systems outages and significant systems changes.³³⁷

After careful consideration of the views of commenters, although the Commission is adopting the definition of “SCI event” as proposed, the requirements of Regulation SCI are tiered in a manner that the Commission believes is responsive to the concerns of commenters about the breadth of the definition.³³⁸ Specifically, and as explained in further detail below, the Commission is incorporating a risk-based approach to the obligations of SCI entities with respect to SCI events.³³⁹

The Commission is not incorporating a materiality threshold as requested by some commenters,³⁴⁰ including by limiting the definition of SCI event to only those events that are considered by SCI entities to be truly disruptive to the market.³⁴¹ Rather, the Commission

term includes events that cause a disruption to the SCI entity’s ability to conduct its core functions).

³³⁵ See ITG Letter at 12.

³³⁶ 17 CFR 242.301(b)(6)(ii)(G).

³³⁷ See OTC Markets Letter at 16. In addition, some commenters objected to the inclusion of systems compliance issues within the definition of SCI events. See *infra* notes 403-405 and accompanying text.

³³⁸ See *supra* notes 331-337 and accompanying text.

³³⁹ Under this risk-based approach, for example, de minimis SCI events will not be subject to the immediate Commission reporting requirements as proposed, but rather, SCI entities will only be required to make, keep, and preserve records regarding de minimis SCI events and submit de minimis systems disruptions and de minimis systems intrusions to the Commission in quarterly summary reports. See Rule 1002(b)(5).

³⁴⁰ See *supra* notes 334 and 337 and accompanying text.

³⁴¹ See *supra* note 333 and accompanying text.

believes that the adopted Commission notification and information dissemination requirements for SCI events will help to focus the Commission's and SCI entities' resources on the more significant SCI events by providing appropriate exceptions from reporting and dissemination for events that have no or de minimis impacts on an SCI entity's operations or market participants. In addition, the Commission believes that SCI event should not be defined as outlined in Rule 301(b)(6)(ii)(G) under Regulation ATS as suggested by one commenter,³⁴² because Rule 301(b)(6)(ii)(G) requires Commission notification of "material systems outages."³⁴³ Such an approach would exclude any systems compliance issues or systems intrusions, two types of events that the Commission believes should be included as SCI events. This approach would also create a materiality threshold for systems disruptions, which the Commission believes would not be appropriate, as discussed below.

In addition, by not including a materiality threshold within the definition, SCI entities will be required to assess, take corrective action, and keep records of all such events, some of which may initially seem insignificant to an SCI entity, but which may later prove to be the cause of significant systems issues at the SCI entity. An SCI entity's records of de minimis SCI events may also be useful to the Commission in that they may, for example, aid the Commission in identifying patterns of de minimis SCI events that together might result in a more impactful SCI event, either at an SCI entity or across a group of SCI entities, or circumstances in which an SCI event causes de minimis systems issues for one particular SCI entity but results in significant issues for another SCI entity. The Commission also believes that the ability to view

³⁴² See supra note 337 and accompanying text.

³⁴³ See 17 CFR 242.301(b)(6)(ii)(G). Rule 301(b)(6)(ii)(G) also requires that ATSS promptly notify the Commission of significant systems changes.

such events in the aggregate and across multiple SCI entities is important to allow the Commission and its staff to be able to gather information about trends related to SCI events that could not otherwise be properly discerned. Information about trends will assist the Commission in fulfilling its oversight role by keeping Commission staff informed about the nature and frequency of the types of de minimis SCI events that SCI entities encounter. Moreover, information about trends and notifications of de minimis SCI events generally can also inform the Commission of areas of potential weaknesses, or persistent or recurring problems, across SCI entities and also should help the Commission better focus on common types of SCI events or issues with certain types of SCI systems across SCI entities. This information also will permit the Commission and its staff to issue industry alerts or guidance if appropriate. In addition, this information would allow the Commission and its staff to review SCI entities' classification of SCI events as de minimis SCI events.

In addition, although the definition of SCI event is unchanged, to address commenters' concerns, the Commission has determined to modify the various components of that definition (i.e., the definition of systems disruption, systems compliance issue, and systems intrusion), in certain respects, as discussed below.

a. Systems Disruption

Proposed Rule 1000(a) would have defined "systems disruption" as "an event in an SCI entity's SCI systems that results in: (1) a failure to maintain service level agreements or constraints; (2) a disruption of normal operations, including a switchover to back up equipment with near-term recovery of primary hardware unlikely; (3) a loss of use of any SCI system; (4) a loss of transaction or clearance and settlement data; (5) significant backups or delays in processing; (6) a significant diminution of ability to disseminate timely and accurate market data;

or (7) a queuing of data between systems components or queuing of messages to or from customers of such duration that normal service delivery is affected.”³⁴⁴ As discussed below, in response to comments, the Commission is substantially modifying the proposed definition of systems disruption in adopted Rule 1000.

One commenter stated that the proposed definition of systems disruption was reasonable, but recommended that it be expanded to encompass disruptions originating from a third party.³⁴⁵ However, many other commenters believed that the definition of systems disruption was too broad and would include minor events that they believed should be excluded from the definition.³⁴⁶ Several commenters suggested ways to limit the scope of the defined term. For example, some commenters suggested limiting the definition to material disruptions.³⁴⁷ One of these commenters added that systems disruptions should exclude any regularly planned outages occurring during the normal course of business.³⁴⁸ Another commenter recommended that development and testing environments should be excluded from the definition of systems disruption.³⁴⁹ One commenter suggested modifying the definition to include only two elements: (1) disruptions of either the SCI systems or of the operations of the SCI entity that have the effect

³⁴⁴ See proposed Rule 1000(a) and Proposing Release, supra note 13, at Section III.B.3.a.

³⁴⁵ See Lauer Letter at 5-6.

³⁴⁶ See, e.g., FINRA Letter at 16; BATS Letter at 9; Omgeo Letter at 7; NYSE Letter at 14; Joint SROs Letter at 6; OCC Letter at 6; SIFMA Letter at 9-10; and OTC Markets Letter at 21.

³⁴⁷ See DTCC Letter at 6; SIFMA Letter at 9; OCC Letter at 6; OTC Markets Letter at 21; and Joint SROs Letter at 6.

³⁴⁸ See DTCC Letter at 7.

³⁴⁹ See FINRA Letter at 11, 16 (noting also that the many elements of the defined term were vague). See also Section IV.A.2.b (discussing the definition of “SCI systems,” including the elimination of test and development systems from its definition).

of disrupting the delivery of the SCI service provided by those systems; and (2) degradations of SCI systems processing creating backups or delays of such a degree and duration that the delivery of service is effectively disrupted or unusable by the market participants who use the systems.³⁵⁰

Two commenters believed that the proposed definition of systems disruption was too rigid and should provide for more flexibility and discretion.³⁵¹ Both commenters were skeptical that an event should be reportable solely because it matched the description of one of the seven elements of the definition.³⁵² One of these commenters noted that the Commission's proposed definition seeks to codify as a formal definition language used by the ARP Inspection Program that was meant to provide flexibility and latitude in determining what constitutes a systems disruption.³⁵³ The other commenter thought that the seven prongs of the proposed definition of "systems disruption" were appropriate considerations in determining whether a systems disruption had occurred, but that an SCI entity should be afforded more discretion and flexibility in determining whether a particular issue meets the definition.³⁵⁴

Service Level Agreements

Two commenters believed that the first element of the definition regarding service level agreements should be eliminated.³⁵⁵ One of these commenters stated that an SCI entity's

³⁵⁰ See Omgeo Letter at 11.

³⁵¹ See Omgeo Letter at 7; and OCC Letter at 6-8.

³⁵² See Omgeo Letter at 7; and OCC Letter at 6-8.

³⁵³ See Omgeo Letter at 7.

³⁵⁴ See OCC Letter at 6. This commenter also critiqued or requested clarification for each prong of the definition, as discussed further below.

³⁵⁵ See NYSE Letter at 13; and BATS Letter at 9.

regulatory requirements should not depend upon the negotiated language of an agreement between business partners, while the other commenter noted that, in some cases, a private contract might have more stringent requirements than required by regulation, which would, in effect, transform such agreements into new regulatory obligations.³⁵⁶ Other commenters stated this element should be revised to capture only the most significant disruptions to a service level agreement.³⁵⁷ In addition, one commenter expressed concern that SCI entities may forgo negotiating detailed and stringent service level agreements if the first element were to be adopted as proposed.³⁵⁸

Disruptions of Normal Operations

Two commenters stated that the second element of the definition needs clarification because the phrase “disruption of normal operations” is vague and overbroad and therefore could potentially include minor events.³⁵⁹ Two commenters stated that, if a switchover is utilized and there is no material impact on the core services, then there should not be a requirement to notify the Commission of a systems disruption.³⁶⁰ One of these commenters added that programming errors that occur prior to production and regularly scheduled maintenance should not be

³⁵⁶ See NYSE Letter at 13; and BATS Letter at 9.

³⁵⁷ See DTCC Letter at 7 (suggesting that the definition capture only the most significant disruptions to a service level agreement that are caused by the SCI entity and that impede its ability to perform its core functions and critical operations); and OCC Letter at 7. See also Omgeo Letter at 9 (noting concerns that this element could require reporting of events too minor to be noticed by participants and that do not cause any disruptions of service or material risks to the entity or users).

³⁵⁸ See OCC Letter at 7.

³⁵⁹ See NYSE Letter at 13; and Omgeo Letter at 8.

³⁶⁰ See BATS Letter at 9; and SIFMA Letter at 10.

considered disruptions.³⁶¹ Several commenters also recommended that testing errors should not be included in the definition,³⁶² and one commenter stated that testing errors should only be included if they result in a material impact on an SCI entity's operations.³⁶³

Loss of Use of Any System

One commenter stated that the term "loss of use of any SCI system" is unclear and expressed concern that the lack of clarity may lead to interpretive differences and inconsistencies in application among SCI entities.³⁶⁴ Three commenters discussed failovers to backup systems, with one commenter stating the Commission should clarify whether this constitutes a loss of use of a system,³⁶⁵ another commenter stating that it should not be considered a systems disruption,³⁶⁶ and the third commenter stating that it should only be considered a systems disruption if there is an impact on normal operations.³⁶⁷

Loss of Data

Several commenters stated that losses of transaction or clearance and settlement data that are immediately retrieved, promptly corrected, or, for clearance and settlement data, resolved prior to the close of the trading day should not be systems disruptions.³⁶⁸ One commenter

³⁶¹ See BATS Letter at 10.

³⁶² See BATS Letter at 11; SIFMA Letter at 10; and NYSE Letter at 13.

³⁶³ See Omgeo Letter at 9 (noting that inclusion of testing errors would discourage SCI entities from conducting effective quality assurance programs and could undermine good quality engineering practices).

³⁶⁴ See OCC Letter at 7.

³⁶⁵ See *id.*

³⁶⁶ See NYSE Letter at 13.

³⁶⁷ See Direct Edge Letter at 3.

³⁶⁸ See, e.g., OCC Letter at 7; DTCC Letter at 7; SIFMA Letter at 10; and Omgeo Letter at 11.

suggested that the rule be revised to include as a systems disruption data that is altered or corrupted in some way.³⁶⁹ Another commenter stated that this prong of the definition should include a materiality qualifier.³⁷⁰

Backups or Delays and Market Data Dissemination

With respect to the fifth and sixth elements of the definition regarding significant backups or delays in processing and a significant diminution of ability to disseminate timely and accurate market data, one commenter expressed support for the inclusion of such performance degradations in the definition of systems disruptions but stated that it believed that the Commission's interpretation of the term "significant" in the SCI Proposal was overly broad because it would encompass delays that are small and, in fact, insignificant.³⁷¹

Data Queuing

With respect to the seventh element, one commenter stated that queuing of data is a very good indicator of a problem, but also noted that it is not necessarily being properly monitored by most firms and suggested that the Commission require SCI entities to monitor queue depth.³⁷² However, several other commenters stated that queuing of data is normal and necessary.³⁷³ Some commenters suggested that the Commission should only require reporting of such queuing if it materially affects the delivery of core services to customers.³⁷⁴ One commenter asked for

³⁶⁹ See Omgeo Letter at 11.

³⁷⁰ See NYSE Letter at 14.

³⁷¹ See Omgeo Letter at 9. See also Proposing Release, supra note 13, at 18101-02.

³⁷² See Lauer Letter at 5.

³⁷³ See, e.g., BATS Letter at 10; DTCC Letter at 7; SIFMA Letter at 10; Omgeo Letter at 10; and Joint SROs Letter at 6.

³⁷⁴ See, e.g., BATS Letter at 10-11; DTCC Letter at 7; Omgeo Letter at 10; and OCC Letter at 8.

additional clarification on this element because all systems have queues to some extent with normal functionality and only certain queues should trigger recovery actions.³⁷⁵ One commenter expressed concern that language in the SCI Proposal stating that “queuing of data is a warning signal of significant disruption”³⁷⁶ would make events that are precursors to system disruptions themselves become system disruptions.³⁷⁷

Customer Complaints

Several commenters objected to the Commission’s discussion in the SCI Proposal regarding customer complaints,³⁷⁸ stating that the Commission should not consider each instance in which a customer or systems user complains or inquires about a slowdown or disruption of operations as an indicator of a systems disruption.³⁷⁹ For example, one commenter noted that customer complaints are often ultimately determined to be the result of system errors or discrepancies on the customer’s end, and stated that requiring an SCI entity to treat these complaints as significant systems disruptions simply because they are made would impose an unnecessary burden on the SCI entity.³⁸⁰

Definition of “Systems Disruption” as Adopted

After careful consideration of the views of commenters, the Commission is removing the seven specific types of systems malfunctions that were proposed to define systems disruption.

³⁷⁵ See NYSE Letter at 14.

³⁷⁶ See Proposing Release, *supra* note 13, at 18102.

³⁷⁷ See Omgeo Letter at 9.

³⁷⁸ See Proposing Release, *supra* note 13, at 18102.

³⁷⁹ See, e.g., DTCC Letter at 7; Omgeo Letter at 10; BATS Letter at 11; NYSE Letter at 14; and OCC Letter at 8.

³⁸⁰ See Omgeo Letter at 10-11.

As adopted, "systems disruption" is defined in Rule 1000 to mean "an event in an SCI entity's SCI systems that disrupts, or significantly degrades, the normal operation of an SCI system."

The Commission has considered commenters' suggestions and feedback with respect to the proposed definition, including the criticisms of various aspects of the seven specific types of systems malfunctions delineated in the SCI Proposal and believes that the adopted definition, which largely follows the definition suggested by a commenter, is appropriate.³⁸¹ Specifically, this commenter recommended that the definition of systems disruption be revised to have two elements: (1) disruptions of either the SCI systems or of the operations of the SCI entity that have the effect of disrupting the delivery of the SCI service provided by those systems; and (2) degradations of SCI systems processing creating backups or delays of such a degree and duration that the delivery of service is effectively disrupted or unusable by the market participants who use the systems.³⁸²

The Commission agrees with commenters that the proposed definition of systems disruption had the potential to be both over-inclusive and under-inclusive. The Commission believes that the adopted definition appropriately represents a change in focus of the definition from the prescriptive seven prongs in the SCI Proposal's definition that represented the effects caused by a disruption of an SCI entity's systems to, instead, whether a system is halted or degraded in a manner that is outside of its normal operation. The Commission believes the revised definition sets forth a standard that SCI entities can apply in a wide variety of circumstances to determine in their discretion whether a systems issue should be appropriately categorized as a systems disruption. Further, because the adopted definition of systems

³⁸¹ See id. at 11.

³⁸² See supra note 353 and accompanying text.

disruption takes into account whether a systems problem is outside of normal operations, the Commission also believes that partly addresses the concerns of the commenters suggesting that the definition of systems disruption include a materiality qualifier.³⁸³

Because the Commission agrees with commenters regarding the difficulties of the proposed definition of “systems disruption,” it is not including any of the specific types of systems malfunctions in the adopted definition of “systems disruption.” Thus, the Commission believes SCI entities would likely find it helpful to establish parameters that can aid them and their staff in determining what constitutes the “normal operation”³⁸⁴ of each of its SCI systems, and when such “normal operation” has been disrupted or significantly degraded because those parameters have been exceeded. The Commission agrees with commenters who noted that, given its voluntary nature, entities that participate in the ARP Inspection Program are afforded a certain degree of flexibility and discretion in reporting systems outages, and agrees that, given its proposed application to a mandatory rule, the proposed definition limited the flexibility and discretion of SCI entities in a manner that was overly rigid.³⁸⁵ Although the specific types of

³⁸³ As discussed more fully below, an SCI entity’s assessment of the impact of an event meeting the definition of a systems disruption will affect whether it is subject to an immediate Commission notification obligation, or a recordkeeping and quarterly reporting obligation. See *infra* Section IV.B.3.c (discussing the exclusion of de minimis systems disruptions from immediate Commission notification requirements in Rule 1002(b)(5)).

³⁸⁴ The Commission notes that, for certain SCI systems, “normal operation” may include a certain degree of operational variability that would allow for a given amount of degradation of functionality (e.g., some data queuing or some slowing of response times) before the system’s operations reach the point of being “significantly degraded.” However, such variability parameters may be included as part of an SCI entity’s policies and procedures so that the SCI entity and its personnel would be aware of them before the occurrence of systems issues.

³⁸⁵ Commenters highlighted many examples where a rigid interpretation of the proposed definition had the potential to incorporate into the definition events that could be

systems malfunctions have been removed from the adopted definition of systems disruption, the Commission nonetheless continues to believe, as suggested by one commenter,³⁸⁶ that the types of systems malfunctions that comprised the proposed definition may be useful to SCI entities to consider as indicia of a systems disruption.

As discussed in the SCI Proposal³⁸⁷ and by certain commenters,³⁸⁸ the seven categories of malfunctions in the proposed definition of "systems disruption" have their origin in ARP staff guidance regarding when ARP participants should notify the Commission of system outages and represent practical examples that SCI entities should consider to be systems disruptions in many circumstances. The Commission notes that the revised definition is intended to address some commenters' concerns with the particular elements of the definition of systems disruption as originally proposed. For example, under the modified definition, if an SCI system experiences an unplanned outage but fails over smoothly to its backup system such that there is no disruption or significant degradation of the normal operation of the system, the outage of the primary system would not constitute a systems disruption. On the other hand, an SCI entity may determine that, even when a primary system fails over smoothly to its backup system such that users are not impacted by the failover, operating from the backup system without additional redundancy would not constitute normal operation. In this case, the outage of the primary

considered part of normal operation. See, e.g., supra notes 361, 364, 368, 369, 374, and 379 and accompanying text. As adopted, however, such events would not be captured by the definition of systems disruptions because an event that disrupts, or significantly degrades, the normal operation of an SCI system would not be considered the "normal operation" of such SCI system.

³⁸⁶ See supra note 354 and accompanying text.

³⁸⁷ See Proposing Release, supra note 13, at 18101.

³⁸⁸ See supra note 353 and accompanying text.

system would fall within the definition of systems disruption. Further, the Commission believes it would be appropriate for an SCI entity to take into account regularly scheduled outages or scheduled maintenance as part of “normal operations.”³⁸⁹ In particular, a planned disruption to an SCI system that is a part of regularly scheduled outages or scheduled maintenance would not constitute a systems disruption or be subject to the requirements of Regulation SCI, if such regularly scheduled outages or scheduled maintenance are part of the SCI entity’s normal operations. With regard to data queuing, to the extent that such queuing is part of the normal functionality of a system and does not cause a disruption or significant degradation of normal operations, it would not be captured by the rule, which is limited to events occurring to an SCI system that are outside its normal operations.³⁹⁰ Additionally, by eliminating the seven types of malfunctions from the definition as proposed, the Commission has responded to commenters who expressed concern that events that are precursors to system disruptions, such as the queuing of data, would themselves be systems disruptions.³⁹¹ Similarly, by eliminating the seven types of malfunctions, the Commission has addressed comments that called for the elimination of specific elements of the proposed definition, such as service level agreements.³⁹²

Further, the Commission agrees with commenters that customer complaints may be indicia of a systems issue,³⁹³ but that a customer complaint alone would not be determinative of

³⁸⁹ See supra note 361 and accompanying text.

³⁹⁰ See supra notes 372-377 and accompanying text.

³⁹¹ See supra note 377 and accompanying text.

³⁹² See supra notes 355 and 358 and accompanying text.

³⁹³ The Commission agrees, as noted by some commenters, that in some instances, customer complaints may be the result of a problem at a system not operated by (or on behalf of) an applicable SCI entity, but rather a system operated by the customer itself. See supra note 380 and accompanying text.

whether a system problem has occurred that meets the definition of systems disruption under Regulation SCI.³⁹⁴ With respect to the commenters who stated that losses of transaction or clearance and settlement data that are immediately retrieved, promptly corrected, or, for clearance and settlement data, resolved prior to the close of the trading day should not be systems disruptions, the adopted definition would exclude these events if they do not disrupt or significantly degrade the normal operations of an SCI system.³⁹⁵ However, if loss of transaction or clearance and settlement data disrupts or significantly degrades the normal operation of an SCI system, it would constitute a systems disruption and be subject to the requirements of Regulation SCI (e.g., immediate or quarterly Commission notification, depending on the impact of the disruption).

Several commenters also suggested that testing errors or other disruptions in development and testing environments should be excluded from the definition of systems disruption.³⁹⁶ The Commission notes that, as discussed above, development and testing systems have been excluded from the definition of SCI systems, and thus such disruptions would not be subject to the requirements of Regulation SCI.³⁹⁷

³⁹⁴ See supra notes 379-380 and accompanying text.

³⁹⁵ See supra note 368. The Commission notes that for clearance and settlement systems, normal operations would include all steps necessary to effectuate timely and accurate end of day settlement. In response to the commenter who stated that the definition of systems disruption should be revised to include data that is altered or corrupted in some way, because the Commission has determined to eliminate the pronged approach to the definition of systems disruption, the Commission notes that, under the adopted definition, data that is altered or corrupted in some way may be a systems disruption if such altered or corrupted data disrupt or significantly degrade the affected SCI system's normal operation. See supra note 369.

³⁹⁶ See supra notes 361-363 and accompanying text.

³⁹⁷ See supra Section IV.A.2.b (discussing the definition of "SCI systems").

The Commission is not incorporating a materiality threshold into the definition of systems disruption as requested by some commenters.³⁹⁸ Rather, as discussed below, the requirements of Regulation SCI are tiered in a manner that the Commission believes is responsive to commenters' concerns regarding the breadth of the definition of systems disruption (while stopping short of including a materiality standard).³⁹⁹ In particular, the Commission believes that the adopted Commission notification and information dissemination requirements for SCI events (i.e., quarterly Commission reporting of de minimis systems disruptions, and an exception for de minimis systems disruptions from the information dissemination requirement) will help to focus the Commission's and SCI entities' resources on the more significant systems disruptions. In addition, by not including a materiality threshold within the definition, SCI entities will be required to assess, take corrective action, and keep records of all systems disruptions, some of which may initially seem insignificant to an SCI entity, but which may later prove to be the cause of significant systems disruptions at the SCI entity. An SCI entity's records of de minimis systems disruptions may also be useful to the Commission in that they may, for example, aid the Commission in identifying patterns of de minimis systems disruptions that together might result in a more impactful SCI event, either at an SCI entity or across a group of SCI entities, or circumstances in which a systems disruption causes de minimis systems issues for one particular SCI entity but results in significant issues for another SCI entity. The Commission also believes that the ability to view de minimis SCI events in the aggregate and

³⁹⁸ See supra note 347 and accompanying text.

³⁹⁹ See Rule 1002(b)(5) and infra Section IV.B.3.c (discussing the Commission notification requirement for SCI events and requiring a quarterly summary report for de minimis systems disruptions). See also Rule 1002(c)(4) and infra Section IV.B.3.d (discussing information dissemination requirement for certain SCI events, but excluding de minimis systems disruptions).

across multiple SCI entities is important to the Commission and its staff to be able to gather information about trends related to such systems disruptions that could not otherwise be properly discerned. Information about trends will assist the Commission in fulfilling its oversight role by keeping Commission staff informed about the nature and frequency of the types of de minimis systems disruptions that SCI entities encounter. Moreover, information about trends can also inform the Commission of areas of potential weaknesses, or persistent or recurring problems, across SCI entities and also should help the Commission better focus on common types of systems disruptions with certain types of SCI systems across SCI entities. This information also would permit the Commission and its staff to issue industry alerts or guidance if appropriate. In addition, this information would allow the Commission and its staff to review SCI entities' classification of events as de minimis systems disruptions. Moreover, the Commission believes that, even without adopting a materiality threshold, the adopted definition of SCI systems further focuses the scope of the definition of systems disruption.⁴⁰⁰

The Commission also believes that it is unnecessary to modify the definition of systems disruption specifically to encompass disruptions originating from a third party, as one commenter suggested.⁴⁰¹ The definition of systems disruption does not limit such events with respect to the source of the disruption, whether an internal source at the SCI entity or an external third party source.

b. Systems Compliance Issue

Proposed Rule 1000(a) would have defined the term "systems compliance issue" as "an event at an SCI entity that has caused any SCI system of such entity to operate in a manner that

⁴⁰⁰ See supra Sections IV.A.2.b (discussing the definition of "SCI systems").

⁴⁰¹ See supra note 345.

does not comply with the federal securities laws and rules and regulations thereunder or the entity's rules or governing documents, as applicable."⁴⁰² The Commission is adopting the definition of systems compliance issue substantially as proposed, with modifications to refine its scope.

Two commenters stated that the term "systems compliance issue" should be deleted from the definition of SCI event entirely.⁴⁰³ One of these commenters stated that the inclusion of systems compliance issue as an SCI event would be a departure from the ARP Inspection Program and ARP Policy Statements.⁴⁰⁴ The other commenter argued that any report regarding a systems compliance issue is an admission that the SCI entity has violated a law, rule, or one of its governing documents, creating a risk of an enforcement action or other liability for the SCI entity.⁴⁰⁵

Other commenters stated that the proposed definition is too broad and should be refined to include only those issues that are material or significant.⁴⁰⁶ Commenters' specific recommendations included limiting the definition to those systems compliance issues that: have a material and significant effect on members;⁴⁰⁷ can be reasonably expected to result in significant harm or loss to market participants or impact the operation of a fair and orderly

⁴⁰² See proposed Rule 1000(a) and Proposing Release, supra note 13, at Section III.B.3.b.

⁴⁰³ See Omgeo Letter at 13; and NYSE Letter at 16.

⁴⁰⁴ See Omgeo Letter at 14.

⁴⁰⁵ See NYSE Letter at 16.

⁴⁰⁶ See, e.g., Joint SROs Letter at 2, 8; ISE Letter at 6; SIFMA Letter at 13; Liquidnet Letter at 3; CME Letter at 8; DTCC Letter at 6; OCC Letter at 13; and FINRA Letter at 17 (stating that systems compliance issues should be reportable only if they would directly impact the market or a member firm's ability to comply with FINRA rules). See also BATS Letter at 13.

⁴⁰⁷ See ISE Letter at 6-7.

market;⁴⁰⁸ or have a materially negative impact on the SCI entity's ability to perform its core functions.⁴⁰⁹ One commenter also noted that the term should be specifically defined to take account of an SCI entity's function, such as clearing agencies' ability to comply with Section 17A.⁴¹⁰

After considering the view of commenters that the proposed definition of systems compliance issue is too broad,⁴¹¹ the Commission is revising the definition to mean an event that has caused an SCI system to operate "in a manner that does not comply with the Act" and the rules and regulations thereunder and the entity's rules and governing documents, as applicable.⁴¹² The Commission believes the refinement from "federal securities laws" to "the Act" (*i.e.*, the Securities Exchange Act of 1934) will appropriately focus the definition on Exchange Act compliance rather than other areas of the federal securities laws. Although the Commission did not receive specific comment suggesting that it amend the definition of systems compliance issue by using the term "the Act" instead of the broader "federal securities laws," commenters did suggest that the Commission limit the scope of the definition to only apply to those sections of the Act that are applicable to a particular SCI entity⁴¹³ or the SCI entity's

⁴⁰⁸ See Liquidnet Letter at 3; and CME Letter at 8. See also FINRA Letter at 17.

⁴⁰⁹ See DTCC Letter at 6; and OCC Letter at 13.

⁴¹⁰ See DTCC Letter at 6. See also *infra* Sections IV.B.3.c and IV.B.3.d (discussing comments with respect to systems compliance issues and their relation to Commission notification and information dissemination to members or participants).

⁴¹¹ See *supra* note 406 and accompanying text.

⁴¹² As noted above, proposed Rule 1000 defined systems compliance issue as an event at an SCI entity that has caused any SCI system of such entity to operate "in a manner that does not comply with the federal securities laws" and rules and regulations thereunder or the entity's rules and governing documents, as applicable.

⁴¹³ See *supra* note 410 and accompanying text.

rules.⁴¹⁴ The Commission agrees with these commenters insofar as they advocated for focusing the scope to a more specific set of securities laws and for reducing the burden on SCI entities, and further believes this refinement does not compromise the objective of the definition, which is to capture systems compliance issues with respect to SCI entities' obligations under the Exchange Act. The Commission believes that the refinement provides additional clarity to SCI entities that, for purposes of Regulation SCI, their obligations are with respect to compliance with the Exchange Act and the rules and regulations thereunder and the entity's rules and governing documents.⁴¹⁵

The Commission disagrees with commenters who suggested removing systems compliance issues from the definition of SCI event altogether.⁴¹⁶ Although systems compliance issues have not been within the scope of the ARP Inspection Program,⁴¹⁷ the Commission believes that inclusion of systems compliance issues in the definition of SCI event and the resulting applicability of the Commission reporting, information dissemination, and recordkeeping requirements to systems compliance issues is important to help ensure that SCI systems are operated by SCI entities in compliance with the Exchange Act, rules thereunder, and their own rules and governing documents.

⁴¹⁴ See supra note 406 and accompanying text.

⁴¹⁵ Notwithstanding this provision's focus on compliance with the Exchange Act and the rules and regulations thereunder and the entity's rules and governing documents, the Commission notes that its objective in adopting Regulation SCI is not, for example, to change the obligations of SCI entities that are public companies with respect to their disclosure obligations under the Securities Act of 1933. See 15 U.S.C. § 77a et seq.

⁴¹⁶ See supra notes 403-405 and accompanying text.

⁴¹⁷ See supra note 404 and accompanying text. See also Proposing Release, supra note 13, at 18087.

In addition, the Commission is not adopting a materiality qualifier⁴¹⁸ or other limiting threshold⁴¹⁹ in the definition of systems compliance issue as suggested by some commenters. Instead, the requirements of Regulation SCI are tiered in a manner that the Commission believes is responsive to commenters' concerns regarding the breadth of the definition of systems compliance issue.⁴²⁰ In particular, the Commission believes that the adopted Commission notification requirement and the information dissemination requirement (each of which provides an exception for systems compliance issues that have no or de minimis impacts on an SCI entity's operations or market participants) will help to focus the Commission's and SCI entities' resources on those systems compliance issues with more significant impacts. In addition, by not including a materiality threshold within the definition, SCI entities will be required to assess, take corrective action, and keep records of all systems compliance issues, some of which may initially seem to have little or no impact, but which may later prove to be the cause of significant systems compliance issues at the SCI entity. The Commission notes that all SCI entities are required to comply with the Exchange Act, the rules and regulations thereunder, and their own rules, as applicable. Therefore, even if an SCI entity determines that a systems compliance issue has no or a de minimis impact, the Commission believes that it is important that it have ready access to records regarding such de minimis systems compliance issues to allow it to more effectively oversee SCI entities' compliance with the Exchange Act and relevant rules. An SCI

⁴¹⁸ See supra notes 406-407 and 409 and accompanying text.

⁴¹⁹ See supra note 408.

⁴²⁰ See Rule 1002(b)(5) and infra Section IV.B.3.c (discussing the Commission notification requirement for SCI events and the exclusion for de minimis systems compliance issues). See also Rule 1002(c)(4) and infra Section IV.B.3.d (discussing the information dissemination requirement for certain SCI events, but excluding de minimis systems compliance issues).

entity's records of de minimis systems compliance issues may also be useful to the Commission in that they may, for example, aid the Commission in identifying areas of potential weaknesses, or persistent or recurring problems, at an SCI entity or across multiple SCI entities. This information also would permit the Commission and its staff to issue industry alerts or guidance if appropriate. In addition, this information would allow the Commission and its staff to review SCI entities' classification of events as de minimis systems compliance issues.

Finally, the Commission believes that, even without adopting a materiality threshold, the adopted definition of SCI systems, as described in Section IV.A.2 above, further focuses the scope of the definition of systems compliance issue.

With respect to a commenter's concern that any report regarding a systems compliance issue would be an admission of a violation and thus create a risk of enforcement action or other liability,⁴²¹ the Commission notes that the Commission notification requirement is not triggered until a responsible SCI personnel has a reasonable basis to conclude that a systems compliance issue has occurred.⁴²² The Commission acknowledges that it could consider the information provided to the Commission in determining whether to initiate an enforcement action. However, the Commission notes that the occurrence of a systems compliance issue also does not necessarily mean that the SCI entity will be subject to an enforcement action. Rather, the Commission will exercise its discretion to initiate an enforcement action if the Commission determines that action is warranted, based on the particular facts and circumstances of an individual situation.⁴²³ With respect to the potential for other types of liability as suggested by

⁴²¹ See supra note 405 and accompanying text.

⁴²² See supra Section IV.B.3.a (discussing the triggering standard).

⁴²³ See, e.g., infra notes 626-628 and accompanying text.

this commenter, many entities that fall within the definition of SCI entity already currently disclose to the Commission and their members or participants certain information regarding systems issues, including issues that may potentially give rise to liability.⁴²⁴ Moreover, the Commission recognizes that compliance with Regulation SCI will increase the amount of information about SCI events available to the Commission and SCI entities' members and participants, and that the greater availability of this information has some potential to increase litigation risks for SCI entities, including the risk of private civil litigation. The Commission believes that the value of disclosure to the Commission, market participants and investors justifies the potential increase in litigation risk. Moreover, the Commission notes that, to the extent members and participants or the public suffer damages when SCI events occur, SCI entities are already subject to litigation risk.

As adopted, Rule 1000 defines "systems compliance issue" as "an event at an SCI entity that has caused any SCI system of such entity to operate in a manner that does not comply with the Act and the rules and regulations thereunder or the entity's rules or governing documents, as applicable." As noted in the SCI Proposal, a systems compliance issue could, for example, occur when a change to an SCI system is made by information technology staff, without the knowledge or input of regulatory staff, that results in the system operating in a manner that does not comply with the Act and rules thereunder or the entity's rules and other governing documents.⁴²⁵ For an SCI SRO, systems compliance issues would include SCI systems operating in a manner that does

⁴²⁴ See supra Section II.B (discussing recent events related to systems issues).

⁴²⁵ See Proposing Release, supra note 13, at 18103.

not comply with the SCI SRO's rules as defined in the Act and the rules thereunder.⁴²⁶ For a plan processor, systems compliance issue would include SCI systems operating in a manner that does not comply with an applicable effective national market system plan. For an SCI ATS or exempt clearing agency subject to ARP, a systems compliance issue would include SCI systems operating in a manner that does not comply with documents such as subscriber agreements and any rules provided to subscribers and users and, for an ATS, described in its Form ATS filings with the Commission.⁴²⁷

c. Systems Intrusion

Proposed Rule 1000(a) defined "systems intrusion" as "any unauthorized entry into the SCI systems or SCI security systems of an SCI entity."⁴²⁸ The proposed definition is being adopted as proposed, with one technical modification to replace the term "SCI security systems" with "indirect SCI systems."⁴²⁹

While one commenter noted its general support for the inclusion of systems intrusions within the scope of Regulation SCI,⁴³⁰ this commenter and others stated that the proposed definition was too broad or vague.⁴³¹ Several commenters asserted that the proposed definition

⁴²⁶ The rules of an SCI SRO include, among other things, its constitution, articles of incorporation, and bylaws. See 15 U.S.C. 78c(a)(27)-(28). See also 17 CFR 240.19b-4(c).

⁴²⁷ Subscriber agreements and other similar documents that govern operations of SCI ATSS and exempt clearing agencies subject to ARP are generally not publicly available, but are typically provided to subscribers and users of such entities. See 17 CFR 242.301(b) for a description of the filing requirements for ATSS.

⁴²⁸ See proposed Rule 1000(a) and Proposing Release, supra note 13, at Section III.B.3.c.

⁴²⁹ See supra Section IV.A.2.d (discussing the definition of "indirect SCI systems").

⁴³⁰ See NYSE Letter at 15.

⁴³¹ See, e.g., NYSE Letter at 15; BATS Letter at 12; DTCC Letter at 7; Omgeo Letter at 11; SIFMA Letter at 10-11; and Joint SROs Letter at 7.

would capture too many insignificant and minor incidents.⁴³² Some commenters recommended limiting the definition to material systems intrusions, and offered various suggestions for how to do so.⁴³³

One commenter stated that the proposed definition was overbroad because it would include both intentional and unintentional conduct, as well as events that have no adverse impact.⁴³⁴ Another commenter also stated that the definition should be modified to make clear that an intrusion that is inadvertent would not qualify as a systems intrusion.⁴³⁵ This commenter further stated that a systems intrusion should be limited to unauthorized access to confidential information or to the SCI systems of an SCI entity that materially disrupts the operations of such

⁴³² See, e.g., BATS Letter at 12; DTCC Letter at 7; Omgeo Letter at 11; SIFMA Letter at 10-11; and Joint SROs Letter at 7.

⁴³³ See, e.g., NYSE Letter at 15 (recommending that the definition include only major intrusions that pose a plausible risk to the trading, routing, or clearance and settlement operations of the exchange or to required market data transmission); Omgeo Letter at 11-12 (expressing concern that the definition did not contain a reference to the materiality of an intrusion, nor the intrusion's impact on markets or market participants); DTCC Letter at 7 (suggesting that the definition capture only unauthorized entries where the SCI entity has reason to believe such entry could materially impact its ability to perform its core functions or critical operations); Joint SROs Letter at 7 (stating that the definition should include only those intrusions that the SCI entity reasonably estimated would result in significant harm or loss to market participants); FINRA Letter at 18 (arguing that only intrusions that have a material impact on the SCI system or a direct impact on the market or market participants should be included); and OCC Letter at 13 (suggesting, as an alternative to a "risk-based" approach, that the definition be limited to any unauthorized entry into the SCI systems or SCI security systems of an SCI entity, which the SCI entity reasonably believes may materially impact its ability to perform its core functions or critical operations).

⁴³⁴ See, e.g., BATS Letter at 12.

⁴³⁵ See SIFMA Letter at 11.

systems.⁴³⁶ Another commenter suggested that the definition focus on the unauthorized control of the confidentiality, integrity, or availability of an SCI system and/or its data.⁴³⁷

Some commenters noted that the proposed definition of systems intrusion did not take into account the multi-layered nature of today's technology systems. Two commenters stated that the multi-layered protections of systems architecture are designed to anticipate intrusions into the outer layer without material risk or impact, thus intrusions into such a peripheral system should not constitute a systems intrusion under the rule.⁴³⁸

Several commenters stated that only successful systems intrusions should be covered in the definition.⁴³⁹ One commenter suggested that this concept be made explicit in the rule text by adding the term "successful" to the definition.⁴⁴⁰ Two commenters, while supporting the inclusion of only successful systems intrusions in the definition, pointed out the value of sharing information regarding unsuccessful systems intrusions, stating that this practice already occurs today among SCI entities, their regulators, and appropriate law enforcement agencies.⁴⁴¹

As adopted, Rule 1000 defines "systems intrusion" to mean "any unauthorized entry into the SCI systems or indirect SCI systems of an SCI entity." This definition is intended to cover any unauthorized entry into SCI systems or indirect SCI systems, regardless of the identity of the person committing the intrusion (whether they are outsiders, employees, or agents of the SCI

⁴³⁶ See id.

⁴³⁷ See NYSE Letter at 15.

⁴³⁸ See SIFMA Letter at 11; and Omgeo Letter at 12. The Commission discusses below the comments that advocated greater Commission use of FS-ISAC for reporting systems intrusions.

⁴³⁹ See BIDS Letter at 17; SIFMA Letter at 11; NYSE Letter at 15; DTCC Letter at 8.

⁴⁴⁰ See NYSE Letter at 15.

⁴⁴¹ See BIDS Letter at 17; and DTCC Letter at 8.

entity), and regardless of whether or not the intrusion was part of a cyber attack, potential criminal activity, or other unauthorized attempt to retrieve, manipulate, or destroy data, or access or disrupt systems of SCI entities. Thus, for example, this definition is intended to cover the introduction of malware or other attempts to disrupt SCI systems or indirect SCI systems provided that such systems were actually breached. In addition, the definition is intended to cover unauthorized access, whether intentional or inadvertent, by employees or agents of the SCI entity that resulted from weaknesses in the SCI entity's access controls and/or procedures. In response to comments, the Commission emphasizes that the definition of systems intrusion does not include unsuccessful attempts at unauthorized entry because an unsuccessful systems intrusion is much less likely to disrupt the systems of an SCI entity than a successful intrusion. The Commission believes that it is unnecessary and redundant to specifically state in the definition of systems intrusion that unauthorized entries must be "successful" because the term "entry" incorporates the concept of successfully gaining access to an SCI system or indirect SCI system.

Further, the Commission is not incorporating a materiality threshold for the definition of systems intrusion or otherwise limiting the definition of systems intrusion to only those systems intrusions that are major or significant as requested by some commenters. The Commission believes that, even without adopting a materiality threshold, the adopted definitions of SCI systems and indirect SCI systems further focus the scope of the definition of systems intrusion. Further, because any unauthorized entry into an SCI system or indirect SCI system is a security breach of which the Commission, having responsibility for oversight of the U.S. securities markets, should be notified, the Commission is not including a materiality threshold. In addition, as discussed below, the requirements of Regulation SCI are tiered in a manner that the

Commission believes is responsive to commenters' concerns regarding the breadth of the definition of systems intrusion.⁴⁴² By not including a materiality threshold within the definition, SCI entities will be required to assess, take corrective action, and keep records of all systems intrusions, some of which may initially seem insignificant to an SCI entity, but which may later prove to be the cause of significant systems issues at the SCI entity. An SCI entity's records of de minimis systems intrusions may also be useful to the Commission in that they may, for example, aid the Commission in identifying patterns of de minimis systems intrusions that together might result in a more impactful SCI event, either at an SCI entity or across a group of SCI entities, or circumstances in which a systems intrusion causes de minimis systems issues for one particular SCI entity but results in significant issues for another SCI entity. The Commission also believes that the ability to view de minimis systems intrusions in the aggregate and across multiple SCI entities is important to allow the Commission and its staff to be able to gather information about trends related to such systems intrusions that could not otherwise be properly discerned. Information about trends will assist the Commission in fulfilling its oversight role by keeping Commission staff informed about the nature and frequency of the types of de minimis systems intrusions that SCI entities encounter. Moreover, information about trends and notifications of de minimis systems intrusions generally can also inform the Commission of areas of potential weaknesses, or persistent or recurring problems, across SCI entities and also should help the Commission better focus on common types of systems intrusions or issues with certain types of SCI systems across SCI entities. This information also would permit the

⁴⁴² See Rule 1002(b)(5) and *infra* Section IV.B.3.c (discussing the Commission notification requirement for SCI events and requiring a quarterly summary report for de minimis systems intrusions). See also Rule 1002(c)(4) and *infra* Section IV.B.3.d (discussing information dissemination requirement for certain SCI events, but excluding de minimis systems intrusions).

Commission and its staff to issue industry alerts or guidance if appropriate. In addition, this information would allow the Commission and its staff to review SCI entities' classification of events as de minimis systems intrusions.

The Commission also is not distinguishing between intentional and unintentional systems intrusions, as suggested by some commenters.⁴⁴³ The Commission acknowledges that intentional systems intrusions may result in more severe disruptions to the systems of an SCI entity than unintentional or inadvertent intrusions. On the other hand, the Commission believes that it should be notified of successful unintentional or inadvertent systems intrusions because they can still indicate weaknesses in a system's security controls. To the extent that these systems intrusions have no or a de minimis impact on the SCI entity's operations or on market participants, they will only be subject to a quarterly reporting requirement and will be excepted from the information dissemination requirement.⁴⁴⁴

Additionally, the Commission does not agree that the definition of systems intrusion should be limited to unauthorized access to confidential information⁴⁴⁵ or should be focused on the unauthorized control of the confidentiality, integrity, or availability of an SCI system and/or its data⁴⁴⁶ because the Commission believes that these modifications would create a definition that would limit the Commission's ability to be aware of events that fall outside the limited

⁴⁴³ See supra notes 434-435 and accompanying text.

⁴⁴⁴ See Rule 1002(b)(5) and infra Section IV.B.3.c (discussing the Commission notification requirement for SCI events and requiring a quarterly summary report for de minimis systems intrusions). See Rule 1002(c)(4), and infra Sections IV.B.3.d (discussing the information dissemination requirements for certain SCI events, but excluding de minimis systems intrusions).

⁴⁴⁵ See supra note 436 and accompanying text.

⁴⁴⁶ See supra note 437 and accompanying text.

definition that commenters suggested but that could, for example, have industry-wide implications. Similarly, with respect to the comment that intrusions into a peripheral system should not constitute a systems intrusion because the multi-layered protections of systems architecture are designed to anticipate intrusions into the outer layer and help prevent material risk or impact,⁴⁴⁷ the Commission believes that its discussion of indirect SCI systems in Section IV.A.2.d above responds to commenters' concerns by explaining that systems intrusions into an indirect SCI system could cause or increase the likelihood of an SCI event with respect to an SCI system. And to the extent a system intrusion occurs with respect to an SCI system or indirect SCI system but the SCI entity's multi-layered systems architecture helps prevent material risk or impact, the Commission notes that de minimis systems intrusions (if such a system intrusion was determined to be de minimis) would be subject to less frequent Commission reporting requirements and would not be subject to the information dissemination requirements.

B. Obligations of SCI Entities – Rules 1001-1004

Proposed Rules 1000(b)(1)-(9) are renumbered as adopted Rules 1001-1004. Adopted Rule 1001 corresponds to proposed Rules 1000(b)(1)-(2) and contains the policies and procedures requirements for SCI entities with respect to operational capability and the maintenance of fair and orderly markets (Rule 1001(a)), systems compliance (Rule 1001(b)), and identification and designation of responsible SCI personnel and escalation procedures (Rule 1001(c)).⁴⁴⁸ Adopted Rule 1002 corresponds to proposed Rules 1000(b)(3)-(5) and contains the obligations of SCI entities with respect to SCI events, which include corrective action,

⁴⁴⁷ See supra note 438 and accompanying text.

⁴⁴⁸ The discussion of Rule 1001(c), which relates to the triggering standard for Rule 1002, is discussed below in Section IV.B.3.a.

Commission notification, and information dissemination. Adopted Rule 1003 corresponds to proposed Rules 1000(b)(6)-(8) and contains requirements relating to material systems changes and SCI reviews. Finally, adopted Rule 1004 corresponds to proposed Rule 1000(b)(9) and contains requirements relating to business continuity and disaster recovery plan testing, including requiring participation of designated members or participants of SCI entities in such testing.

1. Policies and Procedures to Achieve Capacity, Integrity, Resiliency, Availability and Security – Rule 1001(a)

a. Proposed Rule 1000(b)(1)

Proposed Rule 1000(b)(1) would have required an SCI entity to: (1) establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems and, for purposes of security standards, SCI security systems, have levels of capacity, integrity, resiliency, availability, and security, adequate to maintain the SCI entity's operational capability and promote the maintenance of fair and orderly markets; and (2) include certain required elements in such policies and procedures. As proposed, these policies and procedures were required to provide for: (A) the establishment of reasonable current and future capacity planning estimates; (B) periodic capacity stress tests of systems to determine their ability to process transactions in an accurate, timely, and efficient manner; (C) a program to review and keep current systems development and testing methodology; (D) regular reviews and testing of systems, including backup systems, to identify vulnerabilities pertaining to internal and external threats, physical hazards, and natural or manmade disasters; (E) 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 two-hour resumption of clearance and settlement services following a wide-scale disruption; and (F) standards that result in systems being designed, developed, tested, maintained, operated, and

surveilled in a manner that facilitates the successful collection, processing, and dissemination of market data.

Proposed Rule 1000(b)(1)(i) also provided that an SCI entity's applicable policies and procedures would be deemed to be reasonably designed if they were consistent with "current SCI industry standards." Proposed Rule 1000(b)(1)(ii) provided that "current SCI industry standards" were to be comprised of "information technology practices that are widely available for free to information technology professionals in the financial sector...and issued by an authoritative body that is a U.S. governmental entity or agency, association of U.S. governmental entities or agencies, or widely recognized organization."⁴⁴⁹ The SCI Proposal also included, on "Table A," a list of publications that the Commission had preliminarily identified as examples of current SCI industry standards in each of nine information security domains.⁴⁵⁰ The SCI Proposal stated that an SCI entity, taking into account its nature, size, technology, business model, and other aspects of its business, could, but would not be required to, use the publications listed on Table A to establish, maintain, and enforce reasonably designed policies and procedures that satisfy the requirements of proposed Rule 1000(b)(1).⁴⁵¹ The SCI Proposal also stated that "current SCI industry standards" were not limited to those identified in the publications on Table A and could include other publications meeting the proposed criteria for "current SCI industry

⁴⁴⁹ See Proposing Release, supra note 13, at 18178

⁴⁵⁰ The domains covered in Table A of the SCI Proposal are: application controls; capacity planning; computer operations and production environment controls; contingency planning; information security and networking; audit; outsourcing; physical security; and systems development methodology. See id. at 18111.

⁴⁵¹ See id. at 18110.

standards.”⁴⁵² In addition, proposed Rule 1000(b)(1)(ii) stated that compliance with “current SCI industry standards” would not be the exclusive means to comply with the requirements of proposed Rule 1000(b)(1).⁴⁵³

b. Comments Received on Proposed Rule 1000(b)(1) and Commission Response

i. Policies and Procedures Generally – Rules 1001(a)(1) and (3)

The Commission received a wide range of comments on proposed Rule 1000(b)(1). With respect to policies and procedures generally, some commenters believed the proposal was too prescriptive.⁴⁵⁴ Several characterized it as a “one-size-fits-all” approach that did not adequately take into account differences between SCI entities and SCI entity systems.⁴⁵⁵ Several commenters objecting to the rule as too prescriptive urged that the adopted rule incorporate a risk-based framework, so that SCI entities and/or systems of greater criticality would be required to adhere to a stricter set of policies and procedures than SCI entities and/or systems of lesser criticality.⁴⁵⁶ These commenters maintained that each SCI entity should have discretion to calibrate its policies and procedures based on its own assessment of the criticality of the SCI

⁴⁵² See *id.* at 18110 (stating that an SCI entity could elect standards contained in publications other than those identified on proposed Table A to comply with the rule).

⁴⁵³ See *id.* at 18109.

⁴⁵⁴ See, e.g., Angel Letter at 2, 8; BIDS Letter at 7; FIF Letter at 3-4; Joint SROs Letter at 4; LiquidPoint Letter at 3-4; MFA Letter at 3; and SIFMA Letter at 12-13.

⁴⁵⁵ See, e.g., FIF Letter at 3-4; FINRA Letter at 31; Joint SROs Letter at 4; KCG Letter at 2-3, 6-8; Liquidpoint Letter at 3-4; MFA Letter at 3; OCC Letter at 3-4; SIFMA Letter at 12-13; UBS Letter at 2-4; Tellefsen Letter at 13; and BIDS Letter at 2-3, 6-9.

⁴⁵⁶ See, e.g., Joint SROs Letter at 4; LiquidPoint Letter at 3; MFA Letter at 3; and SIFMA Letter at 8, 12-13. See also FIF Letter at 4; MSRB Letter at 3; Fidelity Letter at 2; NYSE Letter at 3, 4, 21; FINRA Letter at 13-14; and OCC Letter at 3.

entity and its systems to market stability, or that the Commission should “tier” the obligations of SCI entities or SCI entity systems based on their market function.⁴⁵⁷

In contrast, some commenters stated that the Commission’s proposed approach was too vague or insufficient.⁴⁵⁸ For example, one commenter characterized the minimum elements of policies and procedures in proposed Rule 1000(b)(1)(A)-(F) as “so vague that they will fail to provide any meaningful improvement in technological systems.”⁴⁵⁹ Another commenter stated that the proposed scope of required policies and procedures was appropriate, but that further elaboration on the details was warranted.⁴⁶⁰ One commenter stated that the proposed rule lacked adequate discussion of what it means for policies and procedures to be reasonably designed “to maintain...operational capability and promote the maintenance of fair and orderly markets.”⁴⁶¹

The Commission has carefully considered the views of commenters on its proposed policies and procedures approach to ensuring adequate capacity, integrity, resiliency, availability, and security of SCI systems (and security for indirect SCI systems). The Commission agrees with commenters who stated that requiring SCI entities to have policies and procedures relating to the capacity, integrity, resiliency, availability, and security of SCI systems (and security for indirect SCI systems) should not be a “one-size-fits-all” approach and, as discussed in detail below, is therefore clarifying that the adopted rule is consistent with a risk-based approach, as it

⁴⁵⁷ See, e.g., Joint SROs Letter at 4; FINRA Letter at 13-14; MSRB Letter at 3; MFA Letter at 6; NYSE Letter at 3, 4, and 21; SIFMA Letter at 12-13; FIF Letter at 4; Fidelity Letter at 2; and OCC Letter at 3.

⁴⁵⁸ See Better Markets Letter at 3-5; CAST Letter at 4; CISQ Letter at 2, 5; CISQ2 Letter at 5; and Direct Edge Letter at 4.

⁴⁵⁹ See Better Markets Letter at 3.

⁴⁶⁰ See CISQ Letter at 2.

⁴⁶¹ See Direct Edge Letter at 4.

allows an SCI entity's policies and procedures to be tailored to a particular system's criticality and risk. As noted above, while some commenters characterized the proposed rule as too vague and sought further specificity, others found the rule to be too prescriptive. The Commission believes that the adopted rule provides an appropriate balance between these two opposing concerns by providing a framework that identifies the minimum areas that are required to be addressed by an SCI entity's policies and procedures without prescribing the specific policies and procedures that an SCI entity must follow, or detailing how each element in Rule 1001(a)(2) should be addressed. Given the various types of systems at SCI entities, each of which represent a different level of criticality and risk to each SCI entity and to the securities markets more broadly, the adopted rule seeks to provide flexibility to SCI entities to design their policies and procedures consistent with a risk-based approach, as discussed in further detail below. At the same time, because the Commission believes that additional guidance on how an SCI entity may comply with the rule is warranted in certain areas, the Commission is providing further guidance below. In response to comment, the Commission is adopting Rule 1001(a) with modifications that it believes will better provide SCI entities with sufficient flexibility to develop their policies and procedures to achieve robust systems, while also providing guidance on how an SCI entity may comply with the final rule. Specifically, adopted Rule 1001(a) is modified to: (i) clarify that the rule is consistent with a risk-based approach that requires more robust policies and procedures for higher-risk systems and provides an SCI entity with flexibility to tailor its policies and procedures to the nature of its business, technology, and the relative criticality of each of its SCI systems; (ii) make clear that an SCI entity's reasonable policies and procedures remain subject to ongoing self-assessment; (iii) provide increased flexibility in the manner in which an SCI entity may satisfy the minimum elements of required policies and procedures; and (iv) revise

the criteria for “current SCI industry standards.” In addition, proposed Table A is recharacterized and will be issued as staff guidance that will evolve over time...

Response to Commenters Advocating a Risk-Based Approach

Adopted Rule 1001(a)(1) requires each SCI entity to establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems and, for purposes of security standards, indirect SCI systems, have levels of capacity, integrity, resiliency, availability, and security, adequate to maintain the SCI entity’s operational capability and promote the maintenance of fair and orderly markets. The text of this part of the rule is largely unchanged from the proposal. Although several commenters expressed concern that the proposed rule would have imposed a “one-size-fits-all” approach, requiring all SCI entities to hold all of their SCI systems to the same standards,⁴⁶² this was not the intent of proposed Rule 1000(b)(1), nor is it what adopted Rule 1001(a)(1) requires. By requiring an SCI entity to have policies and procedures “reasonably designed” and “adequate” to maintain operational capability and promote the maintenance of fair and orderly markets, the adopted rule provides an SCI entity with flexibility to determine how to tailor its policies and procedures to the nature of its business, technology, and the relative criticality of each of its SCI systems.⁴⁶³ Although the adopted rule does not assign differing obligations to an SCI entity based on its registration status, or its general market function, as some commenters urged, by allowing each SCI entity to tailor its

⁴⁶² See supra note 455 and accompanying text.

⁴⁶³ See Proposing Release, supra note 13, at 18109 (stating: “The Commission intends to...provide SCI entities sufficient flexibility, based on the nature, size, technology, business model, and other aspects of their business, to identify appropriate policies and procedures that would meet the articulated standard, namely that they be reasonably designed to ensure that their systems have levels of capacity, integrity, resiliency, availability, and security adequate to maintain the SCI entity’s operational capability and promote the maintenance of fair and orderly markets.”).

policies and procedures accordingly, the adopted approach recognizes that there are differences between, and varying roles played by, different systems at various SCI entities. In tandem with the refined definition of "SCI systems," the modified definition of "SCI security systems" (adopted as "indirect SCI systems"), and the new definition of "critical SCI systems,"⁴⁶⁴ adopted Rule 1001(a)(1) explicitly recognizes that policies and procedures that are "reasonably designed" and "adequate" to maintain operational capability and promote the maintenance of fair and orderly markets for critical SCI systems may differ from those that are "reasonably designed" and "adequate" to maintain operational capability and promote the maintenance of fair and orderly markets for other SCI systems, or indirect SCI systems. As such, the Commission believes that its adopted approach in Regulation SCI is consistent with a risk-based approach, and that adopted Regulation SCI may result in the systems of certain SCI entities (for example, those that have few or no critical SCI systems) generally being subject to less stringent policies and procedures than the systems of other SCI entities. Thus, a risk assessment is appropriate for an SCI entity to determine how to tailor its policies and procedures for its SCI systems and indirect SCI systems.

The Commission also believes that requiring an SCI entity to tailor its policies and procedures so that they are reasonably designed and adequate will entail that an SCI entity assess the relative criticality and risk of each of its SCI systems and indirect SCI systems. Evaluation of the risk posed by any particular SCI system to the SCI entity's operational capability and the maintenance of fair and orderly markets will be the responsibility of the SCI entity in the first instance. The Commission believes this approach will achieve the goal of improving

⁴⁶⁴ As a result of these changes, the adopted rule applies to fewer systems than as proposed, and only to those types of systems that the Commission believes pose significant risk to market integrity if not adequately safeguarded.

Commission review and oversight of U.S. securities market infrastructure, but will do so within a more focused framework than as proposed. By being subject to requirements for a more targeted set of SCI systems, and guided by consideration of the relative risk of each of its SCI systems, SCI entities may more easily determine how to allocate their resources to achieve compliance with the regulation than they would have under the proposed regulation.

As noted above, one commenter urged the Commission to discuss what it means for policies and procedures to be reasonably designed “to maintain...operational capability and promote the maintenance of fair and orderly markets.”⁴⁶⁵ This commenter characterized the proposed standard of “maintaining operational capability” as an “introspective standard relevant to the applicable SCI entity,” and the proposed standard of “promoting the maintenance of fair and orderly markets” as implying “some incremental responsibility to the collective market.”⁴⁶⁶ The Commission agrees with this commenter’s characterization and believes that it is appropriate for SCI entities to assess the risk of their systems taking into consideration both objectives, which are related and complementary.⁴⁶⁷ Specifically, the Commission believes that it is important that an SCI entity’s policies and procedures are reasonably designed to ensure its own operational capability, including the ability to maintain effective operations, minimize or eliminate the effect of performance degradations, and have sufficient backup and recovery capabilities. At the same time, an SCI entity’s own operational capability can have broader

⁴⁶⁵ See supra note 461 and accompanying text.

⁴⁶⁶ See Direct Edge Letter at 4.

⁴⁶⁷ The Commission notes that the identification of “critical SCI systems” in Regulation SCI emphasizes that some systems pose greater risk than others to the maintenance of fair and orderly markets if they malfunction, and that it is appropriate for an SCI entity to consider the risk to other SCI entities and market participants in the event of a systems malfunction.

effects and, as entities that play a significant role in the U.S. securities markets and/or have the potential to impact investors, the overall market, or the trading of individual securities,⁴⁶⁸ the Commission believes that the policies and procedures should also be reasonably designed to promote the maintenance of fair and orderly markets.

Periodic Review

Some commenters expressed concern that, when an SCI entity's policies and procedures fail to prevent an SCI event, the Commission might use such failure as the basis for an enforcement action, charging that the policies and procedures were not reasonable.⁴⁶⁹ One commenter suggested that the Commission's focus should be on an entity's adherence to its own set of policies and procedures, developed based on "experience, annual SCI reviews, and other inputs," rather than a "set of generic standards."⁴⁷⁰

In response to these comments, the Commission notes that the reasonably designed policies and procedures approach taken in adopted Rule 1001(a) does not require an entity to guarantee flawless systems. But the Commission believes it should be understood to require diligence in maintaining a reasonable set of policies and procedures that keeps pace with changing technology and circumstances and does not become outdated over time. The Commission is therefore adopting a requirement for periodic review by an SCI entity of the effectiveness of its policies and procedures required by Rule 1001(a), and prompt action by the

⁴⁶⁸ See supra note 59 and accompanying text.

⁴⁶⁹ See, e.g., BATS Letter at 3-4; Angel Letter at 2; and FSR Letter at 5. See also ITG Letter at 14 (stating that no set of policies and procedures could guarantee perfect operational compliance); and NYSE Letter at 32 (urging inclusion of a good faith safe harbor).

⁴⁷⁰ See FIF Letter at 4.

SCI entity to remedy deficiencies in such policies and procedures.⁴⁷¹ An SCI entity will not be found to be in violation of this maintenance requirement solely because it failed to identify a deficiency in its policies and procedures immediately after the deficiency occurred if the SCI entity takes prompt action to remedy the deficiency once it is discovered, and the SCI entity had otherwise reviewed the effectiveness of its policies and procedures and took prompt action to remedy those deficiencies that were discovered, as required by Rule 1001(a)(3).

Further, the occurrence of a systems disruption or systems intrusion will not necessarily mean that an SCI entity has violated Rule 1001(a), or that it will be subject to an enforcement action for violation of Regulation SCI. The Commission will exercise its discretion to initiate an enforcement action if the Commission determines that such action is warranted, based on the particular facts and circumstances. While a systems problem may be probative as to the reasonableness of an SCI entity's policies and procedures, it is not determinative.

ii. Minimum Elements of Reasonable Policies and Procedures – Rule 1001(a)(2)

Proposed Rule 1000(b)(1)(i) would have required that an SCI entity's policies and procedures provide for, at a minimum: (A) the establishment of reasonable current and future capacity planning estimates; (B) periodic capacity stress tests of systems to determine their ability to process transactions in an accurate, timely, and efficient manner; (C) a program to review and keep current systems development and testing methodology; (D) regular reviews and testing of systems, including backup systems, to identify vulnerabilities pertaining to internal and external threats, physical hazards, and natural or manmade disasters; (E) business continuity and disaster recovery plans that include maintaining backup and recovery capabilities sufficiently

⁴⁷¹ See Rule 1001(a)(3).

resilient and geographically diverse to ensure next business day resumption of trading and two-hour resumption of clearance and settlement services following a wide-scale disruption; and (F) standards that result in systems being designed, developed, tested, maintained, operated, and surveilled in a manner that facilitates the successful collection, processing, and dissemination of market data. References to "systems" in the proposed rule were to the proposed definition of SCI systems, and with respect to security standards only, the proposed definition of SCI security systems.

Adopted Rule 1001(a)(2) includes the items formerly proposed as Rules 1001(b)(1)(i)(A)-(F) as renumbered Rules 1001(2)(i)-(vi) and a new item (vii), relating to monitoring of SCI systems. Proposed items (A), (D), and (E) are revised in certain respects in response to comment. In addition, the Commission discusses below each of the adopted provisions of Rule 1001(a)(2) in the context of the adopted definitions of SCI systems and indirect SCI systems, where relevant.⁴⁷²

Capacity Planning

The SCI Proposal stated that policies and procedures for the establishment of reasonable current and future capacity planning (proposed item (A)) would help an SCI entity determine its systems' ability to process transactions in an accurate, timely, and efficient manner, and thereby help ensure market integrity.⁴⁷³ One commenter expressed support for the requirement in

⁴⁷² In particular, the Commission is adopting the language of items (B) and (C) as proposed (renumbered as Rule 1001(a)(2)(ii) and (iii), respectively) but elaborates on the scope of these provisions, as well as the scope of revised item (D) (renumbered as Rule 1001(a)(2)(iv)) and in the context of the adopted definitions of SCI systems and indirect SCI systems.

⁴⁷³ See Proposing Release, supra note 13, at 18107.

proposed item (A),⁴⁷⁴ and another commenter recommended that proposed item (A) be revised to make clear that SCI entity capacity planning estimates apply to “technology infrastructure” capacity, as opposed to capacity with respect to non-technology infrastructure of an SCI entity.⁴⁷⁵ Because the Commission intended proposed item (A) to relate to capacity planning for SCI systems, rather than capacity planning more broadly (for example, in relation to an SCI entity’s office space), the Commission is including this suggested clarification in adopted Rule 1001(a)(2)(i), and thus requires that an SCI entity’s policies and procedures include the establishment of reasonable current and future technology infrastructure capacity planning estimates.

Stress Testing

A few commenters raised concerns about proposed item (B), which required periodic capacity stress tests.⁴⁷⁶ Some of these commenters urged that the adopted rule provide an SCI entity with flexibility to determine, using a risk-based assessment, when capacity stress tests are appropriate.⁴⁷⁷ Others suggested that capacity stress tests be required in specified circumstances or time frames, such as when new capabilities are released into production,⁴⁷⁸ whenever required system capacity increases by 10 percent, on a quarterly basis, or in conjunction with any material

⁴⁷⁴ See MSRB Letter at 9.

⁴⁷⁵ See DTCC Letter at 14-15. The Commission also received comments in regard to capacity planning as it relates to proposed industry standards on the capacity planning domain set out in proposed Table A. See, e.g., infra note 580 and accompanying text.

⁴⁷⁶ See, e.g., CISQ Letter at 5; DTCC Letter at 14; Lauer Letter at 6; MSRB Letter at 9; OCC Letter at 10; and SIFMA Letter at 12.

⁴⁷⁷ See DTCC Letter at 14; and OCC Letter at 10. See also SIFMA Letter at 12 (suggesting that periodic capacity monitoring would be more appropriate and cost-effective than periodic capacity stress testing).

⁴⁷⁸ See MSRB Letter at 9.

systems change.⁴⁷⁹ One commenter suggested that SCI entities should supplement dynamic stress and load testing with static analysis, a technique used to help uncover structural weaknesses in software.⁴⁸⁰ In proposing item (B), the Commission intended for SCI entities to engage in a careful risk-based assessment (as suggested by some commenters)⁴⁸¹ of its SCI systems to determine when to stress test its systems.⁴⁸² Rule 1001(a)(2)(ii), as adopted, affords SCI entities the flexibility to consider the factors suggested by commenters, as appropriate for their specific systems and circumstances.⁴⁸³ The adopted rule does not prescribe a particular frequency or trigger for stress testing; however, because the Commission believes that, in light of the variability in SCI systems, an SCI entity's experience with its particular systems and assessment of risk in this area will dictate when capacity stress testing is warranted. The requirement for periodic capacity stress tests of systems to determine their ability to process transactions in an accurate, timely, and efficient manner is therefore adopted as proposed as Rule 1001(a)(2)(ii).

⁴⁷⁹ See Lauer Letter at 6.

⁴⁸⁰ See CISQ Letter at 5. See also *infra* notes 491 and 497, and 498 and accompanying text (further discussing this comment and the commenter's views on the value of assessing the structural quality of software).

⁴⁸¹ See *supra* note 477 and accompanying text.

⁴⁸² In response to the commenter that suggested periodic capacity monitoring would be more appropriate and cost-effective than periodic capacity stress testing, see *supra* note 477 and accompanying text, the Commission believes that such monitoring is appropriate and may play an important role in an SCI entity's assessing when to stress tests its systems. However, the Commission continues to believe that stress testing is necessary to help an SCI entity determine its systems' ability to process transactions in an accurate, timely, and efficient manner, and thereby help ensure market integrity. See Proposing Release, *supra* note 13, at 18107. While monitoring may be a cost-effective method to determine when a stress test is warranted, the Commission does not believe monitoring alone will be an effective substitute for stress testing, which, unlike monitoring, is designed to challenge systems capacity.

⁴⁸³ See *supra* notes 478-479 and accompanying text.

Systems Development and Testing Methodology

In the SCI Proposal, the Commission explained that proposed item (C), which would require SCI entities to have policies and procedures for a “program to review and keep current systems development and testing methodology,” would help an SCI entity monitor and maintain systems capacity and availability.⁴⁸⁴ The Commission is adopting the language of this item as proposed as Rule 1001(a)(2)(iii).

Two commenters supported this requirement as proposed.⁴⁸⁵ Another commenter argued that sufficient controls were in place with respect to production systems, as proposed, and therefore that separate policies and procedures specifically for the development and testing environment would be unnecessary and duplicative.⁴⁸⁶ This commenter added that, if development and testing systems were not excluded from the definition of SCI systems altogether, then the policies and procedures requirements regarding systems development and testing methodology should not apply separately to these environments. The Commission agrees with this comment, and believes it logically follows that policies and procedures requiring a program to review and keep current systems development and testing methodology for SCI systems, and indirect SCI systems, as applicable, are important if development and testing systems are excluded from the definition of SCI systems, as they are under the adopted regulation.⁴⁸⁷ An SCI entity’s systems development and testing methodology is a core part of

⁴⁸⁴ See Proposing Release, supra note 13, at 18107.

⁴⁸⁵ See CISQ Letter at 2; and MSRB Letter at 9.

⁴⁸⁶ See FINRA Letter at 12.

⁴⁸⁷ See supra Section IV.A.2.b (discussing the definition of “SCI systems”). Because development and testing systems are not part of the adopted definition of “SCI systems,” systems issues with regard to development and testing systems would not be subject to the requirements of adopted Rule 1002 relating to corrective action, Commission

the systems development life cycle for any SCI system. Therefore, the Commission believes that if an SCI entity did not have a program to review and keep current systems development and testing methodology for SCI systems, and indirect SCI systems, as applicable, its ability to assess the capacity, integrity, reliability, availability and security of its SCI systems and indirect SCI systems, as applicable, would be undermined. In complying with this adopted requirement, an SCI entity may wish to consider how closely its testing environment simulates its production environment; whether it designs, tests, installs, operates, and changes SCI systems through use of appropriate development, acquisition, and testing controls by the SCI entity and/or its third-party service providers, as applicable; whether it identifies and corrects problems detected in the development and testing stages; whether it verifies change implementation in the production stage; whether development and test environments are segregated from SCI systems in production; and whether SCI entity personnel have adequately segregated roles between the development and/or test environment, and the production environment.

Reviews of SCI Systems and Indirect SCI Systems

The SCI Proposal explained that proposed item (D), which would have required an SCI entity to establish, maintain, and enforce policies and procedures to review and test regularly SCI systems (and SCI security systems, as applicable), including backup systems, to identify vulnerabilities pertaining to internal and external threats, physical hazards, and natural or manmade disasters, would assist an SCI entity in ascertaining whether such systems are and remain sufficiently secure and resilient.⁴⁸⁸ Proposed item (D) garnered a range of comments.

notification, and dissemination of information on SCI events; or Rule 1003(a) regarding notification of systems changes.

⁴⁸⁸ See Proposing Release, supra note 13, at 18107.

Some commenters addressing this item focused on internal SCI entity testing,⁴⁸⁹ whereas others focused more broadly on industry-wide testing and testing of backup systems.⁴⁹⁰

With respect to comments on internal testing, one commenter suggested that the proposed requirement be expanded beyond testing to cover a range of “quality assurance activities” with each release of software into production.⁴⁹¹ Two commenters advocated for requiring an SCI entity to focus on identifying structural deficiencies, which they stated pose much greater risks than functional deficiencies.⁴⁹² A few commenters urged that groups independent of the team that designed and developed the systems should be involved in testing to offer a diverse perspective.⁴⁹³ One of these commenters further suggested that enforcement of the policies governing development and testing activities should be conducted by a “process audit” role that evaluates compliance with policies, provides guidance to development and testing teams on how to comply, and reports on compliance to senior management.⁴⁹⁴

⁴⁸⁹ See, e.g., CAST Letter at 4; CISQ Letter at 3-7; FIA PTG Letter at 4; Lauer Letter at 6; and MSRB Letter at 10.

⁴⁹⁰ See, e.g., Angel Letter at 2; CoreOne Letter at 3-5; DTCC Letter at 13; FIA PTG Letter at 2; FIX Letter at 1-2; Tradebook Letter at 1-4; UBS Letter at 4; and CISQ Letter at 6. See also *infra* Section IV.B.6 (discussing adopted Rule 1004, requiring business continuity and disaster recovery testing, including required participation of designated members or participants of SCI entities in such testing).

⁴⁹¹ See CISQ Letter at 3-7 (encouraging the Commission to require quality assurance activities other than testing, including that an SCI entity evaluate and measure the structural quality of its SCI systems because “the attributes of an SCI system most critically affecting its capacity, integrity, resiliency, availability, and security are predominantly structural (engineering) rather than functional (correctness)”).

⁴⁹² See CAST Letter at 4; and CISQ Letter at 3-7.

⁴⁹³ See, e.g., CISQ Letter at 7; and Lauer Letter at 6.

⁴⁹⁴ See CISQ Letter at 7. This commenter further recommended that such process audits be conducted at least annually for each SCI system, and more often for SCI systems with operational problems, a record of non-compliance, or those being developed, tested, or operated by an inexperienced staff, and stated that process auditors who perform a

After careful consideration of the comments, the Commission is adopting this provision with modifications as Rule 1001(a)(2)(iv). Specifically, adopted Rule 1001(a)(2)(iv) requires an SCI entity's reasonably designed policies and procedures to include "[r]egular reviews and testing, as applicable, of [its SCI systems and, for purposes of security standards, indirect SCI systems], including backup systems, to identify vulnerabilities pertaining to internal and external threats, physical hazards, and natural or manmade disasters."

As adopted, this provision will afford an SCI entity greater flexibility, through the addition of the phrase "as applicable," to determine how to identify vulnerabilities pertaining to internal and external threats, physical hazards, and natural or manmade disasters. Specifically, the adopted rule replaces the proposed rule's requirement that an SCI entity conduct "regular reviews and testing" of relevant systems (including backup systems) with a more flexible requirement that an SCI entity conduct "regular reviews and testing, as applicable" of relevant systems, including backup systems. In response to some commenters' concerns that the proposed requirement focused too much on regular testing and not enough on other methods to assess systems operation,⁴⁹⁵ the adopted rule provides an SCI entity the flexibility to determine an assessment methodology that would be most appropriate for a given system, or particular functionality of a system. Thus, consistent with commenters' views, the adopted provision does not specifically require both regular reviews and regular testing in connection with an SCI entity's identification of vulnerabilities. Instead, the provision requires reviews or testing (or

mentoring role to software teams have proven a cost-effective mechanism for on-the-job training.

⁴⁹⁵ See supra notes 491-492 and accompanying text.

both) to occur as applicable, so long as the approach is effective to identify vulnerabilities in SCI systems, and indirect SCI systems, as applicable.

While Rule 1001(a)(2)(iv) specifically identifies reviews and testing as means to identify vulnerabilities pertaining to internal and external threats, physical hazards, and natural or manmade disasters, it does not dictate the precise manner or frequency of reviews and testing, and does not prohibit an SCI entity from determining that there are methods other than reviews and testing that may be effective in identifying vulnerabilities. For example, reviews and testing would each be one of the methods that an SCI entity could employ, and each SCI entity would be able to determine which method(s) are most appropriate for each SCI system (or indirect SCI system, as applicable) or particular functionality of a given system, as well as the frequency with which such method(s) should be employed.⁴⁹⁶ In addition, in response to commenters advocating that SCI entities should focus on identifying structural vulnerabilities or

⁴⁹⁶ Rule 1001(a)(2)(iv) would also permit an SCI entity to engage personnel independent of the team that designed and developed the systems in testing, or to employ a process audit role, to comply with this requirement, as some commenters suggested. See *supra* notes 493-494 and accompanying text. Like other methods of review and testing, such engagements could identify vulnerabilities in a number of ways, such as through assessments of the SCI entity's compliance with applicable standards, its risk management and control framework, or its use of resources.

In response to the comment suggesting that process audits be conducted at least annually for each SCI system, and more often for SCI systems with operational problems, a record of non-compliance, or those being developed, tested, or operated by an inexperienced staff, the Commission notes that Rule 1001(a)(2)(iv) does not specify the precise manner or frequency of reviews and tests. Rather, Rule 1001(a)(2)(iv) provides flexibility to an SCI entity in determining the precise manner and frequency of reviews and/or tests. For example, an SCI entity could determine that, in order for its policies and procedures to be reasonably designed, as required by Rule 1001(a), its policies and procedures should provide that process audits be conducted at least annually for some SCI systems, and more frequently for certain other SCI systems.

weaknesses,⁴⁹⁷ an SCI entity may also find it useful to conduct reviews of its software and systems architecture and design to assess whether they have flaws or dependencies that constitute structural risks that could pose a threat to SCI systems' operational capability.⁴⁹⁸

Likewise, an inspection by an SCI entity of its physical premises may be a method of assessing some of the vulnerabilities listed in the rule (such as physical hazards).

Business Continuity and Disaster Recovery

Proposed item (E) would have required an SCI entity to 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 two-hour resumption of clearance and settlement services following a wide-scale disruption. The Commission received significant comment on this aspect of the proposal, with several commenters questioning or challenging the principle that securities market infrastructure resilience is achieved by requiring both geographic diversity and specific recovery times for the backup and recovery capabilities of all SCI entities.⁴⁹⁹ Although several commenters were supportive of the broad goals of the proposed requirement,⁵⁰⁰ others maintained that, because the national market system has built-in redundancies, the proposed geographic diversity and resumption requirements need not apply to all SCI entities to ensure securities market

⁴⁹⁷ See supra note 492 and accompanying text.

⁴⁹⁸ As noted by one commenter, static analysis could be a technique SCI entities could choose to utilize to help uncover structural weaknesses in software. See supra note 480 and accompanying text.

⁴⁹⁹ See, e.g., BIDS Letter at 8; FIA PTG Letter at 4; FIF Letter at 3; Group One Letter at 2-3; KCG Letter at 6-8, 11-14; FINRA Letter at 35-36; Angel Letter at 12; and ITG Letter at 15.

⁵⁰⁰ See Direct Edge Letter at 4; FINRA Letter at 35; ISE Letter at 2; and MSRB Letter at 10.

resilience.⁵⁰¹ Some of these commenters urged that the specific redundancy requirement implicit in the proposed geographic diversity provision should apply to a more limited set of SCI entities.⁵⁰² In addition, some commenters stated that proposed time frames were too inflexible.⁵⁰³

The Commission has carefully considered commenters' views and is revising this provision from the proposal to: (i) specify that the stated recovery timeframes in Regulation SCI are goals, rather than inflexible requirements;⁵⁰⁴ and (ii) provide that the stated two-hour recovery goal applies to critical SCI systems generally. In addition, the Commission is adopting the geographic diversity requirement, which does not specify any minimum distance for an SCI entity's backup and recovery facilities, as proposed. As explained below, the Commission

⁵⁰¹ See, e.g., BIDS Letter at 8; FIA PTG Letter at 4; FIF Letter at 3; Group One Letter at 2-3; and KCG Letter at 6-8, 11-14. According to these commenters, because of the ease with which market participants are able to shift their order flow when there is an issue at one or more markets, the proposed requirements are burdensome and unnecessary. See also Angel Letter at 12 (stating that, if an exchange experiences an issue, other exchanges have more than enough capacity to handle the trading volume, and suggesting that it is not necessary for each exchange to have totally redundant backup facilities if the market network as a whole has sufficient capacity).

⁵⁰² See, e.g., FIA PTG Letter at 4. See also supra note 53 and accompanying text.

⁵⁰³ See, e.g., SIFMA Letter at 13; and Joint SROs Letter at 17.

⁵⁰⁴ See Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial Systems, Securities Exchange Act Release No. 47638 (April 7, 2003), 68 FR 17809, 17812 (April 11, 2003) ("Interagency White Paper"), stating: "Recovery-time objectives provide concrete goals to plan for and test against. They should not be regarded as hard and fast deadlines that must be met in every emergency situation;" and 2003 Policy Statement on Business Continuity Planning for Trading Markets, Securities Exchange Act Release No. 48545 (September 25, 2003), 68 FR 56656, 56658 (October 1, 2003) ("2003 BCP Policy Statement"), stating: "Consistent with the approach taken in the Interagency Paper, the next-day resumption objective should provide a concrete goal to plan for and test against. This should not be regarded as a hard and fast deadline that must be met in every emergency situation."

continues to believe that geographic diversity of physical facilities is an important component of every SCI entity's BC/DR plan.

Recovery Timeframes as Goals

Several commenters addressing proposed item (E) focused their comments specifically on the proposed recovery timeframes.⁵⁰⁵ A few commenters that are clearing agencies specifically expressed concern about the proposed requirement for the two-hour resumption of clearance and settlement services, urging that the two-hour standard be a goal rather than a requirement.⁵⁰⁶ One commenter noted that the "Interagency White Paper itself recognizes that 'various external factors surrounding a disruption such as time of day, scope of disruption, and status of critical infrastructure—particularly telecommunications can affect actual recovery times,' and concludes that '[r]ecover-time objectives provide concrete goals to plan for and test against...they should not be regarded as hard and fast deadlines that must be met in every emergency situation.'"⁵⁰⁷ Several commenters suggested that SCI entities generally be given

⁵⁰⁵ See, e.g., SIFMA Letter at 3, 13, 18; KCG Letter at 11-12; DTCC Letter at 15; OCC Letter at 9-10; Omgeo Letter at 27-28; Angel Letter at 16-17; Direct Edge Letter at 4-5; ISE Letter at 2-5; Joint SROs Letter at 16-17; FINRA Letter at 36; MSRB Letter at 10; Tellefsen Letter at 6; and Group One Letter at 2.

⁵⁰⁶ See DTCC Letter at 15 ("[P]roposed Rule 1000(b)(1)(i)(E) has made what is currently a target within the 2003 Interagency White Paper that clearing and settling services be resumed within 2 hours of a disruption into a requirement that may not be attainable in all circumstances..."); OCC Letter at 9-10 ("While a two-hour recovery time objective is a laudable goal...current guidelines remain appropriate to recover and resume clearing and settlement activities within the business day on which the disruption occurs, with the overall aspiration of achieving recovery and resumption within two hours"); and Omgeo Letter at 27-28 ("While Omgeo agrees that SCI entities should be required to rapidly recover from a wide-scale disruption and resume operations to avoid disrupting the critical markets beyond a single business day, it is unreasonable to require these operations to be resumed within two hours.").

⁵⁰⁷ See Omgeo Letter at 27-28.

more discretion to decide when to resume trading following a wide-scale disruption.⁵⁰⁸ Other commenters stated more broadly that the proposed recovery timeframes were too rigid and inconsistent with the Interagency White Paper and the 2003 BCP Policy Statement.⁵⁰⁹ Other commenters similarly noted that it might be in the public interest and consistent with the protection of investors and the maintenance of fair and orderly markets for the markets to remain closed following a wide-scale disruption.⁵¹⁰

In response to comments that the proposed two-hour recovery time frame was too inflexible,⁵¹¹ the Commission is eliminating the proposed requirement that an SCI entity must “ensure” next business day resumption of trading and two-hour resumption of clearance and settlement services following a wide-scale disruption. The Commission acknowledges that a hard and fast resumption timeframe may not be achievable in each and every case, given the variety of disruptions that potentially could arise and pose challenges even for well-designed business continuity and disaster recovery. For this reason, the Commission is revising the proposed requirement by replacing it with a requirement that an SCI entity have policies and procedures that include “business continuity and disaster recovery plans that include maintaining

⁵⁰⁸ See Angel Letter at 16-17; Direct Edge Letter at 4-5; ISE Letter at 2; Joint SROs Letter at 16-17; and Group One Letter at 2.

⁵⁰⁹ See SIFMA Letter at 13 (noting that the Interagency White Paper recommends that “core clearing and settlement organizations develop the capacity to recover and resume clearing and settlement activities within the business day on which the disruption occurs with the overall goal of achieving recovery and resumption within two hours after an event.” See also Joint SROs Letter at 17 (noting that the 2003 BCP Policy Statement, *supra* note 504, provides that rapid recovery should not be regarded as a hard and fast deadline that must be met in every emergency situation).

⁵¹⁰ See, e.g., Angel Letter at 16-17; Direct Edge Letter at 4-5, 9; ISE Letter at 2-5; and Joint SROs Letter at 16-17.

⁵¹¹ See *supra* notes 506-510 and accompanying text.

backup and recovery capabilities sufficiently resilient and geographically diverse and that are reasonably designed to achieve next business day resumption of trading and two-hour resumption of critical SCI systems following a wide-scale disruption.” Replacement of the phrase “to ensure” with the phrase “reasonably designed to achieve” means that Regulation SCI’s enumerated recovery timeframes are concrete goals, consistent with the Interagency White Paper and 2003 BCP Policy Statement.⁵¹² As such, the rule’s specified recovery timeframes are the standards against which the reasonableness of business continuity and disaster recovery (“BC/DR”) plans will be assessed by the Commission and its inspection staff. Moreover, as recovery goals, rather than hard and fast deadlines, the enumerated time frames in the rule will continue to allow for SCI entities to account for the specific facts and circumstances that arise in a given scenario to determine whether it is appropriate to resume a system’s operation following a wide-scale disruption.

Recovery Timeframe Distinctions

In the SCI Proposal, the Commission solicited comment on whether the proposed next business day resumption of trading following a wide-scale disruption and proposed two-hour resumption of clearance and settlement services following a wide-scale disruption were appropriate.⁵¹³ The Commission also solicited comment on whether it should consider revising the proposed next business day resumption requirement for trading to a shorter period for certain entities that play a significant role within the securities markets.⁵¹⁴ One commenter stated that it agreed with imposing more stringent requirements for resumption of clearance and settlement

⁵¹² See Interagency White Paper, supra note 504, at 17812-13, and the 2003 BCP Policy Statement, supra note 504, at 56658.

⁵¹³ See Proposing Release, supra note 13, at 18112, question 73.

⁵¹⁴ See id. at 18112, question 76.

services than for trading services following a wide-scale disruption.⁵¹⁵ However, this commenter also urged more broadly that the Commission take into account the criticality of the functions performed by an SCI entity to the maintenance of fair and orderly markets in order to tailor the obligations of the rule more effectively.⁵¹⁶ According to this commenter, “[n]otification and remediation requirements...should be tailored to the time sensitivity of each of the functions performed, not applied uniformly across all activities of an SCI entity.” This commenter identified “highly critical functions” as including the primary listing exchanges, trading of securities on an exclusive basis, securities information processors, clearance and settlement agencies, distribution of unique post-trade transparency information, and real-time market surveillance,” and urged the Commission to “leverage the best practices of the Interagency White Paper, and expand them to include the [highly] critical functions....”⁵¹⁷ Other commenters also urged the Commission to consider the criticality of SCI systems functionality and tailor

⁵¹⁵ See SIFMA Letter at 12-13. Specifically, this commenter noted that the Interagency White Paper, supra note 504, distinguishes between “core clearing and settlement organizations” and firms that play “significant roles in the financial markets” and recommended that the Commission continue to distinguish between SCI entities that are responsible for the highly critical function of centralized counterparties (e.g., clearing agencies registered with the Commission) and SCI entities that are not.

⁵¹⁶ See SIFMA Letter at 4.

⁵¹⁷ See id. at 4, 18. SIFMA also listed the distribution of unique post-trade transparency information and real-time market surveillance as highly critical functions. While such systems are not specifically identified in the first prong of the definition of critical SCI systems (as are SCI systems that directly support functionality relating to: (1) clearance and settlement systems of clearing agencies; (2) openings, reopenings, and closings on the primary listing market; (3) trading halts; (4) initial public offerings; (5) the provision of consolidated market data; or (6) exclusively-listed securities), the Commission notes that systems that provide functionality to the securities markets for which the availability of alternatives is significantly limited or nonexistent and without which there would be a material impact on fair and orderly markets are considered critical SCI systems under its second prong. See supra Section IV.A.2.c (discussing the definition of “critical SCI systems”).

requirements accordingly.⁵¹⁸ One commenter noted that the August 2013 Nasdaq SIP outage revealed each of SIAC and Nasdaq (in their roles as plan processors) as a potential “single point of failure” in the national market system, and specifically urged improved backup capabilities for these systems.⁵¹⁹ Another commenter, in the context of questioning the need for all markets to have geographically diverse backups, acknowledged that specific redundancy might be appropriate in certain areas, such as where an instrument is traded only on one exchange or in the case of a primary market during the open and closing periods of the market.⁵²⁰

The Commission has carefully considered these comments and believes they support revising the proposed rule to provide that the two-hour recovery goal specified in the adopted rule, as the standard against which BC/DR plans are to be assessed, should apply not only to “clearance and settlement services,” but more generally to the functions performed by critical SCI systems. Given that the securities markets are dependent upon the reliable operation of critical SCI systems, the Commission believes it is reasonable to distinguish the two-hour and next-business day recovery goals in a manner consistent with other provisions of adopted Regulation SCI: specifically, to have the shorter recovery goal apply to critical SCI systems, and

⁵¹⁸ See, e.g., KCG Letter at 8, 13-14 (suggesting that proposed item (E) apply only to SCI entities that perform critical, unique functions in the market), and at 5 (stating “when critical services are provided, additional heightened regulatory requirements, as proposed in Regulation SCI, may be appropriate”). See also UBS Letter at 3 (urging the Commission to take into consideration the difference between “interruptions of activities that hold significant implications for the National Market System” and “low criticality activities [that] are much more manageable and localized in impact...because market participants are not directly touched or are equipped to quickly route around the problem”). According to this commenter, activities that hold such significant implications would include: “disruption at primary exchange during [the] open/close, [a] problem with protected quote data, [an] outage at listing exchange during [an] IPO, [and] SIP data disruptions.”

⁵¹⁹ See Angel Letter 2 at 3-4.

⁵²⁰ See FIA PTG Letter at 4.

the longer recovery goal apply to resumption of trading by non-critical SCI systems. The Commission also notes that, because the proposed recovery timeframes are being adopted as concrete goals that the policies and procedures must be reasonably designed to achieve, rather than hard and fast requirements, the adopted approach is somewhat more flexible than that proposed. Accordingly, adopted Rule 1001(a)(2)(v) holds BC/DR plans for critical SCI systems (as defined in Rule 1000) to a higher standard than BC/DR plans for resumption of trading operations more generally. Specifically, an SCI entity responsible for a given critical SCI system will be expected to design BC/DR plans that contemplate resumption of critical SCI system functionality to meet a recovery goal of two hours or less. The Commission believes that this approach is consistent with the broader risk-based approach urged by commenters.⁵²¹ The Commission also believes that its approach to holding critical SCI systems to stricter resiliency standards than other systems is an appropriate measure that responds not only to comments received, but also to recent events highlighting the effects of malfunctions in critical SCI systems.⁵²²

Two commenters requested clarification on the expectations for resumption of SCI systems that are not related to trading, clearance, or settlement.⁵²³ In response to this comment, the Commission notes that the adopted definition of SCI systems has been refined from the proposed definition of SCI systems and that all SCI systems could be considered to be “related

⁵²¹ See supra notes 53-57 and accompanying text (summarizing commenters’ recommendations with regard to adopting a risk-based approach generally).

⁵²² See supra Section II.B (discussing recent systems issues, including a systems problem that resulted in certain exclusively-listed securities being unable to trade for over three hours, and a systems problem affecting the SIP that halted trading in all Nasdaq-listed securities for more than three hours).

⁵²³ See FINRA Letter at 36; and MSRB Letter at 10.

to” trading. However, systems that directly support market regulation and/or market surveillance will not be held to the resumption goals of Rule 1001(a)(2)(v) (unless they are critical SCI systems) because the Commission believes that the resumption of trading and critical SCI systems could occur following a wide-scale disruption without the immediate availability of market regulation and/or market surveillance systems (unless they are critical SCI systems). However, systems that directly support trading, order routing, and market data would be subject to the next-business day resumption goal, unless they are also critical SCI systems, in which case they would be subject to the two-hour resumption goal.

One commenter questioned what the expectations are with respect to next-day resumption if an SCI entity loses functionality towards the end of the trading day.⁵²⁴ In response to this comment, the Commission notes that neither the next-business day resumption of trading goal nor the two-hour recovery goal for critical SCI systems is dependent on the time of day that the loss of functionality occurs. Consistent with the Interagency White Paper and 2003 BCP Policy Statement, however, the Commission acknowledges that the time of day of a disruption can affect actual recovery times.⁵²⁵ The Commission believes it is important, particularly with respect to clearing agencies, that SCI entities endeavor to take all steps necessary to effectuate end of day settlement.

Geographic Diversity to Ensure Resilience

⁵²⁴ See Tellefsen Letter at 6.

⁵²⁵ See Interagency White Paper, supra note 504, at 17812, and the 2003 BCP Policy Statement, supra note 504, at 56658.

Several commenters addressing proposed item (E) expressed concern about the proposed geographic diversity requirement.⁵²⁶ Some commenters cited a reluctance on the part of SCI entity members or participants to incur the cost or assume the risk of connecting to a backup site that would only be used infrequently.⁵²⁷ In addition, some commenters cited concerns, such as challenges to market makers generating quotes, if a backup site did not have the same low latency as the primary site.⁵²⁸ One of these commenter suggested that allowing other fully operational exchanges to fill in and perform the duties of an exchange experiencing an outage would offer the advantages of continued operation on tested systems and the introduction of fewer variables.⁵²⁹ Another of these commenters argued that, in many respects, the goal of resilient and redundant markets is already in place due to the existence of multiple competing and interconnected venues, operating as a collective system under Regulation NMS.⁵³⁰

One commenter agreed that it is a best business practice for a market to have backup disaster recovery facilities and robust BC/DR plans, but stated that “significant geographic diversity” should not be an absolute requirement,” because a wide-scale disruption in New York or Chicago would make next day resumption difficult, even with a geographically diverse backup.⁵³¹ This commenter noted that the more remote the backup, the more difficult it would be to staff such a facility, and even more so in a surprise disaster, unless the backup was fully

⁵²⁶ See, e.g., KCG Letter at 13; FIA PTG Letter at 3-4; Group One Letter at 2-3; ISE Letter at 2-5; BIDS Letter at 8; and ITG Letter at 15.

⁵²⁷ See KCG Letter at 13; FIA PTG Letter at 3-4; and Group One Letter at 2-3.

⁵²⁸ See KCG Letter at 13; and FIA PTG Letter at 3-4.

⁵²⁹ See Group One Letter at 2-3.

⁵³⁰ See FIA PTG Letter at 4. See also Angel 2 Letter at 3.

⁵³¹ See ISE Letter at 2-5.

staffed at all times.⁵³² Several commenters also argued that SCI entities that are ATs are less critical to market stability, and therefore should be subject to less stringent geographic diversity and recovery requirements.⁵³³ One commenter suggested eliminating the reference to “geographic diversity” in favor of requiring “comprehensive business continuity and disaster recovery plans with recovery time objectives of the next business day for trading and two hours for clearance and settlement,” and emphasizing as guidance that geographic diversity of physical facilities would be an expected component of any such plan.⁵³⁴

The Commission has carefully considered commenters’ views on the proposed geographic diversity requirement and continues to believe that geographic diversity of physical facilities is an important component of every SCI entity’s BC/DR plan.⁵³⁵ The Commission believes that challenges to recovery are increased when a disruption impacts a broad geographic area, and therefore that an SCI entity’s arrangements to assure resilience in the event of a wide-scale disruption cannot reliably be achieved without geographic diversity of its BC/DR resources.⁵³⁶ The Commission does not agree with commenters who argued that the existence of

⁵³² See *id.*

⁵³³ See BIDS Letter at 8; FIA PTG Letter at 4; ITG Letter at 15; and KCG Letter at 8, 13. These commenters believed that the proposed geographic diversity requirements are burdensome and unnecessary because of the ease with which market participants are able to shift their order flow when there is an issue at one or more markets. In addition, two commenters argued that, because ATs are subject to FINRA regulations with respect to BC/DR plans, further regulation would be redundant and unnecessary. See ITG Letter at 15; and OTC Markets Letter at 9.

⁵³⁴ See Direct Edge Letter at 4.

⁵³⁵ The Commission’s view is consistent with the 2003 BCP Policy Statement. See 2003 BCP Policy Statement, *supra* note 504, at 56658. See also *infra* Section VI.C.2.b (discussing the benefits of geographic diversity).

⁵³⁶ See, e.g., 2003 BCP Policy Statement, *supra* note 504, at 56657 (stating that a critical “lesson learned” from the events of September 11, 2001 is the need for more rigorous

multiple competing and interconnected venues operating as a collective system under Regulation NMS obviates the need for geographic diversity at the individual SCI entity level.⁵³⁷ For example, a wide-scale disruption, such as a natural disaster or man-made attack, could affect a large number of SCI entities, and absent individual SCI entity responsibility for maintaining geographic diversity, there could be a greater likelihood that a critical mass of SCI entities would not be operational, so that the continued maintenance of fair and orderly markets could be impacted. The Commission notes that some of the practical difficulties commenters cited as the basis for objecting to a backup site requirement, such as the cost and operational risk of maintaining a redundant connection to an SCI entity backup facility that would be used infrequently, are concerns raised on behalf of SCI entity members and participants.⁵³⁸ In response to commenters who expressed concern regarding the cost for members or participants to co-locate their systems at backup sites to replicate the speed and efficiency of the primary site, the Commission emphasizes that adopted Rule 1001(a)(2)(v) does not require an SCI entity to require members or participants to use the backup facility in the same way it uses the primary facility. Rather, the assessment of the effectiveness of a BC/DR plan that includes geographically diverse backup facilities is whether it is reasonably designed to achieve next business day resumption of trading and two-hour resumption of critical SCI systems following a wide-scale disruption.

business continuity planning in the financial sector to address problems of wider geographic scope and longer duration than those previously addressed).

⁵³⁷ See supra notes 530 and 533 and accompanying text.

⁵³⁸ See infra Section IV.B.6 (discussing SCI entity BC/DR testing requirements for members or participants).

In response to comments that geographic diversity should be encouraged but not required for all SCI entities, the Commission does not believe that it would be appropriate to eliminate the proposed requirement that SCI entities maintain geographically diverse backup and recovery capabilities (which the Commission understands many SCI entities already have) because, as stated, absent individual SCI entity responsibility for maintaining geographic diversity, there could be a greater likelihood that a critical mass of SCI entities would not be operational following a wide-scale disruption. In response to comment that ATs are less critical to market stability, and therefore should be subject to less stringent geographic diversity and recovery requirements, the Commission notes that ATs that do not have critical SCI systems will be subject to less stringent geographic diversity and recovery requirements than SCI entities that do.⁵³⁹ However, because the Commission believes that SCI ATs have the potential to significantly impact investors, the overall market, and the trading of individual securities as a result of an SCI event, the Commission believes that these entities are appropriate for inclusion in the definition of SCI entity and for the application of the geographic diversity requirement.⁵⁴⁰

⁵³⁹ In addition, in response to commenters who argued that, because ATs are subject to FINRA regulations with respect to BC/DR plans further regulation would be redundant and unnecessary (see supra note 533), the Commission notes that FINRA Rule 4370 generally requires that a member maintain a written continuity plan identifying procedures relating to an emergency or significant business disruption. Unlike Regulation SCI, however, the FINRA rule does not include the requirement that the business continuity and disaster recovery plans be reasonably designed to achieve next business day resumption of trading and two-hour resumption of critical SCI systems following a wide-scale disruption, nor does it require the functional and performance testing and coordination of industry or sector-testing of such plans, which the Commission believes to be instrumental in achieving the goals of Regulation SCI with respect to SCI entities. See also supra note 115.

⁵⁴⁰ See supra notes 107-109 and accompanying text.

Like the proposed rule, the adopted rule does not specify any particular minimum distance or geographic location that would be necessary to achieve geographic diversity.⁵⁴¹ However, as stated in the SCI Proposal, the Commission continues to believe that backup sites should not rely on the same infrastructure components, such as for transportation, telecommunications, water supply, and electric power.⁵⁴² The Commission also continues to believe that an SCI entity should have a reasonable degree of flexibility to determine the precise nature and location of its backup site depending on the particular vulnerabilities associated with those sites, and the nature, size, technology, business model, and other aspects of its business.⁵⁴³ In response to comment that a geographically diverse backup facility is impractical if key personnel do not live sufficiently close to the backup facility, the Commission notes that adopted Regulation SCI does not require an SCI entity to have a geographically diverse backup facility so distant from the primary facility that the SCI entity may not rely primarily on the same labor pool to staff both facilities if it believed it to be appropriate.⁵⁴⁴ Given that the Commission did not propose a specified minimum distance to achieve geographic diversity, the Commission believes that the geographic diversity requirement is reasonable and appropriate for all SCI entities. The geographic diversity requirement is therefore adopted as proposed.

⁵⁴¹ See Proposing Release, supra note 13, at 18108, n. 182 and accompanying text.

⁵⁴² See id.

⁵⁴³ See id.

⁵⁴⁴ An SCI entity with critical SCI systems subject to a two-hour recovery goal may, however, find it prudent to establish back-up facilities a significant distance away from their primary sites, or otherwise address the risk that a wide-scale disruption could impact either or both of the sites and their labor pool. See Interagency White Paper, supra note 504, at 17813.

In sum, the Commission believes that adopted Rule 1001(a)(2)(v), requiring an SCI entity to have business continuity and disaster recovery plans that include maintaining backup and recovery capabilities sufficiently resilient and geographically diverse and that are reasonably designed to achieve next business day resumption of trading and two-hour resumption of critical SCI systems following a wide-scale disruption, is consistent with, and builds upon, both the Interagency White Paper and the 2003 BCP Policy Statement by applying their principles to SCI entities in today's trading environment, one with a heavy reliance on technological infrastructure. The Commission believes that individual SCI entity resilience is fundamental to achieving the goal of improving U.S. securities market infrastructure resilience.

Robust Standards for Market Data

Proposed item (F), requiring an SCI entity to have standards that result in systems being designed, developed, tested, maintained, operated, and surveilled in a manner that facilitates the successful collection, processing, and dissemination of market data, received little comment. One commenter supported the proposed requirement, subject to further clarification about what constitutes market data.⁵⁴⁵ Another commenter believed that this proposed requirement is redundant because SROs and other market participants are already subject to substantial requirements for market data.⁵⁴⁶

While consolidated market data is collected and distributed pursuant to a variety of Exchange Act rules and joint industry plans,⁵⁴⁷ the Commission does not believe that existing

⁵⁴⁵ See MSRB Letter at 8.

⁵⁴⁶ See Angel Letter at 19.

⁵⁴⁷ See, e.g., Rules 601-604 of Regulation NMS and Rule 301(b)(3) of Regulation ATS. See also supra Section IV.A.1.c (discussing definition of plan processor) and Concept Release

requirements have the same focus on ensuring the operational capability of the systems for collecting, processing, and disseminating market data. Thus, the Commission believes that this provision, while consistent with existing rules, acts as a complement to such requirements and is not redundant. Further, as explained above, the term “market data” is not intended to include only consolidated market data, but proprietary market data as well and, as such, SCI systems directly supporting proprietary market data or consolidated market data are subject to the requirements of item (F). As stated in the SCI Proposal, the Commission believes that the accurate, timely, and efficient processing of data is important to the proper functioning of the securities markets. The Commission continues to believe that it is important that each SCI entity’s market data systems are reasonably designed to maintain market integrity and that the proposed requirement would facilitate that goal.⁵⁴⁸ This element, requiring that an SCI entity’s policies and procedures include standards that result in systems being designed, developed, tested, maintained, operated, and surveilled in a manner that facilitates the successful collection, processing, and dissemination of market data, is adopted as proposed, as Rule 1001(a)(2)(vi).

Monitoring

The Commission is adopting an additional provision, designated as Rule 1001(a)(2)(vii), that requires an SCI entity’s policies and procedures to provide for monitoring of SCI systems, and, for purposes of security standards, indirect SCI systems, to identify potential SCI events. Several commenters argued that Regulation SCI should allow entities to adopt and follow escalation procedures instead of providing that obligations under Regulation SCI are triggered by

on Equity Market Structure, supra note 4, at 3600 (discussing various rules and requirements relating to consolidated market data).

⁵⁴⁸ See Proposing Release, supra note 13, at 18108.

one employee's awareness of a systems issue.⁵⁴⁹ The Commission is modifying Regulation SCI in three respects in response to these comments: revising the definition of responsible SCI personnel to focus on senior managers; requiring that an SCI entity have policies and procedures to identify, designate, and escalate potential SCI events to responsible SCI personnel; and explicitly requiring policies and procedures for monitoring.⁵⁵⁰ The requirement that an SCI entity have policies and procedures to provide for monitoring of SCI systems and, for purposes of security standards, indirect SCI systems, is added to make explicit that escalation of a systems problem should occur not only if a systems problem is identified by chance, but rather that an SCI entity should have a monitoring process in place so that systems problems are able to be identified as a matter of standard operations and pursuant to parameters reasonably established by the SCI entity. In addition, the Commission believes that the reliability of escalation of potential SCI events to designated responsible SCI personnel for determination as to whether they are, in fact, SCI events is likely to be more effective when it occurs in connection with established procedures for monitoring of SCI systems and indirect SCI systems and pursuant to a process for the communication of systems problems by those who are not responsible SCI personnel to those who are. The Commission notes that several commenters discussed the role that technology staff play in monitoring and identifying potential systems problems and escalating issues up the chain of command to management as well as legal and/or compliance personnel. Although systems monitoring may already be routine in many SCI entities, there are

⁵⁴⁹ See, e.g., OCC Letter at 12; FINRA Letter at 25-26; Omgeo Letter at 13; FIF Letter at 5; and NYSE Letter at 19-20. See also *infra* notes 758-761 and accompanying text (discussing comments on the proposed "becomes aware" standard).

⁵⁵⁰ See *infra* Section IV.B.3.a (discussing the Commission's determination to further focus the definition of "responsible SCI personnel").

expected benefits of monitoring and thus it is appropriate to require an SCI entity's policies and procedures to provide for monitoring of SCI systems, and, for purposes of security standards, indirect SCI systems, to identify potential SCI events. The Commission believes that monitoring in tandem with escalation to responsible SCI personnel is an appropriate approach to ensuring SCI compliance. As noted, the requirement that an SCI entity have policies and procedures for monitoring provides an SCI entity with flexibility to establish parameters that define the types of systems problems to which technology personnel should be alert, as well as the frequency and duration of monitoring. The Commission also believes this requirement is consistent with a risk-based approach, and that an SCI entity's policies and procedures for monitoring may be tailored to the relative criticality of SCI systems, with critical SCI systems likely to be subject to relatively more rigorous policies and procedures for monitoring than other SCI systems.

iii. Policies and Procedures Consistent with "Current SCI Industry Standards" – Rule 1001(a)(4)

Proposed Rule 1000(b)(1)(ii) stated that an SCI entity's policies and procedures would be deemed to be reasonably designed if they are consistent with "current SCI industry standards," such as those listed on proposed Table A. "Current SCI industry standards" were not limited to those listed on proposed Table A, but were proposed to be required to be: (A) comprised of information technology practices that are widely available for free to information technology professionals in the financial sector; and (B) issued by an authoritative body that is a U.S. governmental entity or agency, association of U.S. governmental entities or agencies, or widely recognized organization. The rule further stated that "compliance with such current SCI industry standards... shall not be the exclusive means to comply with the requirements of paragraph (b)(1)."

The goal of proposed Rule 1000(b)(1)(ii) was to provide guidance to SCI entities on

policies and procedures that would meet the articulated standard of being “reasonably designed to ensure that their systems have levels of capacity, integrity, resiliency, availability, and security, adequate to maintain their operational capability and promote the maintenance of fair and orderly markets.” The proposal sought to provide this guidance by identifying example information technology publications describing processes, guidelines, frameworks, and/or standards that SCI entities could elect to look to in developing its policies and procedures. Proposed Table A set forth an example of one set of technology publications that the Commission preliminarily believed was an appropriate set of reference documents. The SCI Proposal acknowledged that “current SCI industry standards” would not be limited to the publications identified on proposed Table A. As such, an SCI entity’s choice of a current SCI industry standard in a given domain or subcategory thereof could appropriately be different from those contained in the publications identified in proposed Table A.⁵⁵¹ Many commenters, however, objected to the proposed objective criteria for reference publications, and/or one or more of the specific publications listed on proposed Table A. The Commission has carefully considered commenters’ views and is adopting Rule 1000(b)(1)(ii), renumbered as Rule 1001(a)(4), with certain modifications as described below.

Criteria for Identifying SCI Industry Standards: Comments Received and Commission Response

Some commenters disagreed with the Commission’s proposal to require SCI industry standards to be “comprised of information technology practices that are widely available for free to information technology professionals in the financial sector.” Several commenters argued that

⁵⁵¹ See Proposing Release, supra note 13, at 18109.

there were significant disadvantages to requiring that standards be available free of charge.⁵⁵²

One of these commenters stated that requiring standards to be available for free “may encourage SCI entities to use standards that may be outdated when more suitable standards may be available and would be more appropriate.”⁵⁵³ Another of these commenters stated that “the cost or lack thereof of a technology standard or standard framework has no bearing on the quality or appropriateness of such standard or framework and bears no significance to the maintenance of fair and orderly markets.”⁵⁵⁴

Two standard setting organizations commented regarding the use of consensus standards, citing OMB Circular No. A-119, which directs agencies to use voluntary consensus standards (*i.e.*, standards developed by professional standards organizations), and urged the Commission to eliminate the requirement that SCI industry standards be “available for free.”⁵⁵⁵ Another commenter similarly urged that it was important for SCI entities to use publications generated by professional organizations that regularly update their standards and employ open processes for gathering industry input.⁵⁵⁶

The Commission agrees that the cost or lack thereof of a technology standard or standard framework has no bearing on the quality or appropriateness of such standard, and also that SCI entities should be encouraged to use appropriate standards developed by professional

⁵⁵² See ANSI Letter at 1; DTCC Letter at 15; OCC Letter at 9; Omgeo Letter at 33-34; and X9 Letter at 1.

⁵⁵³ See OCC Letter at 9.

⁵⁵⁴ See Omgeo Letter at 33 (noting also that the proposed criteria would eliminate appropriate standards such as ITIL and ISO 27000).

⁵⁵⁵ See ANSI Letter at 1; and X9 Letter at 1.

⁵⁵⁶ See CISQ2 Letter at 6. See also Angel Letter at 8 (suggesting that the proposed criteria could potentially result in the creation of race-to-the-bottom standards organizations that establish lax standards).

organizations that regularly update their standards and employ open processes for gathering industry input. While the Commission did not propose to require that particular standards be used, in response to comment, the Commission is adopting Rule 1001(a)(4) without the criterion in the SCI Proposal that a technology standard be available free of charge. The other criteria are adopted as proposed. Thus, to qualify as an “SCI industry standard,” a publication must be comprised of information technology practices that are widely available to information technology professionals in the financial sector and issued by an authoritative body that is a U.S. governmental entity or agency, association of U.S. governmental entities or agencies, or widely recognized organization. The Commission believes that this criterion is sufficiently flexible to include technology practices issued by professional organizations, including the professional organizations referenced by commenters.⁵⁵⁷

Proposed Table A: Comments Received

The SCI Proposal stated that written policies and procedures that are consistent with the relevant examples of SCI industry standards contained in the publications identified in Table A would be deemed to be “reasonably designed” for purposes of proposed Rule 1000(b)(1).⁵⁵⁸

Proposed Table A listed publications covering nine inspection areas, or “domains,” that Commission staff historically has evaluated under the ARP Inspection Program.⁵⁵⁹

⁵⁵⁷ See infra notes 583-601 and accompanying text. The Commission expresses no view, however, on any particular publication that is not specifically identified in infra notes 584-601, or standards that remain in development (e.g., a standard being drafted by AT 9000) (see infra note 601 and accompanying text).

⁵⁵⁸ See Proposing Release, supra note 13, at 18109.

⁵⁵⁹ See id.

Proposed Table A elicited significant and varied comment. Some commenters objected generally to the Table A framework.⁵⁶⁰ Others objected more specifically to Table A's proposed content,⁵⁶¹ and some commenters objected to Table A as a premature attempt to establish consensus on SCI industry standards where consensus has not yet emerged.⁵⁶²

Table A Framework and Process

One group of commenters suggested that, in lieu of the publications identified in Table A, the Commission should characterize policies and procedures as reasonably designed if they comply with "generally accepted standards."⁵⁶³ Another commenter similarly suggested that the Commission replace the proposed rule's reference to "current SCI industry standards" with the phrase "generally accepted technology principles," and delete Table A and the proposed Table A criteria.⁵⁶⁴ These commenters viewed proposed Table A as flawed in concept.⁵⁶⁵ Specifically, one of these commenters expressed concern that the standards set forth in Table A might not keep pace with a constantly evolving technological landscape and that, despite this

⁵⁶⁰ See, e.g., Angel Letter at 8-9; BATS Letter at 6-7; BIDS Letter at 7; Direct Edge Letter at 2; Joint SROs Letter at 4; MSRB Letter at 11-12; and NYSE Letter at 20-21.

⁵⁶¹ See, e.g., Angel Letter at 8-9; BATS Letter at 6-7; FIF Letter at 3-4; ISE Letter at 11-12; CAST Letter at 10; MSRB Letter at 11-12; DTCC Letter at 15; FINRA Letter at 31; Omgeo Letter at 33; CISQ Letter at 1-2; OCC Letter at 9; Lauer Letter at 5-7; BIDS Letter at 7; and Liquidnet Letter at 3-4.

⁵⁶² See, e.g., FIF Letter at 3-4; Liquidnet Letter at 3-4; UBS Letter at 7; and ISE Letter at 11-12.

⁵⁶³ See Joint SROs Letter at 4.

⁵⁶⁴ See NYSE Letter at 20-21.

⁵⁶⁵ See Joint SROs Letter at 4; and NYSE Letter at 20.

evolution, Commission staff might take a checklist approach to its review of policies and procedures, which would result in unintended consequences.⁵⁶⁶

The other commenter stated that it was more common, and more appropriate in any industry that relies heavily on technology, for an entity to review a variety of different standards for frameworks or best practices, and then adopt a derivative of multiple standards, customizing them for the systems at issue.⁵⁶⁷ According to this commenter, SCI entities would be unlikely to comply with all aspects of any particular standard in Table A at any particular time, thereby “obviating its usefulness.”⁵⁶⁸

Other commenters argued that the Table A concept was flawed because Table A would always be on the verge of being outdated. For example, one commenter characterized the proposed Table A publications as “soon-to-be outdated” and stated that it is crucial that SCI entity policies and procedures be “forward-looking” and able to respond to future threats.⁵⁶⁹ Another commenter stated that the proposed process for updating Table A⁵⁷⁰ would not be

⁵⁶⁶ See Joint SROs Letter at 4. Other commenters similarly expressed concern that SCI entities would closely adhere to the publications listed in Table A (even though the SCI Proposal specified that such adherence would not be the exclusive means to comply with the requirements of proposed Rule 1000(b)(1)), rather than take advantage of the flexibility built into the proposed rule out of concern that if they did not, they would expose themselves to potential regulatory action for failure to comply with Regulation SCI. See, e.g., MSRB Letter at 11; Angel Letter at 8; BATS Letter at 6; and NYSE Letter at 20-21.

⁵⁶⁷ See NYSE Letter at 20.

⁵⁶⁸ See *id.*

⁵⁶⁹ See *id.* See also ISE Letter at 10 (stating that the standards listed in Table A are not the most current or appropriate standards). See also *infra* notes 577-578 and accompanying text.

⁵⁷⁰ In the SCI Proposal, the Commission stated that it “preliminarily believes that, following its initial identification of one set of SCI industry standards...it would be appropriate for Commission staff, from time to time, to issue notices to update the list of previously

sufficiently nimble to assure that SCI entities adhere to the best possible then-current standards, and suggested that the Commission defer to the expertise of the organizations that have established the listed standards and rely on the updates provided by these organizations.⁵⁷¹ Another commenter stated that any “hard coded” solutions are likely to become obsolete very quickly.⁵⁷²

After careful consideration of these comments, the Commission acknowledges that the proposed framework for identifying and updating publications on Table A may not be sufficiently nimble to assure that its list of publications does not become obsolete as technology and standards change. The Commission agrees that, in an industry that relies heavily on technologies that are constantly evolving, the prescription of hard-coded solutions that may become quickly outdated is not the better approach. However, because several commenters stated that there is currently a lack of consensus on what constitutes generally accepted standards or principles in the securities industry,⁵⁷³ the Commission continues to believe that there is value in identifying example publications for SCI entities to consider looking to in establishing policies and procedures that are consistent with “current SCI industry standards.”⁵⁷⁴

identified set of SCI industry standards after receiving appropriate input from interested persons....However, until such time as Commission staff were to update the identified set of SCI industry standards, the then-current set of SCI industry standards would be the [relevant] standards....” Proposing Release, supra note 13, at 18111.

⁵⁷¹ See MSRB Letter at 11-12.

⁵⁷² See Direct Edge Letter at 2.

⁵⁷³ See supra note 633 and accompanying text.

⁵⁷⁴ See Rule 1001(a)(4), which states: “For purposes of [complying with Rule 1001(a)], such policies and procedures shall be deemed to be reasonably designed if they are consistent with current SCI industry standards, which shall be comprised of information technology practices that are widely available to information technology professionals in the financial sector and issued by an authoritative body that is a U.S. governmental entity

After considering the potential disadvantages of “hard-coding” Table A in a Commission release, and the potential benefits of providing further guidance to SCI entities on the meaning of “current SCI industry standards,” the Commission has determined that, rather than the Commission issuing Table A in this release, Commission staff should issue guidance to assist SCI entities in developing policies and procedures consistent with “current SCI industry standards” in a manner that is consistent with the Commission’s response to comments received on proposed Table A, as discussed in this Section IV.B.1.b.iii, and periodically update such guidance as appropriate. The Commission believes that guidance issued by the Commission staff will have the advantage of easier updating and allow for emerging consensus on standards more focused on the securities industry. Thus, concurrent with the Commission’s adoption of Regulation SCI, Commission staff is issuing guidance to SCI entities on developing policies and procedures consistent with “current SCI industry standards.”⁵⁷⁵

Table A Publications

Many commenters who did not urge elimination of Table A altogether addressed the content of proposed Table A. Those commenters did not express opposition to the identification of certain inspection areas or domains on proposed Table A, but some commenters identified issues with specific publications listed on Table A.⁵⁷⁶ Specifically, two commenters stated that

or agency, association of U.S. governmental entities or agencies, or widely recognized organization. Compliance with such current SCI industry standards, however, shall not be the exclusive means to comply with [Rule 1001(a)].”

⁵⁷⁵ Staff Guidance on Current SCI Industry Standards will be available on the Commission’s website at: www.sec.gov.

⁵⁷⁶ See, e.g., Angel Letter at 9; BATS Letter at 6-7; FIF Letter at 3-4; and ISE Letter at 10.

the NIST publication listed for the Systems Development Methodology domain was outdated.⁵⁷⁷ One of these commenters objected to this publication as reflecting a burdensome staged process to software development that favors the “waterfall methodology” over “agile” software development, which generally uses more “nimble processes” and is more typical in the financial services industry today.⁵⁷⁸ Another commenter noted that this publication had both strengths and weaknesses.⁵⁷⁹ Two commenters objected to the FFIEC’s Operations IT Examination Handbook in the capacity planning domain as too generic.⁵⁸⁰ One commenter objected to the inclusion of FFIEC’s Audit IT Examination Handbook.⁵⁸¹ Another commenter stated more broadly that the proposed Table A publications focus too heavily on firm-level risks and do not take into account the technological and economic stability of the U.S. market as a whole.⁵⁸²

In addition, several commenters suggested specific additions to the proposed list of publications on Table A.⁵⁸³ For example, more than one commenter suggested the following

⁵⁷⁷ See BATS Letter at 6; and ISE Letter at 10 (objecting to the inclusion of NIST Security Considerations in the System Development Life Cycle (Special Publication 800-64 Rev. 2) as a suitable “current SCI industry standard” in the systems development methodology domain).

⁵⁷⁸ See BATS Letter at 6-7.

⁵⁷⁹ See CISQ2 Letter at 4-5 (stating that NIST Special Publication 800-64, Rev. 2 and any derivative standard should “be reviewed and if necessary revised by a panel of industry practitioners and technical experts to balance the requirement for rigor with the amount of practices and documentation specified in the standard”).

⁵⁸⁰ See ISE Letter at 10; and FIF Letter at 3-4 (both described this publication as setting forth a process for conducting capacity planning).

⁵⁸¹ See ISE Letter at 10.

⁵⁸² See Angel Letter at 9.

⁵⁸³ See, e.g., CAST Letter; ISE Letter; MSRB Letter; DTCC Letter; FINRA Letter; Omgeo Letter; CISQ2 Letter; OCC Letter; BIDS Letter; Liquidnet Letter; and X9 Letter.

standards as appropriate for inclusion on Table A: COBIT/ISACA,⁵⁸⁴ ISO-27000,⁵⁸⁵ ISO 25000,⁵⁸⁶ and NFPA-1600.⁵⁸⁷ Other standards or publications mentioned by commenters as useful, particularly in the area of software quality or software security, include the CISQ Software Quality Specification,⁵⁸⁸ the Capability Maturity Model Integration (CMMI) framework,⁵⁸⁹ “SANS 20 Critical Security Controls,”⁵⁹⁰ “CWE/SANS Top 25 Most Dangerous Software Errors,”⁵⁹¹ the Open Source Security Testing Methodology Manual (OSSTMM),⁵⁹² the

⁵⁸⁴ See CAST Letter at 10; ISE Letter at 11; and MSRB Letter at 11. COBIT (formerly known as Control Objectives for Information and related Technology) is an enterprise information technology governance framework developed by ISACA (formerly known as the Information Systems Audit and Control Association).

⁵⁸⁵ See DTCC Letter at 15; ISE Letter at 11; FINRA Letter at 31; and Omgeo Letter at 33. FINRA recommended ISO-27000 series because it provides “greater specificity” and may be “less burdensome” than the standards identified in proposed Table A. ISE and DTCC recommended ISO 27000 specifically for application controls, information security and networking, and physical security controls. Omgeo stated more broadly that it models aspects of its program on widely accepted international standards and frameworks such as ITIL and ISO 27000.

⁵⁸⁶ See CAST Letter and CISQ2 Letter. CAST suggested supplementing the SCI industry standards with standards that address development, as well as standards that pertain to structural software quality, such as ISO 25010 and CISQ Software Quality Specification. See CAST Letter at 5. CISQ2 agreed that standards addressing structural software quality are needed and suggested including CISQ Specification for Automated Quality Characteristic Measures: CISQ-TR-2012-01 in Table A. CISQ also pointed to the Capability Maturity Model Integration (CMMI) as another potential option, noting that it was the most widely adopted process standard for rigorous software development practices. See CISQ2 Letter at 3-4.

⁵⁸⁷ See OCC Letter at 9; and ISE Letter at 11. ISE also specifically recommended BS 25999 as an alternative contingency planning standard.

⁵⁸⁸ See CAST Letter at 5; and CISQ Letter at 1.

⁵⁸⁹ See CAST Letter at 10.

⁵⁹⁰ See FIF Letter at 4.

⁵⁹¹ See id.

⁵⁹² See Lauer Letter at 5-7.

BITS Financial Services Roundtable Software Assurance Framework (January 2012),⁵⁹³ the “Build Security In Maturity Model” (BSTMM),⁵⁹⁴ Microsoft’s SDL,⁵⁹⁵ and resources for defining secure software development practices from organizations such as OWASP, WASC and SAFECODE,⁵⁹⁶ and publications issued by Scrum Alliance,⁵⁹⁷ the Association for Software Testing (AST),⁵⁹⁸ the Institute of Electrical and Electronics Engineers (IEEE),⁵⁹⁹ and the Association for Computing Machinery (ACM).⁶⁰⁰ In addition, one commenter suggested a standard currently being drafted by AT 9000, a working group which focuses on trading safety, regulatory requirements, and achieving efficiency and effectiveness of systems involved in automated trading.⁶⁰¹

A few commenters opposed referencing standards in Regulation SCI at the outset and instead supported establishing a process that they believed would, after a certain period of time, yield a coherent set of standards.⁶⁰² One of these commenters urged that best practices should evolve from the Commission’s experience with the annual SCI review process and experience with the ARP program, because such best practices will be specific to the securities industry and

⁵⁹³ See BIDS Letter at 7.

⁵⁹⁴ See id.

⁵⁹⁵ See id.

⁵⁹⁶ See id.

⁵⁹⁷ See Liquidnet Letter at 4.

⁵⁹⁸ See id.

⁵⁹⁹ See id.

⁶⁰⁰ See id.

⁶⁰¹ See X9 Letter at 2.

⁶⁰² See, e.g., FIF Letter at 4, 6; Liquidnet Letter at 3; UBS Letter at 7; and ISE Letter at 11.

reflect the actual practices of SCI entities.⁶⁰³ Finally, several commenters suggested that the Commission establish a working group to develop SCI industry standards.⁶⁰⁴

The Commission has carefully considered these comments, and continues to believe that there is value in identifying publications for SCI entities to consider looking to in establishing reasonable policies and procedures, because doing so will provide guidance on how an SCI entity may comply with adopted Rule 1001(a). The Commission therefore believes that issuance of staff guidance that does this, as discussed above, will be useful for SCI entities. However, after careful consideration of commenters' views regarding the publications on proposed Table A, the Commission believes it is useful to characterize how such staff guidance should be used by SCI entities. In particular, the Commission understands that some commenters who objected to the proposed Table A concept and/or the proposed Table A content were more broadly taking issue with the characterization of certain of the documents on proposed Table A, such as the NIST 800-53 document, as a "standard," rather than a "framework" or a "process."⁶⁰⁵ The Commission believes that many commenters implicitly were questioning why certain identified technology frameworks (such as NIST 800-53) were being labeled as, and thereby elevated to, an

⁶⁰³ See FIF Letter at 4, 6.

⁶⁰⁴ See, e.g., Liquidnet Letter at 3 (urging that a working group consisting of regulators, industry participants (from exchanges, ATs and broker-dealers) and security and controls experts be established to develop a security and controls framework for the industry). See also UBS Letter at 7 (urging the Commission to convene a "cross-industry, multi-disciplinary Working Group" to be responsible for developing recommendations for appropriate standards); and ISE Letter at 11 (recommending that the Commission authorize SCI entities to establish a standards committee to review and recommend specific sets of standards). See also CISQ Letter at 2, 6 (supporting the Table A approach but also seeing value in tailoring existing standards from professional organizations into an industry-specific set of standards for SCI entities).

⁶⁰⁵ The Commission also notes that this point was made by a member of the third panel at the Cybersecurity Roundtable, supra note 39. See also FINRA Letter at 31.

example of “current SCI industry standards” when many SCI entities were already following ISO 27000, COBIT, or other technology standards that they viewed as more specific, relevant, and/or cost effective than the NIST frameworks identified on proposed Table A.⁶⁰⁶ In response to these comments, the Commission believes it is appropriate that the staff’s guidance be characterized as listing examples of publications describing processes, guidelines, frameworks, or standards for an SCI entity to consider looking to in developing reasonable policies and procedures, rather than strictly as listing industry standards. Thus, the Commission believes it is appropriate if Commission staff were to list publications that provide guidance to SCI entities on suitable processes for developing, documenting, and implementing policies and procedures for their SCI systems (and indirect SCI systems, as applicable), taking into account the criticality of each such system.

With respect to the publications commenters suggested for inclusion on proposed Table A, the Commission is not disputing the value of such standards, and believes that each, when considered with respect to a particular system at an SCI entity, may contain appropriate standards for the SCI entity to use as, or incorporate within, its policies and procedures.⁶⁰⁷ The Commission notes that the guidance is intended to be used as a baseline from which the staff may work with SCI entities and other interested market participants to build consensus on industry-specific standards, as discussed more fully below. Further, the Commission believes that the goal of providing general and flexible guidance to SCI entities does not necessitate providing a lengthy list of all the publications that meet the criteria set forth in Rule

⁶⁰⁶ See supra notes 577-601 and accompanying text.

⁶⁰⁷ See supra notes 577-601 and accompanying text.

1001(a)(4).⁶⁰⁸

The Commission continues to believe that it may be appropriate for an SCI entity to choose to adhere to a standard or guideline in a given domain or subcategory thereof that is different from those contained in the staff guidance, and emphasizes that nothing that the staff may include in its guidance precludes an SCI entity from adhering to standards such as ISO 27000, COBIT, or others referenced by commenters to the extent they result in policies and procedures that comply with the requirements of Rule 1001(a).⁶⁰⁹ Moreover, adopted Rule 1001(a)(4) explicitly provides that compliance with current SCI industry standards (i.e., including those publications identified by the Commission staff) is not the exclusive method of compliance with Rule 1001(a). Accordingly, an SCI entity's determination not to adhere to some or all of the publications included in the staff guidance in developing its policies and procedures does not necessarily mean that its policies and procedures will be deficient or unreasonable for purposes of Rule 1001(a)(1). Importantly, the publications listed by Commission staff should be understood to provide guidance to SCI entities on selecting appropriate controls for applicable systems, as well as suitable processes for developing, documenting, and implementing policies and procedures for their SCI systems (and indirect SCI systems, as applicable), taking into account the criticality of each such system. Thus, for example, the Commission believes it would be reasonable for the most robust controls to be

⁶⁰⁸ See supra note 557 and accompanying text.

⁶⁰⁹ Likewise, such guidance would not preclude an SCI entity from adopting a derivative of multiple standards, and/or customizing one or more standards for the particular system at issue, as one commenter suggested. See supra note 567 and accompanying text. In assessing whether an SCI entity's use of such an approach in designing its policies and procedures would be "deemed" to be reasonably designed, the Commission's inquiry would be into whether its policies and procedures were consistent with standards meeting the criteria in adopted Rule 1001(a)(4).

selected and implemented for “critical SCI systems,” as compared to other types of SCI systems, and the Commission believes it would be appropriate that the staff’s guidance include publications that require more rigorous controls for higher-risk systems. The staff guidance is not intended to be static, however. As the Commission staff works with SCI entities, as well as members of the securities industry, technology experts, and interested members of the public, and as technology standards continue to evolve, the Commission anticipates that the Commission staff will periodically update the staff guidance as appropriate.

Another way in which the publications identified by Commission staff should provide guidance to SCI entities is by providing transparency on how the staff will, at least initially, prepare for and conduct inspections relating to Regulation SCI. As discussed in the SCI Proposal and above,⁶¹⁰ for over two decades, ARP staff has conducted inspections of ARP entity systems, with a goal of evaluating whether an ARP entity’s controls over its information technology resources in each domain are consistent with ARP and industry guidelines,⁶¹¹ as identified by ARP staff from a variety of information technology publications that ARP staff believed were appropriate for securities market participants.⁶¹² With the adoption of Regulation SCI, and the resultant transition away from the voluntary ARP Inspection Program to an inspection program under Regulation SCI, the Commission believes it is helpful to establish consistency in its approach to examining SCI entities for compliance with Regulation SCI. Importantly, establishing consistency does not mean that the Commission will take a one-size-

⁶¹⁰ See supra Section II.A.

⁶¹¹ As stated in the SCI Proposal, the domains covered during an ARP inspection depend in part upon whether the inspection is a regular inspection or a “for-cause” inspection. Typically, however, to make the most efficient use of resources, a single ARP inspection will cover fewer than nine domains. See Proposing Release, supra note 13, at 18086.

⁶¹² See id. and supra Section II.A (discussing the ARP Inspection Program).

fits-all or checklist approach. Because the publications identified by Commission staff should be general and flexible enough to be compatible with many widely-recognized technology standards that SCI entities currently use, the Commission believes the publications identified by Commission staff should provide guidance for an SCI entity to self-assess whether its policies and procedures comply with Rules 1001(a)(1)-(2). Moreover, because use of the publications identified by Commission staff is not mandatory, the staff guidance should not be regarded as establishing a checklist, the use of which could result in unintended consequences, but rather a basis for considering how an SCI entity's selected standards relate to the guidance provided by Commission staff and whether they are appropriate standards for use by that particular SCI entity for a given system.

The Commission believes that it would be appropriate that the publications initially identified by Commission staff at a minimum include the nine inspection areas, or "domains," that the Commission identified on Table A in the SCI Proposal and that are relevant to SCI entities' systems capacity, integrity, resiliency, availability, and security, namely: application controls; capacity planning; computer operations and production environment controls; contingency planning; information security and networking; audit; outsourcing; physical security; and systems development methodology.

The Commission believes it would be appropriate that each publication identified by Commission staff be identified with specificity and include the particular publication's date, volume number, and/or publication number, as the case may be. Thus, for SCI entities that establish or self-assess their policies and procedures in reliance on the guidance provided by the publications identified by Commission staff, the Commission believes that the publications should be the relevant publications until such time as the list is updated by Commission staff. Of

course, SCI entities may elect to use publications describing processes, guidelines, frameworks, and/or standards other than those identified by Commission staff to develop policies and procedures that satisfy the requirements of Rules 1001(a)(1)-(2).

As stated in the SCI Proposal, however, the Commission continues to believe that the development of securities-industry specific standards is a worthy goal. Although some commenters urged the Commission not to adopt Table A at the outset, and instead establish a process to achieve that end,⁶¹³ the Commission believes that the better approach is for Commission staff to provide examples of publications through its guidance that form a baseline and remain open to emerging consensus on industry-specific standards. In response to the commenter that suggested that the Commission leverage the annual SCI review process and the SCI inspection process to yield a coherent set of industry-specific standards that could be referenced on Table A, the Commission believes that such an approach could serve as an appropriate input into the future development of such standards.⁶¹⁴ In response to the commenter who stated that the proposed Table A publications do not take into account the technological and economic stability of the U.S. market as a whole,⁶¹⁵ the Commission notes that the technological stability of individual SCI entities, in tandem with a heightened focus on critical SCI systems, are necessary prerequisites to achieving such market-wide goals. Accordingly, the Commission believes that the publications identified by Commission staff today should serve as an appropriate initial set of publications, processes, guidelines, frameworks, and standards for SCI entities to use as guidance to develop their policies and

⁶¹³ See supra note 604 and accompanying text.

⁶¹⁴ See supra note 602 and accompanying text.

⁶¹⁵ See supra note 582 and accompanying text.

procedures under Rule 1001(a). With this guidance as a starting point, the Commission expects that the Commission staff will seek to work with members of the securities industry, technology experts, and interested members of the public towards developing standards relating to systems capacity, integrity, resiliency, availability, and security appropriately tailored for the securities industry and SCI entities, and periodically issue staff guidance that updates the guidance with such standards.

2. Policies and Procedures to Achieve Systems Compliance – Rule 1001(b)

Proposed Rule 1000(b)(2)(i) would have required each SCI entity to establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems operate in the manner intended, including in a manner that complies with the federal securities laws and rules and regulations thereunder and the SCI entity's rules and governing documents, as applicable.

Proposed Rule 1000(b)(2) also would have included safe harbors for an SCI entity and its employees. Specifically, proposed Rule 1000(b)(2)(ii) provided that an SCI entity would be deemed not to have violated proposed Rule 1000(b)(2)(i) if the SCI entity: (1) established policies and procedures reasonably designed to provide for specified elements; (2) established and maintained a system for applying such policies and procedures which would reasonably be expected to prevent and detect, insofar as practicable, any violations of such policies and procedures by the SCI entity or any person employed by the SCI entity; and (3) reasonably discharged the duties and obligations incumbent upon it by such policies and procedures, and was without reasonable cause to believe that such policies and procedures were not being complied with in any material respect. The safe harbor for SCI entities in proposed Rule 1000(b)(2)(ii) specified that the SCI entity's policies and procedures must be reasonably

designed to provide for: (1) testing of all SCI systems and any changes to such systems prior to implementation; (2) periodic testing of all SCI systems and any changes to such systems after their implementation; (3) a system of internal controls over changes to SCI systems; (4) ongoing monitoring of the functionality of SCI systems to detect whether they are operating in the manner intended; (5) assessments of SCI systems compliance performed by personnel familiar with applicable federal securities laws and rules and regulations thereunder and the SCI entity's rules and governing documents, as applicable; and (6) review by regulatory personnel of SCI systems design, changes, testing, and controls to prevent, detect, and address actions that do not comply with applicable federal securities laws and rules and regulations thereunder and the SCI entity's rules and governing documents, as applicable.

In addition, proposed Rule 1000(b)(2)(iii) set forth a safe harbor for individuals. It provided that a person employed by an SCI entity would be deemed not to have aided, abetted, counseled, commanded, caused, induced, or procured the violation by any other person of proposed Rule 1000(b)(2)(i) if the person employed by the SCI entity has reasonably discharged the duties and obligations incumbent upon such person by the policies and procedures, and was without reasonable cause to believe that such policies and procedures were not being complied with in any material respect.

After careful consideration of the comments, proposed Rule 1000(b)(2) is adopted as Rule 1001(b) with modifications, as discussed below.

a. Reasonable Policies and Procedures to Achieve Systems Compliance

The Commission received significant comment on its proposal to require that SCI entities establish, maintain, and enforce written policies and procedures reasonably designed to ensure systems compliance. Some commenters supported the broad goals of a policies and procedures

requirement to help ensure that SCI systems operate as intended.⁶¹⁶ Other commenters questioned whether any set of policies and procedures could guarantee perfect operational compliance.⁶¹⁷ One commenter emphasized that no set of policies and procedures can guarantee 100% operational compliance and that, historically, the Commission has allowed entities to use a reasonableness standard so that policies and procedures are required to be reasonably designed to promote compliance, and the same should be used for the underlying predicate requirement in Regulation SCI.⁶¹⁸ A few commenters expressed concern that, in instances where an SCI entity's policies and procedures failed to prevent SCI events, the Commission might use such failures as the basis for an enforcement action, charging that the policies and procedures were not reasonable.⁶¹⁹ One commenter believed that compliance with Regulation SCI should be measured against a firm's adherence to its own set of policies and procedures that are in keeping with SCI system objectives, and such policies should be reviewed and updated as part of the annual SCI review process.⁶²⁰ Another commenter requested that the Commission more clearly distinguish between liability under Regulation SCI and liability for SCI events, stating that

⁶¹⁶ See MSRB Letter at 12-13; SIFMA Letter at 12; and MFA Letter at 3. Two of these commenters believed that SCI entities that perform critical market functions should be required to have more stringent policies and procedures than less critical SCI entities. See SIFMA Letter at 12; and MFA Letter at 3-4.

⁶¹⁷ See ITG Letter at 14. See also BATS Letter at 3-4, 6.

⁶¹⁸ See ITG Letter at 14.

⁶¹⁹ See BATS Letter at 3-4; Angel Letter at 4; and FSR Letter at 5. One of these commenters considered this possibility as, in effect, imposing a strict liability standard with respect to systems issues, and was concerned that the proposed approach would result in "finger-pointing" and constant enforcement actions for immaterial violations that desensitize people to actual material violations. See FSR Letter at 3-8.

⁶²⁰ See FIF Letter at 4.

compliance with Regulation SCI and compliance with other federal securities laws and rules must remain distinct.⁶²¹

Whereas adopted Rule 1001(a)⁶²² concerns the robustness of the SCI entity's systems; adopted Rule 1001(b)⁶²³ concerns the operational compliance of an SCI entity's SCI systems with the Exchange Act, the rules and regulations thereunder, and the SCI entity's governing documents. The Commission continues to believe, as stated in the SCI Proposal, that a rule requiring SCI entities to establish, maintain, and enforce policies and procedures reasonably designed to ensure operational compliance will help to: ensure that SCI SROs comply with Section 19(b)(1) of the Exchange Act;⁶²⁴ reinforce existing SRO rule filing processes to assist market participants and the public in understanding how the SCI systems of SCI SROs are intended to operate; and assist SCI SROs in meeting their obligations to file plan amendments to SCI Plans under Rule 608 of Regulation NMS.⁶²⁵ It will similarly help other SCI entities (i.e., SCI ATSS, plan processors, and exempt clearing agencies subject to ARP) to achieve operational compliance with the Exchange Act, the rules and regulations thereunder, and their governing documents.

The Commission notes that Rule 1001(b) is intended to help prevent the occurrence of systems compliance issues at SCI entities. The Commission discussed in Section IV.A.3.b the rationale for further focusing the definition of systems compliance issue (i.e., replacing the

⁶²¹ See FSR Letter at 6.

⁶²² Adopted Rule 1001(a) was proposed as Rule 1000(b)(1).

⁶²³ Adopted Rule 1001(b) was proposed as Rule 1000(b)(2).

⁶²⁴ See 15 U.S.C. 78s(b)(1) (requiring each SRO to file with the Commission copies of any proposed rule or any proposed change in, addition to, or deletion from the rules of the SRO).

⁶²⁵ See Proposing Release, *supra* note 13, at 18115.

reference to operating “in the manner intended, including in a manner that complies with the federal securities laws” with a reference to operating “in a manner that complies with the Act”). To provide consistency between the definition of systems compliance issue and the requirement for policies and procedures to ensure systems compliance, the Commission is similarly revising Rule 1001(b)(1) to require each SCI entity to establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems operate “in a manner that complies with the Act” and the rules and regulations thereunder and the entity’s rules and governing documents, as applicable.

As noted above, some commenters expressed concern that an SCI entity would be found to be in violation of Rule 1001(b) if an SCI event occurs.⁶²⁶ Consistent with the discussion above regarding Rule 1001(a), the Commission emphasizes that the occurrence of a systems compliance issue at an SCI entity does not necessarily mean that the SCI entity has violated Rule 1001(b) of Regulation SCI. As stated in the SCI Proposal, an SCI entity will not be deemed to be in violation of Rule 1001(b) solely because it experienced a systems compliance issue.⁶²⁷ The

⁶²⁶ See supra notes 617-620 and accompanying text. One of these commenters believed that compliance with Regulation SCI should be measured against a firm’s adherence to its own set of policies and procedures that are in keeping with SCI systems objectives. See supra note 620 and accompanying text. The Commission understands this commenter to be expressing the same concern as other commenters that an SCI entity would be found to be in violation of Rule 1001(b) if an SCI event occurs. This commenter also noted that policies and procedures should be reviewed and updated as part of the annual SCI review process. See supra note 620 and accompanying text. The comment regarding reviews and updates of policies and procedures is addressed below. See infra note 673 and accompanying text.

⁶²⁷ Also, as noted in the SCI Proposal, an employee of an SCI entity would not be deemed to have aided, abetted, counseled, commanded, caused, induced, or procured the violation by any other person of Rule 1001(b) merely because the SCI entity at which the employee worked experienced a systems compliance issue. See Proposing Release, supra note 13, at 18116.

Commission also notes that Rule 1001(b) requires systems compliance policies and procedures to be reasonably designed.⁶²⁸ The Commission acknowledges that reasonable policies and procedures will not ensure the elimination of all systems issues, including systems compliance issues. While a systems compliance issue may be probative as to the reasonableness of an SCI entity's policies and procedures, it is not determinative. Further, the occurrence of a systems compliance issue also does not necessarily mean that the SCI entity will be subject to an enforcement action. Rather, the Commission will exercise its discretion to initiate an enforcement action if the Commission determines that action is warranted, based on the particular facts and circumstances of an individual situation.

In response to one commenter's request that the Commission more clearly distinguish between liability under Regulation SCI and liability for SCI events,⁶²⁹ the Commission notes that liability under Regulation SCI is separate and distinct from liability for other violations that may arise from the underlying SCI event. In particular, whether an SCI entity violated Regulation SCI does not affect the determination of whether the underlying SCI event also caused the SCI entity to violate other laws or rules, and compliance with Regulation SCI is not a safe harbor or other shield from liability under other laws or rules. Thus, even if the occurrence of an SCI

⁶²⁸ As stated above, one commenter noted that no set of policies and procedures can guarantee 100% operational compliance and that historically, the Commission has allowed entities to use a reasonableness standard so that policies and procedures are required to be reasonably designed to promote compliance, and the same approach should be used for Regulation SCI. See supra note 618 and accompanying text. The Commission agrees with this commenter that reasonably designed policies and procedures might not completely eliminate the occurrence of systems compliance issues. Also, adopted Rule 1001(b) is consistent with this commenter's suggestion, because it requires policies and procedures that are "reasonably designed" to ensure systems compliance.

⁶²⁹ See supra note 621 and accompanying text.

event does not cause an SCI entity to be found to be in violation of Regulation SCI, the SCI entity may still be liable under other Commission rules or regulations, the Exchange Act, or SRO rules for the underlying SCI event.⁶³⁰

b. Proposed Safe Harbor for SCI Entities

i. Comments Received

In the SCI Proposal, the Commission solicited comment on the proposed approach to include safe harbor provisions in proposed Rule 1000(b)(2) and specifically asked whether commenters agreed with the proposed inclusion of safe harbors.⁶³¹ Many commenters specifically addressed the safe harbors in proposed Rule 1000(b)(2). Two commenters urged elimination of the proposed safe harbors.⁶³² One of these commenters stated that the safe harbors were framed so generally that they would be easy to invoke.⁶³³ This commenter also stated that inclusion of a safe harbor provision for compliance standards would unnecessarily and severely limit the Commission's ability to deter violations through meaningful enforcement actions.⁶³⁴ The other commenter stated that, if a safe harbor is adopted, the Commission should be as specific as possible in establishing how to qualify for the safe harbor, and recommended that Commission guidance ensure that SCI entities are actively building and improving upon

⁶³⁰ For example, it is possible for an SCI SRO to have established, maintained, and enforced reasonably designed systems compliance policies and procedures consistent with the requirements of Rule 1001(b) of Regulation SCI, but still potentially violate Section 19(g) of the Exchange Act if the operation of its systems is inconsistent with its own rules. See 15 U.S.C. 78s(g) (requiring every SRO to comply with the Exchange Act, the rules and regulations thereunder, and its own rules).

⁶³¹ See Proposing Release, supra note 13, at 18117, question 104.

⁶³² See Better Markets Letter at 5-6; and Lauer Letter at 7-8.

⁶³³ See Better Markets Letter at 5-6.

⁶³⁴ See id. at 6.

safety systems and not simply checking boxes and doing the minimal amount necessary to ensure compliance.⁶³⁵

In contrast, several commenters supported the inclusion of a safe harbor in proposed Rule 1000(b)(2) in theory, but objected to the proposed approach.⁶³⁶ Some commenters stated that the proposed safe harbor, with its prescriptive requirements, would evolve into the de facto rule itself as SCI entities decide to adhere to the requirements of the safe harbor rather than risk a potential enforcement action stemming from an SCI event.⁶³⁷ One of these commenters noted that the safe harbor merely further defined the elements that the policies and procedures must have by providing a list of points that reasonably designed policies and procedures must cover.⁶³⁸ This commenter believed that including a requirement for reasonably designed policies and procedures and providing a safe harbor when those policies and procedures are reasonably designed is inherently circular, and expressed concern about liability under Regulation SCI whenever there is a systems or technology malfunction or error.⁶³⁹ This commenter also compared the proposed SCI entity safe harbor to other rules, stating that the other rules requiring policies and procedures recognize the need for those policies and procedures to be reasonably designed in light of the manner in which business is conducted.⁶⁴⁰ This commenter further noted

⁶³⁵ See Lauer Letter at 7-8.

⁶³⁶ See, e.g., Angel Letter; Direct Edge Letter; FSR Letter; ITG Letter; MSRB Letter; NYSE Letter; OCC Letter; OTC Markets Letter; and Joint SROs Letter.

⁶³⁷ See ITG Letter at 14 (stating that “[t]he safe harbor contains so many requirements that it operates as a rule by itself”); and FSR Letter at 8.

⁶³⁸ See FSR Letter at 4-5.

⁶³⁹ See *id.* at 5-6.

⁶⁴⁰ See FSR Letter at 8-9 (expressing concern that the safe harbor will become the sole yardstick by which conduct is measured and, even if the safe harbor were non-exclusive, it could become the de facto standard to the exclusion of other, legitimate approaches).

that, if the Commission intends that all SCI entities conform to the standards articulated in the safe harbor, the Commission should set them forth as express provisions of the rule, although this commenter believed that such an approach would be misguided because it would create strictures that impose protocols that may not be suitable for certain market participants.⁶⁴¹

Several other commenters expressed concern that the proposed safe harbors were unclear.⁶⁴² One group of commenters noted that the provisions in the proposed safe harbors were vague, subjective, and merely duplicate elements that would result from a logical interpretation of Rule 1000(b)(1),⁶⁴³ which these commenters believed offered no safe harbor protection at all.⁶⁴⁴ Another commenter stated that the use of a reasonableness standard with respect to the design of systems and the discharge of duties under an SCI entity's policies and procedures would mean that an SCI entity and its employees would never know with certainty whether they met the terms of the safe harbor.⁶⁴⁵ Another commenter similarly stated that SCI entities cannot know if they have complied with the safe harbor unless more guidance is provided on the concept of "reasonable policies and procedures" and the Commission explains

⁶⁴¹ See FSR Letter at 9.

⁶⁴² See, e.g., FSR Letter; OCC Letter; and OTC Markets Letter.

⁶⁴³ See Joint SROs Letter at 13 (stating that the proposed safe harbor should provide a more objective and transparent approach, and provide SCI entities a clear, affirmative defense from allegations of having violated Regulation SCI).

⁶⁴⁴ See Joint SROs Letter at 13.

⁶⁴⁵ See OCC Letter at 11. This commenter also questioned the value of the safe harbors as proposed and requested that the Commission consider including bright-line tests and minimum standards in the safe harbor provisions to better guide SCI entities and their employees in avoiding liability under Regulation SCI. See OCC Letter at 11. See also NYSE Letter at 30 (noting that the Commission provided no guidance on the phrase "policies and procedures reasonably designed").

what constitutes adequate testing, monitoring, assessments, and review for each system.⁶⁴⁶ One commenter agreed with the need for a safe harbor but stated that the proposed safe harbor is not sufficiently robust because it contains “vague and extensive requirements that are overly subjective” and the Commission therefore would be “likely to review an SCI entity’s interpretation of the safe harbor in the event of a systems issue with the benefit of 20/20 hindsight.”⁶⁴⁷ This commenter expressed concern that the occurrence of a significant systems event would mean that an exchange did not have reasonable policies and procedures and would be outside the terms of the proposed safe harbor.⁶⁴⁸

A few commenters suggested specific alternatives to the proposed safe harbors.⁶⁴⁹ One commenter recommended that the Commission adopt a safe harbor with objective criteria to protect SCI entities from enforcement actions under Regulation SCI except in cases of intentional or reckless non-compliance or patterns of non-compliance with Regulation SCI, or if an SCI entity fails to implement reasonable corrective action in response to a written communication from the Commission regarding Regulation SCI.⁶⁵⁰ This commenter urged that,

⁶⁴⁶ See OTC Markets Letter at 15.

⁶⁴⁷ See NYSE Letter at 30.

⁶⁴⁸ See id.

⁶⁴⁹ See, e.g., FSR Letter; ITG Letter; OTC Markets Letter; Joint SROs Letter; and NYSE Letter.

⁶⁵⁰ See NYSE Letter at 29, 31-32. This commenter also suggested that SCI entity employees be protected except in instances where employees intentionally or recklessly fail to discharge their duties and obligations under the SCI entity’s policies and procedures. See NYSE Letter at 29, 31-32. This comment and the individual safe harbor are addressed in Section IV.B.2.d below. Another commenter, expressing support for NYSE’s suggested approach for SCI entities and their employees, stated that an objective standard would provide the proper incentives for compliance and allow SCI entities to reasonably evaluate their potential exposure when an SCI event occurs and act quickly in the critical moments following an SCI event. See OTC Markets Letter at 16.

even if the Commission does not include the suggested safe harbor, the adopting release should clearly state that the Commission will not pursue enforcement actions against SCI entities that establish, maintain, and enforce compliance policies and procedures or act in good faith, notwithstanding a violation of Regulation SCI.⁶⁵¹

One group of commenters similarly recommended that the Commission adopt an objective safe harbor.⁶⁵² These commenters noted that minor mistakes and unintentional errors occur in the daily operations of running a business, and a safe harbor should provide protection to SCI entities that follow the policies and procedures as intended, including in the resolution and containment of such mistakes and errors.⁶⁵³ These commenters believed that it should be sufficient for an SCI entity to qualify for the safe harbor if it adopts policies and procedures reasonably designed to comply with Regulation SCI and does not knowingly violate such policies and procedures.⁶⁵⁴ These commenters further requested that the Commission clarify its views on the protections of the safe harbor for inadvertent violations of other laws and rules despite compliance with Regulation SCI and expand the safe harbor to explicitly cover such instances.⁶⁵⁵

One commenter suggested simplifying the safe harbor to require only that an SCI entity adopt reasonable policies and procedures to comply with proposed Regulation SCI, which should

⁶⁵¹ See NYSE Letter at 32, n. 41.

⁶⁵² See Joint SROs Letter at 13-14.

⁶⁵³ See id.

⁶⁵⁴ See id. These commenters suggested a parallel safe harbor for employees of SCI entities. See id. at 14.

⁶⁵⁵ See id.

include reasonable ongoing responsibilities related to testing and monitoring.⁶⁵⁶ Another commenter believed that the safe harbor should grant immunity from enforcement penalties for all problems that are self-reported by SCI entities and individuals.⁶⁵⁷ One commenter suggested that Regulation SCI should: (1) encourage parties to discover and remediate technology errors and malfunctions, and/or deficiencies in their policies and procedures; (2) avoid ipso facto liability under Regulation SCI for failures by technology or systems; and (3) require some form of causation in order for liability to attach.⁶⁵⁸ This commenter also recommended that the Commission provide safe harbors from liability under both proposed Rules 1000(b)(1) and (2) where either: (1) the SCI entity or SCI personnel discovers and remediates a problem without regulatory intervention and assuming no underlying material violation; or (2) no technology error or problem has occurred, but the policies and procedures might benefit from improvements.⁶⁵⁹ According to this commenter, the remediation safe harbor should also apply to underlying technology problems if the SCI entity had complied with Regulation SCI.⁶⁶⁰ One commenter expressed concern that, without a safe harbor and a guarantee of immunity, the disclosures to the Commission required under Regulation SCI would provide a roadmap for litigation against non-SRO entities.⁶⁶¹

⁶⁵⁶ See ITG Letter at 14.

⁶⁵⁷ See Angel Letter at 4.

⁶⁵⁸ See FSR Letter at 9.

⁶⁵⁹ See id. at 9-10.

⁶⁶⁰ See id. at 3, 9-10.

⁶⁶¹ See OTC Markets Letter at 15-16 (stating that “entities that do not have SRO immunity, such as ATSSs, may be subject to liability based on information reported under Reg. SCI’s Rule 1000(b)(4)(iv)...[w]ithout a safe harbor and a guarantee of immunity, this kind of disclosure provides a roadmap for litigation against non-SRO SCI entities”).

ii. **Elimination of Proposed Safe Harbor for SCI Entities and Specification of Minimum Elements**

As discussed in greater detail below, after careful consideration of the comments, and in light of the more focused scope of Regulation SCI, the Commission has determined not to adopt the proposed safe harbor for SCI entities.⁶⁶² Rather, Rule 1001(b) sets forth non-exhaustive minimum elements that an SCI entity must include in its systems compliance policies and procedures. The Commission recognizes that the precise nature, size, technology, business model, and other aspects of each SCI entity's business vary. Therefore, the minimum elements are intended to be general in order to accommodate these differences, and each SCI entity will need to exercise judgment in developing and maintaining specific policies and procedures that are reasonably designed to achieve systems compliance. The Commission also believes that SCI entities should consider the evolving nature of the securities industry, as well as industry practices and standards, in developing and maintaining such policies and procedures. As such, the elements specified in Rule 1001(b) are non-exhaustive, and each SCI entity should consider on an ongoing basis what steps it needs to take in order to ensure that its policies and procedures are reasonably designed.

In the SCI Proposal, the Commission stated that, “[b]ecause of the complexity of SCI systems and the breadth of the federal securities laws and rules and regulations thereunder and the SCI entities’ rules and governing documents, the Commission preliminarily believes that it would be appropriate to provide an explicit safe harbor for SCI entities and their employees in

⁶⁶² The Commission’s decision not to adopt an SCI entity safe harbor also addresses a commenter’s concern that the inclusion of a safe harbor provision in Rule 1001(b) could unnecessarily and severely limit the Commission’s ability to deter violations through meaningful enforcement actions. See *supra* notes 633-634 and accompanying text. As discussed in Section IV.B.2.d below, however, the Commission is adopting a safe harbor for personnel of SCI entities.

order to provide greater clarity as to how they can ensure that their conduct will comply with [Rule 1000(b)(2)].⁶⁶³

One reason that the Commission is not adopting the proposed safe harbor for SCI entities is that the Commission has focused the scope of Regulation SCI as adopted. For example, adopted Rule 1001(b) requires policies and procedures that are reasonably designed to ensure compliance with “the Act”—rather than operating “in the manner intended, including in a manner that complies with the federal securities laws” as was proposed—and the rules and regulations thereunder, and the SCI entity’s rules and governing documents. Therefore, the requirement under adopted Rule 1001(b) is more targeted than the requirement under proposed Rule 1000(b)(2), and alleviates some of the concern regarding the “breadth of the federal securities laws and rules and regulations thereunder” that was expressed in the SCI Proposal. The Commission expects that SCI entities are familiar with their obligations under the Exchange Act, the rules and regulations thereunder, and their own rules and governing documents. In addition, as discussed in Section IV.A.2.b above, the Commission has further focused the scope of SCI systems, which also alleviates some of the concern regarding the “complexity of SCI systems” that was expressed in the SCI Proposal.⁶⁶⁴

Further, as noted above, in the SCI Proposal, the Commission stated its preliminary belief that it would be appropriate to provide an explicit safe harbor for SCI entities in order to provide greater clarity on how they could comply with proposed Rule 1000(b)(2).⁶⁶⁵ Rather than achieving this goal, commenters argued that the proposed safe harbor merely further defined the

⁶⁶³ See Proposing Release, supra note 13, at 18115.

⁶⁶⁴ See id.

⁶⁶⁵ See id.

elements that the policies and procedures must have, and did not include sufficient guidance or specificity to SCI entities seeking to rely on it.⁶⁶⁶ For example, one commenter noted that the policies and procedures specified in the safe harbor would still need to be “reasonably designed.”⁶⁶⁷ Further, the Commission acknowledges some commenters’ concern that the proposed safe harbor, “with its prescriptive requirements,” could evolve into the de facto rule itself.⁶⁶⁸

As discussed above, the Commission is not adopting a safe harbor for SCI entities. Rather, adopted Rule 1001(b)(1) requires an SCI entity to have reasonably designed policies and procedures to achieve systems compliance and adopted Rule 1001(b)(2) specifies non-exhaustive, general minimum elements that an SCI entity must include in its systems compliance policies and procedures. These minimum elements are based on the elements contained in the

⁶⁶⁶ See supra notes 638-639, 643-648 and accompanying text. With respect to the group of commenters who suggested that the safe harbor should give SCI entities a clear, affirmative defense from allegations of having violated Regulation SCI, as discussed above, the Commission is eliminating the proposed safe harbor for SCI entities. See supra note 643. As discussed below, the Commission believes that, by specifying non-exhaustive minimum elements that an SCI entity must include in its systems compliance policies and procedures, the rule will encourage SCI entities to actively build and improve upon the compliance of their systems, rather than limit their compliance to some fixed elements of a safe harbor.

⁶⁶⁷ See supra notes 638-639 and accompanying text. This commenter also compared the proposed SCI entity safe harbor to other rules, stating that the other rules requiring policies and procedures recognize the need for those policies and procedures to be reasonably designed in light of the manner in which business is conducted. See supra note 640 and accompanying text. Rule 1001(b), as adopted, requires policies and procedures to be “reasonably designed” to ensure the compliance of SCI systems. Therefore, Rule 1001(b) recognizes the need for policies and procedures to be reasonably designed in light of the manner in which an SCI entity’s business is conducted.

⁶⁶⁸ See supra note 637 and accompanying text and supra note 640. The Commission acknowledges that some commenters who believed that the proposed safe harbor was inadequate also advocated for alternative safe harbors, such as those that require knowledge or recklessness for liability. These comments are discussed below in Section IV.B.2.b.iii.

proposed safe harbor for SCI entities, but modified in response to concerns raised by commenters. As adopted, Rules 1001(b)(1) and (b)(2) specify the minimum elements of reasonably designed policies and procedures to achieve systems compliance, and at the same time provide flexibility by permitting an SCI entity to establish policies and procedures that are reasonably designed based on the nature, size, technology, business model, and other aspects of its business. Moreover, the Commission believes that, by specifying non-exhaustive, general minimum elements of systems compliance policies and procedures, the rule will encourage SCI entities to actively build and improve upon the compliance of their systems rather than limit their compliance to bright-line tests or the fixed elements of a safe harbor, and encourage the evolution of sound practices over time. In addition, the Commission notes that there currently are no publicly available written industry standards regarding systems compliance that are applicable to all SCI entities that can serve as the basis for a clear, objective safe harbor, as there is with current SCI industry standards (e.g., the publications listed in staff guidance) relating to operational capability. Even if such standards existed, the Commission believes that the specificity necessary to achieve the goal of a clear, objective safe harbor would disincentivize SCI entities from continuing to improve their systems over time. Finally, the Commission believes that, because the minimum elements specified in Rule 1001(b)(2) are non-exhaustive, Rule 1001(b) can accommodate the possibility that, as technology evolves, additional or updated elements could become appropriate for SCI entities to include in their systems compliance policies and procedures to ensure that such policies and procedures remain reasonably designed on an ongoing basis.

iii. Response to Other Comments on the SCI Entity Safe Harbor

With respect to commenters who requested clarification on the protection of the safe harbor for inadvertent violations of other laws and rules despite compliance with Regulation SCI,⁶⁶⁹ as noted above, the Commission clarifies that liability under Regulation SCI is separate and distinct from liability for other violations that may arise from the underlying SCI events under other laws and rules. Specifically, Regulation SCI imposes new requirements on SCI entities and is not intended to alter the standards for determining liability under other laws or rules. Therefore, if an SCI entity is in compliance with Regulation SCI but inadvertently violates another law or rule, whether or not the SCI entity will be liable under the other law or rule depends on the standards for determining liability under such law or rule. Because the new requirements under Regulation SCI are separate and distinct from existing requirements under other laws or rules, Regulation SCI is not a shield from liability under such laws or rules.

The Commission also does not believe that it would be appropriate to provide a safe harbor for all problems that are self-reported by SCI entities and individuals or that are discovered and remediated without regulatory intervention, as suggested by commenters.⁶⁷⁰ In particular, Rule 1001(b) is intended to help ensure that SCI entities operate their systems in compliance with the Exchange Act and relevant rules in the first place, and thus is not only focused on helping to ensure that SCI entities appropriately respond to a compliance issue (e.g., by taking corrective action or reporting the issue to the Commission) after it has occurred and impacted the market or market participants. Therefore, the Commission does not believe that the suggested self-report or remediation safe harbors will effectively further this intent of Rule 1001(b). In particular, the Commission notes that reporting and remediation of SCI events are

⁶⁶⁹ See supra notes 655 and 660 and accompanying text.

⁶⁷⁰ See supra notes 657 and 659 and accompanying text.

separately required under Rules 1002(b) and (a) of Regulation SCI, respectively. The purposes of Rule 1002(b) include keeping the Commission informed of SCI events after they have occurred. Moreover, Rule 1002(a) is intended to ensure that SCI entities remedy a systems issue and mitigate the resulting harm after the issue has already occurred. The Commission believes that, if an SCI entity is protected from liability under Rule 1001(b) simply because it self-reported systems compliance issues or discovered and remediated systems compliance issues without regulatory intervention, the SCI entity will not be effectively incentivized to have reasonably designed policies and procedures to ensure systems compliance in the first place. As discussed above, the occurrence of an SCI event will not necessarily cause a violation of Regulation SCI. Further, the occurrence of a systems compliance issue also does not necessarily mean that the SCI entity will be subject to an enforcement action. Rather, the Commission will exercise its discretion to initiate an enforcement action if the Commission determines that action is warranted, based on the particular facts and circumstances of an individual situation.

As discussed above, some commenters expressed concern that the occurrence of a significant systems issue would mean that an SCI entity did not have reasonable policies and procedures and therefore suggested “objective” safe harbors.⁶⁷¹ The Commission notes that all

⁶⁷¹ See supra notes 650-654 and accompanying text. As discussed above, some of these commenters suggested that the safe harbor should protect SCI entities from enforcement action except in cases of intentional or reckless non-compliance, or patterns of non-compliance with Regulation SCI. See supra note 650 and accompanying text. As an alternative to the intentional and recklessness standard, one of these commenters requested that the Commission specifically state that the Commission will not pursue enforcement actions against SCI entities that establish, maintain, and enforce systems compliance policies and procedures or act in good faith, notwithstanding a violation of Regulation SCI. See supra note 651 and accompanying text. One commenter noted that it should be sufficient for an SCI entity to qualify for the safe harbor if it adopts policies and procedures reasonably designed to comply with Regulation SCI and does not

SCI entities are required to comply with the Exchange Act, the rules and regulations thereunder, and their own rules and governing documents, as applicable, and the purpose of Rule 1001(b) is to effectively help ensure compliance of the operation of SCI systems with these laws and rules. The Commission does not believe that Rule 1001(b) would further this goal to the same degree if the Commission were to adopt commenters' safe harbor suggestions (i.e., an SCI entity is deemed to be in compliance with Rule 1001(b) so long as: the SCI entity is not knowingly out of compliance; such non-compliance is not intentional, reckless, or in bad faith; or there is no pattern of non-compliance) because, with these suggested "objective" safe harbors, SCI entities may not be effectively incentivized to establish, maintain, and enforce reasonably designed policies and procedures to ensure systems compliance. Moreover, the Commission notes that Rule 1001(b) requires "reasonably designed" policies and procedures, which already provides flexibility to SCI entities in complying with the rule. The Commission also emphasizes again that, while it is eliminating the safe harbor for SCI entities, the occurrence of a systems compliance issue may be probative, but is not determinative, of whether an SCI entity violated Regulation SCI. As noted above, an SCI entity would not be deemed to be in violation of Rule 1001(b)(1) merely because it experienced a systems compliance issue. Further, the occurrence of a systems compliance issue also does not necessarily mean that the SCI entity will be subject to an enforcement action. Rather, the Commission will exercise its discretion to initiate an enforcement action if the Commission determines that action is warranted, based on the particular facts and circumstances of an individual situation.

knowingly violate such policies and procedures. See supra note 654 and accompanying text.

Further, as noted above, one commenter recommended that the Commission provide a safe harbor where no technology error or problem has occurred, but the policies and procedures might benefit from improvements.⁶⁷² The Commission believes that there may be instances where an SCI entity's policies and procedures might benefit from improvement, even though they are reasonably designed. In such instances, the SCI entity is in compliance with Rule 1001(b) and therefore does not need a safe harbor. At the same time, the Commission notes that there may be instances where no technology error or problem has occurred, but an SCI entity's policies and procedures with regard to systems compliance might nonetheless be deficient and not satisfy the requirements of Rule 1001(b). The Commission does not believe that it would be appropriate to provide a safe harbor in these instances. As noted above, Rule 1001(b) is intended to help ensure that SCI entities operate their SCI systems in compliance with the Exchange Act and relevant rules. The Commission does not believe that a safe harbor that effectively insulates deficient policies and procedures will further the intent of this rule. Further, the Commission notes that one requirement of Rule 1001(b)(1) is that an SCI entity "maintain" its policies and procedures. To explicitly set forth an SCI entity's obligation to review and update its policies and procedures, similar to Rule 1001(a), the Commission is adopting a requirement for periodic review by an SCI entity of the effectiveness of its systems compliance policies and procedures, and prompt action by the SCI entity to remedy deficiencies in such policies and procedures.⁶⁷³

⁶⁷² See supra note 659 and accompanying text.

⁶⁷³ See Rule 1001(b)(3). The adoption of this review and update requirement is consistent with the views of some commenters. See supra notes 620 and accompanying text (discussing a commenter's suggestion that policies and procedures should be reviewed and updated as part of the annual SCI review process) and 658 and accompanying text (discussing a commenter's suggestion that Regulation SCI should encourage parties to discover and remediate deficiencies in policies and procedures). The Commission notes that Rule 1001(b)(3) requires SCI entities to review and update their systems compliance

The Commission notes that an SCI entity will not be found to be in violation of this maintenance requirement solely because it failed to identify a deficiency immediately after the deficiency occurred, if the SCI entity takes prompt action to remedy the deficiency once it is discovered, and the SCI entity had otherwise appropriately reviewed the effectiveness of its policies and procedures and took prompt action to remedy those deficiencies that were discovered.

Finally, as noted above, one commenter believed that, without a safe harbor and a guarantee of immunity (such as the regulatory immunity of SROs), information provided to the Commission pursuant to Rule 1000(b)(4)(iv) would provide a roadmap for litigation. As discussed below in Section IV.B.3.c, the Commission acknowledges that, if an SCI entity experiences an SCI event, it could become the subject of litigation (including private civil litigation). At the same time, the Commission notes that the information submitted to the Commission pursuant to Regulation SCI will be treated as confidential, subject to applicable law.⁶⁷⁴ On the other hand, the Commission acknowledges that it could consider the information provided to the Commission pursuant to Rule 1002(b) in determining whether to initiate an enforcement action. The Commission notes that all SCI entities are required to comply with the Exchange Act, the rules and regulations thereunder, and their own rules and governing

policies and procedures rather than simply “encourage” the discovery and remediation of deficiencies because, in order to achieve the intended benefits of Rule 1001(b), an SCI entity’s systems compliance policies and procedures must remain reasonably designed. If the Commission simply encourages SCI entities to review and update their systems compliance policies and procedures, the Commission believes that there would be a greater likelihood that such policies and procedures might become outdated and less effective in preventing systems compliance issues.

⁶⁷⁴ The Commission notes that the General Instructions to Form SCI, Item G. Paperwork Reduction Act Disclosure, provides that the Commission “will keep the information collected pursuant to Form SCI confidential to the extent permitted by law.” See *infra* Section IV.C.2.

documents, as applicable, and the requirement for Commission notification of systems compliance issues is intended to assist the Commission in its oversight of such compliance. With respect to the regulatory immunity of SROs, the Commission notes that, although courts have found that SROs are entitled to absolute immunity from private claims under certain circumstances,⁶⁷⁵ if an SRO fails to comply with the provisions of the Exchange Act, the rules or regulations thereunder, or its own rules, the Commission is still authorized to impose sanctions.⁶⁷⁶ As such, like other SCI entities, SROs are not immune from Commission sanctions. Finally, as discussed in detail above, the Commission does not believe that it would be appropriate to provide a safe harbor for all problems that are self-reported to the Commission by SCI entities and individuals.

c. Minimum Elements of Reasonable Policies and Procedures

The safe harbor for SCI entities in proposed Rule 1000(b)(2)(ii) specified that, to qualify for the safe harbor, the SCI entity's policies and procedures must be reasonably designed to provide for: (1) testing of all SCI systems and any changes to such systems prior to implementation; (2) periodic testing of all SCI systems and any changes to such systems after their implementation; (3) a system of internal controls over changes to SCI systems; (4) ongoing monitoring of the functionality of SCI systems to detect whether they are operating in the manner intended; (5) assessments of SCI systems compliance performed by personnel familiar

⁶⁷⁵ The Commission notes that SRO immunity applies only under certain circumstances. In particular, "when acting in its capacity as a SRO, [the SRO] is entitled to immunity from suit when it engages in conduct consistent with the quasi-governmental powers delegated to it pursuant to the Exchange Act and the regulations and rules promulgated thereunder." See DL Capital Group, LLC v. NASDAQ Stock Market, Inc., 409 F.3d 93, 97 (2d Cir. 2005) (quoting D'Alessio v. New York Stock Exchange, Inc., 258 F.3d 93, 106 (2d Cir. 2001)).

⁶⁷⁶ See 15 U.S.C. 78s(g).

with applicable federal securities laws and rules and regulations thereunder and the SCI entity's rules and governing documents, as applicable; and (6) review by regulatory personnel of SCI systems design, changes, testing, and controls to prevent, detect, and address actions that do not comply with applicable federal securities laws and rules and regulations thereunder and the SCI entity's rules and governing documents, as applicable. In the SCI Proposal, the Commission asked whether each element of the proposed safe harbor for SCI entities was appropriate.⁶⁷⁷

Several commenters addressed one or more of the proposed safe harbor elements.

As discussed above, rather than adopting the proposed safe harbor for SCI entities, the Commission is specifying non-exhaustive, general minimum elements that an SCI entity must include in its systems compliance policies and procedures. The minimum elements are based on the proposed safe harbor. These elements are: (i) testing of all SCI systems and any changes to SCI systems prior to implementation; (ii) a system of internal controls over changes to SCI systems; (iii) a plan for assessments of the functionality of SCI systems designed to detect systems compliance issues, including by responsible SCI personnel and by personnel familiar with applicable provisions of the Act and the rules and regulations thereunder and the SCI entity's rules and governing documents; and (iv) a plan of coordination and communication between regulatory and other personnel of the SCI entity, including by responsible SCI personnel, regarding SCI systems design, changes, testing, and controls designed to detect and prevent systems compliance issues. Each of these elements is discussed below.

As noted above, some commenters requested more guidance or certainty regarding the safe harbor elements (e.g., by including bright-line tests and minimum standards).⁶⁷⁸ As

⁶⁷⁷ See Proposing Release, supra note 13, at 18116-17.

⁶⁷⁸ See supra notes 645-647 and accompanying text.

discussed above in Section IV.B.2.b, the Commission is not adopting a safe harbor but is specifying the minimum elements that an SCI entity must include in its systems compliance policies and procedures. By generally requiring policies and procedures to be reasonably designed and specifying non-exhaustive, general minimum elements of systems compliance policies and procedures, the Commission intends to provide specificity on how to comply with Rule 1001(b), and at the same time provide a reasonable degree of flexibility to SCI entities in establishing and maintaining policies and procedures that are appropriately tailored to each SCI entity.

Regarding elements (1) and (2) of the proposed safe harbor, a few commenters opposed the inclusion of a requirement that an SCI entity conduct periodic testing of systems absent systems changes.⁶⁷⁹ One commenter stated that it performs testing prior to implementation of trading systems changes in the production environment and conducts regression testing to ensure that the changes did not introduce any undesired side-effects.⁶⁸⁰ This commenter explained that the proposed periodic testing requirement would impose additional cost and not provide any benefit.⁶⁸¹ One commenter believed that the pre- and post-implementation testing components of the safe harbor, which would apply to all systems changes, could potentially drive SCI entities to take a narrow view of what constitutes a systems change.⁶⁸² Another commenter sought

⁶⁷⁹ See FINRA Letter at 33; BATS Letter at 7; and ISE Letter at 7.

⁶⁸⁰ See ISE Letter at 7.

⁶⁸¹ See *id.* See also FINRA Letter at 33.

⁶⁸² See Direct Edge Letter at 6. This commenter expressed concern that, under the proposed approach, any opening of a customer port, the removal of access rights from a departing employee, and the previously unscheduled closing of the market for the death of a U.S. president all involve "changes" to SCI systems that need to be tracked, approved, and catalogued within the construct of an enterprise-wide change management system. See *id.* This commenter stated that these "changes" cannot all be tested, either prior to or

further guidance from the Commission on the scope of periodic testing of all SCI systems and whether, for example, systems testing would be required following a systems change if the SCI entity has already provided notice of the systems change to the Commission.⁶⁸³ One commenter requested clarification that the testing described in proposed Rules 1000(b)(2)(ii)(A)(1) and (2) refers to testing to ensure that SCI systems operate in the manner intended, and noted that testing should not be required to be periodic, but instead should be based on the relative risks of non-compliance arising from any changes being introduced into production or any changes to the applicable laws or rules.⁶⁸⁴ One commenter stated that it believed that the frequency and type of testing under proposed Rules 1000(b)(2)(ii)(A)(1) and (2) are open to interpretation.⁶⁸⁵

After consideration of the views of commenters, the Commission believes that testing of SCI systems and changes to such systems prior to implementation is appropriate for inclusion as a required element of systems compliance policies and procedures. As noted in the SCI Proposal, elements (1) and (2) of the proposed safe harbor were intended to help SCI entities to identify potential problems before such problems have the ability to impact markets and investors.⁶⁸⁶ The Commission believes that testing prior to implementation of SCI systems and prior to implementation of any SCI systems changes would likely be an important component for achieving this goal and it is included as a required element of systems compliance policies and

after implementation, without an extraordinary amount of redundancy and bureaucracy, if at all. See id. This commenter therefore suggested requiring instead “[a]ppropriate testing of [SCI] systems and changes to such systems prior to their implementation.” See id.

⁶⁸³ See OCC Letter at 11.

⁶⁸⁴ See MSRB Letter at 13-14.

⁶⁸⁵ See NYSE Letter at 30.

⁶⁸⁶ See Proposing Release, supra note 13, at 18115.

procedures.⁶⁸⁷ In contrast, the Commission believes that the value of the proposed element for additional testing in the absence of systems changes may be variable, depending on the SCI system or change to an SCI system at issue.⁶⁸⁸ At the same time, each SCI entity should consider on an ongoing basis what steps it needs to take in order to ensure that its policies and procedures are reasonably designed, including whether its policies and procedures should provide for testing of certain systems changes after their implementation to ensure that they operate in compliance with the Exchange Act and relevant rules.

With regard to element (3) of the proposed safe harbor, one commenter stated that it is unclear what minimum standards are required for the internal controls under proposed Rule 1000(b)(2)(ii)(A)(3).⁶⁸⁹ As discussed above, the Commission believes it is appropriate to set forth minimum elements of systems compliance policies and procedures that are broad enough to provide SCI entities with reasonable flexibility to design their policies and procedures based on

⁶⁸⁷ With respect to a commenter's concern that "changes" to SCI systems could include, for example, any opening of a customer port, the removal of access rights from a departing employee, and the previously unscheduled closing of the market for the death of a U.S. president, the Commission does not view these as changes to an SCI entity's systems, because the Commission believes that these actions are part of an SCI entity's standard operations. See *supra* note 682. In particular, the Commission believes that the opening of a customer port, the removal of access rights, and the closing of the market are existing functionalities at SCI entities, and are routinely performed by SCI entities without the need to change existing functionalities.

⁶⁸⁸ See *supra* notes 681-682 and accompanying text. The Commission notes that a commenter asked about the scope of periodic testing under the proposed safe harbor, and whether systems testing under the proposed safe harbor would be required following a systems change if the SCI entity has already provided notice of the systems change to the Commission. Another commenter noted that testing under the proposed safe harbor should not be required to be periodic, but instead could be based on the relative risks of non-compliance arising from any changes being introduced into production or any changes to applicable laws or rules. The Commission is not requiring periodic testing or testing following systems changes in Rule 1001(b), and, as discussed above, the Commission is not adopting the proposed safe harbor.

⁶⁸⁹ See NYSE Letter at 30.

the nature, size, technology, business model, and other aspects of their businesses. Therefore, while the Commission believes that a system of internal controls over changes to SCI systems is appropriate for inclusion as a required element of systems compliance policies and procedures, the Commission is not specifying the minimum standard for internal controls. As stated in the SCI Proposal, a system of internal controls and ongoing monitoring of systems functionality are intended to help ensure that an SCI entity adopts a framework that will help it bring newer, faster, and more innovative SCI systems online without compromising due care, and to help prevent SCI systems from becoming noncompliant resulting from, for example, inattention or failure to review compliance with established written policies and procedures. The Commission believes that such internal controls would likely include, for example, protocols that provide for: communication and cooperation between legal, business, technology, and compliance departments in an SCI entity; appropriate authorization of systems changes by relevant departments of the SCI entity prior to implementation; review of systems changes by legal or compliance departments prior to implementation; and monitoring of systems changes after implementation.

With regard to elements (4)-(6) of the proposed safe harbor, one commenter noted that the proposed requirement related to ongoing monitoring was too broad and should be eliminated or revised to be more flexible.⁶⁹⁰ This commenter noted that the proposal for “monitoring of the functionality of [SCI] systems to detect whether they are operating in the manner intended” is potentially quite broad and seems to suggest some form of independent validation.⁶⁹¹ Another commenter asked the Commission to clarify how the testing requirements in proposed Rules

⁶⁹⁰ See FINRA Letter at 33-34.

⁶⁹¹ See *id.*

1000(b)(2)(ii)(1) and (2) (testing prior to and after implementation) differ from those in proposed Rule 1000(b)(2)(ii)(A)(5) (assessments of systems compliance by personnel familiar with applicable laws and rules).⁶⁹² One commenter noted that the monitoring, assessments, and reviews under proposed Rules 1000(b)(2)(ii)(A)(4), (5), and (6) are unclear.⁶⁹³ Two commenters sought guidance on how an SCI entity could satisfy the requirements related to reviews and assessments by legal and compliance personnel (i.e., proposed Rules 1000(b)(2)(ii)(A)(5) and (6)).⁶⁹⁴ One of these commenters suggested that each SCI entity be given the discretion to determine the level of familiarity necessary to qualify as personnel able to undertake the assessments and which personnel are regulatory personnel, and asked whether these two categories of personnel are different.⁶⁹⁵ Another commenter also sought clarification on the meaning of the term “regulatory personnel” and suggested that each SCI entity should have discretion in determining which of its employees constitute regulatory personnel.⁶⁹⁶ One commenter expressed concern that review by regulatory personnel of SCI systems would unreasonably expose non-technology persons to potential liability if an SCI entity suffers a malfunction.⁶⁹⁷

After consideration of the views of commenters, the Commission believes that “a plan for assessments of the functionality of SCI systems designed to detect systems compliance issues,

⁶⁹² See MSRB Letter at 13.

⁶⁹³ See NYSE Letter at 30.

⁶⁹⁴ See FINRA Letter at 34-35; and MSRB Letter at 13.

⁶⁹⁵ See MSRB Letter at 13-14.

⁶⁹⁶ See OCC Letter at 11. See also FINRA Letter at 34-35 (requesting more guidance on which types of personnel are intended to fulfill the requirements of proposed Rules 1000(b)(2)(ii)(A)(5) and (6)).

⁶⁹⁷ See ITG Letter at 14.

including by responsible SCI personnel and by personnel familiar with applicable provisions of the Act and the rules and regulations thereunder and the SCI entity's rules and governing documents" is appropriate for inclusion as a required element of systems compliance policies and procedures. In particular, rather than "ongoing monitoring of the functionality of [SCI] systems to detect whether they are operating in the manner intended" and also "assessments of SCI systems compliance...", the Commission believes that "a plan for assessments" of SCI systems compliance would be more appropriate.⁶⁹⁸ The Commission notes that "a plan for assessments" could include, for example, not only a plan for monitoring, but also a plan for testing or assessments, as appropriate, and at a frequency (e.g., periodic or continuous) that is based on the SCI entity's risk assessment of each of its SCI systems.⁶⁹⁹ The Commission is not specifying the manner and frequency of assessments that must be set forth in such plan because the Commission believes that each SCI entity will likely be in the best position to assess and determine the assessment plan that is most appropriate for its SCI systems. The Commission emphasizes that the nature and frequency of the assessments contemplated by an SCI entity's plan will vary based on a range of factors, including the entity's governance structure, business

⁶⁹⁸ The Commission notes that "a plan for assessments" is derived from a combination of the "ongoing monitoring" and "assessments" elements of the proposed SCI entity safe harbor. Because "a plan for assessments" could provide for ongoing (i.e., periodic or continuous) monitoring, the Commission believes that it would be duplicative to include both monitoring and a plan for assessments as required elements of systems compliance policies and procedures.

⁶⁹⁹ See supra note 690 and accompanying text (discussing the view of a commenter that the proposed element of the SCI entity safe harbor related to ongoing monitoring was too broad and should be eliminated or revised to be more flexible) and supra note 694 and accompanying text (discussing comments seeking guidance on how an SCI entity could satisfy the requirements related to reviews and assessments by legal and compliance personnel). Further, in response to a commenter, a plan for assessments is different from the testing of SCI systems prior to implementation of systems changes. See supra note 692 and accompanying text.

lines, and legal and compliance framework. The plan for assessments does not require the SCI entity to conduct a specific kind of assessment, nor does it require that assessments be performed at a certain frequency. The plan, however, may address the specific reviews required by Rule 1003(b)(1).

In addition, in response to a commenter's concern that the proposed safe harbor element of "monitoring of the functionality of [SCI] systems to detect whether they are operating in the manner intended" is potentially quite broad and seems to suggest some form of independent validation, the Commission notes that it is not requiring SCI entities to include independent validation in their assessment plans.⁷⁰⁰ However, if an SCI entity determines that its reasonably designed systems compliance policies and procedures should provide for independent validation in its assessment plan under certain circumstances, then the SCI entity should design its policies and procedures accordingly. In that case, pursuant to Rule 1001(b), which requires an SCI entity to establish, maintain, and enforce its written policies and procedures, the SCI entity would be required to enforce its own policies and procedures, including those related to independent validation.

In addition, the Commission believes that "a plan of coordination and communication between regulatory and other personnel of the SCI entity, including by responsible SCI personnel, regarding SCI systems design, changes, testing, and controls designed to detect and prevent systems compliance issues" is appropriate for inclusion as a required element of systems compliance policies and procedures. As noted in the SCI Proposal, assessments of SCI systems compliance by personnel familiar with applicable laws and rules and regulatory personnel review of SCI systems design, changes, testing, and controls are intended to help foster coordination

⁷⁰⁰ See supra note 691 and accompanying text.

between the information technology and regulatory staff of an SCI entity so that SCI events and other issues related to SCI systems would be more likely to be addressed by a team of staff in possession of the requisite range of knowledge and skills.⁷⁰¹ They are also intended to help ensure that an SCI entity's business interests do not undermine regulatory, surveillance, and compliance functions and, more broadly, the requirements of the Exchange Act, during the development, testing, implementation, and operation processes for SCI systems.⁷⁰² The Commission believes that a plan of coordination and communication between regulatory and other personnel, including by responsible SCI personnel, would further these same goals.

The Commission expects that an SCI entity will determine for itself the responsible SCI personnel and other personnel who have sufficient knowledge of relevant laws and rules to be able to effectively implement systems assessments,⁷⁰³ such that the SCI entity's policies and procedures are reasonably designed to ensure that SCI systems operate in compliance with the Exchange Act and relevant rules, as required by Rule 1001(b).⁷⁰⁴ Similarly, the Commission expects that an SCI entity will determine for itself the regulatory and other personnel, including responsible SCI personnel, who have sufficient knowledge with respect to the legal and technical aspects of systems design, changes, testing, and controls to engage in coordination and communication regarding such operations, such that the SCI entity's policies and procedures are

⁷⁰¹ See Proposing Release, supra note 13, at 18116.

⁷⁰² For example, profit incentive could lead an SCI entity to introduce a new functionality before regulatory personnel are able to adequately check that the functionality will operate in compliance with relevant laws and rules.

⁷⁰³ See supra notes 694-696 and accompanying text (describing comments on the proposed safe harbor related to who would be involved in systems assessments).

⁷⁰⁴ Criteria for identification of such personnel could, for example, be set forth in the SCI entity's systems compliance policies and procedures.

reasonably designed to ensure that its SCI systems operate in compliance with the Exchange Act and relevant rules, as required by Rule 1001(b).⁷⁰⁵

One commenter sought clarity on how an SCI entity would satisfy the requirement that it does “not have reasonable cause to believe the policies and procedures were not being complied with.”⁷⁰⁶ Another commenter stated that there is no guidance for SCI entities on how to appropriately follow the procedures that they have developed and stated that as proposed, it would be reasonable to interpret the safe harbor as excluding any SCI entity that suffers a significant systems event.⁷⁰⁷ One commenter believed that the Commission should resolve any potential ambiguity between the requirements of proposed Rule 1000(b)(2)(ii)(C)(1) (requiring SCI entities to reasonably discharge the duties and obligations set forth in the policies and procedures) and proposed Rule 1000(b)(2)(ii)(C)(2) (requiring that SCI entities not have reasonable cause to believe such policies and procedures were not being complied with).⁷⁰⁸ As discussed throughout this section, the Commission is not adopting the proposed safe harbor for SCI entities. Therefore, as adopted, Rule 1001(b) does not include the provisions of proposed Rules 1000(b)(2)(ii)(B) and (C). Further, the Commission believes that proposed Rules 1000(b)(2)(ii)(B) and (C) reiterated the requirements for SCI entities to establish, maintain, and enforce their systems compliance policies and procedures, and provided an example of how SCI entities could satisfy these requirements. For example, the SCI Proposal noted that proposed

⁷⁰⁵ Some commenters expressed concern regarding the potential liability for regulatory personnel. See supra note 697 and accompanying text. The Commission discusses individual liability in Section IV.B.2.d below.

⁷⁰⁶ See FINRA Letter at 35.

⁷⁰⁷ See OTC Markets Letter at 15.

⁷⁰⁸ See MSRB Letter at 13-15.

Rules 1000(b)(2)(ii)(B) and (C) specified that an SCI entity's policies and procedures must be reasonably designed to achieve SCI systems compliance, and that, as part of such policies and procedures, the SCI entity must establish and maintain systems for applying those policies and procedures, and enforce its policies and procedures, in a manner that would reasonably allow it to prevent and detect violations of the policies and procedures.⁷⁰⁹ The Commission believes that Rule 1001(b), as adopted, provides flexibility to SCI entities regarding their methods for establishing, maintaining, and enforcing their systems compliance policies and procedures.

d. Individual Safe Harbor

Proposed Rule 1000(b)(2)(iii) set forth a safe harbor for individuals. It provided that a person employed by an SCI entity would be deemed not to have aided, abetted, counseled, commanded, caused, induced, or procured the violation by any other person of proposed Rule 1000(b)(2)(i) if the person employed by the SCI entity has reasonably discharged the duties and obligations incumbent upon such person by the policies and procedures, and was without reasonable cause to believe that such policies and procedures were not being complied with in any material respect.

In the SCI Proposal, the Commission asked whether commenters agreed with the requirements of the proposed safe harbor for employees of SCI entities, and whether a similar safe harbor should be available to individuals other than employees of SCI entities.⁷¹⁰ Some commenters specifically addressed the proposed safe harbor for individuals.⁷¹¹ Several commenters urged that individuals not be subject to liability under Regulation SCI absent an

⁷⁰⁹ See Proposing Release, supra note 13, at 18116.

⁷¹⁰ See id. at 18117, question 103.

⁷¹¹ See, e.g., Angel Letter; Direct Edge Letter; FINRA Letter; FSR Letter; and MSRB Letter.

intentional act of willful misconduct.⁷¹² Two commenters questioned the need for a safe harbor for individuals generally,⁷¹³ and one commenter stated that inclusion of a safe harbor would unnecessarily and severely limit the Commission's ability to deter violations through meaningful enforcement actions.⁷¹⁴ Two commenters questioned why the proposed safe harbor for

⁷¹² See Direct Edge Letter at 6; and MSRB Letter at 17. See also *supra* notes 650 and 654 and accompanying text (discussing comments suggesting individual safe harbors). One commenter suggested that the safe harbor should provide that a person employed by an SCI entity shall be deemed not to have aided, abetted, counseled, commanded, caused, induced, or procured the violation by any other person unless such violation directly or indirectly relates to the duties and obligations of such person under the policies and procedures described in Rule 1000(b)(2)(i) and such person: (A) has not reasonably discharged the applicable duty or obligation under such policies and procedures; (B) was not directed by his or her supervisor, SCI entity legal counsel, SCI senior management, or the governing body of the SCI entity to act in a manner that would constitute such a failure to discharge such duty or obligation; and (C) acted recklessly or intentionally with respect to such failure to discharge such duty or obligation. See MSRB Letter at 17. The Commission believes that elements (A) and (B) of this commenter's suggestion are consistent with the adopted individual safe harbor. In particular, the Commission notes that the safe harbor specifies that an individual must have reasonably discharged the duties and obligations incumbent upon such person by the SCI entity's policies and procedures. The Commission believes that there can be instances where a person has reasonably discharged his or her duties and obligations under the SCI entity's policies and procedures, even though such person was directed by his or her supervisor, SCI entity legal counsel, SCI entity senior management, or the governing body of the SCI entity to act in a manner that is inconsistent with his or her duties that are set forth the policies and procedures. For example, the SCI entity's reasonably designed policies and procedures could specifically set forth circumstances where certain personnel of the SCI entity may direct another person to act outside of his or her duties or obligations that are set forth in the policies and procedures.

⁷¹³ See FINRA Letter at 35; and FSR Letter at 3-8 (stating that the proposed rule lacks clarity over why individuals need a safe harbor when the policies and procedures requirement is placed exclusively on SCI entities, and lacks clarity regarding to whom SCI entities or SCI personnel would be liable for a breach and how liability would be apportioned between market participants for an SCI event). See also MSRB Letter at 15 (seeking further clarification from the Commission regarding the nature of the potential liabilities faced by individuals).

⁷¹⁴ See Better Markets Letter at 6.

individuals was limited to SCI entity employees.⁷¹⁵ One commenter expressed concern that the proposed safe harbor for individuals could be counterproductive and create an environment of second-guessing and distrust, where employees act in a way to avoid potential liability (i.e., each person would be effectively deputized to police others' actions).⁷¹⁶ A few commenters added that the proposed safe harbor for individuals, and the resulting implication of potential individual liability, may have the unintended consequence of limiting the ability of SCI entities to hire the best available talent in information technology, risk-management, and compliance disciplines.⁷¹⁷ One commenter questioned why the proposed safe harbor for individuals would apply only to actions of aiding any other person and not apply to any actions of the reporting individual.⁷¹⁸

After careful consideration of these comments, the Commission is adopting the individual safe harbor with certain modifications. With respect to the commenter who expressed concern that a safe harbor would "unnecessarily and severely" limit the Commission's ability to deter violations through meaningful enforcement actions,⁷¹⁹ the Commission notes that Regulation SCI only imposes obligations directly on SCI entities and the Commission is not adopting a safe harbor for SCI entities. Further, personnel of SCI entities qualify for the individual safe harbor

⁷¹⁵ See FINRA Letter at 35; and MSRB Letter at 17. These commenters suggested extending the safe harbor to contractors, consultants, and other non-employees used by SCI entities in connection with their SCI systems. See FINRA Letter at 35; and MSRB Letter at 17.

⁷¹⁶ See MSRB Letter at 15-17.

⁷¹⁷ See Direct Edge Letter at 6; and MSRB Letter at 17.

⁷¹⁸ See Angel Letter at 4.

⁷¹⁹ See supra note 714 and accompanying text.

under Rule 1001(b) only if they satisfy certain requirements.⁷²⁰ In particular, in connection with a Commission finding that an SCI entity violated Rule 1001(b), the individual safe harbor will not apply if an SCI entity personnel failed to reasonably discharge his or her duties and obligations under the policies and procedures. In addition, for an SCI entity personnel who is responsible for or has supervisory responsibility over an SCI system, the individual safe harbor also will not apply if he or she had reasonable cause to believe that the policies and procedures related to such an SCI system were not in compliance with Rule 1001(b) in any material respect. Therefore, the Commission does not believe that the individual safe harbor will “unnecessarily and severely” limit the Commission’s ability to deter violations.

With respect to commenters who questioned the need for an individual safe harbor because Rule 1001(b) imposes an obligation on SCI entities,⁷²¹ the Commission agrees that Regulation SCI imposes direct obligations on SCI entities, and does not impose obligations directly on personnel of SCI entities. At the same time, as with all other violations of the Exchange Act and rules that impose obligations on an entity, there is a potential for secondary liability for an individual who aided and abetted or caused a violation. The Commission is therefore revising the individual safe harbor to clarify that personnel of an SCI entity shall be deemed not to have aided, abetted, counseled, commanded, caused, induced, or procured the violation by “an SCI entity” (rather than “any other person”) of Rule 1001(b) if the elements of the safe harbor are satisfied.

⁷²⁰ As discussed below in this section, the Commission is extending the safe harbor to all personnel of an SCI entity, rather than only persons employed by an SCI entity, as proposed.

⁷²¹ See supra note 713 and accompanying text.

As noted above, one commenter questioned why the proposed safe harbor for individuals would only apply to actions of aiding another and not apply to any direct violative action of the reporting individual.⁷²² The Commission notes that the individual safe harbor only applies to actions of aiding, abetting, counseling, commanding, causing, inducing, or procuring the violation by an SCI entity because Regulation SCI does not impose any direct obligations on personnel of SCI entities. Therefore, individuals could not be found to be in violation of Regulation SCI, except through aiding, abetting, counseling, commanding, causing, inducing, or procuring the violation by an SCI entity of Regulation SCI.

With respect to commenters who suggested extending the individual safe harbor to contractors, consultants, and other non-employees used by SCI entities in connection with their SCI systems,⁷²³ the Commission agrees with these comments and is extending the safe harbor to all "personnel of an SCI entity," rather than only persons employed by an SCI entity, as was proposed. Specifically, the Commission believes that contractors, consultants, and other similar non-employees may act in a capacity similar to an SCI entity's employees, and thus should be able to avail themselves of the individual safe harbor if they satisfy its requirements.

To be covered by the individual safe harbor, for which the individual has the burden of proof, personnel of an SCI entity must: (i) have reasonably discharged the duties and obligations incumbent upon such person by the SCI entity's policies and procedures; and (ii) be without reasonable cause to believe that the policies and procedures relating to an SCI system for which such person was responsible, or had supervisory responsibility, were not established, maintained, or enforced in accordance with Rule 1001(b) in any material respect. Element (i) of the adopted

⁷²² See supra note 718 and accompanying text.

⁷²³ See supra note 715 and accompanying text.

individual safe harbor is substantively unchanged from the proposal. For the reasons discussed below in this section, element (ii) of the adopted individual safe harbor specifies that it applies only to a person who is responsible for or has supervisory responsibility over an SCI system. In addition, rather than requiring an individual to be without reasonable cause to believe that systems compliance policies and procedures “were not being complied with in any material respect” as proposed, element (ii) of the adopted safe harbor requires the applicable personnel to be without reasonable cause to believe that the relevant systems compliance policies and procedures “were not established, maintained, or enforced” in accordance with Rule 1001(b) in any material respect. The Commission notes that element (ii) of the adopted safe harbor tracks the language of the general requirement under Rule 1001(b) that an SCI entity “establish, maintain, and enforce” written policies and procedures reasonably designed to ensure systems compliance, and appropriately reflects the responsibilities of a person who is responsible for or has supervisory responsibility over an SCI system.⁷²⁴

The Commission believes that it is appropriate to not provide a safe harbor to a person with responsibility over an SCI system if such person had reasonable cause to believe that the policies and procedures for such system were not established, maintained, or enforced as required by Rule 1001(b) in a material respect. The limited application of this element to such personnel (rather than to any person employed by an SCI entity as proposed) is intended to mitigate commenters’ concerns that the proposed safe harbor would create an environment of

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As noted below, the Commission believes it is appropriate in the context of the safe harbor that, if a person with responsibility over an SCI system becomes aware of potential material non-compliance of the SCI entity’s policies and procedures related to that system, such person should take action to review and address, or direct other personnel to review and address, such material non-compliance.

distrust and limit the ability of SCI entities to hire high quality personnel.⁷²⁵ In particular, personnel who are not responsible for and do not have supervisory responsibility over SCI systems can qualify for the individual safe harbor, regardless of their belief regarding the reasonableness of the SCI entity's systems compliance policies and procedures. Therefore, such personnel would not be "deputized to police" the actions of other personnel, as a commenter believed they would.⁷²⁶ Further, with respect to personnel who are responsible for or have supervisory responsibility over an SCI system, such personnel likely already have the responsibility to supervise others' activities related to that SCI system, which would provide such personnel with information to form a reasonable belief regarding the reasonableness of the policies and procedures. Because Rule 1001(b) is intended to help prevent the occurrence of systems compliance issues at SCI entities, the Commission believes that it is appropriate for supervisory personnel to be knowledgeable regarding the entity's policies and procedures regarding systems compliance, which may be accomplished through training provided by the SCI entity. Moreover, the Commission believes it is appropriate in the context of the safe harbor that, if a person with responsibility over an SCI system becomes aware of potential material non-compliance of the SCI entity's policies and procedures related to that system, such person should take action to review and address, or direct other personnel to review and address, such material non-compliance. Finally, to further mitigate commenters' concern that potential individual liability may limit the hiring ability of SCI entities,⁷²⁷ as noted above, personnel of an SCI entity will not be deemed to have aided, abetted, counseled, commanded, caused, induced, or procured

⁷²⁵ See supra notes 716-717 and accompanying text.

⁷²⁶ See supra note 716 and accompanying text.

⁷²⁷ See supra note 717 and accompanying text.

the violation by an SCI entity of Regulation SCI merely because the SCI entity experienced a systems compliance issue, whether or not the person was able to take advantage of the individual safe harbor.

As noted above, with respect to a personnel of an SCI entity who is not responsible for and does not have supervisory responsibility over SCI systems, the safe harbor provides that such personnel shall be deemed not to have aided, abetted, counseled, commanded, caused, induced, or procured the violation by an SCI entity of Rule 1001(b) if such person has reasonably discharged the duties and obligations incumbent upon him or her by the systems compliance policies and procedures. Therefore, unlike personnel who are responsible for or have supervisory responsibility over SCI systems, these persons would not be liable even if the SCI entity itself did not have reasonably designed systems compliance policies and procedures or did not enforce its policies and procedures, as long as they discharged their duties and obligations under the policies and procedures in a reasonable manner.⁷²⁸ The Commission believes this safe harbor is appropriate because the persons who will seek to rely on this safe harbor are those who do not have responsibility for the establishment, maintenance, and enforcement of the policies and procedures, or the actions of other personnel of the SCI entity.

With respect to commenters who argued that individuals should not be subject to liability under Regulation SCI absent an intentional act of willful misconduct,⁷²⁹ the Commission notes again that Regulation SCI imposes direct obligations only on SCI entities, and not on individuals.

⁷²⁸ The Commission believes that, in order for a person to reasonably discharge his duties and obligations under the SCI entity's policies and procedures, that person must be able to understand his duties and obligations under such policies and procedures, which may be accomplished through training provided by the SCI entity.

⁷²⁹ See supra note 712 and accompanying text.

However, as with all other violations of provisions of the Exchange Act and rules that impose obligations on an entity, there is a potential for secondary liability for an individual who aided and abetted or caused a violation. As discussed above in the context of SCI entities, all SCI entities are required to comply with the Exchange Act, the rules and regulations thereunder, and their own rules and governing documents, as applicable, and the purpose of Rule 1001(b) is to effectively help ensure compliance of the operation of SCI systems with the Exchange Act, the rules and regulations thereunder, and their own rules and governing documents. The Commission does not believe that the rule would further this goal to the same degree if the Commission adopts commenters' suggestions for the individual safe harbor (i.e., personnel of an SCI entity are permitted to cause an SCI entity to be out of compliance with Rule 1001(b) so long as the personnel did not act intentionally or willfully).

3. SCI Events: Corrective Action; Commission Notification; Dissemination of Information – Rule 1002

Adopted Rule 1002, which corresponds to proposed Rules 1000(b)(3)-(5), requires an SCI entity to take corrective action, notify the Commission, and disseminate information regarding certain SCI events.

a. Triggering Standard

As proposed, the obligation of an SCI entity to take corrective action (proposed Rule 1000(b)(3)), notify the Commission (proposed Rule 1000(b)(4)), and disseminate information (proposed Rule 1000(b)(5)) would have been triggered upon “any responsible SCI personnel becoming aware of” an SCI event.⁷³⁰ Proposed Rule 1000(a) defined “responsible SCI personnel” to mean, for a particular SCI system or SCI security system impacted by an SCI

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See proposed Rules 1000(b)(3), 1000(b)(4)(i)-(ii), and 1000(b)(5)(i)-(ii).

event, any personnel, whether an employee or agent, of an SCI entity having responsibility for such system.⁷³¹ In the SCI Proposal, the Commission noted that this proposed definition was intended to include any personnel of the SCI entity having responsibility for the specific system(s) impacted by a given SCI event.⁷³² The Commission stated that such personnel would include any technology, business, or operations staff with responsibility for such systems, and with respect to systems compliance issues, any regulatory, legal, or compliance personnel with legal or compliance responsibility for such systems.⁷³³ The Commission also explained that “responsible SCI personnel” would not be limited to managerial or senior-level employees of the SCI entity and could include junior personnel with responsibility for a particular system.⁷³⁴

After considering the views of commenters, the Commission is modifying the proposed standard for triggering corrective action, Commission notification, and dissemination of information obligations in adopted Rule 1002, including by amending the definition of responsible SCI personnel, as discussed below.

Responsible SCI Personnel

Many commenters expressed concern that the proposed definition of responsible SCI personnel was too broad.⁷³⁵ These commenters generally urged the Commission to revise the scope of the definition to cover only those employees in management or supervisory roles that

⁷³¹ See proposed Rule 1000(a) and Proposing Release, supra note 13, at Section III.C.3.a.

⁷³² See Proposing Release, supra note 13, at 18118.

⁷³³ See id.

⁷³⁴ See id.

⁷³⁵ See, e.g., Omgeo Letter at 13; MSRB Letter at 6; BATS Letter at 8; Liquidnet Letter at 3; CME Letter at 7; OCC Letter at 12; Joint SROs Letter at 12; FINRA Letter at 25-26; and OTC Markets Letter at 19. See also NYSE Letter at 19 (stating that the proposed definition was too vague and suggesting an alternative approach). See also infra note 761 and accompanying text.

have responsibility over an SCI system, rather than including relatively junior or inexperienced employees.⁷³⁶ Some of these commenters stated that junior employees and/or technology personnel may not have the training or breadth of knowledge or experience necessary to identify, analyze, and determine whether a systems issue is an SCI event under the rule.⁷³⁷ Similarly, one commenter advocated limiting responsible SCI personnel to employees with full knowledge and authority over a system.⁷³⁸ Some commenters also suggested that SCI entities should have the discretion to decide which employees are responsible SCI personnel.⁷³⁹

Similarly, several commenters emphasized the importance of escalation policies and procedures, pursuant to which technology staff or junior employees could assess a systems problem and escalate the issue up the chain of command to management as well as legal and/or compliance personnel, who will help determine whether a systems issue was an SCI event and whether the obligations under Regulation SCI are triggered.⁷⁴⁰ These commenters argued that the rule should allow entities to adopt and follow such escalation procedures rather than triggering the obligations under Regulation SCI upon one employee's awareness of a systems

⁷³⁶ See, e.g., Omgeo Letter at 13; MSRB Letter at 6, 18; NYSE Letter at 19; BATS Letter at 8; Liquidnet Letter at 3; CME Letter at 7; OCC Letter at 12; Joint SROs Letter at 12; FINRA Letter at 25-26; and OTC Markets Letter at 19. Similarly, with regard to the Commission notification requirement in proposed Rule 1000(b)(4), one commenter stated that the obligation to notify the Commission should only be triggered when the responsible SCI personnel notifies the officer or senior staff responsible for the SCI system or systems generally. See DTCC Letter at 9.

⁷³⁷ See, e.g., OCC Letter at 12; FINRA Letter at 25-26; and OTC Markets Letter at 19.

⁷³⁸ See FIF Letter at 3, 5.

⁷³⁹ See, e.g., Liquidnet Letter at 3; NYSE Letter at 19; and Joint SROs Letter at 12.

⁷⁴⁰ See, e.g., OCC Letter at 12; FINRA Letter at 25-26; Omgeo Letter at 13; FIF Letter at 5; and NYSE Letter at 19-20.

issue.⁷⁴¹ One commenter also asserted that limiting the definition of responsible SCI personnel would be appropriate if the Commission also required a robust escalation procedure.⁷⁴²

Some commenters also expressed concern about the potential liability that responsible SCI personnel could face if the rule were adopted as proposed, given the breadth of the definition of “responsible SCI personnel.”⁷⁴³ Specifically, commenters asserted that, as a result of including junior and information technology personnel within the definition and the potential liability of such individuals, the proposed provision would make it more difficult for SCI entities to attract and retain high quality information technology employees.⁷⁴⁴ Another commenter noted that responsible operations or technical personnel may not be in a position to make legal determinations about when a compliance issue has arisen.⁷⁴⁵

After consideration of the views of commenters, the Commission has revised the term “responsible SCI personnel” to mean, “for a particular SCI system or indirect SCI system impacted by an SCI event, such senior manager(s) of the SCI entity having responsibility for such system, and their designee(s).”⁷⁴⁶ The Commission agrees that the proposed definition of responsible SCI personnel was broad and, consistent with the views of some commenters,

⁷⁴¹ See, e.g., OCC Letter at 12; FINRA Letter at 25-26; Omgeo Letter at 13; FIF Letter at 5; and NYSE Letter at 19-20.

⁷⁴² See FIF Letter at 5.

⁷⁴³ See, e.g., NYSE Letter at 19; BATS Letter at 8; Joint SROs Letter at 13; and OTC Markets Letter at 18. See also *supra* note 717.

⁷⁴⁴ See, e.g., NYSE Letter at 19; BATS Letter at 8; Joint SROs Letter at 13; and OTC Markets Letter at 18. These commenters therefore recommended that the definition include only senior personnel who would more appropriately be responsible for making a determination as to whether an SCI event had occurred given their knowledge and authority.

⁷⁴⁵ See Omgeo Letter at 13.

⁷⁴⁶ See adopted Rule 1000.

believes that it is appropriate to instead focus the adopted definition on senior personnel of SCI entities that have responsibility for a particular system.⁷⁴⁷ The Commission believes that adopting a more focused definition of responsible SCI personnel to include only senior managers having responsibility for a given system (and their designees) addresses commenters' concerns that the obligations of the rule could have been triggered upon the awareness of junior or inexperienced employees who lack the knowledge or experience to be able to make a determination regarding whether an SCI event had, in fact, occurred.⁷⁴⁸ The Commission believes that the revised definition is a better approach than the proposed definition because, consistent with suggestions from some commenters, it will appropriately allow SCI entities to adopt procedures that would require personnel of an SCI entity to escalate a systems issue to senior individuals who are responsible for a particular system and who have the ability and authority to appropriately analyze and assess the issue affecting the SCI system or indirect SCI system, and their designees, as applicable.⁷⁴⁹

The Commission also notes that, consistent with some commenters' recommendations, under the adopted rule, SCI entities will be afforded flexibility to determine which personnel to designate as "responsible SCI personnel."⁷⁵⁰ Specifically, SCI entities will need to affirmatively identify one or more senior managers that have responsibility for each of its SCI systems or

⁷⁴⁷ See generally supra notes 735-738 and accompanying text.

⁷⁴⁸ See supra notes 736-737. See also note 738 and accompanying text.

⁷⁴⁹ See supra Section IV.B.1.b (discussing Rule 1001(a)(1)(2)(vii), which requires an SCI entity to have policies and procedures to provide for monitoring of SCI systems, and indirect SCI systems, as applicable, to identify potential SCI events, and escalate them to responsible SCI personnel); and infra notes 758-761 and accompanying text.

⁷⁵⁰ See supra note 739 and accompanying text.

indirect SCI systems.⁷⁵¹ In addition, the Commission notes that the definition of responsible SCI personnel affords SCI entities with the flexibility to designate one or more other personnel as designees for a given system.⁷⁵² The Commission believes that it is important to include designees within the definition of responsible SCI personnel to provide an SCI entity with the flexibility that it may need, and which the Commission believes is necessary, given the varying sizes, natures, and complexities of each SCI entity. A senior manager may name a designee (or designees) who would also have responsibility for a given system with regard to Regulation SCI, for example, if the senior manager is absent, is occupied with other oversight responsibilities for a period of time, or because of other practical limitations, is otherwise unavailable to assess the SCI entity's obligations under Regulation SCI at a given point in time. The Commission believes it is likely that the designation of a designee and such designee's particular responsibilities with regard to an SCI system or indirect SCI system would be addressed by an SCI entity's policies and procedures, as discussed below. However, the Commission notes that while the definition of "responsible SCI personnel" does not permit the senior manager having responsibility for an applicable system to disclaim responsibility under the rule by delegating it fully to one or more designees (i.e., the adopted rule reads "and their designees" rather than "or their designees"), it may assist SCI entities in fulfilling their responsibilities under Regulation SCI by allowing them to delegate to personnel other than senior managers such that those designees can also serve in the role of responsible SCI personnel.

⁷⁵¹ See Rule 1001(c).

⁷⁵² The Commission notes that the rules do not, however, require SCI entities to have designees. Rather, each SCI entity has the discretion to have designees if they choose to do so.

The Commission further believes that the modifications to the definition addresses some commenters' concerns regarding the potential liability of junior SCI personnel, as the obligations of the rule are now triggered only when senior managers, rather than junior employees, having responsibility for a particular system have a reasonable basis to conclude that an SCI event has occurred.⁷⁵³ Further, the Commission reiterates that Regulation SCI imposes direct obligations on SCI entities and does not impose obligations directly on personnel of SCI entities. For these reasons, the Commission believes that an SCI entity's ability to attract and retain employees should not be negatively affected by the requirements of Regulation SCI, as adopted.⁷⁵⁴ The Commission also reiterates that the occurrence of an SCI event may be probative, but is not determinative of whether an SCI entity violated Regulation SCI.⁷⁵⁵

In light of the more focused definition of responsible SCI personnel and consistent with commenters' suggestions,⁷⁵⁶ the Commission believes it is appropriate to also adopt a policies and procedures requirement with respect to the designation of responsible SCI personnel and escalation procedures. As discussed above, many commenters highlighted the importance of escalation procedures and advocated for their use as an alternative to the adoption of a broader

⁷⁵³ See supra notes 743-744 and accompanying text.

⁷⁵⁴ See supra notes 721 and 743-744 and accompanying text. The Commission notes that commenters' concerns regarding potential liability of employees were related to the scope of the proposed definition of responsible SCI personnel and the effect on the hiring and retention of junior and information technology personnel. Commenters believed that the definition should instead focus on senior managers who could appropriately be held responsible given their responsibilities and authority to take necessary actions under the rule.

⁷⁵⁵ See, e.g., supra notes 470 and 627 and accompanying text.

⁷⁵⁶ See supra notes 740-742 and accompanying text and infra notes 759-761 and accompanying text.

definition of responsible SCI personnel.⁷⁵⁷ Specifically, the Commission is adopting Rule 1001(c), which requires each SCI entity to “[e]stablish, maintain, and enforce reasonably designed written policies and procedures that include the criteria for identifying responsible SCI personnel, the designation and documentation of responsible SCI personnel, and escalation procedures to quickly inform responsible SCI personnel of potential SCI events.” The Commission believes that it is important for an SCI entity’s policies and procedures to have a defined set of criteria for identifying responsible SCI personnel so that such personnel are identified in a consistent manner across all of an SCI entity’s operations and with regard to all of its SCI systems and indirect SCI systems. The Commission believes that SCI entities are best suited to establish the appropriate criteria for such a designation but notes that such criteria could include, for example, consideration of the level of knowledge, skills, and authority necessary to take the required actions under the rules. The Commission also believes it is important for policies and procedures to include the designation and documentation of responsible SCI personnel, so that it is clear to all employees of the SCI entity who the designated responsible SCI personnel are for purposes of the escalation procedures and so that Commission staff can easily identify such responsible SCI personnel in the course of its inspections and examinations and other interactions with SCI entities. The Commission also believes that, given the more focused definition of responsible SCI personnel, escalation procedures to quickly inform responsible SCI personnel of potential SCI events are necessary to help ensure that the appropriate person(s) are provided notice of potential SCI events so that any appropriate actions can be taken in accordance with the requirements of Regulation SCI without unnecessary delay. Such escalation procedures would establish the means by which, and actions required for,

⁷⁵⁷ See supra notes 740-742 and accompanying text.

escalating information regarding a systems issue that may be an SCI event up the chain of command to the responsible SCI personnel, who will be responsible for determining whether an SCI event has occurred and what resulting obligations may be triggered. The Commission notes that each SCI entity may establish escalation procedures that conform to its needs, organization structure, and size. By requiring that responsible SCI personnel are “quickly inform[ed]” of potential SCI events, the Commission intends to require that escalation procedures emphasize promptness and ensure that responsible SCI personnel are informed of potential SCI events without delay. At the same time, the rule does not prescribe a specific time requirement in order to give flexibility to SCI entities in recognition that immediate notification may not be possible or feasible. Further, similar to adopted Rules 1001(a) and 1001(b), Rule 1001(c) requires that an SCI entity periodically review the effectiveness of the policies and procedures related to responsible SCI personnel, and to take prompt action to remedy deficiencies in such policies and procedures.

Becomes Aware

Several commenters criticized the proposed requirement that certain obligations under Regulation SCI be triggered when a responsible SCI personnel “becomes aware” of an SCI event. Some commenters stated that the standard was vague and lacked clarity regarding when, exactly, responsible SCI personnel would be deemed to become aware of an SCI event.⁷⁵⁸ Further, some commenters noted that the “becomes aware” standard emphasized immediate action over methodical escalation, diagnosis, and resolution procedures.⁷⁵⁹ As noted above,

⁷⁵⁸ See, e.g., BATS Letter at 8-9; NYSE Letter at 19; and Joint SROs Letter at 12.

⁷⁵⁹ See Joint SROs Letter at 3, 9, and 12. See also OCC Letter at 12; FINRA Letter at 25-26; Omgeo Letter at 13; FIF Letter at 5; and NYSE Letter at 19-20.

several commenters emphasized the importance of escalation policies and procedures, and argued that the rule should allow entities to adopt and follow such escalation procedures rather than triggering the obligations under Regulation SCI upon one employee's awareness of a systems issue.⁷⁶⁰ Another commenter suggested specific revisions to the triggering standard so that the phrase "responsible SCI personnel becoming aware" would be eliminated entirely and replaced with "SCI entity having a reasonable basis to conclude," which it believed would allow for escalation through a normal chain of command.⁷⁶¹

With regard to the Commission notification requirements specifically,⁷⁶² one commenter suggested that SCI entities should only be required to notify the Commission "upon confirming the existence of an SCI event,"⁷⁶³ while another commenter stated that the rule should require notification to the Commission as soon as reasonably practicable after responsible personnel becomes aware of the SCI event.⁷⁶⁴ Similarly, one commenter believed that the "becomes aware" standard was problematic because it would require notification before an SCI entity has accurate information upon which to act.⁷⁶⁵

After consideration of the views of commenters, the Commission has determined to revise the triggering standard so that SCI entities will be required to comply with the obligations of adopted Rule 1002 upon responsible SCI personnel having "a reasonable basis to conclude"

⁷⁶⁰ See supra notes 740-742 and accompanying text.

⁷⁶¹ See NYSE Letter at 19.

⁷⁶² See infra Section IV.B.3.c (discussing the Commission notification requirement for SCI events).

⁷⁶³ See Direct Edge Letter at 8.

⁷⁶⁴ See Omgeo Letter at 17.

⁷⁶⁵ See FIF Letter at 5 (urging that notification be required when "accurate and actionable" information is provided to responsible SCI personnel). See also BATS Letter at 9.

that an SCI event has occurred, as suggested by a commenter.⁷⁶⁶ This standard permits an SCI entity to gather relevant information and perform an initial analysis and assessment as to whether a systems issue may be an SCI event, rather than requiring an SCI entity to take corrective action, notify the Commission, and/or disseminate information about an SCI event immediately upon responsible SCI personnel becoming aware of an SCI event.⁷⁶⁷ Thus, the Commission believes that the “reasonable basis to conclude” standard should provide some additional flexibility and time for judgment to determine whether there is a “reasonable basis to conclude” in contrast to the “becomes aware” standard which many commenters noted would be difficult to apply in practice due to the difficulty of determining when an individual, in fact, “becomes aware” of an SCI event.⁷⁶⁸ Further, the Commission believes that, consistent with commenters’ recommendations, the revised standard, in conjunction with the revised definition of “responsible SCI personnel,” will allow an SCI entity to adopt and follow its internal escalation policies and procedures to inform senior SCI entity personnel of systems issues, and allow meaningful assessment of the issues by such senior management prior to triggering obligations of the rule.⁷⁶⁹

⁷⁶⁶ See adopted Rules 1002(a), (b), and (c). See also *supra* note 761.

⁷⁶⁷ See *supra* notes 759 and 763-765 and accompanying text. Additionally, the Commission does not agree with the commenter who stated that notification should be required only as soon as reasonably practicable after responsible personnel become aware of an SCI event because that standard would unnecessarily delay the requirement for an SCI entity to take necessary actions under the rule and the Commission’s knowledge of an SCI event. See *supra* note 764.

⁷⁶⁸ See *supra* note 758 and accompanying text.

⁷⁶⁹ See *supra* notes 758-760 and accompanying text. The Commission believes that the adopted standard similarly allows for escalation of a systems issue to senior officials because the Commission believes that having “a reasonable basis to conclude” is a good indication that an SCI event has likely occurred and does not require that the responsible SCI personnel come to a definitive conclusion, which would cause unnecessary delay in taking the actions required by Regulation SCI. Rather, once responsible SCI personnel have a reasonable basis to conclude that an SCI event has occurred, the Commission

At the same time, the Commission believes that the obligations of the rule will continue to be triggered in a timely manner because the Commission is adopting a separate requirement in Rule 1001(c), as noted above, for escalation procedures to quickly inform responsible SCI personnel of potential SCI events.

b. Corrective Action – Rule 1002(a)

Proposed Rule 1000(b)(3) required an SCI entity, upon any responsible SCI personnel becoming aware of an SCI event, to begin to take appropriate corrective action including, at a minimum, mitigating potential harm to investors and market integrity resulting from the SCI event and devoting adequate resources to remedy the SCI event as soon as reasonably practicable.⁷⁷⁰ The corrective action requirement is being adopted substantially as proposed, but with the triggering standard modified as discussed above.⁷⁷¹

believes that an SCI entity should begin to take corrective action, provide notice to the Commission, and/or disclose such event, as applicable, because these requirements are designed to ensure that the SCI entity begins to take action in a timely fashion to mitigate potential harm arising from the incident and that the Commission and relevant market participants are kept apprised of an SCI event even where a definitive conclusion is not yet available. The Commission does not agree with the commenter that it should apply the triggering standard only to the SCI entity rather than responsible SCI personnel. The Commission notes, as discussed above, that the adopted definition of responsible SCI personnel imposes obligations only upon the senior personnel of an SCI entity that have responsibility for a particular system. Additionally, the Commission believes that it is important to apply the triggering standard to responsible SCI personnel rather than to the SCI entity because, when combined with an SCI entity's policies and procedures with respect to the designation of responsible SCI personnel and escalation and monitoring procedures, the triggering standard is designed to ensure that senior managers are provided notice of potential SCI events so that any appropriate actions can be taken in accordance with the requirements of Regulation SCI without unnecessary delay.

⁷⁷⁰ See proposed Rule 1000(b)(3) and Proposing Release, supra note 13, at 18117.

⁷⁷¹ See supra Section IV.B.3.a (discussing the triggering standard).

Two commenters supported the corrective action provision generally.⁷⁷² Several commenters stated that the proposed requirement put too great an emphasis on immediately taking corrective action at the expense of thoroughly analyzing the SCI event and its cause, considering potential remedies, and/or acting in accordance with internal policies and procedures before committing to a plan to take corrective action.⁷⁷³ One group of commenters suggested that the rule should make clear that “corrective action” should also include a variety of other potential actions, such as communicating with responsible parties, diagnosing the root cause, disclosing to members and the public, and mitigating potential harm by following their policies and procedures.⁷⁷⁴ Another commenter stated that, in certain circumstances, it is “aggressive to presume that one individual’s knowledge should prompt an immediate response by the SCI [e]ntity at large.”⁷⁷⁵ This commenter further stated that a standard requiring an SCI entity to mitigate potential harm to investors is extremely vague.⁷⁷⁶

As adopted, Rule 1002(a) requires an SCI entity, upon any responsible SCI personnel having a reasonable basis to conclude that an SCI event has occurred, to begin to take appropriate corrective action including, at a minimum, mitigating potential harm to investors and market integrity resulting from the SCI event and devoting adequate resources to remedy the SCI event as soon as reasonably practicable. The Commission continues to believe that this provision of Regulation SCI is important to make clear that each SCI entity has the obligation to

⁷⁷² See MSRB Letter at 17 and DTCC Letter at 9-10.

⁷⁷³ See SIFMA Letter at 3; OCC Letter at 14; Joint SROs Letter at 11; LiquidPoint Letter at 4; DTCC Letter at 10; and Direct Edge Letter at 7.

⁷⁷⁴ See Joint SROs at 11.

⁷⁷⁵ See Direct Edge Letter at 7.

⁷⁷⁶ Id.

respond to SCI events with appropriate steps necessary to remedy the problem or problems causing such SCI event and mitigate the negative effects of the SCI event, if any, on market participants and the securities markets more broadly. As discussed below, the specific steps that an SCI entity will need to take to mitigate the harm will be dependent on the particular systems issue, its causes, and the estimated impact of the event, among other factors. To the extent that a systems issue affects not only the particular users of an SCI system, but also has a more widespread impact on the market generally, as may be likely with regard to systems issues affecting critical SCI systems, the SCI entity will need to consider how it might mitigate any potential harm to the overall market to help ensure market integrity. For example, an SCI entity would need to take steps to regain a system's ability to process transactions in an accurate, timely, and efficient manner, or to ensure the accurate, timely, and efficient collection, processing, and dissemination of market data.

As noted above, many of the comments on this requirement are related to the standard for triggering the obligation to take corrective action under this provision, namely "upon any SCI responsible personnel becoming aware of" an SCI event. As discussed above, the Commission has further focused the scope of the term "responsible SCI personnel" in response to commenters' concerns that the term was too broad and could inappropriately capture junior and/or inexperienced employees. Further, as discussed above, the Commission has revised the "becomes aware" standard to instead trigger obligations when responsible personnel have "a reasonable basis to conclude" an SCI event has occurred. As explained above, the Commission believes that these important modifications are responsive to commenters' concerns that the corrective action requirement could be triggered upon the knowledge of only one individual or a junior employee of a systems issue without sufficient time to analyze and assess the systems

problem and follow internal escalation procedures. Under the adopted standard, only when (i) suspected systems problems are escalated to senior managers of the SCI entity who have responsibility for the SCI system or indirect SCI system experiencing an SCI event and their designees, and (ii) such personnel have “a reasonable basis to conclude” that an SCI event has occurred are the appropriate corrective actions required by Rule 1002(a) triggered.

Further, in response to commenters who stated that the proposed rule places too large an emphasis on immediate corrective action,⁷⁷⁷ in addition to the modifications noted above which are intended to allow for appropriate time for an SCI entity to perform an initial analysis and preliminary investigation into a potential systems issue before the obligations under Rule 1002(a) are triggered, the Commission notes that it does not use the term “immediate” in either the proposed or adopted rules. Rather, the Commission emphasizes that the rule requires that corrective action be taken “as soon as reasonably practicable” once the triggering standard has been met. The Commission believes that, because the facts and circumstances of each specific SCI event will be different, this standard ensures that an SCI entity will take necessary corrective action soon after an SCI event, but not without sufficient time to first consider what is the appropriate action to remedy the SCI event in a particular situation and how such action should be implemented.

Moreover, the Commission has considered the comment that the rule prescribe in more specificity the particular types of corrective action that must be taken by an SCI entity and believes that it is appropriate to adopt, as proposed, a rule that requires more generally that “appropriate” corrective action be taken and requires that, at a minimum, the SCI entity take appropriate steps to mitigate potential harm to investors and market integrity resulting from the

⁷⁷⁷ See supra notes 773-775 and accompanying text.

SCI event and devote adequate resources to remedy the SCI event. The Commission notes that the rule is designed to afford flexibility to SCI entities in determining how to best respond to a particular SCI event in order to remedy the problem causing the SCI event and mitigate its effects. As a general matter, though, the Commission agrees that such corrective action would likely include a variety of actions, such as those identified by one group of commenters, including determining the scope of the SCI event and its causes, making a determination regarding its known and anticipated impact, following adequate internal diagnosis and resolution policies and procedures, and taking additional action to respond as each SCI entity deems appropriate.⁷⁷⁸ The Commission also notes that certain other specific types of corrective action identified by such commenters are already required by other provisions of Regulation SCI, such as communicating and escalating the issue to responsible personnel and making appropriate disclosures to members or participants regarding the SCI event.⁷⁷⁹

c. Commission Notification – Rule 1002(b)

i. Proposed Rule 1000(b)(4)

Proposed Rule 1000(b)(4) addressed the Commission notification obligations of an SCI entity upon any responsible SCI personnel becoming aware of an SCI event.⁷⁸⁰ Specifically, proposed Rule 1000(b)(4)(i) required an SCI entity, upon any responsible SCI personnel becoming aware of a systems disruption that the SCI entity reasonably estimated would have a material impact on its operations or on market participants, any systems compliance issue, or any

⁷⁷⁸ See supra note 774 and accompanying text.

⁷⁷⁹ See adopted Rule 1001(c) (requiring policies and procedures that include, among other things, escalation procedures to quickly inform responsible SCI personnel of potential SCI events) and Rule 1002(c) (requiring dissemination of information regarding SCI events).

⁷⁸⁰ See proposed Rule 1000(b)(4) and Proposing Release, supra note 13, at Section III.C.3.b.

systems intrusion ("immediate notification SCI event"), to notify the Commission of such SCI event, which could be done orally or in writing (e.g., by email). Proposed Rule 1000(b)(4)(ii) required an SCI entity to submit a written notification pertaining to any SCI event to the Commission within 24 hours of any responsible SCI personnel becoming aware of the SCI event. Proposed Rule 1000(b)(4)(iii) required an SCI entity to submit to the Commission continuing written updates on a regular basis, or at such frequency as reasonably requested by a representative of the Commission, until such time as the SCI event was resolved.

Proposed Rule 1000(b)(4)(iv) detailed the types of information that was required for written notifications under proposed Rule 1000(b)(4).⁷⁸¹ In addition, proposed Rule 1000(b)(4)(iv)(C) required an SCI entity to provide a copy of any information disseminated regarding the SCI event to its members or participants or on the SCI entity's publicly available website.

⁷⁸¹ Specifically, the SCI Proposal required written notifications and updates to be made electronically and required initial written notifications to include all pertinent information known about an SCI event, including: (1) a detailed description of the SCI event; (2) the SCI entity's current assessment of the types and number of market participants potentially affected by the SCI event; (3) the potential impact of the SCI event on the market; and (4) the SCI entity's current assessment of the SCI event, including a discussion of the SCI entity's determination regarding whether the SCI event was a dissemination SCI event or not. In addition, as proposed, to the extent available as of the time of the initial notification, Exhibit 1 to Form SCI would have required inclusion of the following information: (1) a description of the steps the SCI entity was taking, or planned to take, with respect to the SCI event; (2) the time the SCI event was resolved or timeframe within which the SCI event was expected to be resolved; (3) a description of the SCI entity's rule(s) and/or governing documents, as applicable, that related to the SCI event; and (4) an analysis of the parties that may have experienced a loss, whether monetary or otherwise, due to the SCI event, the number of such parties, and an estimate of the aggregate amount of such loss. See proposed Rule 1000(b)(4)(iv)(A).

As described below, adopted Rule 1002(b) retains the general framework of proposed Rule 1000(b)(4) for Commission notification of SCI events, but makes several modifications in response to comments.

Comments Regarding Commission Notification of SCI Events

One commenter generally supported proposed Rule 1000(b)(4), stating that it would enhance transparency and might allow the Commission to see patterns in small, seemingly non-material SCI events that are worthy of attention.⁷⁸² However, many other commenters expressed concerns about proposed Rule 1000(b)(4).⁷⁸³ Many of these commenters stated that the scope of proposed Rule 1000(b)(4) was too broad, and that the notification requirement would lead to over-reporting to the Commission.⁷⁸⁴ Commenters also suggested various ways to revise the reporting requirement. For example, several commenters recommended requiring notification to the Commission only for “material” or “significant” events.⁷⁸⁵ For example, one commenter recommended reporting most SCI events as part of the annual SCI review process, while

⁷⁸² See Lauer Letter at 6. The Commission also notes that, although many other commenters expressed reservations with proposed Rule 1000(b)(4), many of these commenters also expressed their general support for a notification rule that is more limited in scope. See, e.g., ITG Letter at 12 (stating that a reduction in notifications would result in lower costs, reduce the over-reporting of events, and allow the Commission to focus on events that warrant review); and FINRA Letter at 18 (“FINRA fully supports the Commission’s goal of ensuring that Commission staff is informed of events that could potentially impact the market”).

⁷⁸³ See, e.g., NYSE Letter at 21; BATS Letter at 12-13; ITG Letter at 12; FINRA Letter at 16-17; Omgeo Letter at 16; SIFMA Letter at 13; ISE Letter at 6; OCC Letter at 11; and CME Letter at 9.

⁷⁸⁴ See, e.g., NYSE Letter at 22; Omgeo Letter at 16; SIFMA Letter at 14; ISE Letter at 6; and OCC Letter at 12.

⁷⁸⁵ See, e.g., ITG Letter at 12; CME Letter at 9; DTCC Letter at 8; and Omgeo Letter at 15.

focusing Commission notification on material SCI events.⁷⁸⁶ Similarly, another commenter suggested that SCI entities should only be required to report information relating to “impactful” systems disruptions in an annual report to the Commission rather than in near real time reports.⁷⁸⁷ Another commenter recommended requiring notification only for systems issues that warrant notification to an SCI entity’s subscribers or participants.⁷⁸⁸ Some commenters recommended a risk-based approach under which each SCI event would be subject to a risk-based assessment, in which the obligation to notify the Commission would be based on the attendant risk, with only material events requiring notification.⁷⁸⁹

Commenters also identified potential problems resulting from a notification requirement that they perceived as too broad. For example, one commenter stated that the notification requirements have the potential to create efficiency issues, delay system remediation, create substantial resource demands, and create instability, which would diminish an SCI entity’s ability to be responsive to investors and damage market efficiency.⁷⁹⁰ Similarly, several commenters stated that the proposed Commission notification provision would require SCI entities to divert resources to comply with the requirement which, in turn, would risk delaying resolution of the SCI event that is being reported on.⁷⁹¹ Other commenters suggested that the

⁷⁸⁶ See FIF Letter at 4.

⁷⁸⁷ See BATS Letter at 10.

⁷⁸⁸ See OTC Markets Letter at 19 (stating that the notification requirement to the Commission should be aligned with the current industry practice of notifying SCI entities’ subscribers of material events, explaining that competitive forces motivate entities to promptly notify subscribers about significant issues).

⁷⁸⁹ See, e.g., OCC Letter at 13; SIFMA Letter at 13; Omgeo Letter at 1; FINRA Letter at 14; and NYSE Letter at 25.

⁷⁹⁰ See UBS Letter at 3.

⁷⁹¹ See Omgeo Letter at 16; MSRB Letter at 19; and OCC Letter at 14.

proposed rule would result in large volumes of data and reporting, which would present challenges to, and burdens on, SCI entities as well as Commission staff.⁷⁹² One commenter also questioned the extent to which the reported information provided by the notifications would be useful to the Commission.⁷⁹³

Some commenters focused their comments on the proposal's requirements for Commission reporting of systems intrusions and offered alternative approaches to reporting systems intrusions. One commenter stated that, in order to limit the number of notifications, SCI entities should be required to investigate and keep a record of all systems intrusions that did not cause a material disruption of service, or that were a malicious (but unsuccessful) attempt in gaining unauthorized access to confidential data, and make these records available to the Commission staff if requested.⁷⁹⁴ Another commenter recommended that non-material systems intrusions be recorded within the SCI entity's records.⁷⁹⁵ Another commenter suggested that systems intrusions in a development or testing environment should only be reportable if there is a likelihood that the same issue or vulnerabilities exist in the current production environment and cannot be verified within a certain period, such as, for example, 24 to 48 hours.⁷⁹⁶ In addition, one commenter suggested that, for systems intrusions, rather than impose the Commission notification requirement on SCI entities, the Commission should instead require SCI entities to

⁷⁹² See SunGard Letter at 5; and Joint SROs Letter at 7.

⁷⁹³ See NYSE Letter at 22.

⁷⁹⁴ See Omgeo Letter at 12.

⁷⁹⁵ See DTCC Letter at 8.

⁷⁹⁶ See FINRA Letter at 11-12.

establish policies and procedures reasonably designed to prevent, detect, and respond to systems intrusions.⁷⁹⁷

One commenter stated that the Commission should support the enhancement of the Financial Services Information Sharing and Analysis Center (“FS-ISAC”)⁷⁹⁸ and another commenter suggested that non-material cyber-relevant events be provided to and disseminated through FS-ISAC rather than the Commission.⁷⁹⁹ Some commenters further suggested that certain systems intrusions should be reported to FS-ISAC.⁸⁰⁰

Other commenters stated that reporting a systems compliance issue is reporting a legal conclusion, and that requiring an SCI entity to do so would overburden them with extensive technical and legal analysis and potentially expose those entities to Commission sanctions or litigation.⁸⁰¹ Several commenters expressed concerns regarding the confidentiality of the information provided pursuant to proposed Rule 1000(b)(4), and stated that the such information should be confidential and protected from public disclosure.⁸⁰² One of these commenters

⁷⁹⁷ See BATS Letter at 12. This commenter believed that the cost of the proposed requirement would outweigh any benefits because the proposed rule would require SCI entities to “rapidly investigate and report a multitude of minor incidents that regularly occur during the normal course of business.” Id.

⁷⁹⁸ FS-ISAC is a service that gathers information from a multitude of sources related to threat, vulnerability, and risk of cyber and physical security and communicates timely notifications and authoritative information specifically designed to help protect critical systems and assets from physical and cybersecurity threats. See FS-ISAC: Financial Services – Information Sharing and Analysis Center, available at: www.fsisac.com.

⁷⁹⁹ See BIDS Letter at 10; and Omgeo Letter at 12.

⁸⁰⁰ See SIFMA Letter at 14 (recommending that systems intrusions be reported to FS-ISAC in addition to the Commission); and Omgeo Letter at 12 and 21 (recommending that non-material systems intrusions be reported solely to FS-ISAC).

⁸⁰¹ See OTC Markets Letter at 16. See also NYSE Letter at 16.

⁸⁰² See NYSE Letter at 24; Joint SROs Letter at 12; and DTCC Letter at 11.

requested that the Commission confirm in the final rule that the information will remain confidential.⁸⁰³

Commenters also raised other general concerns and made suggestions with regard to proposed Rule 1000(b)(4). One commenter argued that the proposed rules could cause SCI entities to release information before all relevant factors are known, which could be counterproductive and harmful.⁸⁰⁴ Another commenter was concerned that SCI entities would be required to provide notification reports multiple times to different Commission staff for the same event.⁸⁰⁵ Another commenter suggested that the proposed requirement is onerous and costly and thus, to realize benefits, the Commission, based on notifications received from SCI entities, should provide regular summary-level feedback that communicates the types, frequency, severity, and impact of market incidents across all reporting entities and other related data on the root cause of problems.⁸⁰⁶ Another commenter suggested that the Commission provide examples, such as publications and reference blueprints, which could be useful to SCI entities as they attempt to understand the types of SCI events that warrant Commission notification.⁸⁰⁷ Finally, some commenters broadly questioned the Commission's legal authority to adopt

⁸⁰³ See DTCC Letter at 11.

⁸⁰⁴ See ITG Letter at 13.

⁸⁰⁵ See NYSE Letter at 22. Another commenter suggested that the notification requirement with respect to system disruptions should make clear that multiple notifications are not required if a disruption impacts multiple SCI entities. See FINRA Letter at 22.

⁸⁰⁶ See BIDS Letter at 10.

⁸⁰⁷ See SunGard Letter at 6.

Regulation SCI as proposed, asserting, among other things that the Commission's proposed notification requirement was beyond its legal authority.⁸⁰⁸

ii. Rule 1002(b)

After careful consideration of the comments on proposed Rule 1000(b)(4), the Commission is adopting Rule 1002(b), with several modifications in response to comments.⁸⁰⁹

Overview

The Commission notes that, even without the modifications the Commission is making in adopted Rule 1002(b), the proposed Commission notification rule would require Commission notice of fewer SCI events than as proposed as a result of the adopted definitions of SCI systems, indirect SCI systems, systems disruption, and systems compliance issue, and the revised triggering standard discussed above. In addition, the Commission has determined to refine the scope of the adopted Commission notification requirement by incorporating a risk-based approach that requires SCI entities, for purposes of Commission notification, to divide SCI events into two main categories: SCI events that "[have] had, or the SCI entity reasonably estimates would have, no or a de minimis impact on the SCI entity's operations or on market participants" ("de minimis" SCI events); and SCI events that are not de minimis SCI events. De minimis SCI events will not be subject to an immediate Commission notification requirement as proposed. Instead, all de minimis SCI events will be subject to recordkeeping requirements, and de minimis systems disruptions and de minimis systems intrusions will be subject to a quarterly reporting obligation, as set forth in adopted Rule 1002(b)(5). For SCI events that are not de

⁸⁰⁸ See NYSE Letter at 4-6; and OTC Markets at 6. See *infra* notes 833-837 and accompanying text (discussing "Commission Legal Authority").

⁸⁰⁹ Specific comments on proposed Rules 1000(b)(4)(i)-(iii) that are not discussed above are discussed below in conjunction with the Commission's response to those comments.

minimis, Commission notification will be governed by adopted Rules 1002(a)(1)-(4), which is substantially similar to proposed Rules 1000(b)(4)(ii)-(iv), but relaxed in certain respects in response to comment, as discussed below.

Effect of Revised Definitions and Revised Triggering Standard on Commission Notification Requirement

The Commission believes that the revisions made to a number of definitions already focus the scope of the Commission notification requirement in adopted Rule 1002(b) from the SCI Proposal. For example, elimination of member regulation and member surveillance systems from the adopted definition of SCI systems will substantially reduce the potential number of SCI events that would be subject to Commission notification under the proposal.⁸¹⁰ Likewise, systems problems that would otherwise meet the definition of SCI event do not meet the definition of an SCI event if they occur in the development or testing environment.⁸¹¹ In addition, the Commission believes that the revised definition of “systems disruption” and “systems compliance issue” also will result in fewer systems issues being identified as SCI events.⁸¹² In tandem with the revised definitions, the Commission also believes that the revised triggering standard for notification of SCI events, which affords an SCI entity time to evaluate whether a potential SCI event is an actual SCI event, will also result in fewer SCI events being

⁸¹⁰ See supra Section IV.A.2.b (discussing the definition of “SCI systems”).

⁸¹¹ See supra note 796 and accompanying text. See also supra Section IV.A.2.b (discussing the definition of “SCI systems”). According to one commenter who supported excluding non-market systems from the definition of SCI systems and the notification and dissemination requirements, applying the reporting requirements to non-market systems “would significantly increase the volume of the reports the Commission receives.” FINRA Letter at 10. (“If the definition of SCI systems is broadly construed to apply to non-market regulatory and surveillance systems, approximately 111 FINRA systems could be subject to Regulation SCI.”) FINRA Letter at 7.

⁸¹² See supra Section IV.A.3 (discussing the definition of “SCI event,” “systems disruption,” and “systems compliance issue”).

subject to the requirements of Rules 1002(b)(1)-(4).⁸¹³ The Commission believes that these changes respond to comments that proposed Rule 1000(b)(4) was overbroad and overly burdensome for SCI entities.⁸¹⁴

Exclusion of De Minimis SCI Events from Immediate Notification Requirements: Adopted Rule 1002(b)(5)

Adopted Rule 1002(b)(5) states that the requirements of Rules 1002(b)(1)-(4) do not apply to any SCI event that has had, or the SCI entity reasonably estimates would have, no or a de minimis impact on the SCI entity's operations or on market participants. For such de minimis events, Rule 1002(b)(5) requires that an SCI entity: (i) make, keep, and preserve records relating to all such SCI events; and (ii) submit to the Commission a report, within 30 calendar days after the end of each calendar quarter, containing a summary description of such systems disruptions and systems intrusions, including the SCI systems and, for systems intrusions, indirect SCI systems, affected by such systems disruptions and systems intrusions during the applicable calendar quarter.

The Commission believes that this exception will result in a less burdensome reporting framework for de minimis SCI events than for other SCI events, and therefore responds to comment that the proposed reporting framework was too burdensome. The Commission believes that the quarterly reporting of de minimis systems disruptions and de minimis systems intrusions will reduce the frequency and volume of SCI event notices submitted to the Commission and also will allow both the SCI entity and its personnel, as well as the Commission

⁸¹³ See supra Section IV.B.3.a (discussing the definition of "responsible SCI personnel") and Section IV.B.3.a (discussing the triggering standard).

⁸¹⁴ See supra note 784 and accompanying text. See also Section VI (discussing comments regarding the burdens associated with proposed Rule 1000(b)(4)).

and its staff, to focus their attention and resources on other, more significant SCI events. Consistent with taking a risk-based approach in other aspects of Regulation SCI, the Commission believes this modification from the SCI Proposal will result in more focused Commission monitoring of SCI events than if this aspect of the SCI Proposal was adopted without modification. Further, by reducing the number of SCI event notices provided to the Commission on an immediate basis as compared to the SCI Proposal, the adopted rule should also impose lower compliance costs and fewer burdens than if this aspect of the SCI Proposal was adopted without modification.

However, the Commission has determined not to incorporate a materiality threshold as requested by some commenters,⁸¹⁵ to limit the Commission reporting requirements to those events that are considered by SCI entities to be truly disruptive to the markets, as suggested by other commenters,⁸¹⁶ or to limit the Commission reporting requirement only to those events that warrant notification to an SCI entity's subscribers or participants, as suggested by still other commenters.⁸¹⁷ The Commission has made this determination because while there may be SCI events with little apparent impact on an SCI entity's operations or on market participants and the burden on an SCI entity to provide immediate notice to the Commission every time such an event occurs may not justify the benefit of providing such notice to the Commission on an immediate basis, the Commission does not believe that such de minimis events are irrelevant or that the Commission should never be made aware of them. To fulfill its oversight role, the Commission believes that the Commission and its staff should regularly be made aware of de

⁸¹⁵ See, e.g., supra note 785 and accompanying text.

⁸¹⁶ See, e.g., supra notes 785-787.

⁸¹⁷ See supra note 788.

de minimis systems disruptions and de minimis systems intrusions and should have ready access to records regarding de minimis systems compliance issues that SCI entities are facing and addressing because, as the regulator of the U.S. securities markets, it is important that the Commission and its staff have access to information regarding all SCI events (including de minimis SCI events) and their impact on the technology systems and systems compliance of SCI entities, which may also provide useful insights into learning about indications of more impactful SCI events. The Commission has, however, determined to distinguish the timing of its receipt of information regarding SCI events based on their impact: those SCI events that an SCI entity reasonably estimates to have a greater impact are subject to "immediate" notification upon responsible SCI personnel having a reasonable basis to conclude that an SCI event has occurred; and those SCI events that an SCI entity reasonably estimates to have no or a de minimis impact are subject to recordkeeping obligations, and for de minimis systems disruptions and de minimis systems intrusions, a quarterly summary notification. Despite commenters' arguments to the contrary that de minimis SCI events do not warrant the Commission's and its staff's attention, the Commission believes that quarterly reporting of de minimis systems disruptions and de minimis systems intrusions and review of records regarding de minimis systems compliance issues is beneficial to the Commission and its staff in understanding SCI entity systems operations at the level of the individual SCI entity, as well as across the spectrum of SCI entities, and to monitor compliance with the Exchange Act and rules thereunder. The Commission notes that, while it is not requiring that de minimis systems compliance issues be submitted to the Commission in quarterly reports, Commission staff may request records relating to such de minimis systems compliance issues as necessary. The Commission encourages and does not

intend to inhibit an evaluation by SCI entities of systems compliance issues, including de minimis systems compliance issues, which may inherently involve legal analysis.

As noted, some commenters focused specifically on systems intrusions, urging the Commission to modify or significantly reduce the instances in which notice of systems intrusions would be required,⁸¹⁸ or provide that non-material systems intrusions not be reported at all, and only be recorded by the SCI entity.⁸¹⁹ The Commission believes that the recordkeeping and quarterly reporting requirement for de minimis systems intrusions described in Rule 1002(b)(5) is partially responsive to these comments, but also believes that notice of intrusions in SCI systems and indirect SCI systems is important to allow the Commission and its staff to detect patterns or understand trends in the types of systems intrusions that may be occurring at multiple SCI entities. However, as compared to what would have been required if the SCI Proposal was adopted without modification, the Commission expects that the exception from the immediate reporting requirement provided for de minimis SCI events under Rule 1002(b)(5) will result in a much lower number of systems intrusions that SCI entities will be required to immediately report to the Commission than commenters believed,⁸²⁰ and will achieve this result without compromising the Commission's interest in receiving more timely notification of impactful SCI events.

In addition, some commenters suggested that certain types of systems intrusions or non-material SCI events be reported exclusively to FS-ISAC or to both the Commission and FS-

⁸¹⁸ See supra notes 794-797 and accompanying text.

⁸¹⁹ See supra notes 794-795 and accompanying text.

⁸²⁰ See, e.g., supra note 794 and accompanying text (discussing a commenter's suggestion to limit the number of notifications by requiring recordkeeping of all systems intrusions that did not cause a material disruption of service or that were a malicious (but unsuccessful) attempt in gaining unauthorized access to confidential data).

ISAC, and some advocated that the Commission support the enhancement of FS-ISAC.⁸²¹ The Commission believes that FS-ISAC, and other information sharing services play an important role in assisting SCI entities and other entities with respect to security issues. Consistent with views shared by several members of the third panel at the Cybersecurity Roundtable, to the extent SCI entities determine that such information sharing services are useful, the Commission encourages SCI entities to cooperate with and share information relating to information security threats and related issues with such entities to further enhance their utility.⁸²² At the same time, for the reasons discussed above,⁸²³ the Commission believes that it is important that the Commission directly receive information regarding systems intrusions from SCI entities, through immediate notifications or quarterly reports, as applicable.

In response to comments that recordkeeping of non-material SCI events would be more appropriate than reporting, the Commission believes that quarterly reporting of de minimis systems disruptions and de minimis systems intrusions will better achieve the goal of keeping Commission staff informed regarding the nature and frequency of SCI events that arise but are reasonably estimated by the SCI entity to have a de minimis impact on the entity's operations or on market participants. Importantly, submission and review of regular reports will facilitate Commission staff comparisons among SCI entities and thereby permit the Commission and its

⁸²¹ See supra notes 799-800 and accompanying text.

⁸²² See supra notes 39-40 and accompanying text. During the Cybersecurity Roundtable, panelists referenced other services that they believed useful to SROs, including the Financial Services Sector Coordinating Council for Critical Infrastructure Protection and Homeland Security (FSSCC), the Clearing House and Exchange Forum (CHEF), and the Worldwide Federation of Exchange's recently established Global Exchanges Cyber Security Working Group (GLEX). See supra note 39.

⁸²³ See supra notes 904-906 and accompanying text.

staff to have a more holistic view of the types of systems operations challenges that were posed to SCI entities in the aggregate.

With regard to de minimis systems compliance issues, however, the Commission believes the goals of Regulation SCI can be achieved through the SCI entity's obligation to keep, and provide to representatives of the Commission upon request, records of such de minimis systems compliance issues. The Commission believes that systems compliance issues generally are more specific to a particular entity's systems and rules and less likely, as compared to systems disruptions and systems intrusions, to raise market-wide issues that could affect several SCI entities. Accordingly, information on such events are less likely to provide valuable insight into trends and risks across the industry and, therefore, the Commission believes that the benefits of receiving quarterly reports on such de minimis systems compliance issues would be less relative to de minimis systems disruptions and de minimis systems intrusions. Further, the Commission notes that, based on Commission staff's experience with notifications of compliance-related issues at SROs, the Commission believes that SCI entities will experience a relatively small number of systems compliance issues each year, and thus, its regular examinations of SCI entities will provide an adequate mechanism for reviewing and addressing de minimis systems compliance issues affecting SCI entities. As noted above, Commission staff may request records relating to such de minimis systems compliance issues as necessary.

In response to the concerns raised by one commenter that the notification requirements have the potential to create efficiency issues, delay system remediation, create substantial resource demands, and create instability, the Commission believes that these concerns have been mitigated by the numerous changes made from the proposal, such as the adoption of a quarterly reporting framework for de minimis systems disruptions and de minimis systems intrusions and

revised definitions of the terms SCI systems, indirect SCI systems, systems disruption, and systems compliance issue, in addition to the reduction in the obligations SCI entities have with respect to reporting requirements.⁸²⁴ In addition, ARP entities today are able to regularly notify the Commission of systems related issues, such as systems outages, and the Commission therefore believes that the notification requirements will not require a majority of SCI entities to develop policies and procedures that are incongruous with their current practice. Moreover, the Commission believes that providing SCI entities with 30 days after the end of each quarter is adequate time for an SCI entity to prepare its report without unduly diverting SCI entity resources away from focusing on SCI events occurring in real time.⁸²⁵

The Commission believes that requiring SCI entities to report de minimis systems disruptions and de minimis systems intrusions quarterly balances the interest of SCI entities in having a limited reporting burden for such types of events with the Commission's interest in oversight of the information technology programs and systems compliance of SCI entities.⁸²⁶ Similarly, the Commission believes that requiring recordkeeping of de minimis systems compliance issues allows the Commission to adequately monitor compliance with the Exchange Act and rules thereunder, while reducing the burdens on SCI entities with regard to providing information to the Commission on such de minimis systems compliance issues. Accordingly, the Commission has determined to exclude certain SCI events from the immediate Commission

⁸²⁴ See supra note 790.

⁸²⁵ See supra notes 791-793 and accompanying text.

⁸²⁶ The Commission notes an SCI entity should be prepared for the possibility that Commission staff may, whether upon request pursuant to Rule 1002(b)(3), Rule 1005(b)(3), or Rule 1007 or during an examination of its compliance with Regulation SCI, include a review of the entity's classification of SCI events as de minimis SCI events under Rule 1002(b).

reporting requirements, subject to certain recordkeeping and reporting requirement for such events, as applicable.⁸²⁷

As described above, the de minimis exception from the immediate Commission notification requirements applies to systems compliance issues as well as systems disruptions and systems intrusions. The Commission believes that this approach strikes a balance that will help focus the Commission's and SCI entities' resources on those systems compliance issues with more significant impacts. Even if an SCI entity determines that the impact of the systems compliance issue is none or negligible, however, the Commission believes that it should have ready access to records regarding such systems compliance issues, and notes that Rule 1002 requires that an SCI entity take corrective action with respect to all SCI events, including de minimis systems compliance issues.⁸²⁸

The Commission recognizes that in many cases, the discovery of a potential systems compliance issue may be of a different nature than the discovery of potential systems disruptions or systems intrusions, as the latter types of events often have an immediately apparent and

⁸²⁷ While the facts and circumstances surrounding a particular SCI event will ultimately determine the severity of a given event, including whether the event is reasonably estimated to be a de minimis event, a wide range of factors may be relevant to an SCI entity in making such a determination. For example, such factors could include, but are not limited to: whether critical SCI systems are impacted; the duration of the SCI event; whether there is a loss of redundancy (that negatively impacts, for example, a source of power, telecommunications, or other key service); whether an alternate trading system is available following a trading system disruption; the size of the affected market trading volume; whether the processes for trade completion or clearance and settlement are adversely impacted; whether settlement is completed on time; whether an event is resolved prior to the market's open; whether a post-trade event is resolved before the market closes; whether a failover, despite being successful, results in a given system operating without a backup; and the number of securities symbols that are adversely affected.

⁸²⁸ See infra note 829 and accompanying text.

negative impact on the operations of a given system of the SCI entity. In contrast, in many instances, a systems compliance issue may require the involvement of various personnel (potentially including compliance and/or legal personnel) and a period of time may be required to afford such personnel the chance to perform a preliminary legal analysis to analyze whether a systems compliance issue had, in fact, occurred. Because Rule 1002(b)(1) only requires notification to the Commission when responsible SCI personnel have a “reasonable basis to conclude” that a non-de minimis SCI event has occurred, the Commission believes it is appropriate for an SCI entity to notify the Commission of a non-de minimis systems compliance issue after it has conducted such a preliminary legal analysis, unless the nature of the issue makes it readily identifiable as a systems compliance issue.⁸²⁹ Further, if an SCI entity determines that a systems compliance issue is de minimis, such event will not be required to be reported immediately to the Commission, but rather the SCI entity will be required to keep, and provide to representatives of the Commission upon request, records of such de minimis systems compliance issue. Thus, the Commission believes that, as adopted, the requirements with respect to systems compliance issues are reasonable because SCI entities are afforded flexibility to assess and understand potential SCI events and are not required to notify the Commission prior to forming a reasonable basis to conclude that an SCI event has occurred. The Commissions also believes that, as part of its oversight of the securities markets, it should have access to

⁸²⁹ At the same time, the Commission cautions SCI entities against unnecessarily delaying Commission notifications of SCI events, including systems compliance issues. The Commission notes that the notification requirement is triggered when responsible SCI personnel have a reasonable basis to conclude that an SCI event has occurred and not, for example, when responsible SCI personnel have definitively concluded that an SCI event has occurred. As discussed above, the Commission does not believe it is appropriate for an SCI entity to delay notifying its regulator of a systems compliance issue once the SCI entity has a reasonable basis to conclude there is one. See supra note 828 and accompanying text.

information regarding de minimis systems compliance issues when requested. And, although some commenters expressed concern that a systems compliance issue is a legal conclusion that requires time to analyze and could possibly expose the entity to liability if reported,⁸³⁰ as discussed above, the Commission believes these concerns will be mitigated by the revised triggering standard for the obligations in Rule 1002.⁸³¹ However, while commenters are correct that the occurrence of a systems compliance issue may expose an SCI entity to liability,⁸³² the occurrence of an SCI event will not necessarily cause a violation of Regulation SCI. Further, the occurrence of a systems compliance issue also does not necessarily mean that the SCI entity will be subject to an enforcement action. Rather, the Commission will exercise its discretion to initiate an enforcement action if the Commission determines that action is warranted, based on the particular facts and circumstances of an individual situation.

Commission Legal Authority

As noted above, some commenters broadly questioned the Commission's legal authority to adopt certain provisions of Regulation SCI as proposed, including those relating to Commission notification of SCI events, as well as Commission notification of material systems changes.⁸³³ Section 11A(a)(2) of the Exchange Act directs the Commission, having due regard

⁸³⁰ See OTC Markets Letter at 16; and NYSE Letter at 16.

⁸³¹ See supra Section IV.B.3.a (discussing the triggering standard).

⁸³² If an SRO fails to, among other things, comply with the provisions of the Exchange Act, the rules or regulations thereunder, or its own rules, the Commission is authorized to impose sanctions. See 15 U.S.C. 78s(g).

⁸³³ See supra note 808 and accompanying text. See infra note 1268 (noting comments relating to the Commission's legal authority for the proposed access provision, which the Commission has determined not to adopt in its final rules because the Commission can adequately assess an SCI entity's compliance with Regulation SCI through existing recordkeeping requirements and examination authority, as well as through the new recordkeeping requirement in Rule 1005 of Regulation SCI).

for the public interest, the protection of investors, and the maintenance of fair and orderly markets, to use its authority under the Exchange Act to facilitate the establishment of a national market system for securities in accordance with the Congressional findings and objectives set forth in Section 11A(a)(1) of the Exchange Act. Among the findings and objectives in Section 11A(a)(1) 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.” In addition, Sections 6(b), 15A, and 17A(b)(3) of the Exchange Act impose obligations on national securities exchanges, national securities associations, and clearing agencies, respectively, to be “so organized” and “[have] the capacity to...carry out the purposes of [the Exchange Act].”

Consistent with this statutory authority, the Commission is adopting Regulation SCI to require, among other things, that SCI entities: (1) provide certain notices and reports to the Commission to improve Commission oversight of securities market infrastructure; and (2) have comprehensive policies and procedures in place to help ensure the robustness and resiliency of their technological systems, and also that their technological systems operate in compliance with the Exchange Act, rules thereunder, and with their own rules and governing documents. These requirements are important to furthering the directives in Section 11A(a)(2) of the Exchange Act that the Commission, having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets, facilitate the establishment of a national market system for securities in accordance with the Congressional findings and objectives set forth in

Section 11A(a)(1) of the Exchange Act, including the economically efficient execution of securities transactions.

As discussed in Section I, the U.S. securities markets have been transformed in recent years by technological advancements that have enhanced the speed, capacity, efficiency, and sophistication of the trading functions that are available to market participants. Central to these technological advancements have been changes in the automated systems that route and execute orders, disseminate quotes, clear and settle trades, and transmit market data. At the same time, however, these technological advances have generated an increasing risk of operational problems with automated systems, including failures, disruptions, delays, and intrusions. Accordingly, in today's securities markets, properly functioning technology is central to the maintenance of fair and orderly markets, the national market system, and the efficient and effective market operations and the execution of securities transactions. While the Commission's ARP Inspection Program has been active in this area, the Commission has not adopted rules specific to these matters. The Commission believes that the adoption of Regulation SCI, with the modifications from the SCI Proposal as discussed above, and compliance with the regulation by SCI entities, will further the goals of the national market system. It will help to ensure the capacity, integrity, resiliency, availability, and security of the automated systems of entities important to the functioning of the U.S. securities markets, as well as reinforce the requirement that such systems operate in compliance with the Exchange Act and rules and regulations thereunder, thus strengthening the infrastructure of the U.S. securities markets and improving its resilience when technological issues arise. In addition, Regulation SCI establishes an updated and formalized regulatory framework, thereby helping to ensure more effective Commission oversight of these systems whose proper functioning is central to the maintenance of fair and orderly markets and

for the continued operation of the national market system. For these reasons, the Commission disagrees with the comments questioning the Commission's legal authority to adopt Regulation SCI.

More specifically, the Commission disagrees with comment regarding its legal authority under Rule 1002(b) related to Commission notification of SCI events. As discussed above, having immediate notice and continuing updates of non-de minimis SCI events, quarterly reports related to de minimis systems disruptions and de minimis systems intrusions, and recordkeeping requirements for de minimis SCI events, directly enables the Commission to have more effective oversight of the systems whose proper functioning is central to the maintenance of fair and orderly markets and for the continued operation of the national market system. In this respect, Rule 1002(b) is integral to furthering the statutory purposes of Section 11A of the Act under which the Commission is directed to act. Moreover, the Commission underscores that the adopted Commission notification provisions would require immediate Commission notice of fewer SCI events than as proposed because the adopted definitions of SCI systems, indirect SCI systems, systems disruption, and systems compliance issue have been refined from the proposal, and de minimis SCI events are not subject to immediate notice.

Some commenters also questioned the Commission's legal authority to require Commission notification of material systems changes.⁸³⁴ As discussed in more detail below, the material systems change reports are intended to make the Commission and its staff aware of significant systems changes at SCI entities, and thereby improve Commission oversight of U.S. securities market infrastructure, which directly furthers the findings and objectives set forth in

⁸³⁴ See infra note 1046 and accompanying text.

Section 11A(a)(1) of the Exchange Act.⁸³⁵ The Commission believes that the adopted material systems change notification requirement will allow the Commission to more efficiently and effectively participate in discussions with SCI entities when systems issues occur and will allow Commission staff to effectively prepare for inspections and examinations of SCI entities. Moreover, Rule 1003(a), as adopted, differs significantly from the proposed requirements as it no longer requires 30-day advance notification, but rather requires quarterly reports of material systems changes. As such, the requirement is designed not to result in “close, minute regulation of computer systems and computer security.”⁸³⁶ Additionally, the Commission notes that Regulation SCI does not provide for a new review or approval process for SCI entities’ material systems changes.⁸³⁷

Immediate Commission Notification – Proposed Rule 1000(b)(4)(i)

Commenters also specifically discussed proposed Rule 1000(b)(4)(i) regarding reporting to the Commission on immediate notification SCI events. One commenter stated that it generally supported the immediate notification requirement of proposed Rule 1000(b)(4)(i) in the case of material SCI events,⁸³⁸ but other commenters were critical.⁸³⁹ For example, some commenters stated that the Commission should adopt a materiality threshold which would only

⁸³⁵ See infra Section IV.B.4 (discussing the requirement to notify the Commission of material systems changes).

⁸³⁶ See infra note 1046.

⁸³⁷ As noted below in Section IV.B.4, Commission staff will not use material systems change reports to require any approval of prospective systems changes in advance of their implementation pursuant to any provision of Regulation SCI, or to delay implementation of material systems changes pursuant to any provision of Regulation SCI.

⁸³⁸ See MSRB Letter at 18.

⁸³⁹ See, e.g., NYSE Letter at 22.

require an SCI entity to immediately report material SCI events.⁸⁴⁰ Similarly, one group of commenters suggested a tiered method that would reserve immediate notification to the Commission for truly critical events “where the Commission’s input would contribute to an expedient resolution,” while requiring SCI entities to have written policies and procedures that focus the SCI entity’s attention primarily on taking corrective measures during an SCI event and maintaining records to provide information to the Commission and members and participants as appropriate.⁸⁴¹ Two commenters suggested that different reporting standards should apply to different types of systems, suggesting, for example, that immediate notification should be required only for higher priority systems.⁸⁴²

⁸⁴⁰ See SIFMA Letter at 13; FIF Letter at 4; ITG Letter at 12; NYSE Letter at 23; FINRA Letter at 10, 22; and OCC Letter at 13. One commenter stated that, in considering factors that would determine whether or not an SCI event is material, the Commission should consider the overall market disruption caused by the SCI event, the length of the event, the financial impact of the event, and the inability to meet core regulatory obligations regarding order handling and execution activities. See ITG Letter at 13. Similarly, two commenters stated that, with respect to systems compliance issues or systems intrusions, immediate notification SCI events should be limited to systems compliance issues or systems intrusions that the SCI entity reasonably estimates would have a material impact on its operations or on market participants. See MSRB Letter at 18; and Omgeo Letter at 15. Further, in the case of intrusions, one commenter stated that notifications could also include intrusions that would cause a malicious unauthorized access to confidential data, but recommended that other types of intrusions be subject to recordkeeping. See Omgeo Letter at 15. One group of commenters supported implementing a materiality threshold for systems compliance issues, which it stated should be based on factors such as the number of members affected, financial impact and operation impact, and these guidelines should be articulated in the SCI entities’ policies and procedures. See Joint SROs Letter at 9.

⁸⁴¹ See Joint SROs Letter at 10.

⁸⁴² See FINRA Letter at 22 (suggesting, for example, that immediate Commission notification should not be required for SCI events that occur in systems that do not provide real-time data to the market); and SIFMA Letter at 13 (stating that that lower priority systems should only be reported on an aggregate and periodic basis).

One commenter questioned the adequacy of the Commission's asserted basis and purpose for requiring notification for the vast majority of SCI events.⁸⁴³ In this commenter's view, the Commission's asserted rationale for the Commission notification requirement⁸⁴⁴ would only support requiring immediate notification for a limited number of SCI events, where the Commission's involvement is necessary.⁸⁴⁵ For other SCI events, in which the Commission would only be gathering and analyzing submitted information, the commenter stated that the Commission's rationale for requiring immediate notification is insufficient.⁸⁴⁶

Some commenters addressed the use of the term "immediately" in the proposed rule. One commenter characterized the proposed immediate reporting requirements as rigid, and questioned why reporting could not occur "promptly" with follow-up as reasonably requested by the Commission staff.⁸⁴⁷ Another commenter stated that immediate notification is unrealistic and predicted that it could trigger an innumerable amount of false alarms.⁸⁴⁸

Other commenters addressed SCI events that occur outside of normal business hours. Two commenters believed that an SCI entity should not be required to notify the Commission of an SCI event outside of normal business hours.⁸⁴⁹ Other commenters stated that material events

⁸⁴³ See NYSE Letter at 21-22.

⁸⁴⁴ See Proposing Release, supra note 13, at 18119.

⁸⁴⁵ See NYSE Letter at 22; see also Joint SROs Letter at 10.

⁸⁴⁶ See NYSE Letter at 22.

⁸⁴⁷ See BATS Letter at 12.

⁸⁴⁸ See Direct Edge Letter 8.

⁸⁴⁹ See FINRA Letter at 21; and BATS Letter at 12. FINRA also stated that an SCI entity should have one full business day to report an SCI event.

should require immediate notification to the Commission, but all other types of events should be reported by the next business day.⁸⁵⁰

One commenter stated that immediate notification of an SCI event may be difficult where an SCI entity uses a third party to operate its systems, and therefore believed that an SCI entity should not be responsible for reporting an SCI event caused by a third party unless there is a material impact to the market or the SCI entity's ability to meet its service level agreements.⁸⁵¹ This commenter stated that the rule should permit SCI entities flexibility on how to address third party issues and requested further guidance from the Commission in this area.⁸⁵²

Immediate Notification of SCI Events: Adopted Rule 1002(b)(1)

Adopted Rule 1002(b)(1) requires each SCI entity to notify the Commission of an SCI event immediately upon any responsible SCI personnel having a reasonable basis to conclude that an SCI event has occurred (unless it is a de minimis SCI event). Such notification may be provided orally (e.g., by telephone) or in writing (e.g., by email or on Form SCI). Although many commenters were critical of the immediate notification provision, Rule 1002(b)(1) substantially retains the requirements of proposed Rule 1000(b)(4)(i), but is modified in certain respects in response to comments.

⁸⁵⁰ See, e.g., DTCC Letter at 9 (stating that, outside of normal business hours, an SCI entity should only be required to notify the Commission of the most critical events; i.e., those with the potential to impact the core functions and critical operations of the SCI entity); and OCC Letter at 14 (stating that when an event is material because it could have a market-wide impact or impact the core functions of an SCI entity, immediate notification should be required even outside of normal business hours, but all other SCI events should be reported no later than the next business day).

⁸⁵¹ See FINRA Letter at 22; see also *supra* Section IV.A.2.b (discussing the definition of "SCI systems" as it relates to third parties).

⁸⁵² See FINRA Letter at 22.

The Commission has considered the views of commenters who stated that the Commission should require immediate notification only for material SCI events, or when Commission involvement would contribute to an expedient resolution.⁸⁵³ Given the Commission's oversight responsibilities over SCI entities and the U.S. securities market generally, the notification rule is not intended to be limited to instances in which SCI entities might believe that it would be useful for the Commission to provide input. SCI event notifications also serve the function of providing the Commission and its staff with information about the potential impact of an SCI event on the securities markets and market participants more broadly, which potential impacts may not be readily apparent or important to the SCI entity reporting such an event. Moreover, the Commission believes that there will be instances in which an SCI entity will not know the significance of an SCI event at the time of the occurrence of an event, or whether such event (or, potentially, the aggregated impact of several SCI events occurring, for example, across many SCI entities) will warrant the Commission's input or merit the Commission's awareness, nor does the Commission believe it should be solely within an SCI entity's discretion to make such a determination. And SCI entities retain the flexibility to revise their initial assessments should they subsequently determine that the event in question was incorrectly initially assessed to be a de minimis event (or incorrectly initially assessed to not be a de minimis event). Consequently, the Commission does not agree with commenters who stated that only material SCI events should be reported to the Commission immediately.⁸⁵⁴

⁸⁵³ See supra notes 838-846 and accompanying text.

⁸⁵⁴ See, e.g., supra note 842 and accompanying text.

The Commission has also considered comments that the term “immediately” as used in proposed Rule 1000(b)(4) is rigid and unrealistic.⁸⁵⁵ The Commission, in adopting Rule 1002(b), has retained the requirement that SCI entities must notify the Commission immediately; however, as discussed in detail above,⁸⁵⁶ the triggering standard has been modified so that the notification obligations of Rule 1002(b) are triggered only upon any responsible SCI personnel having a reasonable basis to conclude that an SCI event has occurred. The Commission believes this modification responds to commenters concerns that the “immediate” reporting requirement is too rigid or would pose practical difficulties, as it allows additional time for escalation to senior SCI entity personnel and for the performance of preliminary analysis and assessment regarding whether an SCI event has, in fact, occurred before requiring notification to the Commission. As such, the Commission believes that the immediate notification requirement of Rule 1002(b)(1) will not unduly cause “false alarms,” as one commenter stated.⁸⁵⁷ At the same time, the Commission believes that the immediate notification requirement, as adopted, will help ensure that the Commission and its staff are kept apprised of SCI events after they occur, and as their impact unfolds and is mitigated and, ultimately, as the SCI entity engages in corrective

⁸⁵⁵ See supra note 847 and accompanying text.

⁸⁵⁶ See supra Section IV.B.3.a (discussing the triggering standard).

⁸⁵⁷ See supra note 848 and accompanying text. The Commission notes that, if an SCI entity at some point after submitting an immediate notification concludes after further investigation and analysis that it was incorrect in its initial determination that an SCI event had occurred, the SCI entity should alert the Commission of its updated assessment pursuant to Rule 1002(b)(3). Relatedly, Rule 1002(b) is designed to provide SCI entities flexibility in notifying the Commission of the details regarding an SCI event (for example, through the ability to provide the Rule 1002(b)(2) written notification on a good faith, best efforts basis) and time to assess and analyze the SCI event (for example, by requiring that the Rule 1002(b)(2) written notification only provide a description of the SCI event, including the system(s) affected, and with additional information only required to the extent available at that time).

action to resolve the SCI events. Additionally, the Commission notes that immediate notifications made pursuant to Rule 1002(b)(1) may be made orally (e.g., by telephone) or in a written form (e.g., by email or on Form SCI).⁸⁵⁸ The Commission notes that, by not prescribing the precise method of communication for an immediate notification, SCI entities are afforded the flexibility to determine the most effective and efficient method to communicate with the Commission.

The Commission has also considered comments that immediate notification should not be required outside of normal business hours, or that it should only be required outside of normal business hours in the case of material SCI events.⁸⁵⁹ The Commission notes that the adopted rule will afford SCI entities considerable flexibility in how to communicate an immediate notification to the Commission—that is, SCI entities may satisfy the immediate notification requirement simply by communicating with the Commission via telephone or e-mail. In addition, because an SCI entity's obligation to report to the Commission is not triggered until responsible SCI personnel has a reasonable basis to conclude that an SCI event has occurred,⁸⁶⁰ the Commission does not believe that timely notification, even outside of normal business, is so onerous that it necessitates allowing a full business day to comply. Particularly because it has determined to exclude de minimis SCI events from the immediate notification requirement, the Commission believes that it is reasonable to require that an SCI event (except those specified in Rule 1002(b)(5)) be reported to the Commission orally (e.g., by telephone) or in writing (e.g., by

⁸⁵⁸ The Commission notes that, prior to the compliance date of Regulation SCI, Commission staff intends to notify SCI entities of the e-mail addresses, phone numbers, and contact persons that SCI entities should use when notifying the Commission of SCI events under Rule 1002(b).

⁸⁵⁹ See, e.g., supra notes 849 and 794-797 and accompanying text.

⁸⁶⁰ See supra Section IV.B.3.a (discussing the triggering standard).

email or on Form SCI) when responsible SCI personnel have a reasonable basis to conclude that an SCI event has occurred, even if such communication may be outside of normal business hours. Because the rule provides flexibility to more easily enable communication—by permitting oral notification—of the fact of an SCI event to the Commission, and because only non-de minimis SCI events are subject to this requirement, the Commission believes notice to the Commission is appropriate sooner rather than later. In addition, as discussed above, the Commission believes that there may be situations where the severity of an SCI event may not be immediately apparent to an SCI entity experiencing the event, but the Commission, from its unique position, may determine as a result of receiving multiple immediate notifications, each related to an SCI event of a similar nature, that the SCI event is part of a pattern of a larger, more significant occurrence. The Commission is therefore adopting Rule 1002(b) to require that an SCI entity notify the Commission of an SCI event immediately upon any responsible SCI personnel having a reasonable basis to conclude that an SCI event has occurred, without an exception for periods outside of normal business hours.

In addition, as noted above, the information submitted to the Commission pursuant to Regulation SCI will be treated as confidential, subject to applicable law⁸⁶¹ and, as noted in Sections IV.B.1.b.i and IV.B.2.a, the occurrence of an SCI event does not necessarily mean that an SCI entity has violated Regulation SCI.

The Commission disagrees with the commenter who stated that the Commission should not require SCI entities to be responsible for reporting an SCI event caused by a third party because immediate notification would be difficult.⁸⁶² An SCI event, whether or not caused by a

⁸⁶¹ See supra note 674.

⁸⁶² See supra notes 851-852 and accompanying text.

third party system, by definition relates to an SCI system or indirect SCI system. As explained in Section IV.A.2 above (discussing the definitions of “SCI systems” and “indirect SCI systems”), the Commission has adopted the definition of SCI systems to include, specifically, those systems of SCI entities that would be reasonably likely to impact the protection of investors and the maintenance of fair and orderly markets and an SCI entity’s operational capability, and has not excluded third party systems from the definition. As stated above, if an SCI entity is uncertain of its ability to manage a third-party relationship to satisfy the requirements of Regulation SCI, then it would need to reassess its decision to outsource the applicable system to such third party.⁸⁶³

In response to comment that SCI entities would be required to provide notification reports multiple times to different Commission staff for the same event,⁸⁶⁴ the Commission notes that rule does not include such a requirement. In addition, the Commission also disagrees with the commenter who stated that, for systems disruptions, notifications should not be required from each separate entity where a disruption impacts multiple SCI entities.⁸⁶⁵ Excusing immediate notification where a given event seems to be affecting multiple SCI entities would not be appropriate because the Commission, as the centralized receiver of notifications, will be the entity that will be in a position to determine whether, in fact, SCI entities are concurrently experiencing the same SCI event. Moreover, even if a given event affects multiple SCI entities, it may be the case that the event impacts each SCI entity and the affected systems in a different

⁸⁶³ See supra note 260 and accompanying text.

⁸⁶⁴ See, e.g., supra note 805 and accompanying text.

⁸⁶⁵ See, e.g., id.

manner, and thus the Commission believes it is important to receive individual notifications from each affected SCI entity.

Written Commission Notification: Proposed Rule 1000(b)(4)(ii)

Commenters also specifically discussed and suggested alternatives to proposed Rule 1000(b)(4)(ii), which would have required an SCI entity, within 24 hours of any responsible SCI personnel becoming aware of any SCI event, to submit a written notification pertaining to such SCI event to the Commission. Many commenters stated that the proposed 24-hour time frame was too short or burdensome.⁸⁶⁶ Several commenters specifically suggested that the Commission extend the time frame to allow SCI entities to attend to the SCI event without also devoting resources to notifying the Commission, suggesting different time frames they believed to be appropriate.⁸⁶⁷ One commenter suggested that SCI entities be given until 24 to 48 hours after final resolution of the SCI event to submit a written notification.⁸⁶⁸ Another commenter similarly recommended that, where real-time notification is needed, written notification should not be required unless an SCI event remains unresolved after a reasonable period (such as 10 or 15 days).⁸⁶⁹

⁸⁶⁶ See NYSE Letter at 23; FINRA Letter at 19; BATS Letter at 12; DTCC Letter at 9; MSRB Letter at 18; SIFMA Letter at 13; FIF Letter at 5; BIDS Letter at 10; Omgeo Letter at 17; and CME Letter at 9.

⁸⁶⁷ Commenters suggested time frames of 48 hours (CME Letter at 9); 72 hours (OCC Letter at 12; DTCC Letter at 9, 11 (noting, however, that details surrounding an SCI event should not be required to be provided in writing until after the investigation of the event is complete and the event has been resolved)); and five business days (BIDS Letter at 10).

⁸⁶⁸ See FINRA Letter at 20. This commenter further suggested that, if an SCI event has not been fully resolved within a reasonable period, e.g., 10 or 15 days, an SCI entity could be required to submit written notification based on currently available information at the end of that period, with periodic status updates via telephone or email, and a final written submission within 24 to 48 hours after the event has been fully resolved.

⁸⁶⁹ See SIFMA Letter at 14.

Some commenters also suggested that, if the Commission retains the 24-hour requirement, it should require provision of less information. For example, one commenter suggested that SCI entities should only be required to provide whatever information is sufficiently reliable at that time.⁸⁷⁰ Two other commenters stated that SCI entities should not be required to include an estimate of the markets and participants impacted by an SCI event or to quantify such impact because this requirement may create a risk of civil liability for the SCI entity.⁸⁷¹ Another commenter recommended that the rule require only a brief written summary that is one or two paragraphs, which could be supplemented by oral communications and a longer summary within 15 days after an SCI event has been fully resolved.⁸⁷²

With respect to the information provided to the Commission via notification of an SCI event, one commenter suggested that the rule provide a safe harbor for entities and employees for either inadvertent omissions in a submitted report, or when a good faith, documented determination is made that no report is required.⁸⁷³ One commenter stated that the Commission should expressly provide that initial written submissions are to be made on a best efforts basis and SCI entities will incur no liability or penalty for any unintentional inaccuracies

⁸⁷⁰ See FINRA Letter at 20. This commenter also suggested that the rule require an SCI entity to assess the “business impact” of an SCI event, noting that this information may provide more context than requiring an SCI entity to estimate the number of market participants impacted by an SCI event (which in some cases could be zero, but still have a negative impact on the SCI entity). See FINRA Letter at 30.

⁸⁷¹ See DTCC Letter at 10; and Omgeo Letter at 30. Omgeo added that such a calculation would be difficult to compute, likely inaccurate, and of little use to the Commission.

⁸⁷² See Omgeo Letter at 17.

⁸⁷³ See *id.* at 18.

or omissions contained in these submissions.⁸⁷⁴ Some commenters stated that entities should not be liable for information that is later found to be incomplete or inaccurate.⁸⁷⁵

Some commenters⁸⁷⁶ questioned the purpose of requiring that information disseminated to members and participants (under proposed Rule 1000(b)(5)) be copied and attached to Form SCI as part of notifications to the Commission, and considered it “an overly broad inclusion of communications” that would have “a chilling effect on communications between the SCI entities and their members and participants,”⁸⁷⁷ while another commenter argued that, when an exchange is having a technology issue, many members may be reaching out to the exchange’s staff with requests for information and status. Therefore, that commenter questioned the feasibility, need, and potential impact of the proposed requirement that SCI entities provide a copy of any information disseminated to date regarding the SCI event to their members or participants.⁸⁷⁸

One commenter stated that, to reduce the cost of compliance, the Commission should accept the same notifications of service interruptions that an ATS already provides to its subscribers.⁸⁷⁹

⁸⁷⁴ See FINRA Letter at 20.

⁸⁷⁵ See, e.g., SIFMA Letter at 14; and UBS Letter at 4 (stating that SCI entities acting in good faith should not be held accountable if details offered in reports to the Commission are substantially different from what is revealed by further analysis).

⁸⁷⁶ Because the requirement to provide information disseminated to an SCI entity’s members or participants is now included in the Final Report (Rule 1002(b)(4)) instead of with the 24-written notification requirement as proposed, the Commission’s response to these comments is discussed below in the subsection “Final Report: Adopted Rule 1002(b)(4).”

⁸⁷⁷ See Joint SROs Letter at 11.

⁸⁷⁸ See Direct Edge Letter at 7-8.

⁸⁷⁹ See BIDS Letter at 11.

Commenters also provided suggestions for limiting the circumstances for which 24-hour written notification would be required under proposed Rule 1000(b)(4)(ii). One commenter stated that only SCI events that materially impact an SCI entity's operations or market participants should be subject to the 24-hour written notification requirement, but questioned whether 24 hours was realistic even for those events.⁸⁸⁰ One commenter suggested that proposed Rule 1000(b)(4)(ii) only apply to significant SCI events and that other events only be subject to a recordkeeping requirement.⁸⁸¹ In addition, some commenters suggested that if an SCI entity has provided oral notification to the Commission, it should not be required to file written notice within 24 hours after the initial report unless reasonably requested by the Commission.⁸⁸²

Written Notification Within 24 Hours: Adopted Rule 1002(b)(2)

Adopted Rule 1002(b)(2) requires an SCI entity, within 24 hours of any responsible SCI personnel having a reasonable basis to conclude that the SCI event has occurred, to submit a written notification pertaining to such SCI event to the Commission. Rule 1002(b)(2) allows for such written notifications to be made on a good faith, best efforts basis and requires that it include: (i) a description of the SCI event, including the system(s) affected; and (ii) to the extent available as of the time of the notification: the SCI entity's current assessment of the types and number of market participants potentially affected by the SCI event; the potential impact of the SCI event on the market; a description of the steps the SCI entity has taken, is taking, or plans to take, with respect to the SCI event; the time the SCI event was resolved or timeframe within

⁸⁸⁰ See MSRB Letter at 18.

⁸⁸¹ See CME Letter at 9.

⁸⁸² See BATS Letter at 12; and Omgeo Letter at 17. See also DTCC Letter at 10; and OCC Letter at 14 (suggesting 72 hours to provide written information after providing verbal notification).

which the SCI event is expected to be resolved; and any other pertinent information known by the SCI entity about the SCI event.

The Commission has considered comments stating that 24 hours is too short and burdensome a duration for an SCI entity to submit a compliant written notification.⁸⁸³ The Commission understands commenters' concerns that SCI entities may still be actively investigating and working to resolve an SCI event and that information it initially provides to the Commission about an SCI event may not ultimately prove correct.⁸⁸⁴ Therefore, in line with commenters' concerns regarding a good faith and best efforts standard,⁸⁸⁵ the Commission has modified the 24-hour written notification requirement in adopted Rule 1002(b) to make clear that the written notification should be provided on a "good faith, best efforts basis." This modification acknowledges that a written notification provided within 24 hours may provide only a preliminary assessment of the SCI event, that additional information may come to light after the initial 24-hour period, and that the initial assessment may prove in retrospect to be incorrect or incomplete. Consequently, the adopted rule requires that the written notification provided within 24 hours be submitted on a good faith, best efforts basis, and does not require that the written notification be a comprehensive or complete assessment of the SCI event (unless, of course, an SCI entity has completed a full assessment by such time). The Commission believes that a "good faith" standard will help to ensure that SCI entities will not be accountable for unintentional inaccuracies or omissions contained in these submissions, and a "best efforts" standard will help to ensure that SCI entities will make a diligent and timely attempt to provide

⁸⁸³ See, e.g., supra note 866 and accompanying text.

⁸⁸⁴ See supra notes 873-875 and accompanying text.

⁸⁸⁵ See id.

all the information required by the written notification requirement. The Commission also notes that an SCI entity will not need to submit a written notification where an SCI entity documents that an SCI event is determined to be a de minimis SCI event, other than including de minimis systems disruptions and de minimis systems intrusions in the quarterly report required by Rule 1002(b)(5). As discussed in further detail below, in the event that new information comes to light or previously reported information is found to be materially incorrect, adopted Rule 1002(b)(3) requires an SCI entity to update the information at that time, and does not require that such updates be written.⁸⁸⁶ The Commission believes these modifications will help ensure that SCI entities are able to provide the information required by Rule 1002(b)(2) within 24 hours, and therefore the Commission is not modifying the timeframe to extend beyond 24 hours, as requested by several commenters.⁸⁸⁷ Moreover, because the information need only be provided on a good faith, best efforts basis and, pursuant to Rule 1002(b)(3), updates can be provided on a regular basis to correct any materially incorrect information previously provided or when new material information is discovered, the Commission disagrees with commenters that stated that the information required by Rule 1002(b) should be provided only after resolution of the SCI event. The Commission continues to believe that Rule 1002(b)(2)'s requirement to provide information to the Commission within 24 hours is appropriately tailored to help the Commission and its staff quickly assess the nature and the scope of an SCI event and will contribute to more timely and effective Commission oversight of systems whose proper functioning is central to the

⁸⁸⁶ See infra note 909 and accompanying text.

⁸⁸⁷ See supra notes 867-869 and accompanying text; and Proposing Release, supra note 13, at 18119.

maintenance of fair and orderly markets, and that this would particularly be the case for SCI events that are not yet resolved.⁸⁸⁸

Adopted Rule 1002(b)(2) is also responsive to comments urging the Commission to require less information in a 24-hour written notification.⁸⁸⁹ Specifically, whereas proposed Rule 1000(b)(4) required a detailed description of the SCI event, adopted Rule 1002(b)(2)(i) specifies that an SCI entity must only provide “a description of the SCI event, including the system(s) affected.” Additional information is only required to the extent available as of the time of the notification, which includes an “SCI entity’s current assessment of the types and number of market participants potentially affected by the SCI event; the potential impact of the SCI event on the market; a description of the steps the SCI entity has taken, is taking, or plans to take, with respect to the SCI event; the time the SCI event was resolved or timeframe within which the SCI event is expected to be resolved; and any other pertinent information known by the SCI entity about the SCI event.”⁸⁹⁰ This information is the type of necessary information that SCI entities are able to provide in a short timeframe and that the Commission has come, over time, to rely upon to properly assess systems issues.

Additionally, the Commission notes that adopted Rule 1002(b) does not require that an SCI entity provide the Commission, at the time of the initial notice to the Commission, with its current assessment of the SCI event, including a discussion of the determination of whether it is subject to a dissemination requirement, as proposed in Rule 1000(b)(4).

⁸⁸⁸ See supra notes 868 and 872 and accompanying text.

⁸⁸⁹ See supra notes 870-872 and accompanying text.

⁸⁹⁰ Rule 1002(b)(2)(ii). The information required to be provided in Rule 1002(b)(2)(ii) is a subset of information proposed to be required under Rule 1000(b)(4)(iv)(A)(1)-(2) of the SCI Proposal.

The Commission has also determined to further refine the scope of information that needs to be reported in the 24-hour written notification by requiring that the following items instead be included in the final report under Rule 1002(b)(4), rather than in the 24-hour written notification required by Rule 1002(b)(2): a description of the SCI entity's rule(s) and/or governing document(s), as applicable, that relate to the SCI event; and an analysis of parties that may have experienced a loss, whether monetary or otherwise, due to the SCI event, the number of such parties, and an estimate of the aggregate amount of such loss.⁸⁹¹

In response to commenters who suggested that the Commission limit the events for which 24-hour written notification would be required to material events,⁸⁹² the Commission notes that it has partially responded to such comments by providing an exception to the immediate notification requirement for de minimis events in Rule 1002(b)(5). The Commission believes that this exception should reduce the overall number of SCI events subject to immediate notification requirements as compared to what would have been required if the SCI Proposal was adopted without modification and, consequently, the requirement to submit a written notification within 24 hours of an SCI event, thereby alleviating some of the burdens about which commenters expressed concerns. Moreover, the Commission believes that a materiality

⁸⁹¹ At the same time, if such information is known at the time of the notification, the SCI entity will be required to provide it pursuant to Rule 1002(b)(2)(ii)'s requirement that the SCI entity provide "any other pertinent information known...about the SCI event." Additionally, such information would be provided under the requirement to provide the Commission with regular updates under Rule 1002(b)(3)'s requirement to provide any of the information listed in Rule 1002(b)(2)(ii) if it becomes available after the time of submission of the 24-hour notification. The Commission also notes that Rule 1002(b)(4)(ii) requires that an SCI entity include in the final report a copy of any information disseminated pursuant to Rule 1002(c) by the SCI entity to date regarding an SCI event to any of its members or participants.

⁸⁹² See supra note 880 and accompanying text.

threshold would likely exclude from the 24-hour written notification a large number of SCI events that are not de minimis SCI events but that the Commission, as part of its oversight role, should be updated on so that the Commission and its staff can quickly assess the nature and scope of those SCI events and potentially assist the SCI entity in identifying the appropriate response, including ways to mitigate the impact of SCI events on investors and promote the maintenance of fair and orderly markets. The Commission reemphasizes that the information to be provided under the 24-hour written notification would represent the SCI entity's preliminary assessment—performed on a good faith, best efforts basis—of the SCI event, and only certain key information is required under the 24-hour written notification, with “other pertinent information” required only where “known by the SCI entity” within the 24-hour timeframe. For these reasons, the Commission has determined not to adopt a materiality threshold for the requirement that an SCI entity update the Commission within 24 hours after it has a reasonable basis to conclude that an SCI event has occurred.

Additionally, the Commission disagrees with those commenters who stated that written notification should only be required when reasonably requested by the Commission.⁸⁹³ The Commission believes that it should be notified of all SCI events and that all SCI events (other than those specified in Rule 1002(b)(5)) should be subject to the 24-hour written notification requirement because, by articulating in a single notification what is currently known about an SCI event and the steps expected to be taken to respond to the SCI event, the Commission will be better able to assess the nature and scope of, and respond to, SCI events and potentially assist SCI entities in identifying the appropriate response, including ways to mitigate the impact of SCI events on investors and promote the maintenance of fair and orderly markets.

⁸⁹³ See supra note 882 and accompanying text.

In response to the comment that the Commission should accept the same notifications of service interruptions that an ATS provides to its subscribers,⁸⁹⁴ the Commission believes that SCI ATSS can use the types of information contained in ATS notices to subscribers when completing Form SCI, but nevertheless believes that it is more useful and efficient for the Commission and its staff to be able to have all SCI event notifications standardized in a single format (i.e., Form SCI).

As discussed above, the information required under the adopted 24-hour written notification requirement has been refined as compared with the requirements in the proposal. Consequently, the Commission believes that SCI entities should be able to provide the Commission with this information in a written format, and does not agree that such information should be provided in an oral format, as requested by some commenters, regardless of the manner in which the immediate notification was provided to the Commission.⁸⁹⁵ The Commission emphasizes that regular updates provided under Rule 1002(b)(3) may, however, be provided either orally or in written form.⁸⁹⁶

In response to commenters that stated SCI entities should not be required to include an estimate of the market participants impacted by an SCI event or to quantify such impact because this requirement may create a risk of civil liability for the SCI entity,⁸⁹⁷ the Commission notes that the information submitted to the Commission pursuant to Regulation SCI will be treated as

⁸⁹⁴ See supra note 879 and accompanying text.

⁸⁹⁵ See supra notes 872 and 882 and accompanying text.

⁸⁹⁶ See infra note 911 and accompanying text.

⁸⁹⁷ See supra note 871.

confidential, subject to applicable law, including amended Rule 24b-2.⁸⁹⁸ Moreover, the requirement to provide a 24-hour written notification does not itself create a risk of civil liability, but the Commission acknowledges that the information provided to it may be subject to FOIA requests.

Regarding the comment that the requirement to include an estimate of the markets and participants impacted by an SCI event or to quantify such impact would be difficult to compute, likely inaccurate, and of little use to the Commission,⁸⁹⁹ the Commission disagrees. The rule requires an SCI entity to provide its current assessment of the types and number of market participants potentially affected by the SCI event and the potential impact of the SCI event on the market, to the extent this information is available as of the time of the notification, rather than an exact computation. In addition, the rule does not require that the assessment be submitted only if the SCI entity ensures that it is free of inaccuracies. Further, contrary to the commenter's suggestion, the Commission believes that such estimates will be of significant use to the Commission and its staff in understanding the potential severity of the SCI event. In addition, because the SCI entity is likely to be in the best position to assess an SCI event, the Commission also believes that an assessment of the impact of an SCI event on markets and participants is useful because it affords the Commission the opportunity to learn the SCI entity's perspective on the potential or actual impact of an SCI event.⁹⁰⁰

Written Commission Updates: Proposed Rule 1000(b)(4)(iii)

⁸⁹⁸ See supra notes 802-803 and accompanying text. For a discussion of the amendment to Rule 24b-2, see infra notes 1245-1248 and accompanying text.

⁸⁹⁹ See supra note 871 and accompanying text.

⁹⁰⁰ The Commission notes that SCI entities retain the flexibility to provide additional information to the Commission as part of their assessments, such as providing the "business impact" of an SCI event, as suggested by one commenter. See supra note 870.

Commenters also addressed proposed Rule 1000(b)(4)(iii), which required an SCI entity to provide the Commission written updates pertaining to an SCI event on a regular basis, or at such frequency as reasonably requested by a representative of the Commission, until the SCI event was resolved. Some commenters urged the Commission to provide clarity on the definition of “resolved.”⁹⁰¹ For example, one commenter suggested that the Commission should define the resolution of an SCI event to be when the affected SCI systems have been normalized,⁹⁰² and another commenter stated that there should be a precise definition of when an SCI event is resolved and that definition should be linked directly to the definition of the SCI event itself.⁹⁰³ Other commenters expressed concern that the continuing update requirement could divert resources from resolution of the SCI event and suggested that updates be required only to the extent they would not interfere with event resolution.⁹⁰⁴ One commenter stated that continual updates should only be necessary if the SCI entity had not resolved the event within a reasonable period, such as 10 to 15 days.⁹⁰⁵

Other commenters addressed the method of providing updates. For example, one commenter stated that only oral communication should be required when an SCI event is ongoing, and that the rule should allow a written supplement to a final or post mortem report if additional information comes to light regarding the SCI event.⁹⁰⁶ Another commenter suggested that updates should be permitted to be in writing or provided orally based on the judgment of the

⁹⁰¹ See DTCC Letter at 11; and Omgeo Letter at 18.

⁹⁰² See DTCC Letter at 11.

⁹⁰³ See Omgeo Letter at 18.

⁹⁰⁴ See MSRB Letter at 19; and OCC Letter at 14.

⁹⁰⁵ See FINRA Letter at 20.

⁹⁰⁶ See Omgeo Letter at 17.

SCI entity.⁹⁰⁷ Finally, one commenter stated that requests for updates regarding SCI events should only be permitted to come from senior staff at the Commission.⁹⁰⁸

Regular Updates: Adopted Rule 1002(b)(3)

Rule 1002(b)(3) requires that, until such time as an SCI event is resolved, and the SCI entity's investigation of the SCI event is closed, an SCI entity provide the Commission with updates pertaining to the SCI event on a regular basis, or at such frequency as reasonably requested by a representative of the Commission. Updates are required to correct any materially incorrect information previously provided, or when new material information is discovered, including not limited to, any of the information listed in Rule 1002(b)(2)(ii).

While the Commission recognizes that providing the Commission with such updates imposes an additional reporting requirement on SCI entities, the Commission also believes that updates are important to allow the Commission to fully monitor the SCI event. In addition, the Commission believes that the update requirement will encourage SCI entities to formalize their processes for gathering information on SCI events, which will help to ensure that responsible SCI personnel receive accurate and updated information on SCI events as they are being resolved, and further, that this process may be helpful to SCI entities when providing information about SCI events to their members or participants. Also, because the Commission has revised the requirements of the 24-hour notification to allow SCI entities to provide information on a good faith, best efforts basis and has limited the scope of information required in that report as discussed above, the Commission believes that updates to the Commission to correct materially incorrect information previously reported or when new material information is discovered as

⁹⁰⁷ See MSRB Letter at 19.

⁹⁰⁸ See NYSE Letter at 24.

required by the rule is important to keep the Commission up to date with accurate information, including the following: the SCI entity's current assessment of the types and number of market participants potentially affected by the SCI event; the potential impact of the SCI event on the market; a description of the steps the SCI entity has taken, is taking, or plans to take, with respect to the SCI event; the time the SCI event was resolved or timeframe within which the SCI event is expected to be resolved; and any other pertinent information known by the SCI entity about the SCI event. Consequently, the Commission does not agree with the commenter who suggested that updates should be only required if an SCI event has not been resolved within a reasonable amount of time, such as 10 to 15 days.⁹⁰⁹

The Commission believes that updates regarding this information are important to enhance the Commission's oversight of the securities markets and its informed and continued understanding of an SCI event. Moreover, the Commission underscores that updates are only required to the extent that they correct any materially incorrect information previously provided or when new material information is discovered, including but not limited to, any of the information listed in Rule 1002(b)(2)(ii), thereby alleviating the burden to SCI entities of providing such updates absent such circumstances.⁹¹⁰ The Commission has also eased the requirements of the proposed update provision by eliminating the proposed requirements that an SCI entity attach a copy of any information disseminated to date regarding the SCI event to its members or participants or on the SCI entity's publicly available website; a description of the

⁹⁰⁹ See supra note 870 and accompanying text.

⁹¹⁰ The requirement that updates regarding new or corrected information be provided on a regular basis (unless an alternative, specific frequency is reasonably requested by a representative of the Commission) is designed to take into account the fact that new or updated information may develop at different frequencies for different SCI events.

SCI entity's rule(s) and/or governing document(s), as applicable, that relate to the SCI event; an analysis of parties that may have experienced a loss, whether monetary or otherwise, due to the SCI event, the number of such parties, and an estimate of the aggregate amount of such loss. Instead, these information requirements must only be provided as part of the final report required by Rule 1002(b)(4), and the Commission therefore believes that burdens associated with the continuing update requirement will be streamlined because SCI entities will not need to devote resources to providing written updates while an SCI event is ongoing.

At the same time, the Commission is cognizant of the burdens associated with requiring written updates and therefore has revised the update requirement in adopted Rule 1002(b)(3) to remove the proposed requirement that such updates be provided in written form. Thus, submission of updates may be provided either orally or in written form, and will result in a lighter burden on SCI entities than the proposed requirement, and is responsive to commenters that suggested that SCI entity resources would be better directed to resolving an SCI event.⁹¹¹

In response to comment that the Commission provide guidance to clarify when an SCI event has been "resolved"⁹¹² and in line with the particular comment that the concept of resolution should be linked directly to the definition of the SCI event itself,⁹¹³ the Commission believes that an SCI event is resolved when the event no longer meets the definitions of a systems disruption, systems intrusion, or systems compliance issue, as defined in Rule 1000, and

⁹¹¹ See supra note 791 and accompanying text. SCI entities may, but are not required to, utilize Form SCI to submit such updates. See Section IV.D (discussing Form SCI). The Commission also believes that, to the extent commenters suggested that the Commission permit oral updates, they did so because, at least in part, oral updates are less burdensome to SCI entities than written updates. See supra notes 906-907 and accompanying text.

⁹¹² See supra notes 902-903 and accompanying text.

⁹¹³ See supra note 903 and accompanying text.

that an SCI entity's Rule 1002(b) reporting obligations are completed when an SCI entity submits a final report as required by Rule 1002(b)(4). Further, the Commission does not believe that it is necessary to prescribe that requests to SCI entities regarding updates should come solely from senior Commission staff, as suggested by one commenter.⁹¹⁴ The Commission believes that requiring an SCI entity to update the Commission at such frequency as reasonably requested by a representative of the Commission provides appropriate flexibility to the Commission to request additional information as necessary, but does not anticipate that requests will be made by multiple members of the Commission staff because the Commission expects that such requests would be coordinated by a particular group of Commission staff that are assigned to handle specific reports from SCI entities.

Final Report: Adopted Rule 1002(b)(4)

Adopted Rule 1002(b)(4) requires that if an SCI event is resolved and the SCI entity's investigation of the SCI event is closed within 30 days of the occurrence of the SCI event, then within five business days after the resolution of the SCI event and closure of the SCI entity's investigation regarding the SCI event, the SCI entity is to submit a final written notification pertaining to such SCI event to the Commission ("final report"). The final report is required to include: (i) a detailed description of: the SCI entity's assessment of the types and number of market participants affected by the SCI event; the SCI entity's assessment of the impact of the SCI event on the market; the steps the SCI entity has taken, is taking, or plans to take, with respect to the SCI event; the time the SCI event was resolved; the SCI entity's rule(s) and/or governing document(s), as applicable, that relate to the SCI event; and any other pertinent information known by the SCI entity about the SCI event; (ii) a copy of any information

⁹¹⁴ See supra note 802 and accompanying text.

disseminated pursuant to Rule 1002(c) by the SCI entity to date regarding the SCI event to any of its members or participants; and (iii) an analysis of parties that may have experienced a loss, whether monetary or otherwise, due to the SCI event, the number of such parties, and an estimate of the aggregate amount of such loss. Rule 1002(b)(4) also specifies that, if an SCI event is not resolved or the SCI entity's investigation of the SCI event is not closed within 30 days of the occurrence of the SCI event, then, the SCI entity is required to submit a written notification pertaining to such SCI event to the Commission within 30 days after the occurrence of the SCI event containing the information required in Rules 1002(b)(4)(i)-(iii), to the extent known at the time. Within five business days after the resolution of such SCI event and closure of the investigation regarding such SCI event, the SCI entity is required to submit a final written notification pertaining to such SCI event to the Commission containing the information specified in the rule.

As an initial matter, the Commission notes that several of the items that are specifically required to be described in the final report (as specified in adopted Rule 1002(b)(4)) were proposed to be required to be provided to the Commission under proposed Rule 1000(b)(4)(ii), within a shorter time frame.⁹¹⁵ The Commission believes that the adopted rule, by requiring that this information be submitted to the Commission after resolution of an SCI event and closure of the SCI entity's investigation, will encourage SCI entities to devote resources first to resolving the SCI event, and providing status reports when required, and then to preparing a comprehensive final report. In particular, as some commenters suggested, certain information

⁹¹⁵ The Commission notes that while proposed Rule 1000(b)(4)(iv)(C) specified that an SCI entity was required to provide a copy of any information disseminated on the SCI entity's publicly available website, adopted Rule 1002(b)(4) specifies that an SCI entity provide a copy of any information disseminated pursuant to Rule 1002(c) by the SCI entity to date regarding the SCI event to any of its members or participants.

would be more accurate, and therefore more useful, if provided after an SCI event is resolved.⁹¹⁶ The Commission believes that the information required under Rule 1002(b)(4) will provide the Commission with a comprehensive analysis to more fully understand and assess the impact caused by the SCI event. In addition, the Commission ordinarily would expect an SCI entity to include the root cause of an SCI event as part of “any other pertinent information” known about the SCI event. The Commission also believes that certain of the information requested by Rule 1002(b)(4) is more suitable to be provided after, rather than prior to, resolution of an SCI event. Specifically, much of the information required by Rule 1002(b)(4) (an analysis of parties that may have experienced a loss, whether monetary or otherwise, due to the SCI event, the number of such parties, and an estimate of the aggregate amount of such loss) can only be comprehensively known after the final resolution of an SCI event.⁹¹⁷

Similarly, the Commission is revising the proposed requirement that SCI entities provide to the Commission a copy of any information disclosed by the SCI entity to date regarding the SCI event to any of its members or participants. First, rather than requiring that SCI entities provide a copy of “any information disclosed by the SCI entity,” the adopted rule requires that SCI entities provide a copy of any information “disseminated pursuant to paragraph (c) of [Rule 1002]” by the SCI entity to date regarding the SCI event to any of its members or participants.

The Commission believes that this refined requirement will more appropriately capture only the

⁹¹⁶ See *supra* notes 870-878 and accompanying text.

⁹¹⁷ The Commission notes that a notification required pursuant to proposed Rule 1000(b)(4)(ii) required the SCI entity to provide information on the “potential impact of the SCI event on the market,” whereas adopted Rule 1002(b)(4)(ii)(A) requires a description of “the SCI entity’s assessment of the impact of the SCI event on the market.” Because adopted Rule 1002(b)(4) requires a final report upon resolution of an SCI event and the closure of the SCI entity’s investigation of the SCI event, the Commission believes it is appropriate that an SCI entity provide its assessment of the impact of the SCI event in the final report, rather than information on the SCI event’s potential impact.

information needed for the Commission to assess compliance with the dissemination requirements of Rule 1002(c). Further, to limit the burden on, and provide additional flexibility to, SCI entities as they resolve SCI events, the adopted rule does not require this information to be included as part of a Form SCI submission until the final report is to be submitted to the Commission. The Commission believes that it is sufficient to require that this information be included in the final report because it is an important part of the record of an SCI event and SCI entity's response to such event.⁹¹⁸ As noted above, one commenter questioned the purpose of this requirement and expressed concern that it may negatively impact open communication between an SCI entity and its members and participants,⁹¹⁹ while another commenter questioned the feasibility, need, and potential impact of this requirement in light of the numerous communications that SCI entities will engage in with their members or participants.⁹²⁰ While the Commission recognizes that it is possible that the requirement could have some chilling effect on such communications, it believes that this information is important for SCI entities to share with the Commission because it is an efficient means for the Commission to assess whether SCI entities are complying with the dissemination requirements of Rule 1002(c). Further, the Commission believes that, by requiring that SCI entities provide a copy only of information disseminated pursuant to Rule 1002(c) (rather than all information disclosed to members or

⁹¹⁸ Under Rule 1002(b)(4), SCI entities are required to provide a copy of any information disseminated pursuant to Rule 1002(c) by the SCI entity to date regarding the SCI event to any of its members or participants.

⁹¹⁹ See supra note 877.

⁹²⁰ See supra note 878 and accompanying text. Specifically, this commenter noted that there could be hundreds of communications between the SCI entity and its members or participants during a systems incident and questioned the feasibility of, and need for, recreating and providing to the Commission a copy of all such communications. Further, the commenter noted that this requirement could have an unintended effect of discouraging open communication between the SCI entity and its members.

participants regarding the SCI event), it addresses one commenter's concern that it would be difficult, unnecessary, and could impede open communication, to provide the Commission with a copy of all information disclosed to members or participants, which could include hundreds of individual communications via email or telephone for each SCI event.

The Commission also believes that, if an SCI event is not resolved or the SCI entity's investigation of the SCI event is not closed within 30 days of the occurrence of the SCI event, it is reasonable to require that an SCI entity submit within thirty business days after the occurrence of the SCI event the information required in Rule 1002(b)(4)(ii), to the extent known at the time, because this timeframe provides SCI entities with flexibility to continue their investigation while also apprising the Commission of relevant information discovered during the course of the SCI entity's investigation. Moreover, the rule takes into account the Commission's recognition that an SCI entity's investigation regarding an SCI may not yet be complete despite the fact that the SCI event itself has resolved. In such cases, within five business days after the SCI event has resolved and the investigation regarding the SCI event has closed, the Commission believes that it is reasonable and necessary to provide it with a comprehensive and complete understanding of the SCI event. Consequently, SCI entities are required to submit a final written notification that contains all information required by Rule 1002(b).

Goals of Adopted Commission Notification Rule

As discussed in greater detail above, the Commission has carefully considered the views of commenters as well as what it believes is necessary for the Commission and its staff with respect to the timing and content of notifications regarding SCI events, and believes that the adopted rule will be less burdensome for SCI entities than if the proposed rule was adopted without modification, while still resulting in meaningful notice to the Commission and its staff

with information about SCI events in a timely manner that permits the Commission to fulfill its oversight role.

With regard to comments on the resource and efficiency demands of the notification requirements,⁹²¹ the Commission believes that while SCI entities will need to devote resources to fulfilling the notification requirements, the Commission does not believe that these resources will diminish SCI entities' ability to respond to SCI events because it is the Commission's experience that the staff that engages in corrective action is generally distinct from the staff that has been charged with notifying the Commission of systems issues. Consequently, the Commission does not believe that, due to this requirement, staff that engages in corrective action will be unable to fulfill its responsibilities after implementation of Regulation SCI.

The Commission believes that adopted Rules 1002(b)(1)-(4) are responsive to concerns that the proposed Commission notification requirements would have required SCI entities to notify the Commission of information before all relevant facts are known.⁹²² As discussed, in tandem with the revised triggering standard, which affords an SCI entity time to assess whether an SCI event has occurred,⁹²³ the adopted rule affords an SCI entity the flexibility to gather information for the 24-hour written notification on a good faith best, efforts basis,⁹²⁴ and adopted Rule 1002(b)(3) makes clear that an SCI entity is required to update the Commission to correct any materially inaccurate information previously provided, or when pertinent new information is discovered, until such time as the SCI event is resolved, and the SCI entity's investigation of the

⁹²¹ See supra notes 790-793.

⁹²² See supra note 804 and accompanying text.

⁹²³ See supra Section IV.B.3.a (discussing the triggering standard).

⁹²⁴ See supra discussion of "good faith, best efforts" above.

SCI event is closed. Further, the final report for a given SCI event is only required once, when both the SCI event is resolved and the SCI entity's investigation of the SCI event is closed, with an interim report required only when an SCI event is not resolved or the SCI entity's investigation of the SCI event is not closed within 30 days of the occurrence of the SCI event. Taken together, the Commission believes that Rule 1002(b) does not require reporting before all relevant fact are known, which one commenter suggested would be counterproductive and harmful.⁹²⁵ Instead, the Commission believes that the rule is designed to provide SCI entities with a process that gives them sufficient time to submit information to the Commission when known. In addition, and in response to comment questioning the usefulness of the notification requirement for the Commission,⁹²⁶ the Commission believes that adopted Rule 1002(b) will foster a system for comprehensive reporting of SCI events, which should enhance the Commission's review and oversight of U.S. securities market infrastructure and foster cooperation between the Commission and SCI entities in responding to SCI events. The Commission also believes that the aggregated data that will result from the reporting of SCI events will enhance its ability to comprehensively analyze the nature and types of various SCI events and identify more effectively areas of persistent or recurring problems across the systems of all SCI entities. Some commenters suggested that the Commission provide to SCI entities regular summary-level feedback on SCI entities' notifications⁹²⁷ or provide examples of the types of SCI events that warrant notification.⁹²⁸ To the extent it believes that guidance or other

⁹²⁵ See supra note 804.

⁹²⁶ See supra note 793.

⁹²⁷ See supra note 806 and accompanying text.

⁹²⁸ See supra note 807 and accompanying text.

information, including summary-level feedback, publications, or reference blueprints, would be appropriate to share, the Commission or its staff may do so in the future.

d. Dissemination of Information – Rule 1002(c)

i. Proposed Rule 1000(b)(5)

Proposed Rule 1000(b)(5) would have required an SCI entity to provide specified information relating to “dissemination SCI events” to SCI entity members or participants. The term “dissemination SCI event” was proposed to mean an SCI event that is a: (1) systems compliance issue; (2) systems intrusion; or (3) systems disruption that results, or the SCI entity reasonably estimates would result, in significant harm or loss to market participants.

Proposed Rule 1000(b)(5)(i)(A) would have required an SCI entity, promptly after any responsible SCI personnel becomes aware of a dissemination SCI event other than a systems intrusion, to disseminate to its members or participants the following information about such SCI event: (1) the systems affected by the SCI event; and (2) a summary description of the SCI event. Proposed Rule 1000(b)(5)(i)(B) would have required an SCI entity to further disseminate to its members or participants, when known: (1) a detailed description of the SCI event; (2) the SCI entity’s current assessment of the types and number of market participants potentially affected by the SCI event; and (3) a description of the progress of its corrective action for the SCI event and when the SCI event has been or is expected to be resolved. Proposed Rule 1000(b)(5)(i)(C) would have further required an SCI entity to provide regular updates to members or participants on any of the information required to be disseminated under proposed Rules 1000(b)(5)(i)(A) and (i)(B). In the case of a systems intrusion, the proposed rule permitted a limited delay in dissemination if the dissemination would compromise the security of the SCI

entity's systems.⁹²⁹ Except for the delay in dissemination of information for systems intrusions in specified circumstances, the proposed rule did not distinguish dissemination obligations based on the severity or impact of a dissemination SCI event.

ii. Comments Regarding Information Dissemination

Two commenters generally supported proposed Rule 1000(b)(5).⁹³⁰ One commenter characterized it as "one of the major benefits of th[e] proposal."⁹³¹ Another commenter suggested broadening the proposal to require an SCI entity to reveal dissemination SCI events to the public at large, and not just to its members or participants.⁹³² This commenter believed that public dissemination of the facts of an SCI event would help enhance investor confidence by preventing speculation and misinformation, and would provide important learning opportunities for the industry and other SCI entities.⁹³³

⁹²⁹ See proposed Rule 1000(b)(5)(ii) (permitting a delay in dissemination of information regarding a systems intrusion if "the SCI entity determines that dissemination of such information would likely compromise the security of the SCI entity's SCI systems or SCI security systems, or an investigation of the systems intrusion, and documents the reasons for such determination").

⁹³⁰ See Angel Letter at 5; and MFA Letter at 7.

⁹³¹ See Angel Letter at 5. This commenter stated: "Instead of keeping information about hardware failures, system intrusions, and software glitches private, sharing the information will alert others in the industry about such problems and help to reduce system wide costs of diagnosing problems, as well as result in improved responses to technology problems. These will serve as warnings to the other SCI entities to stay vigilant to prevent similar problems from occurring on their platforms." Angel Letter at 5.

⁹³² See MFA Letter at 7.

⁹³³ See *id.*

In contrast, many commenters urged the Commission to revise the proposed dissemination requirement.⁹³⁴ For example, a few commenters expressed concern that the proposal would require dissemination of too much information too soon.⁹³⁵ One of these commenters stated that the proposed rule would be counterproductive and harmful because it would cause the release of information before all relevant facts are known and suggested dissemination should only be required when the SCI entity has credible information that can be acted upon.⁹³⁶ Another commenter suggested that dissemination should only be required when the information to be disseminated is certain and clear.⁹³⁷ Another commenter urged that, if immediate dissemination is required, then the information required to be disseminated should be limited to communication of the basic fact that there is a systems issue and additional information will be provided when known.⁹³⁸

Several commenters opposed requiring information dissemination to all members and participants.⁹³⁹ For example, some commenters urged that an SCI entity be required to provide information only to members or participants actually impacted by an SCI event, or that interact

⁹³⁴ See, e.g., NYSE Letter at 28-29; FINRA Letter at 24; BATS Letter at 13; DTCC Letter at 11-12; OCC Letter at 16; CME Letter at 9-10; ICI Letter at 4; Oppenheimer Letter at 2; Direct Edge Letter at 8; Omgeo Letter at 21; ITG Letter at 13; and FIA PTG Letter at 3.

⁹³⁵ See, e.g., DTCC Letter at 12, NYSE Letter at 29; and ITG Letter at 13.

⁹³⁶ See ITG Letter at 13. See also supra note 804 and accompanying text.

⁹³⁷ See DTCC Letter at 12.

⁹³⁸ See NYSE Letter at 29 (stating also that the scope of the information required to be provided is too extensive, particularly given the timing requirements of the proposed rule).

⁹³⁹ See, e.g., MSRB Letter at 20-21; DTCC Letter at 11; CME Letter at 10; NYSE Letter at 28; FINRA Letter at 24-25; ISE Letter at 6-7; SIFMA Letter at 15; and OCC Letter at 17.

with the SCI system impacted, rather than to all members or participants of an SCI entity.⁹⁴⁰

One commenter recommended that an SCI entity be required to disseminate information only to persons reasonably likely to be affected by a significant systems issue.⁹⁴¹ Two commenters stated that SCI entities should have reasonable discretion to determine who among their members and participants should receive notification of an SCI event, as well as the manner and timing for providing notice.⁹⁴² A few commenters more broadly expressed concern that the proposed rule would result in over-reporting of information about SCI events and would have limited usefulness.⁹⁴³ Some of these commenters stated that the proposed approach would result in SCI entity members and participants becoming immunized to the notifications because they would receive too many notifications and therefore would not focus on the truly significant events.⁹⁴⁴

⁹⁴⁰ See MSRB Letter at 20-21; DTCC Letter at 11; CME Letter at 9; NYSE Letter at 28; FINRA Letter at 25; and ISE Letter at 6-7. In addition, one of these commenters sought clarification on whether the term “participant” refers to a formal participant or, more broadly speaking, any market participant that interacts with the SCI system in question. See MSRB Letter at 20. See also Omgeo Letter at 21, and *infra* note 954.

⁹⁴¹ See NYSE Letter at 28.

⁹⁴² See SIFMA Letter at 15 (urging that an SCI entity should have discretion to determine which participants or members are affected and how to notify them); and OCC Letter at 17 (urging that an SCI entity should be able to limit the communication to those members and participants that are actually affected and to provide the communication on a confidential and secure basis when the SCI entity has reasonable certainty of the information that is required to be provided).

⁹⁴³ See, e.g., CME Letter at 9; FIA PTG Letter at 3; and Omgeo Letter at 39. See also Fidelity Letter at 5 (requesting that the Commission provide greater specificity regarding the types of dissemination SCI events that must be disclosed and to whom disclosure must be made).

⁹⁴⁴ See, e.g., Omgeo Letter at 40; FIA PTG Letter at 3; and CME Letter at 9.

Several commenters suggested that the Commission apply the proposed dissemination requirement to fewer types of SCI events.⁹⁴⁵ For example, several commenters stated that information dissemination should only be required for material or significant SCI events.⁹⁴⁶ One commenter suggested that, for an SCI event that is “de minimis,” information dissemination to members or participants should not be required at all.⁹⁴⁷ This commenter suggested that a de minimis SCI event would be one that is limited in impact, brief in duration, or involves little or no member or participant harm.⁹⁴⁸ Another commenter noted that, as proposed, Commission notification would be required for a systems disruption if the systems disruption had a “material impact” on the SCI entity’s operations or on market participants, whereas information dissemination to members or participants would be required if an SCI entity reasonably estimated that the systems disruption would result “in significant harm or loss to market participants.”⁹⁴⁹ This commenter criticized the differing standards for Commission notification and member/participant notification and suggested that the Commission clarify the standards or adopt a uniform standard for both types of notifications.⁹⁵⁰

Several commenters specifically opposed the proposed dissemination requirement for systems compliance issues. Some commenters urged that an SCI entity be required to

⁹⁴⁵ See, e.g., NYSE Letter at 28; FIA PTG Letter at 3; FINRA Letter at 24; BATS Letter at 13; OCC Letter at 16-17; CME Letter at 9-10; ICI Letter at 4; Oppenheimer Letter at 2; and Direct Edge Letter at 8.

⁹⁴⁶ See NYSE Letter at 28; FIA PTG Letter at 3; FINRA Letter at 24; BATS Letter at 13; OCC Letter at 16-17; CME Letter at 9-10; ICI Letter at 4; Oppenheimer Letter at 2; and Direct Edge Letter at 8.

⁹⁴⁷ See BATS Letter at 13.

⁹⁴⁸ See *id.*

⁹⁴⁹ See OCC Letter at 16.

⁹⁵⁰ See *id.*

disseminate information only for material or significant systems compliance issues.⁹⁵¹ One of these commenters stated that prompt dissemination of information regarding systems compliance issues to members or participants might lead to widespread dissemination of extraneous and potentially inaccurate information.⁹⁵²

Regarding systems intrusions, a few commenters stated that dissemination of systems intrusions information could raise significant risks and security concerns.⁹⁵³ One commenter recommended that a dissemination requirement apply only in the case of members, participants, or clients for whom confidential data was disclosed, processing was impacted, or where such member, participant, or client could take further action to mitigate the risk of such disclosure.⁹⁵⁴ This commenter also expressed support for the limited exception for intrusions that would compromise an investigation or resolution of the systems intrusion, noting that once dissemination would no longer compromise an investigation or the resolution of the issue, the entity should notify materially affected members, participants, or clients.

One commenter stated that information should not be disseminated regarding disruptions in regulatory or surveillance systems, nor should information be disseminated about intrusions or compliance issues, arguing that the information could be misused, or if disseminated too soon,

⁹⁵¹ See, e.g., FINRA Letter at 24; Joint SROs Letter at 9; SIFMA Letter at 12; BATS Letter at 13; MSRB Letter at 6; and CME Letter at 10.

⁹⁵² See Joint SROs Letter at 8.

⁹⁵³ See DTCC Letter at 11; and NYSE Letter at 29. See also Direct Edge Letter at 3 (suggesting that, to ensure that sensitive information does not fall into the wrong hands, the Commission should require reporting of systems intrusions to the Commission, and only require public disclosure in instances where there is a risk of significant harm to the SCI entity's customers).

⁹⁵⁴ See Omgeo Letter at 21.

could be inaccurate and misleading.⁹⁵⁵ Two other commenters also expressed concern that information dissemination should not be required when the information provided might be misused to the detriment of the markets or investors, such as with respect to systems intrusions or issues relating to surveillance systems.⁹⁵⁶

iii. Rule 1002(c)

In the SCI Proposal, the Commission stated that the intended purpose of the proposed rule was twofold: to aid members or participants of SCI entities in determining whether their trading activity has been or might be impacted by the occurrence of an SCI event at an SCI entity so that they could consider that information in making trading decisions, seeking corrective action or pursuing remedies, or taking other responsive action; and to provide an incentive for SCI entities to devote more resources and attention to improving the integrity and compliance of their systems and preventing the occurrence of SCI events.⁹⁵⁷ Although commenters generally did not object to the Commission's stated rationale for proposed Rule 1000(b)(5), several commenters suggested that the proposed approach did not adequately consider circumstances in which the proposed information dissemination might not be helpful to the market or market participants, or could be detrimental to the markets or market participants. One commenter, however, urged that public dissemination of information regarding SCI events would help to prevent speculation and misinformation regarding such events.⁹⁵⁸

⁹⁵⁵ See NYSE Letter at 29. See also *supra* note 935 and accompanying text.

⁹⁵⁶ See ICI Letter at 4; and Oppenheimer Letter at 2.

⁹⁵⁷ See Proposing Release, *supra* note 13, at 18120.

⁹⁵⁸ See *supra* note 933 and accompanying text.

The Commission has carefully considered the views of commenters with respect to proposed Rule 1000(b)(5), and has determined to adopt it as Rule 1002(c), with several modifications in response to comment. In particular, the Commission has determined to eliminate the definition of “dissemination SCI event” from the final rule and adopt an information dissemination requirement that scales dissemination obligations in accordance with the nature and severity of an SCI event. In response to comment that the proposed rule would result in over-reporting of information about SCI events and have limited usefulness, the Commission has further focused the rule from the proposal by requiring dissemination of information about SCI events that are not major SCI events only to affected SCI entity members and participants, and excepting de minimis SCI events and SCI events regarding market regulation or market surveillance systems from the information dissemination requirement.⁹⁵⁹ In the case of a “major SCI event,” the Commission agrees with the commenter who stated that requiring dissemination should help to prevent speculation and misinformation regarding such events.⁹⁶⁰ Therefore, in the case of a “major SCI event,” the adopted rule requires an SCI entity to disseminate information to all of its members or participants. At the same time, as with other SCI events, any SCI event that meets the definition of major SCI event that has had, or the SCI entity reasonably estimates would have, no or a de minimis impact on the SCI entity’s operations or on market participants is excepted from the information dissemination requirement.⁹⁶¹ The Commission believes the revised approach will better achieve the purpose of maximizing the

⁹⁵⁹ See supra notes 943-956 and accompanying text.

⁹⁶⁰ See supra note 933 and accompanying text.

⁹⁶¹ See Rule 1002(c)(4)(ii).

utility of information disseminated to SCI entity members and participants while simultaneously reducing compliance burdens for SCI entities.

Rule 1002(c)(1): Information Dissemination for Systems Disruptions and Systems Compliance Issues

Adopted Rule 1002(c)(1) generally addresses dissemination requirements for systems disruptions and systems compliance issues. Rule 1002(c)(1)(i) requires an SCI entity, promptly after any responsible SCI personnel has a reasonable basis to conclude that an SCI event that is a systems disruption or systems compliance issue has occurred, to disseminate information about such SCI event, unless an exception applies. When the dissemination obligation is triggered,⁹⁶² Rule 1002(c)(1)(i) requires an SCI entity to disseminate to the persons specified in Rule 1002(c)(3) information on the system(s) affected by the SCI event and a summary description of the SCI event. Thereafter, Rule 1002(c)(1)(ii) provides that, when known, an SCI entity shall promptly further disseminate: a detailed description of the SCI event; the SCI entity's current assessment of the types and number of market participants potentially affected by the SCI event; and a description of the progress of its corrective action for the SCI event and when the SCI event has been or is expected to be resolved. Rule 1002(c)(1)(iii) provides that, until resolved, an SCI entity shall provide regular updates of any information required to be disseminated under Rules 1002(c)(1)(i) and (ii). The specified types of information and the update requirements are unchanged from the proposal. The Commission continues to believe that, for the dissemination of information to be meaningful, it is necessary for an SCI entity to describe the SCI event in sufficient detail to permit a member or participant to determine whether and how it was affected

⁹⁶² See supra Section IV.B.3.a (discussing the triggering standard).

by the SCI event and make appropriate decisions based on that determination.⁹⁶³ Adopted Rule 1002(c)(1)(i) requires that the information initially disseminated include the systems affected by the SCI event and a summary description of the SCI event, and only after responsible SCI personnel have a reasonable basis to conclude that a systems disruption or systems compliance issue has occurred. Implicit in this requirement is that the disseminated information be accurate. Without the dissemination of accurate information, the impact on the SCI entity's members or participants or the market may be more pronounced because market participants may not recognize that an SCI event is occurring, or may mistakenly attribute unusual market activity to some other cause.

Adopted Rule 1002(c)(1) also requires that required information be disseminated "promptly."⁹⁶⁴ Although the Commission agrees that SCI entities should not prematurely disseminate information regarding an SCI event, lest it be inaccurate, speculative, misleading, or otherwise unhelpful, as some commenters were concerned about,⁹⁶⁵ the Commission does not agree with the commenter who suggested that information dissemination be provided at a time chosen by the SCI entity.⁹⁶⁶ The Commission believes that accurate information that is timely is more likely to aid a market participant in determining whether its trading activity has been or might be impacted by the occurrence of an SCI event than accurate information that is delayed. However, as compared to Commission notification, which is required to be provided immediately after an SCI entity has a reasonable basis to conclude that an SCI event has

⁹⁶³ See Proposing Release, supra note 13, at 18120.

⁹⁶⁴ The persons to whom the required information about systems disruptions and systems compliance issues is to be disseminated are specified in Rules 1002(c)(3) and (4).

⁹⁶⁵ See also supra notes 935-938 and 933 and accompanying text.

⁹⁶⁶ See supra note 942 and accompanying text.

occurred, and which notice may be provided orally, dissemination of information to SCI entity members or participants is required to be provided promptly. The requirement for prompt dissemination, as opposed to immediate dissemination, is designed to provide some limited flexibility to an SCI entity to determine an efficient way to disseminate information to multiple potentially affected members or participants, or all of its members or participants, as the case may be, in a timely manner. Likewise, as new information becomes known, immediate updates are not required, but an SCI entity is obligated to also disseminate updated information "promptly" after it is known. The Commission believes that adopted Rule 1002(c)(1) strikes an appropriate balance by requiring an SCI entity to disseminate specific information about SCI events, but also permits an SCI entity to have time to check relevant facts before disseminating that information. The Commission therefore believes that adopted Rule 1002(c)(1) is responsive to comment that the proposed rule would have required release of information too soon, before it is determined to be credible, or before relevant facts were known.⁹⁶⁷

Rule 1002(c)(2): Information Dissemination for Systems Intrusions

Adopted Rule 1002(c)(2) requires an SCI entity, promptly after any responsible SCI personnel has a reasonable basis to conclude that an SCI event that is a systems intrusion has occurred, to disseminate a summary description of the systems intrusion, including a description of the corrective action taken by the SCI entity and when the systems intrusion has been or is expected to be resolved, unless the SCI entity determines that dissemination of such information would likely compromise the security of the SCI entity's SCI systems or indirect SCI systems, or an investigation of the systems intrusion, and documents the reasons for such determination. This rule applies to systems intrusions that are not de minimis events. In response to

⁹⁶⁷ See supra notes 935-938 and accompanying text.

commenters stating that information about a systems intrusion in many cases will be sensitive and raise security concerns, and those urging that the dissemination requirement apply only in limited cases,⁹⁶⁸ the Commission notes that, although it does not wholly exclude systems intrusions from the dissemination requirement, the rule permits a delay in dissemination of any information about a systems intrusion if dissemination would compromise the security of the SCI entity's SCI systems or indirect SCI systems, or an investigation of the systems intrusion, and the SCI entity documents the reason for such determination.⁹⁶⁹ Adopted Rule 1002(c)(2) also provides that the content of the required disclosure for a systems intrusion is less detailed than required for other types of SCI events. These provisions are unchanged from the SCI Proposal.⁹⁷⁰ As stated in the SCI Proposal, the Commission continues to believe that there may be circumstances in which the dissemination of information related to a systems intrusion should be delayed to avoid compromising the investigation or resolution of a systems intrusion.⁹⁷¹ Also, as stated in the SCI Proposal, the affirmative documentation required by Rule 1002(c)(2) is important to allow the Commission to ensure that SCI entities are not improperly invoking the limited exception provided by Rule 1002(c)(2).⁹⁷² This delayed dissemination provision permits an SCI entity to delay providing information about an intrusion to its members or participants to protect legitimate security concerns. However, under Rule 1002(c)(2), if an SCI entity cannot, or

⁹⁶⁸ See, e.g., supra notes 953-954 and accompanying text.

⁹⁶⁹ See Rule 1002(c)(4) (excepting de minimis systems intrusions and intrusions into market regulation or market surveillance systems from the dissemination requirement) and Rule 1001(c)(2) (permitting a delay in dissemination).

⁹⁷⁰ The persons to whom the required information about a systems intrusion is to be disseminated (provided the circumstances warranting a delay do not apply) is specified in Rules 1002(c)(3) and (4).

⁹⁷¹ See Proposing Release, supra note 13, at 18120.

⁹⁷² See id.

can no longer, determine that information dissemination as required by Rule 1002(c)(2) would likely compromise the security of the SCI entity's SCI systems or indirect SCI systems, or an investigation of the systems intrusion, no delay (or further delay, if applicable) in dissemination is permitted.⁹⁷³ Pursuant to Rule 1002(c)(2), information about a systems intrusion is required to be disseminated eventually, as the Commission believes that circumstances permitting a delay (i.e., dissemination of information would likely compromise the security of the SCI entity's SCI systems or indirect SCI systems, or an investigation of the systems intrusion), will not continue indefinitely.⁹⁷⁴

Rule 1002(c)(3): To Whom Information Is to be Disseminated

Adopted Rule 1002(c)(3) provides that the information required to be provided under Rules 1002(c)(1) and (2) promptly after any responsible SCI personnel has a reasonable basis to conclude that an SCI event has occurred, shall be promptly disseminated by the SCI entity to those members or participants of the SCI entity that any responsible SCI personnel has reasonably estimated may have been affected by the SCI event, and promptly disseminated to any additional members or participants that any responsible SCI personnel subsequently reasonably estimates may have been affected by the SCI event. The rule further requires that, for major SCI events, such information shall be disseminated by the SCI entity to all of its members or participants. As noted, several commenters urged that an SCI entity be required to disseminate information relating to an SCI event only to those members or participants affected

⁹⁷³ See id.

⁹⁷⁴ Some commenters urged modifications to the proposed rule that would further circumscribe the proposed dissemination requirement for systems intrusions. See, e.g., supra notes 953-954 and accompanying text (urging that dissemination for systems intrusions only be required for affected persons and only if material). These comments are addressed in the discussion of adopted Rules 1002(c)(3) and (4).

by the SCI event.⁹⁷⁵ Some suggested that an SCI entity have discretion to determine who should receive information regarding SCI events,⁹⁷⁶ and one suggested that SCI events warrant public disclosure.⁹⁷⁷ Others expressed more general concern that the breadth of the proposed dissemination requirement would result in over-reporting of information about SCI events because they believed that SCI entities would over-report out of an abundance of caution⁹⁷⁸ or that SCI entity members and participants would become immunized to reports of SCI events and not focus on significant events.⁹⁷⁹

After careful consideration of the comments, the Commission believes that, to maximize the utility of information dissemination, a more tailored approach to who should receive information about an SCI event is warranted, based on an SCI event's impact. Because information about an SCI event is likely to be of greatest value to those market participants affected by it, who can use such information to evaluate the event's impact on their trading and other activities and develop an appropriate response, adopted Rule 1002(c)(3) requires prompt dissemination to those members or participants of the SCI entity that any responsible SCI personnel has reasonably estimated may have been affected by the SCI event. With respect to more serious SCI events, however, the Commission believes that dissemination to all members or participants of an SCI entity is warranted. Accordingly, under adopted Regulation SCI, certain SCI events will be defined as "major SCI events."

⁹⁷⁵ See supra note 940 and accompanying text.

⁹⁷⁶ See supra note 942 and accompanying text.

⁹⁷⁷ See supra notes 932-933 and accompanying text.

⁹⁷⁸ See supra note 943 and accompanying text.

⁹⁷⁹ See supra notes 943-944 and accompanying text.

Adopted Rule 1000 defines “major SCI event” as “an SCI event that has had, or the SCI entity reasonably estimates would have: (i) any impact on a critical SCI system; or (ii) a significant impact on the SCI entity’s operations or on market participants.” The Commission believes that dissemination of information regarding a major SCI event to all members or participants of an SCI entity is appropriate because major SCI events are likely to impact a large number of market participants (e.g., with respect to critical SCI systems, a disruption of consolidated market data or the clearance and settlement system, or an event significantly impacting the operations of an exchange).⁹⁸⁰ As noted, one commenter suggested broadening the proposed rule to generally require an SCI entity to reveal dissemination SCI events (other than intrusions) to the public at large. This commenter expressed the view that public dissemination of the facts of an SCI event would help “enhance investor confidence by presenting the facts of the SCI event, preventing speculation and misinformation, and informing the public of corrective action being taken” and would “serve as an important collective learning opportunity” that would allow for “SCI [e]ntities and market participants [to] learn from [the event]...and build upon their policies and controls as appropriate.” This commenter stated further that such an “industry protocol would help strengthen and enhance the integrity and security of our markets.”⁹⁸¹ The Commission agrees with this commenter that it is appropriate for an SCI entity to present the facts, prevent speculation and misinformation, and provide transparency about corrective action being taken when the impact of an SCI event is most likely

⁹⁸⁰ At the same time, the Commission recognizes that some SCI events that meet the definition of “major SCI event” could also qualify as de minimis SCI events. Like other de minimis SCI events, they are excepted from the information dissemination requirement. See Rule 1002(c)(4).

⁹⁸¹ See supra notes 932-933.

to be felt by many market participants (i.e., when it is a major SCI event). In the context of a major SCI event, the Commission believes these goals can be achieved by requiring an SCI entity to disseminate information to all of its members or participants (as opposed to the “public at large”). Moreover, the Commission believes it is appropriate to require dissemination of information on major SCI events to all of the SCI entity’s members or participants because these market participants are the most likely to act on this information. Based on the experience of the Commission and its staff, when an entity disseminates information about a systems issue to all of its members or participants (e.g., on the entity’s website), and that information has the potential to affect the market and investors more broadly (including market participants that may not be members or participants of the SCI entity reporting the event), such information is routinely picked up by financial or other media outlets, and also may be relayed to market participants for whom such information is relevant (e.g., by members or participants of SCI entities to their own clients). Therefore, the Commission believes that when information about a systems issue with broad potential impact is disseminated to all of an SCI entity’s member or participants, such dissemination is tantamount to public dissemination.⁹⁸² As such, the Commission believes that it can achieve the purposes of the rule without requiring public dissemination, and believes that any additional gain in benefits from public dissemination would be minimal. Rule 1002(c)(3) does not specify how an SCI entity is to disseminate information to all of its members or participants when required to do so, but the Commission believes that posting the information on

⁹⁸² The Commission notes that one commenter referred to the dissemination provision in the SCI Proposal as the “public dissemination provision of Proposed Reg SCI.” See NYSE Letter at 28. See also ICI Letter at 4 and Oppenheimer Letter at 4 (each supporting “transparency of SCI events to members and participants of an SCI entity” but recommending that the Commission only require “public dissemination” where such information enhances investor protection).

a website accessible to, at a minimum, all of its member or participants (for example, on a “systems status alerts” page) would meet the rule’s requirements.⁹⁸³

For an SCI event that is neither a major SCI event nor an event identified in Rule 1002(c)(4), however, the information specified in Rule 1002(c)(1) or (2), as applicable, is required to be disseminated by the SCI entity to those members or participants of the SCI entity that any responsible SCI personnel has reasonably estimated may have been affected by the SCI event.⁹⁸⁴ The Commission believes that an SCI entity is generally in the best position to identify those of its members or participants that are or are reasonably likely to be affected by such events. Under this approach, as commenters urged, members or participants not reasonably estimated to be affected by such events will not be the recipients of information likely to be irrelevant to them. The Commission believes that SCI entities will be able to analyze which members or participants are or reasonably likely will be impacted, and the rule requires SCI entities to disseminate information to such members or participants. The requirement that information is to be disseminated only to those members or participants that any responsible SCI personnel has reasonably estimated may have been affected by the SCI event (other than a major SCI event or a de minimis SCI event) addresses the concern raised by some commenters that

⁹⁸³ The Commission notes that, irrespective of the medium chosen to disseminate information to the SCI entity members or participants, the SCI entity would also be required to submit the disseminated information to the Commission as part of the report submitted pursuant to Rule 1002(b)(4). See *supra* Section IV.B.3.c.

⁹⁸⁴ In response to the commenter seeking clarification on whether the term “participant” refers to a formal participant or, more broadly speaking, any market participant that interacts with the SCI system in question (see *supra* note 940), for purposes of adopted Rule 1002, the term “participant” refers to a formal participant. The Commission also notes that, with respect to the MSRB, the term “members” as used in Regulation SCI includes entities that are registered with the MSRB, but does not include “a member of the Board,” which is the definition of “member” in MSRB Rule D-5.

members and participants will become immunized by receiving irrelevant notifications⁹⁸⁵ because, under the adopted approach, members or participants should only receive notifications relevant to them.

Whereas the proposed rule would have required dissemination of information about certain SCI events to all SCI entity members and participants, the adopted rule requires dissemination only to those members and participants reasonably estimated to be affected by an SCI event (other than a major SCI event or a de minimis SCI event). Because it is possible that an SCI entity's reasonable estimate of members or participants affected may change as an SCI event unfolds, the adopted rule also requires prompt dissemination of information to newly identified members or participants reasonably estimated to be affected by an SCI event.⁹⁸⁶ This provision reflects the view that newly identified affected members or participants should receive prompt dissemination of information about an SCI event, just as those originally identified as affected members or participants. Although compliance with this requirement may result in an SCI entity disseminating information at several different times to different members and participants, consistent with commenters' suggestions, the Commission believes that this requirement is appropriately tailored to result in information dissemination being provided to the relevant members or participants of an SCI entity.⁹⁸⁷

⁹⁸⁵ See supra notes 944 and 952 and accompanying text.

⁹⁸⁶ Rule 1002(c)(1) requires that, among other things, the SCI entity must disseminate the SCI entity's current assessment of the types and number of market participants potentially affected by the SCI event, and until resolved, provide regular updates of this and any other information required to be disseminated under the rule.

⁹⁸⁷ The Commission notes that an SCI entity would be in compliance with the rule if it disseminated the required information to all members or participants, rather than disseminating only to those members and participants it reasonably initially estimated to be affected by the event (which might require subsequent dissemination(s) to additional

If an SCI event is a de minimis event – i.e., is an SCI event that has had, or the SCI entity reasonably estimates would have, no or a de minimis impact on the SCI entity's operations or on market participants – the adopted rule does not impose any dissemination requirement.⁹⁸⁸

Adopted Rule 1002(c)(4): Exceptions to the General Rules on Information Dissemination

Adopted Rule 1002(c)(4) provides that the requirements of Rules 1002(c)(1)-(3) shall not apply to: (i) SCI events to the extent they relate to market regulation or market surveillance systems; or (ii) any SCI event that has had, or the SCI entity reasonably estimates would have, no or a de minimis impact on the SCI entity's operations or on market participants. The Commission has added the exception in adopted Rule 1002(c)(4)(i) in response to comments that information should not be disseminated regarding disruptions in regulation and surveillance systems, because dissemination of such information to an SCI entity's members or participants or the public at large could encourage prohibited market activity.⁹⁸⁹ The Commission notes that the exception for market regulation or market surveillance systems is limited to dissemination of information about SCI events related to market regulation or market surveillance systems. Information about an SCI event that impacts other SCI systems would still be required to be

members or participants if its estimate regarding those members or participants that were affected by a given SCI event changes over time).

⁹⁸⁸ See discussion of adopted Rule 1002(c)(4) below (excepting, among other things, de minimis systems SCI events from the dissemination requirement). See also *supra* Section IV.B.3.c (discussing Rule 1002(b)(5), which requires that, for de minimis SCI events, an SCI entity is required to: (i) make, keep, and preserve records relating to all such SCI events; and (ii) submit to the Commission a report, within 30 calendar days after the end of each calendar quarter, containing a summary description of such systems disruptions and systems intrusions, including the SCI systems and, for systems intrusions, indirect SCI systems, affected by such systems disruptions and systems intrusions during the applicable calendar quarter).

⁹⁸⁹ See *supra* notes 955-956 and accompanying text.

disseminated in accordance with Rule 1002(c) even if that same SCI event also impacts market regulation or market surveillance systems.

The exception in Rule 1002(c)(4)(ii) for de minimis SCI events is consistent with the Commission's approach to excluding de minimis SCI events from the immediate Commission notification requirements in Rule 1002(b), and is therefore responsive to comment that notification and dissemination of systems disruptions were subject to differing standards under the proposal,⁹⁹⁰ as well as to the comment that a de minimis SCI event should not be subject to dissemination.⁹⁹¹ With respect to the comment that dissemination should only be required for material or significant SCI events,⁹⁹² while the Commission is not limiting the dissemination requirement as suggested by these commenters, the exception for de minimis SCI events is responsive to this comment, to an extent. Moreover, the Commission believes that a materiality threshold would likely exclude from the information dissemination requirement a large number of SCI events that are not de minimis SCI events, but that an SCI entity's members or participants should be made aware of so that they can quickly assess the nature and scope of those SCI events and identify the appropriate response, including ways to mitigate the impact of the SCI events. The Commission also believes that, even without adopting a materiality threshold, the adopted definitions of SCI systems and indirect SCI systems significantly focus the scope of the Commission dissemination requirements from the SCI Proposal.

⁹⁹⁰ See supra notes 949-950 and accompanying text.

⁹⁹¹ See supra notes 947-948 and accompanying text; Section IV.B.3.c (discussing Rule 1002(b)) and supra note 988 and accompanying text. The Commission notes that, because major SCI events are a subset of SCI events, the exception in Rule 1002(c)(4)(ii) also applies to major SCI events that meet the requirements of that rule.

⁹⁹² See supra note 946 and accompanying text; see also supra notes 941 and 944 and accompanying text.

Consistent with its statements in the SCI Proposal, the Commission notes that the requirements relating to dissemination of information in Regulation SCI relate solely to Regulation SCI.⁹⁹³ Nothing in adopted Regulation SCI should be construed as superseding, altering, or affecting the reporting obligations of SCI entities or their affiliates under other federal securities laws or regulations. Accordingly, in the case of an SCI event, SCI entities or their affiliates subject to the public company reporting requirements of Section 13 or Section 15(d) of the Exchange Act would need to comply with their disclosure obligations pursuant to those provisions (including, for example, with respect to Regulation S-K and Forms 10-K, 10-Q, and 8-K) in addition to their disclosure and reporting obligations under Regulation SCI.⁹⁹⁴ In addition, the Commission also wishes to highlight that the requirements of Rule 1002(c) address to whom and when SCI entities are obligated under Regulation SCI to disseminate information. Subject to any applicable laws or regulations, SCI entities still retain the flexibility to disseminate information—e.g., to their members or participants, the public, or market participants that interact with the affected SCI systems—at any time they determine to be appropriate.

⁹⁹³ See Proposing Release, supra note 13, at 18119, n. 235.

⁹⁹⁴ As an additional example, nothing in adopted Regulation SCI should be construed as superseding any obligations under Regulation FD. SCI entities may also wish to consider staff guidance on this topic. See CF Disclosure Guidance: Topic No. 2, Cybersecurity (October 13, 2011), available at: <http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm>.

4. Notification of Systems Changes – Rule 1003(a)

a. Proposed Definition of Material Systems Change, Proposed Rules 1000(b)(6) and (b)(8)(ii)

Proposed Rule 1000(a) would have defined the term “material systems change” as a change to one or more: (1) SCI systems of an SCI entity that: (i) materially affects the existing capacity, integrity, resiliency, availability, or security of such systems; (ii) relies upon materially new or different technology; (iii) provides a new material service or material function; or (iv) otherwise materially affects the operations of the SCI entity; or (2) SCI security systems of an SCI entity that materially affects the existing security of such systems. In the SCI Proposal, the Commission set forth examples that it preliminarily believed could be included within the proposed definition of material systems change.⁹⁹⁵

Proposed Rule 1000(b)(6)(i) would have required an SCI entity, absent exigent circumstances, to notify the Commission in writing at least 30 calendar days before implementation of any planned material systems changes, including a description of the planned material systems changes as well as the expected dates of commencement and completion of implementation of such changes. If exigent circumstances existed, or if the information previously provided to the Commission regarding any planned material systems change had

⁹⁹⁵ These examples included: major systems architecture changes; reconfiguration of systems that would cause a variation greater than five percent in throughput or storage; the introduction of new business functions or services; changes to external interfaces; changes that could increase susceptibility to major outages; changes that could increase risks to data security; changes that were, or would be, reported to or referred to the entity’s board of directors, a body performing a function similar to the board of directors, or senior management; and changes that could require allocation or use of significant resources. See Proposing Release, supra note 13, at 18105-06. These examples were cited in the 2001 Staff ARP Interpretive Letter. The Commission also stated its preliminary belief that any systems change occurring as a result of the discovery of an actual or potential systems compliance issue would be material. See id.

become materially inaccurate, proposed Rule 1000(b)(6)(ii) would have required the SCI entity to notify the Commission, either orally or in writing, with any oral notification to be memorialized within 24 hours after such oral notification by a written notification, as early as reasonably practicable. A written notification to the Commission made pursuant to proposed Rule 1000(b)(6) would have been required to be made electronically on Form SCI and include all information as prescribed in Form SCI and the instructions thereto.

Proposed Rule 1000(b)(8)(ii) would have required each SCI entity to submit to the Commission a report, within 30 calendar days after the end of June and December of each year, containing a summary description of the progress of any material systems change during the six month period ending on June 30 or December 31, as the case may be, and the date, or expected date, of completion of implementation of such changes. A written notification to the Commission made pursuant to proposed Rule 1000(b)(8)(ii) would have been required to be made electronically on Form SCI and include all information as prescribed in Form SCI and the instructions thereto.

b. Quarterly and Supplemental Material Systems Change Reports – Rule 1003(a)

i. Adopted Rule 1003(a)(1): Quarterly Material Systems Change Reports

Many commenters viewed the proposed 30-day advance notification requirement for material systems changes as burdensome.⁹⁹⁶ For example, one commenter believed that the Commission significantly underestimated the number of material systems changes, and

⁹⁹⁶ See, e.g., NYSE Letter at 26; BATS Letter at 14; ISE Letter at 8; BIDS Letter at 14; UBS Letter at 3-4; SIFMA Letter at 15; ITG Letter at 8 and 13; FIF Letter at 5; MFA Letter at 5-6; CME Letter at 11; FINRA Letter at 27; Joint SROs Letter at 7; and OTC Markets Letter at 20.

suggested that the proposal might require reporting of as many as 60 material systems changes per week, rather than that same amount per year, as the Commission estimated in the SCI Proposal.⁹⁹⁷ Some commenters stated that many SCI entities implement frequent agile modifications rather than major episodic or “waterfall” changes, and therefore viewed the proposed 30-day advance notification requirement as favoring a model that employs waterfall changes over agile changes.⁹⁹⁸ Several commenters stated more broadly that the proposed requirement would mandate constant reporting that would stifle innovation, interfere with an SCI entity’s natural planning and development process, and potentially do more harm than good by curtailing an SCI entity’s ability to respond to systems issues with appropriate fixes.⁹⁹⁹ Several commenters also expressed concern that the burden of reporting would incentivize an SCI entity to change its systems less often instead of making smaller and more frequent iterative systems adjustments, which they believed would be inconsistent with current software best practices, curtail innovation, and expose their systems to increased risk.¹⁰⁰⁰ One commenter questioned the purpose of the proposed requirement, stating that the Commission has not presented any empirical evidence that major or material technology changes by SCI entities are in fact the leading cause of market disruption, and that non-material systems changes by SCI entities and

⁹⁹⁷ See BATS Letter at 14. See also NYSE Letter at 26; and ISE Letter at 8 (stating that the proposal would require reporting of too many routine changes), and *infra* discussion of the definition of material systems change.

⁹⁹⁸ See KCG Letter at 19; FIF Letter at 5; UBS Letter at 4; and ITG Letter at 8. “Agile” software development, which involves smaller, more frequent changes in software code, is contrasted with the “waterfall” methodology, which involves larger, episodic software overhauls.

⁹⁹⁹ See KCG Letter at 19; FIF Letter at 5; UBS Letter at 4; BATS Letter at 14; and ITG Letter at 8. See also SunGard Letter at 3.

¹⁰⁰⁰ See KCG Letter at 19; FIF Letter at 5; UBS Letter at 4; BATS Letter at 14; and ITG Letter at 8. See also SIFMA Letter at 16.

non-SCI entities have a high likelihood of causing market disruptions, but they are not captured by the proposal.¹⁰⁰¹ At the same time, this commenter stated that providing 30-day advance notification of these non-material systems changes would hamstring SCI entities.¹⁰⁰²

Some commenters also noted that Regulation ATS already requires an ATS to report material changes to the operation of the ATS at least 20 calendar days prior to their implementation.¹⁰⁰³ One of these commenters noted that it is common for an ATS to finalize the systems specifications for a change close to when the ATS wants to go live with the change, but the ATS must wait 20 days before implementation, and occasionally the questions from Commission staff can further delay implementation.¹⁰⁰⁴ This commenter expressed concern that Regulation SCI would lengthen the notification requirement to 30 calendar days and broaden the requirement to include any significant systems change, not just a material change to the operation of the ATS.¹⁰⁰⁵

The Commission continues to believe that it is important to receive notifications of planned and implemented material changes to SCI systems or the security of indirect SCI systems in connection with its oversight of U.S. securities market infrastructure.¹⁰⁰⁶ However,

¹⁰⁰¹ See SunGard Letter at 3.

¹⁰⁰² See *id.*

¹⁰⁰³ See BIDS Letter at 14; and ITG Letter at 8.

¹⁰⁰⁴ See ITG Letter at 8.

¹⁰⁰⁵ See *id.*

¹⁰⁰⁶ See Proposing Release, *supra* note 13, at 18122, 18144. As noted above, one commenter argued that the Commission has not presented any empirical evidence that major or material technology changes by SCI entities are in fact the leading cause of market disruption, and that non-material systems changes have a high likelihood of causing market disruptions. See *supra* note 1001 and accompanying text. The Commission notes that the primary purpose of Rule 1003(a) is not to prevent market disruptions. Rather, it is to keep the Commission and its staff informed of the systems changes that SCI entities

after considering the views of commenters regarding the 30-day advance notification requirement, the Commission is instead adopting a quarterly reporting requirement, which will permit the Commission and its staff to have up-to-date information regarding an SCI entity's systems development progress and plans, to aid in understanding the operations and functionality of the systems and any material changes thereto, without requiring SCI entities to submit a notification to the Commission for each material systems change.¹⁰⁰⁷ Specifically, Rule 1003(a)(1) requires an SCI entity, within 30 calendar days after the end of each calendar quarter, to submit to the Commission a report describing completed, ongoing, and planned material systems changes to its SCI systems and security of indirect SCI systems, during the prior, current, and subsequent calendar quarters, including the dates or expected dates of commencement and completion.¹⁰⁰⁸

determine to be material, which will assist the Commission with its oversight of U.S. securities market infrastructure. While the Commission acknowledges that non-material systems changes could cause market disruptions, the Commission agrees with this commenter that requiring Commission notification of all systems changes would be burdensome. See *supra* note 1002 and accompanying text (noting this commenter's view that providing 30-day advance notification of non-material systems changes would hamstring SCI entities).

¹⁰⁰⁷ As discussed in more detail below, the Commission is also not adopting the proposed definition of material systems change or the proposed semi-annual reporting requirement.

¹⁰⁰⁸ Using the quarter ending December 31, 2014 as an example, an SCI entity would be required to submit a report by January 30, 2015 (*i.e.*, within 30 calendar days after December 31, 2014) that describes material systems changes that the SCI entity has made (including the dates when those changes commenced and were completed), are currently implementing (including the dates when those changes commenced and are expected to be completed), and plan to make (including the dates those changes are expected to commence and complete) for the period from October 1, 2014 (the beginning of the prior calendar quarter) through June 30, 2015 (the end of the subsequent calendar quarter). The next report that corresponds to the quarter ending March 31, 2015 would be required to be submitted by April 30, 2015. As discussed in more detail below, Rule 1003(a)(2) requires an SCI entity to promptly submit a supplemental report notifying the

The Commission believes that elimination of the 30-day advance notification requirement for material systems changes is responsive to commenters who were concerned that the proposed approach was unsuited to the agile systems development methodology that some SCI entities use today. In particular, an SCI entity will have the ability to implement material systems changes without having to individually report each material systems change to the Commission 30 days in advance, which commenters noted could lead SCI entities to favor the waterfall methodology of systems changes over the agile methodology.¹⁰⁰⁹ The Commission also believes that the adopted quarterly reporting requirement provides more flexibility to SCI entities with respect to the timing of implementing material systems changes. In particular, SCI entities will not be required to wait 30 calendar days after notifying the Commission in order to implement a material systems change. Therefore, the adopted rule is responsive to commenters who stated that the proposed rule would stifle innovation, interfere with an entity's planning and development process, and expose SCI entities' systems to risk. Moreover, the Commission believes that elimination of the proposed 30-day advance notification requirement is responsive to commenters' concern that ATSS are already required to report material changes to the

Commission of a material error in or material omission from a report previously submitted under Rule 1003(a)(1).

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At the same time, because systems changes utilizing the waterfall methodology are often planned well in advance, these systems changes would generally be included in the quarterly report, as Rule 1003(a) requires the quarterly report to describe, among other things, planned material systems changes during the subsequent calendar quarter. However, this requirement of Rule 1003(a) is not limited to planned material systems changes utilizing the waterfall methodology, but also would apply to planned material systems changes utilizing other development methodologies, including the agile methodology.

operation of the ATSS at least 20 calendar days prior to implementation, and that proposed Regulation SCI would extend the advance notification period to 30 calendar days.¹⁰¹⁰

The Commission also believes that adopting the quarterly reporting requirement instead of the 30-day advance notification requirement lessens SCI entities' burden of compliance as compared to the proposal.¹⁰¹¹ For example, rather than submitting a Form SCI for each material systems change, an SCI entity is now required to submit four reports each year pursuant to Rule 1003(a)(1) and, as applicable, supplemental reports pursuant to Rule 1003(a)(2). To the extent certain material systems changes are related or similar, an SCI entity will not be required to separately notify the Commission of each change. Instead, the SCI entity can describe such related changes within the single quarterly report. The Commission also believes that this quarterly report process will provide the Commission and its staff with a more efficient framework to review material systems changes that are described in the larger context afforded by such periodic reports, rather than parsing every submission that reports a material systems change.¹⁰¹²

¹⁰¹⁰ The Commission notes that the adoption of Rule 1003(a) does not affect an SCI ATS's existing obligation under Rule 301(b)(2)(ii) of Regulation ATS to file amendments on Form ATS at least 20 calendar days prior to implementing material change to the operation of the ATS. Therefore, with respect to a material systems change, an SCI ATS may be required to describe such change in a quarterly report under Rule 1003(a) and submit an amendment to Form ATS.

¹⁰¹¹ See supra notes 996-997 and accompanying text.

¹⁰¹² The Commission acknowledges that some systems changes deployed by an SCI entity may not by themselves be considered material by the SCI entity, but that, in the aggregate, can be considered material by the SCI entity (e.g., making a series of small systems changes over time in order to implement a broad systems change). The Commission believes that the adopted quarterly reporting requirement is better suited to capture such changes than the proposed 30-day advance notification requirement (i.e., 30-day advance notification for each single systems change that is by itself considered material by the SCI entity).

One commenter expressed concern that the proposed exception for exigent circumstances was too narrow.¹⁰¹³ Because adopted Rule 1003(a)(1) requires quarterly reports of material systems changes rather than 30-day advance notification of each material systems change, the Commission is not adopting the proposed "exigent circumstances" exception. Specifically, the Commission notes that the purpose of the exception was to accommodate situations where it would not be prudent or desirable for an SCI entity to delay a systems change simply to provide 30-day advance notification of the change. At the same time, the Commission notes that, because Rule 1003(a)(1) requires in part a description of completed, ongoing, and planned material systems changes during the prior and current calendar quarters, an SCI entity's quarterly report will be required to include a description of all material changes to its SCI systems or the security of its indirect SCI systems, including those that have been implemented in response to exigent circumstances during the prior and current calendar quarters.

Several commenters suggested possible alternatives to the proposed requirements related to material systems changes. Some commenters suggested eliminating the proposed advance notification requirement for material systems changes.¹⁰¹⁴ One of these commenters explained that information regarding material systems changes would be available to the Commission during an inspection, but stated that, if an advance notification requirement is adopted, it should be folded into the proposed semi-annual reporting requirement.¹⁰¹⁵ Another commenter similarly urged that the Commission require only semi-annual reporting of material systems

¹⁰¹³ See BATS Letter at 15.

¹⁰¹⁴ See MFA Letter at 7 and ITG Letter at 13-14. See also Joint SROs Letter at 8 (stating that material systems changes should be reported in a periodic, post-hoc basis, as was required under ARP).

¹⁰¹⁵ See MFA Letter at 7.

changes, as proposed in Rule 1000(b)(8).¹⁰¹⁶ One commenter supported the reporting of material systems changes in the annual SCI review report.¹⁰¹⁷ One commenter believed that information related to systems changes should be reported periodically.¹⁰¹⁸ Another commenter noted that if the Commission retains the 30-day advance notification requirement, it should be limited to material systems changes of only higher priority SCI systems and that notifications of changes to lower criticality systems could be provided at the time of the change or periodically.¹⁰¹⁹

Some commenters suggested that the Commission provide more flexibility and allow SCI entities more time to report material systems changes.¹⁰²⁰ One commenter supported giving SCI entities discretion to determine the appropriate timing and format for reporting changes to the Commission, and stated that the current practice under ARP to submit quarterly reports that cover changes for the previous and upcoming quarters has proven effective in keeping the Commission staff apprised of planned and completed systems changes.¹⁰²¹

One commenter suggested that SCI entities be required to keep records of all systems changes and technical issues, and make that information available to the Commission upon

¹⁰¹⁶ See Direct Edge Letter at 8.

¹⁰¹⁷ See CME Letter at 11.

¹⁰¹⁸ See NYSE Letter at 27.

¹⁰¹⁹ See SIFMA Letter at 15.

¹⁰²⁰ See NYSE Letter at 27; FINRA Letter at 27; and MSRB Letter at 22. See also CME Letter at 11 (stating “instead of setting firm time limits under which an entity is required to submit notifications of material systems changes under Rule 1000(b)(6), the Commission should instead simply require ‘timely advance notice of all material planned changes to SCI systems that may impact the reliability, security, or adequate scalable capacity of such systems’”).

¹⁰²¹ See FINRA Letter at 27.

request.¹⁰²² If the Commission decides to retain the notification requirement, this commenter recommended that it be satisfied through periodic (ideally, quarterly) reporting of material systems changes.¹⁰²³ One commenter believed the Commission should allow all 30-day advance notifications regarding pending material systems changes to be communicated orally, and only submitted in writing after development and testing is completed and the feature is finalized.¹⁰²⁴

The Commission believes that the adopted quarterly reporting requirement is responsive to commenters who requested additional flexibility or time for material systems change notifications, as well as to commenters who suggested that such notices be submitted on a periodic or quarterly basis.¹⁰²⁵ The Commission does not agree with the commenters who suggested that the Commission completely eliminate the advance notification requirements. The Commission believes that advance notifications of planned material systems changes will help ensure that the Commission has up-to-date information regarding important future systems changes at an SCI entity, to aid in its understanding of the operations and functionality of the systems post-change.¹⁰²⁶ As adopted, Rule 1003(a)(1) requires an SCI entity to provide the

¹⁰²² See OTC Markets Letter at 20.

¹⁰²³ See *id.* This commenter also noted that this would allow for the elimination of proposed Rule 1000(b)(6)(ii), which required notices for material inaccuracies in prior notifications. See OTC Markets Letter at 20-22. According to this commenter, quarterly updates would disclose material deviations from plans described in a previous report, whether stemming from inaccuracies in prior reports or new information that prompts beneficial deviations from a systems implementation plan. See *id.*

¹⁰²⁴ See Omgeo Letter at 22.

¹⁰²⁵ Because the Commission is only adopting a quarterly reporting requirement for material systems changes, the adopted approach is responsive to a commenter's suggestion that notifications of changes to lower criticality systems could be provided at the time of the change or periodically. See *supra* note 1019 and accompanying text.

¹⁰²⁶ The Commission acknowledges that there may occasionally be unexpected material systems changes that are not reported to the Commission in advance, but expects that

Commission with advance notification of planned material systems changes in the current and subsequent quarters through the quarterly reports. As noted above, after considering the views of commenters, the Commission is not adopting the proposed 30-day advance notification requirement for each material systems change.

The Commission is also not adopting commenters' suggestion that material systems changes be reported semi-annually or annually.¹⁰²⁷ As noted in the SCI Proposal, proposed Rule 1000(b)(8)(ii) required semi-annual reports because the proposal would have separately required information relating to each planned material systems change to be submitted at least 30 calendar days before its implementation.¹⁰²⁸ Thus, in the SCI Proposal, the Commission stated its preliminary view that requiring ongoing summary reports more frequently would not be necessary.¹⁰²⁹ At the same time, the Commission expressed the concern that a longer period of time would permit significant updates and milestones relating to systems changes to occur without notice to the Commission.¹⁰³⁰ Because the Commission is not adopting the 30-day advance notification requirement, the Commission believes that it is appropriate to require more frequent reports of material systems changes than on a semi-annual basis. Further, as noted above, some commenters suggested quarterly reports, which is consistent with the practice of some entities under the ARP Inspection Program.¹⁰³¹

material systems changes generally will be planned well in advance and reported in the quarterly report accordingly.

¹⁰²⁷ See supra notes 1015-1017 and accompanying text.

¹⁰²⁸ See Proposing Release, supra note 13, at 18124.

¹⁰²⁹ See id.

¹⁰³⁰ See id.

¹⁰³¹ See supra notes 1021, 1023 and accompanying text.

The Commission does not agree with the commenter who suggested that Regulation SCI should only require SCI entities to keep records of all systems changes and make that information available to the Commission upon request.¹⁰³² Similarly, the Commission does not agree with commenters who suggested that SCI entities be given discretion to determine the timing of the reports.¹⁰³³ The Commission believes that quarterly reporting of material systems changes will help ensure that the Commission has, on an ongoing basis, a comprehensive view and up-to-date information regarding material systems changes at an SCI entity.

With respect to the commenter who suggested that all 30-day advance material systems change notifications should be provided orally, and submitted in writing only after the changes are fully tested and implemented,¹⁰³⁴ the Commission notes that it is not adopting the proposed 30-day advance notification requirement for material systems changes.

With respect to the commenter who suggested giving SCI entities discretion to determine the format for reporting changes to the Commission,¹⁰³⁵ the Commission notes that Rule 1003(a) does not prescribe a specific style that the quarterly reports should take. The Commission intends for the quarterly report to allow the Commission and its staff to gain a sufficient level of understanding of the material systems changes that have been implemented, are on-going, and are planned for the future, which would aid the Commission and its staff in understanding the

¹⁰³² See supra note 1022 and accompanying text. As discussed above, this commenter also stated that, if the Commission decides to retain the notification requirement for material systems changes, the Commission should require periodic (ideally, quarterly) reporting. See supra note 1023 and accompanying text. Adopted Rule 1003(a)(1) is consistent with this commenter's alternative suggestion.

¹⁰³³ See supra note 1021 and accompanying text. See also supra note 1020.

¹⁰³⁴ See supra note 1024 and accompanying text.

¹⁰³⁵ See supra note 1021 and accompanying text.

operations and functionality of the systems of an SCI entity and any changes to such systems. In particular, the Commission notes that Rule 1003(a)(1) only specifically requires the quarterly reports to “describe” the material systems changes and the dates or expected dates of their commencement and completion. Therefore, Rule 1003(a)(1) gives each SCI entity reasonable flexibility in determining precisely how to describe its material systems changes in the report in a manner that best suits the needs of that SCI entity as well as the needs of the Commission and its staff.¹⁰³⁶ In addition, to the extent the Commission seeks additional information about a given change noted in a quarterly report, an SCI entity would be required to provide Commission staff with such information in accordance with Rule 1005 (Recordkeeping Requirements Related to Compliance with Regulation SCI).¹⁰³⁷

The Commission also notes that the quarterly reports are required to include descriptions of material systems changes during the prior calendar quarter that were completed, ongoing, or planned. Therefore, if a report for the first quarter of a given year discusses the SCI entity’s plan to implement a particular series of material changes to an SCI system, Rule 1003(a)(1) requires that, in the report for the second quarter of that year, the SCI entity describe the material systems changes that were completed, ongoing, and planned in the first quarter, including the planned changes discussed in the prior quarter’s report, as applicable.

Several commenters expressed concern that the proposed 30-day advance notification requirement would potentially give the Commission new authority to “reject” a Form SCI filing describing material systems changes, similar to the way the Commission may reject an

¹⁰³⁶ See also Omgeo Letter at 43 (requesting that the Commission specify in the final rule the required content for a planned material systems change notification).

¹⁰³⁷ See *infra* Section IV.C.

improperly filed proposed rule change pursuant to Rule 19b-4 under the Exchange Act.¹⁰³⁸

Three commenters requested that the Commission clarify how proposed Rule 1000(b)(6) would relate to Rule 19b-4, suggesting that there may be unnecessary redundancy between the two processes.¹⁰³⁹ Another commenter suggested limiting the types of changes that would require 30-day advance notification to those changes that are already required to be filed with the Commission as proposed rule changes for immediate effectiveness under Section 19(b)(3)(A) of the Exchange Act (excluding those filings that would not become operative for 30 days after the date of the filing because those filings would already provide the Commission with 30 days' advance notification of the material systems changes).¹⁰⁴⁰ This commenter also noted that where a material systems change would be filed for approval under Section 19(b)(2) of the Exchange Act, the Section 19(b)(2) approval process provides the Commission sufficient notification of the systems change.¹⁰⁴¹ One commenter stated that proposed Rule 1000(b)(6) was improperly premised on the notion that the Commission should be responsible for a minutely-detailed understanding of the IT infrastructure of SCI entities and for assessing prospective changes in advance of their implementation.¹⁰⁴²

¹⁰³⁸ See Omgeo Letter at 23; and SIFMA Letter at 16. See Section 19(b) of the Exchange Act, 15 U.S.C. 78s(b).

¹⁰³⁹ See KCG Letter at 19; Joint SROs Letter at 8; and FIF Letter at 5.

¹⁰⁴⁰ See MSRB Letter at 22.

¹⁰⁴¹ See MSRB Letter at 22. This commenter also suggested that material systems changes (other than those filed pursuant to Rule 19b-4 under the Exchange Act) be reported semi-annually, or that de minimis changes be excepted from the notice requirement altogether if the Commission continues to require 30-day advance notification. See MSRB Letter at 22-23. As discussed above, the Commission is adopting a quarterly reporting requirement for systems changes that an SCI entity determines to be material.

¹⁰⁴² See Direct Edge Letter at 1, 8. See also ITG Letter at 13-14 (stating that the Exchange Act does not enable the Commission to "bootstrap its SRO rule review authority or its

The Commission disagrees with commenters who believed that material systems change reports are redundant given the rule filing requirements of Rule 19b-4 under the Exchange Act, or that material systems change reports should not be required if the SCI entity submitted certain types of rule filings regarding the same change.¹⁰⁴³ The Commission acknowledges that some systems changes require proposed rule changes under Rule 19b-4, and some Rule 19b-4 proposed rule changes result in systems changes. However, based on Commission staff's experience with the ARP Inspection Program and the rule filing process, the Commission believes that the type of information regarding systems changes included in rule filings is different from the type of information that will be included in reports on material systems changes. In particular, the technical details or specifications of SCI systems and indirect SCI systems are generally not specifically set forth in the rules of an SCI SRO. Therefore, technical information regarding systems changes is usually not set forth in rule filings. In addition, the Commission notes that the rule filing process and the material systems change reports serve different purposes. In particular, the material systems change reports are intended to inform the Commission and its staff of important technical changes to an SCI entity's systems. On the other hand, the rule filing process provides notice of changes to an SCI entity's rules, including, for example, the statutory basis for such changes, and in some cases seeks approval by the

national market system authority to force regulated entities to submit upcoming material systems changes for agency approval" and that "the Commission need only receive notifications when they are a significant part of proposed rule changes by SROs or amendments to Form ATS of material changes to the operation of the ATS").

¹⁰⁴³ See supra notes 1039-1041 and accompanying text. The Commission notes that the requirement under Regulation SCI to submit reports of material systems changes does not alter an SRO's obligation to file proposed rule changes, the obligation of participants of an SCI Plan to file a proposed amendment to such SCI Plan, or any other obligation any SCI entity may have under the Exchange Act or rules thereunder.

Commission of the rule changes. Therefore, if an SCI SRO submits a rule filing regarding a particular systems change and the change is also included in a material systems change report, the information included in the rule filing may not necessarily further the goal of the material systems change reporting requirement, and the information included in the material systems change report may not necessarily assist in the Commission's review of the rule filing.

Moreover, commenters' concern regarding the redundancy between the rule filing process and the material systems change reports stemmed from concerns regarding the 30-day advance notification requirement. As discussed above, the Commission is not adopting a 30-day advance notification requirement.

The Commission also reiterates that the material systems change reports are intended to inform the Commission and its staff of such changes and help the Commission in its oversight of U.S. securities market infrastructure. Regulation SCI does not provide for a new approval process for SCI entities' material systems changes. As such, Commission staff will not use material systems change reports to require any approval of prospective systems changes in advance of their implementation pursuant to any provision of Regulation SCI,¹⁰⁴⁴ or to delay implementation of material systems changes pursuant to any provision of Regulation SCI.¹⁰⁴⁵

Three commenters questioned the Commission's legal authority to adopt the proposed material systems change notification requirements, including, in particular, those set forth in proposed Rule 1000(b)(6).¹⁰⁴⁶ For the reasons discussed above in Section IV.B.3.c, the

¹⁰⁴⁴ See supra note 1042 and accompanying text.

¹⁰⁴⁵ See supra note 1038 and accompanying text.

¹⁰⁴⁶ See NYSE Letter at 4 (stating the belief that "[a]uthority to facilitate a national market or assure economically efficient execution of securities transaction is remote from close, minute regulation of computer systems and computer security"); ITG Letter at 13 (stating

Commission disagrees with these comments and believes that adopted Rule 1003(a) will assist the Commission in its oversight of U.S. securities market infrastructure consistent with its legal authority under the Exchange Act.

In light of the 30-day advance notification requirement in proposed Rule 1000(b)(6), some commenters suggested eliminating the semi-annual reporting requirement in proposed Rule 1000(b)(8)(ii) because they considered it duplicative and unnecessary.¹⁰⁴⁷ One commenter believed that the required semi-annual reporting requirement was excessive and should instead be incorporated into the annual reporting obligations in proposed Rule 1000(b)(8)(i).¹⁰⁴⁸ As discussed above, the Commission is adopting a quarterly reporting requirement under Rule 1003(a)(1) and is not adopting the proposed 30-day advance notification requirement. Therefore, the Commission is not adopting the requirement in proposed Rule 1000(b)(8)(ii) for semi-annual progress reports.

ii. Definition of Material Systems Change

Commenters generally opposed the proposed definition of material systems change. Many commenters stated their belief that the term was too broad and would therefore necessitate

the belief that the proposed notification requirement for material systems changes “would extend the SEC’s reach far beyond that of a securities regulator and instead enable it to regulate the IT process of marketplace participants” and that the Exchange Act does not enable the Commission to “bootstrap its SRO rule review authority or its national market system authority to force regulated entities to submit upcoming material systems changes for agency approval”); and KCG Letter at 19 (stating the belief that “[t]he Commission does not have authority to stop implementation of systems changes by ATSS or systems changes that exchanges are not required to submit under Section 19(b) of the Exchange Act”).

¹⁰⁴⁷ See Omgeo Letter at 24-25; and OCC Letter at 16.

¹⁰⁴⁸ See CME Letter at 11.

an excessive number of notifications of material systems changes.¹⁰⁴⁹ Some commenters believed that the definition should be revised and offered a variety of suggestions.¹⁰⁵⁰ Several commenters advocated for creating a risk-based definition whereby, for example, notifications are only required for those material systems changes that pose a risk to critical operations of an entity.¹⁰⁵¹ One commenter suggested that the requirement focus on SCI systems only.¹⁰⁵² One commenter stated that SCI entities should be afforded flexibility to establish reasonable standards for defining material systems changes for their systems.¹⁰⁵³

Several commenters sought guidance from the Commission on the materiality threshold, which commenters believed was unclear, explaining, for example, that the term “material” appears both in the term “material systems change” and in the definition of that term.¹⁰⁵⁴

¹⁰⁴⁹ See, e.g., BATS Letter at 14; MFA Letter at 6; ICI Letter at 4; BIDS Letter at 14; Liquidnet Letter at 3; FINRA Letter at 24-26; MSRB Letter at 22; NYSE Letter at 26-27; Joint SROs Letter at 7; CME Letter at 5; Oppenheimer Letter at 3; OTC Markets Letter at 20-21; and Direct Edge Letter at 3.

¹⁰⁵⁰ See, e.g., BATS Letter at 14-15 (recommending that only those material systems changes that are reported to an SCI entity’s board of directors or similar body should be required to be reported to the Commission, which BATS stated is the standard it uses currently for the ARP Inspection Program); OCC Letter at 15 (stating that the reporting of systems changes to the board of directors, or to a similar governing body, is a more appropriate standard for determining materiality than reporting to “senior management”); BIDS Letter at 14-15 (stating its belief that the Commission should define a “material systems change” to be a large-scale architectural upgrade, the implementation of industry-wide rules or other market structure changes, or other technology changes that may be required because of changes in trading rules defined in the exchange’s or the ATS’s trading rule book); and FIF Letter at 5 (recommending that the term be defined to include significant functional enhancements, major technology infrastructure changes, or changes requiring member/participant notifications).

¹⁰⁵¹ See, e.g., OCC Letter at 15; DTCC Letter at 16; Liquidnet Letter at 3; MFA Letter at 6; ICI Letter at 4; CME Letter at 5; and Direct Edge at 4.

¹⁰⁵² See NYSE Letter at 27.

¹⁰⁵³ See FINRA Letter at 27.

¹⁰⁵⁴ See Direct Edge Letter at 3-4; OCC Letter at 15; and NYSE Letter at 26.

Similarly, several commenters requested that the Commission provide more guidance on the meaning of “material” in the context of systems changes because, although the wording of the proposed definition contained the concept of “materiality,” the commenters believed some of the examples provided in the SCI Proposal to be non-material.¹⁰⁵⁵ One commenter asked that the Commission clearly define what types of systems changes are not subject to the prior notification requirement in order to avoid receiving notices of all systems changes, material or otherwise.¹⁰⁵⁶ One commenter asked that the Commission clarify the meaning of “material” and confirm that prior notification would not be required for changes that do not pertain to the production environment.¹⁰⁵⁷

Rather than adopting a detailed definition of material systems change as proposed, Rule 1003(a)(1) requires an SCI entity to establish reasonable written criteria for identifying a change to its SCI systems and the security of indirect SCI systems as material and to report to the Commission those changes the SCI entity identified as material in accordance with such criteria. This change is responsive to a commenter’s suggestion that SCI entities should be granted flexibility to establish reasonable standards for determining whether a systems change is material. In addition, the Commission does not believe that it is appropriate to adopt a precise definition for the term “material systems change” because SCI entities differ in nature, size, technology, business model, and other aspects of their businesses. The Commission notes that there currently is no industry definition of “material systems change” that is applicable to all SCI

¹⁰⁵⁵ See, e.g., Joint SROs Letter at 7; DTCC Letter at 15-16; Omgeo Letter at 23; OCC Letter at 15; FINRA Letter at 27; OTC Markets Letter at 20-21; BIDS Letter at 14; Direct Edge Letter at 3-4; and ISE Letter at 8. See also *supra* note 1050.

¹⁰⁵⁶ See KCG Letter at 20.

¹⁰⁵⁷ See SIFMA Letter at 15-16.

entities that can serve as the basis for a precise definition of the term "material systems change" in Regulation SCI, and believes that whether a systems change is material is dependent on the facts and circumstances, such as the reason for the change and how it may impact operations. Moreover, requiring SCI entities to establish their own reasonable criteria for identifying material systems changes reflects the Commission's view that an SCI entity is in the best position to determine, in the first instance, whether a change, or series of changes, is material in the context of its systems. Because adopted Rule 1003(a)(1) allows each SCI entity to identify material systems changes, it is responsive to commenters' concern that the proposed definition was too broad and would result in an excessive number of notifications, and to commenters' suggestion that the definition should be revised.

Further, the Commission's determination to not adopt the proposed definition of material systems change mitigates commenters' concern that the proposed definition was unclear. In particular, by eliminating the proposed definition of material systems change, the Commission seeks to eliminate the confusion caused by the proposed definition of this term, which contained the word "material." Moreover, some commenters requested additional clarity on the definition of material systems change because they believed that some of the examples the Commission provided in the SCI Proposal were not material systems changes. Because adopted Rule 1003(a)(1) requires SCI entities to establish reasonable written criteria for identifying material systems changes, SCI entities will not be required to identify material systems changes in accordance with the detailed definition and examples from the SCI Proposal. Rather, an SCI entity will have reasonable discretion in establishing the written criteria in order to capture the systems changes that it believes are material. Specifically, the Commission believes that adopted Rule 1003(a) is sufficiently flexible to allow each SCI entity to identify changes that it believes

are material, which may include some of the suggestions identified by the commenters if an SCI entity determines such changes to be appropriate to include in its criteria for identifying material systems changes. For example, if an SCI entity reasonably believes that its systems changes are material if they involve significant functional enhancements, major technology infrastructure changes, or changes requiring member/participant notifications, and such criteria is set forth in the SCI entity's reasonable written criteria, the SCI entity may identify material systems changes in accordance with such written criteria. Likewise, if an SCI entity reasonably believes that some of the examples of material systems changes identified in the SCI Proposal can appropriately serve as criteria for identifying material systems changes, and such criteria is set forth in the SCI entity's reasonable written criteria, the SCI entity may identify material systems changes in accordance with such written criteria.

In response to a commenter's suggestion that the Commission clearly define what types of systems changes are not subject to the prior notification requirement in order to avoid notification of all systems changes, material or otherwise, the Commission notes that Rule 1003(a)(1) specifically requires SCI entities to identify material systems changes and report only material systems changes. With respect to a commenter's question regarding whether prior notification would be required for changes that do not pertain to the production environment, the Commission notes that SCI systems do not include development and testing systems, although indirect SCI systems could include development and testing systems if they are not walled-off from SCI systems. Therefore, Rule 1003(a) could apply to material changes to the security of development and testing systems that are not walled-off from SCI systems. Finally, with respect to a commenter's suggestion that Rule 1003(a) focus only on SCI systems, the Commission believes that notifications of material systems changes regarding the security of indirect SCI

systems is important to the Commission's oversight of U.S. securities market infrastructure. At the same time, the Commission notes that Rule 1003(a)(1) provides that each SCI entity establish its own reasonable criteria for identifying a change to the security of its indirect SCI systems as material. Therefore, to the extent that an SCI entity determines that certain changes to the security of its indirect SCI systems are not material in accordance with its reasonable written criteria, such changes are not required to be reported to the Commission.

As with an SCI entity's other policies and procedures under Regulation SCI, Commission staff may review an SCI entity's established criteria relating to the materiality of a systems change (e.g., in the course of an examination) to determine whether it agrees with the SCI entity's assessment that such criteria is reasonable and in compliance with the requirements of Rule 1003(a). The Commission believes that, by providing SCI entities flexibility in establishing the criteria and reviewing SCI entities' established criteria, it strikes the proper balance between granting discretion to SCI entities and ensuring that SCI entities carry out their obligations under Regulation SCI.

iii. Adopted Rule 1003(a)(2): Supplemental Material Systems Change Reports

A commenter who advocated for a quarterly reporting requirement noted that quarterly updates would disclose material deviations from plans described in a previous report, including those stemming from inaccuracies in prior reports.¹⁰⁵⁸ Another commenter similarly noted that periodic reporting of any inaccuracies is sufficient for oversight purposes.¹⁰⁵⁹ The Commission believes that there may be circumstances in which an SCI entity realizes that information

¹⁰⁵⁸ See OTC Markets Letter at 22.

¹⁰⁵⁹ See NYSE Letter at 28.

previously provided to the Commission in a quarterly report was materially inaccurate or that the quarterly report omitted material information. The Commission believes that it should, on an ongoing basis, have complete and correct information regarding material systems changes at an SCI entity, rather than waiting until the next quarterly report to receive corrected information, as suggested by these commenters. The Commission is therefore adopting Rule 1003(a)(2), which requires an SCI entity to promptly submit a supplemental report to notify the Commission of a material error in or material omission from a report previously submitted under Rule 1003(a)(1). The Commission notes that the supplemental report requirement applies only if the error or omission in a prior report is material.

5. SCI Review – Rule 1003(b)

Proposed Rule 1000(b)(7) required an SCI entity to conduct an SCI review of the SCI entity's compliance with Regulation SCI not less than once each calendar year, and submit a report of the SCI review to senior management of the SCI entity no more than 30 calendar days after completion of such SCI review.¹⁰⁶⁰ Further, proposed Rule 1000(b)(8)(i) required an SCI entity to submit to the Commission a report of the SCI review required by paragraph (b)(7), together with any response by senior management, within 60 calendar days after its submission to senior management of the SCI entity.¹⁰⁶¹

Proposed Rule 1000(a) defined the term "SCI review" to mean a review, following established procedures and standards, that is performed by objective personnel having appropriate experience in conducting reviews of SCI systems and SCI security systems, and which review contains: (1) a risk assessment with respect to such systems of the SCI entity; and

¹⁰⁶⁰ See proposed Rule 1000(b)(7) and Proposing Release, supra note 13, at Section III.C.5.

¹⁰⁶¹ See proposed Rule 1000(b)(8)(i) and Proposing Release, supra note 13, at Section III.C.6.

(2) an assessment of internal control design and effectiveness to include logical and physical security controls, development processes, and information technology governance, consistent with industry standards.¹⁰⁶² In addition, the proposed definition provided that such review must include penetration test reviews of the SCI entity's network, firewalls, and production systems at a frequency of not less than once every three years.¹⁰⁶³

The Commission is adopting the provisions relating to SCI reviews with modifications in response to comment. In addition, the Commission is adopting a definition of "senior management" in Rule 1000 for purposes of the SCI review requirement.

Some commenters expressed support for the proposed requirements for SCI reviews,¹⁰⁶⁴ with a few advocating that the SCI review be conducted by an independent third party, rather than "objective personnel."¹⁰⁶⁵ One commenter noted that it agreed that annual SCI reviews and reports can have a meaningful impact on improving technology and business practices.¹⁰⁶⁶

Another commenter expressed support for proposed Rule 1000(b)(7), but asked for clarification that any review of a processor under an NMS plan be performed independently of reviews of the same entity in other capacities (e.g., as an exchange or other SCI entity).¹⁰⁶⁷

¹⁰⁶² See proposed Rule 1000(a) and Proposing Release, supra note 13, at Section III.C.5.

¹⁰⁶³ See id.

¹⁰⁶⁴ See, e.g., MSRB Letter at 23; Lauer Letter at 5; Better Markets Letter at 5; and Direct Edge Letter at 9.

¹⁰⁶⁵ See Lauer Letter at 5; Better Markets Letter at 5; and BlackRock Letter at 4.

¹⁰⁶⁶ See FIF Letter at 6 (expressing support for the SCI review requirement while also providing suggestions for modifications to the rule).

¹⁰⁶⁷ See Direct Edge Letter at 9.

With regard to the suggestion that the Commission adopt a requirement that SCI reviews be conducted by an independent third party rather than “objective personnel” as proposed,¹⁰⁶⁸ the Commission continues to believe that it is appropriate to permit SCI reviews to be performed by personnel of the SCI entity or an external firm, provided that such personnel are, in fact, objective and, as required by rule, have the appropriate experience to conduct reviews of SCI systems and indirect SCI systems. Experienced personnel should have the knowledge and skills necessary to conduct such reviews. In the SCI Proposal, the Commission noted that to satisfy the criterion that an SCI review be conducted by “objective personnel,” it should be performed by persons who have not been involved in the development, testing, or implementation of such systems being reviewed.¹⁰⁶⁹ The Commission continues to believe that persons who were not involved in the process for development, testing, and implementation of the systems being reviewed would generally be in a better position to identify weaknesses and deficiencies that were not identified in the development, testing, and implementation stages. The Commission believes that, given the requirement that such personnel be “objective,” any personnel with conflicts of interest that have not been adequately mitigated to allow for objectivity should be excluded from serving in this role. In particular, the Commission believes that a person or persons conducting an SCI review should not have a conflict of interest that interferes with their ability to exercise judgment, express opinions, and present recommendations with impartiality. While the Commission recognizes that, as one commenter asserted, all personnel of an SCI entity could be viewed as having some level of conflict of interest,¹⁰⁷⁰ the Commission believes that

¹⁰⁶⁸ See supra note 1065 and accompanying text.

¹⁰⁶⁹ See Proposing Release, supra note 13, at 18123.

¹⁰⁷⁰ See Better Markets Letter at 5.

SCI entities can have appropriate policies and procedures in place to mitigate such conflicts or to help ensure that certain departments and/or specified personnel (such as internal audit departments) are appropriately insulated from such conflicts so as to be able to objectively conduct SCI reviews.¹⁰⁷¹

Accordingly, the Commission believes that the goals of Regulation SCI can be achieved through reviews by either internal objective personnel or external objective personnel. Taking into consideration the advantages and disadvantages associated with each approach, each SCI entity should make its own determination regarding the levels of review or assurance that can be provided by different personnel, the best means to ensure their objectivity, and whether it is appropriate to incur the additional costs of an independent third party review. An SCI entity may, for example, determine that it is appropriate to utilize personnel not employed by the SCI entity (*i.e.*, third parties) to conduct such review each year or only on a less frequent, periodic basis (*e.g.*, every three years), or only with regard to certain of its systems. In addition, with regard to one commenter's suggestion that an SCI review should be performed independently for each capacity in which an SCI entity acts, the Commission notes that the definition of SCI review and provisions of Rule 1003(b) require that an SCI entity perform a review, following

¹⁰⁷¹ For example, the Commission believes that many entities implement a reporting structure pursuant to which internal audit employees or departments report directly to the board of directors or an audit committee of the board. The Commission notes that, while utilizing external personnel (*i.e.*, third parties) to conduct an SCI entity's SCI review generally would not raise the same concerns regarding objectivity, the SCI entity would likewise need to mitigate any conflicts of interest that would prevent such personnel from meeting the objectivity standard required for an SCI review. For example, among the factors an SCI entity may consider in evaluating the objectivity of a third party review could be who within the SCI entity is managing the third party review, is setting the scope of review, is authorizing payment for such review, and has the authority to review and comment on the third party report, among others. Further, an SCI entity may consider the third party's ability to remain objective in light of any other services provided by the third party to the SCI entity.

established procedures and standards, for compliance with Regulation SCI that includes a risk assessment of the SCI entity's SCI systems and indirect SCI systems and an assessment of internal control design and effectiveness of such systems and does not require an SCI entity that serves in two different capacities with respect to Regulation SCI to conduct two independent SCI reviews. The Commission believes that, as a practical matter, an SCI entity may determine that, to comply with these requirements, it is necessary to conduct separate assessments and analysis for each capacity of the SCI entity, because the standards used, risk assessments, applicable policies and procedures, and assessment of internal control design and effectiveness are different with regard to the distinct and differing functions of the SCI entity in each capacity. For example, an entity that meets both the definition of an SCI SRO and a plan processor may determine that it is necessary to conduct separate reviews for each function performed, because, for instance, the findings of a risk assessment determine that certain SCI systems fall into the category of "critical SCI systems" with regard to the functions of the plan processor, but not with regard to the functions of the SRO. At the same time, the Commission notes that, even where separate reviews are conducted, there may be certain overlap in conducting such reviews (for example, the entity may use the same objective reviewer for each function performed), such reviews may be conducted at the same time, and a single SCI review report may contain findings for each capacity.

While other commenters also supported some form of review, many of these commenters stated that the term SCI review is defined too broadly and/or that the SCI review requirements should allow more flexibility.¹⁰⁷² Some commenters expressed concerns about the need to

¹⁰⁷² See, e.g., FINRA Letter at 39-41; Omgeo Letter at 23-24; OCC Letter at 19; NYSE Letter at 35; SIFMA Letter at 17; DTCC Letter at 16-17.

review all systems on an annual basis, which they argued could be costly, burdensome, and unnecessary.¹⁰⁷³ Several commenters suggested the adoption of a risk-based approach for determining the scope of the review, which would entail conducting a risk assessment to determine which systems should be reviewed and how often.¹⁰⁷⁴ Under such an approach, the highest risk systems would be reviewed more frequently than other, less critical systems, which could be reviewed less frequently than annually or on a rotational basis. Similarly, one commenter recommended that SCI reviews should be focused only on those core systems capable of having a material impact on members or participants, and “adjacent” systems should not be subject to the review process.¹⁰⁷⁵

After considering the views of commenters, the Commission has determined to adopt the provisions relating to SCI reviews with modifications in response to comment.¹⁰⁷⁶ Thus,

¹⁰⁷³ See, e.g., FINRA Letter at 39-41; Omgeo Letter at 23-24; OCC Letter at 19; NYSE Letter at 35; DTCC Letter at 16-17; and BIDS Letter at 11.

¹⁰⁷⁴ See, e.g., FINRA Letter at 39-41; OCC Letter at 19; NYSE Letter at 35; SIFMA Letter at 17; DTCC Letter at 16-17; LiquidPoint Letter at 3; and Omgeo Letter at 24. One commenter noted that the proposed SCI review requirement essentially eliminated the ability to utilize its current risk assessment approach to determine the frequency of review for each system (ranging from annually to once every four years). See FINRA Letter at 40.

¹⁰⁷⁵ See FIF Letter at 6.

¹⁰⁷⁶ See adopted Rule 1003(b). However, the Commission is moving the clause regarding penetration test reviews from the definition of SCI review into Rule 1003(b), which addresses the timing of reviews. Further, the adopted definition of SCI review will require that the objective reviewer have “appropriate experience to conduct reviews” rather than “appropriate experience in conducting reviews” as proposed. The Commission believes this revision is appropriate given that, prior to the adoption of Regulation SCI today, no individual or entity would have experience in conducting the specific SCI reviews required by Rule 1003(b). Rather, the Commission believes that there are individuals or entities that have experience in conducting reviews, audits, and/or testing similar to the functions that would be necessary to address certain aspects of the SCI review requirement, and thus, the objective reviewer should have this type of appropriate experience that would allow them to conduct SCI reviews in accordance with

adopted Rule 1003(b) requires an SCI entity to conduct an SCI review of the SCI entity's compliance with Regulation SCI not less than once each calendar year.¹⁰⁷⁷ However, the Commission notes that, because it has revised the scope of the definition of "SCI systems" as described above, fewer systems of each SCI entity will be subject to the SCI review, thereby focusing the overall scope of the SCI review requirement.¹⁰⁷⁸ Further, to address some commenters' concerns about the burdens and inflexibility of the proposed rule and the recommendation that the proposed rule utilize a more risk-based approach, the adopted rule is being revised to allow assessments of SCI systems directly supporting market regulation or market surveillance to be conducted, based upon a risk-assessment, at least once every three years, rather than annually.¹⁰⁷⁹ SCI entities would be required to determine the specific frequency with which to conduct assessments of these systems depending on the risk assessment that they conduct as part of the annual SCI review, provided that these systems are assessed at

the requirements of Regulation SCI. Thus, as adopted, the term "SCI review" means "a review, following established procedures and standards, that is performed by objective personnel having appropriate experience to conduct reviews of SCI systems and indirect SCI systems, and which review contains: (a) A risk assessment with respect to such systems of an SCI entity; and (b) An assessment of internal control design and effectiveness of its SCI systems and indirect SCI systems to include logical and physical security controls, development processes, and information technology governance, consistent with industry standards." See Rule 1000. Further, the Commission is moving the requirement relating to reports to the Commission on SCI reviews from proposed Rule 1000(b)(8) into Rule 1003(b) so that all provisions regarding SCI reviews are in the same rule.

¹⁰⁷⁷ See adopted Rule 1003(b)(1).

¹⁰⁷⁸ The Commission also notes that it has clarified that the definition of "indirect SCI systems" includes only those systems that have not been effectively logically or physically separated from SCI systems. Thus, the scope of the SCI review is also more focused than what some commenters may have believed. It is also further focused by the elimination of references to development and test systems from the penetration test requirement in adopted in Rule 1003(b)(1)(i).

¹⁰⁷⁹ See adopted Rule 1003(b)(1)(ii).

least once every three years. The Commission believes that market regulation and market surveillance systems have the potential to pose less risk to an entity or the market than other SCI systems. While the Commission believes that these systems are essential to investor protection and market integrity and that they can pose a significant risk to the markets in the event of a systems issue, the Commission also believes that certain market regulation and market surveillance systems may not have as immediate or widespread of an impact on the maintenance of fair and orderly markets or an entity's operational capability as the other categories of systems included within the definition of SCI systems. While a systems issue affecting a trading system could result in the immediate inability of a market, and thus market participants, to continue trading on such system and potentially impact trading on other markets as well, the Commission believes that the temporary disruption or failure of a SCI entity's market regulation and/or market surveillance systems in the wake of a wide-scale disruption would likely not have as direct an impact on market participants' ability to continue to trade. Thus, after considering commenters' views regarding the costs and burdens of the proposed SCI review requirements, as well as the suggestion that the Commission incorporate more of a risk-based approach in Regulation SCI, the Commission believes that a longer frequency of review of these systems may be appropriate in cases where the risk assessment conducted as part of the SCI review results in such a determination. The Commission also notes that, as originally proposed the rule would have required penetration test reviews of the SCI entity's network, firewalls and development, testing, and production systems at a frequency of not less than once every three years in recognition of the potentially significant costs that may be associated with the performance of such tests.¹⁰⁸⁰ However, consistent with modifications to the definition of SCI

¹⁰⁸⁰ As noted by some commenters, penetration tests are highly technical and would require

systems, references to development and test systems have been deleted in adopted Rule 1003(b)(1)(i).¹⁰⁸¹ The Commission notes that SCI entities may, however, determine that based on its risk assessment, it is appropriate and/or necessary to conduct such penetration test reviews more frequently than once every three years.

The Commission is not, however, adopting a broader risk-based approach to determine the required frequency of an SCI review (i.e., for SCI systems other than market regulation and market surveillance systems), as suggested by some commenters.¹⁰⁸² The Commission believes that a critical element to ensuring the capacity, integrity, resiliency, and availability of SCI systems and indirect SCI systems is conducting an annual objective review to assess the risks of an SCI entity's systems and the effectiveness of its internal information technology controls and procedures. Such reviews will not only assist the Commission in improving its oversight of the technology infrastructure of SCI entities, but also each SCI entity in assessing the effectiveness of its information technology practices, helping to ensure compliance with the safeguards provided by the requirements of Regulation SCI, identifying potential areas of weakness that require additional or modified controls, and determining where to best devote resources. Further, the Commission believes that the competitive environment of today's securities markets drives

special expertise, and thus the Commission believes such testing could potentially require substantial costs. See, e.g., DTCC Letter at 17; and Omgeo Letter at 44. See also infra Sections V.D.2.d and VI.C.2.b.vi (discussing estimated costs associated with the SCI review requirement, which takes into consideration the costs of penetration testing) and Proposing Release, supra note 13, at 18123 (stating that the Commission seeks to balance the frequency of such tests with the costs associated with performing the tests). As noted in the SCI Proposal, the Commission believes that the penetration test reviews should help an SCI entity evaluate the system's security and resiliency in the face of attempted and successful intrusions. See id.

¹⁰⁸¹ See supra Section IV.A.2.b (discussing elimination of development and test systems from the definition of SCI systems).

¹⁰⁸² See supra note 1074 and accompanying text.

SCI entities to continually update, modify, and introduce new technology and systems, often in an effort to meet specific business needs and achieve “quick-to-market” results, potentially without adequate focus on ensuring the continuous integrity of its systems. In addition, given today’s fast-paced nature of technological advancement, existing controls can quickly become obsolete or ineffective and the relative criticality or risk nature of a system can change over time as well.¹⁰⁸³ Further, as one commenter noted, it is not uncommon for entities to experience repeated unsuccessful attempts to gain access to their systems,¹⁰⁸⁴ which the Commission believes can expose certain vulnerabilities not identified previously and, if successful, also create new vulnerabilities and risk. For these reasons, the Commission believes that it is appropriate to require an SCI entity to conduct an SCI review of its applicable systems not less than once every 12 months.¹⁰⁸⁵

Further, the Commission notes that, as described in detail above, Regulation SCI is consistent with a risk-based approach in several areas, and thus, a risk assessment is appropriate in order to determine the standards and requirements applicable to a given SCI system. As such, the Commission believes that it is appropriate to require SCI entities to conduct a risk-based assessment with regard to its SCI systems and indirect SCI systems as part of its SCI review at

¹⁰⁸³ In addition, the Commission believes changes in personnel with access to SCI systems throughout the year can create additional risk that should be considered in evaluating the risks of any particular system.

¹⁰⁸⁴ See SIFMA Letter at 11.

¹⁰⁸⁵ The Commission notes that, while the rule requires that an SCI review be conducted “not less than once each calendar year,” an SCI entity may determine that it is appropriate to conduct an assessment of an SCI system more frequently, particularly for critical SCI systems. See adopted Rule 1003(b)(1).

least annually to help ensure that SCI entities are meeting the requirements of Regulation SCI.¹⁰⁸⁶

For the reasons noted above, the Commission believes it is appropriate to require that SCI reviews be conducted at least annually, rather than utilizing a risk-based approach to determine the frequency of the required SCI review.¹⁰⁸⁷ At the same time, the Commission notes that this provision is consistent with a risk-based approach in that SCI entities may design the scope and rigor of the SCI review for a particular system based on its risk assessment of such system, provided that the review meets the requirements of the rule, such as including an assessment of internal control design and effectiveness to include logical and physical security controls, development processes, and information technology governance, consistent with industry standards¹⁰⁸⁸ and performing penetration test reviews at least once every three years.¹⁰⁸⁹

Some commenters sought clarification on various aspects of the SCI review requirement. One commenter stated that the term SCI review, as proposed, expanded significantly on what is required under ARP and asked for greater specificity as to the objectives and intended scope of the SCI review.¹⁰⁹⁰ This commenter suggested, as an alternative, that the Commission establish an “agreed upon procedures” approach, which would involve outlining specific SCI review objectives and procedures that would be performed by an objective reviewer.¹⁰⁹¹ One

¹⁰⁸⁶ See adopted Rule 1003(b) and Rule 1000 (definition of “SCI review”).

¹⁰⁸⁷ However, as discussed above, an SCI entity may conduct an SCI review of its market regulation and market surveillance systems based upon its risk assessment of such systems, but not less than once every three years. See adopted Rule 1003(b)(1)(ii).

¹⁰⁸⁸ See adopted Rule 1000 (definition of “SCI review”).

¹⁰⁸⁹ See adopted Rule 1003(b)(1)(i).

¹⁰⁹⁰ See FINRA Letter at 39-40.

¹⁰⁹¹ See *id.* at 40.

commenter also requested that the Commission clarify whether there is a distinction between the existing ARP report and the SCI review and whether the ARP practice of on-site inspections would be eliminated.¹⁰⁹²

With regard to the comment seeking clarity on the scope of the review as compared to what is done under the current ARP Inspection Program,¹⁰⁹³ as noted in the SCI Proposal, the requirement for an annual SCI review was intended to formalize a practice in place under the current ARP Inspection Program in which SROs conduct annual systems reviews following established audit procedures and standards that result in the presentation of a report to senior SRO management on the recommendations and conclusions of the review.¹⁰⁹⁴ Specifically, the ARP Policy Statements called for each SRO to have its automated systems reviewed annually by an "independent reviewer"¹⁰⁹⁵ and stated that independent reviews and analysis should: "(1) cover significant elements of the operations of the automation process, including the capacity planning and testing process, contingency planning, systems development methodology and vulnerability assessment; (2) be performed on a cyclical basis by competent and independent audit personnel following established audit procedures and standards; and (3) result in the presentation of a report to senior SRO management on the recommendations and conclusions of the independent reviewer, which report should be made available to Commission staff for its

¹⁰⁹² See OCC Letter at 19.

¹⁰⁹³ See supra note 1092 and accompanying text. See also supra note 1090 and accompanying text.

¹⁰⁹⁴ See Proposing Release, supra note 13, at 18123.

¹⁰⁹⁵ See ARP I, supra note 1, at 48706-07. ARP I provided that an "independent reviewer" could be either an internal auditor group or an external audit firm so long as the independent reviewer had the competence, knowledge, consistency, and independence sufficient to perform the role.

review and comment.”¹⁰⁹⁶ Similar to (1) above, the definition of SCI review requires the review to contain an assessment of internal control design and effectiveness of its SCI systems and indirect SCI systems to include logical and physical security controls, development processes, and information technology governance, consistent with industry standards. Consistent with element (2), an SCI review must be performed by objective personnel having appropriate experience to conduct reviews of SCI systems and indirect SCI systems and must be performed following established procedures and standards. Finally, like item (3), Rule 1003(b)(2)-(3) requires SCI entities to submit a report of the SCI review to senior management after completion of the review, and following submission to senior management, to submit a report of the SCI review to the Commission, along with any response by senior management. Senior management, after reviewing the report, should note, in addition to any other response that may be made, any material inaccuracy or omission that, to their knowledge, is in the report. In this regard, the Commission recognizes that senior managers, by virtue of their positions and experience, may have differing levels of knowledge regarding their entity’s SCI systems and indirect SCI systems and compliance with Regulation SCI.

While the SCI review requirement in Rule 1003 is based on the ARP review and report, a greater number of automated systems meeting the definition of SCI system or indirect SCI system would be subject to the SCI review requirements because the scope of Regulation SCI expands upon the current ARP Inspection Program. The Commission notes that the SCI review

¹⁰⁹⁶ See ARP II, supra note 1, at 22491. In ARP II, the Commission also explained that, in its view, “a critical element to the success of the capacity planning and testing, security assessment and contingency planning processes for [automated] systems is obtaining an objective review of those planning processes by persons independent of the planning process to ensure that adequate controls and procedures have been developed and implemented.” Id.

is not a substitute for inspections and examinations conducted by Commission staff, and therefore SCI entities should expect that technology systems inspections and examinations will continue following the adoption of Regulation SCI. Along with notifications of material systems changes under adopted Rule 1003(a) and SCI event notifications pursuant to adopted Rule 1002(b), one purpose of SCI reviews will be to aid the Commission and its staff in understanding the operations and risks associated with the applicable systems of an SCI entity.

In addition, as noted above, one commenter, in seeking further clarity on the scope of the SCI review requirement, suggested that the Commission take an “agreed upon approach” which would outline more specific review objectives and procedures that would be performed by the objective reviewer. The Commission believes that an SCI entity should have the ability to design the specific parameters of an SCI review within the confines of the general framework of the rule, including identifying its own review objectives and procedures, given the SCI entity’s in-depth knowledge of, and familiarity with, its own systems and their attendant risks. As such, the adopted rule is designed to provide a general framework for the scope of the SCI review by specifying that the review must include a risk assessment of SCI systems and indirect SCI systems and an assessment of the internal control design and effectiveness of its systems in certain areas.¹⁰⁹⁷ At the same time, the rule provides flexibility by permitting the review to be conducted “following established procedures and standards,” which would be identified and established by the SCI entity itself.¹⁰⁹⁸

Some commenters expressed views on the provisions requiring SCI entities to submit reports of the SCI review to senior management of the SCI entity and to the Commission.

¹⁰⁹⁷ See adopted Rule 1000 (defining “SCI review”).

¹⁰⁹⁸ See *id.*

Specifically, two commenters supported the proposed requirement that reports of the SCI review be submitted to senior management of the SCI entity no later than 30 days after completion of the SCI review.¹⁰⁹⁹ One commenter urged that senior management of an SCI entity certify the report before it is submitted to the Commission in order to promote accountability at the highest ranks of the SCI entity.¹¹⁰⁰ Another commenter believed that 45 days for submission of such reports to senior management would be more appropriate as a target timeframe given the complexity of the issues addressed in an SCI review, and that should this target fail to be met, the Board of Directors Audit Committee (or similar governing body) should be informed of the reason therefor.¹¹⁰¹ Two commenters recommended that the distribution cycle within proposed Rule 1000(b)(8)(i) be modified so that individual, focused audit reports resulting from rotational reviews could be bundled and distributed to the Commission on a regular basis (semi-annually or quarterly).¹¹⁰²

The Commission does not believe that it is necessary to require senior management certification of the report of the SCI review, as suggested by one commenter.¹¹⁰³ Adopted Rules 1003(b)(2)-(3) require that the SCI entity submit a report of the SCI review to senior management of the SCI entity no more than 30 calendar days after completion of such SCI review, and that the SCI entity submit a report of the SCI review, together with any response by senior management, to the Commission and the board of directors of the SCI entity or the equivalent of such board within 60 calendar days after its submission to senior management.

¹⁰⁹⁹ See MSRB Letter at 23; and FIF Letter at 6.

¹¹⁰⁰ See Better Markets Letter at 6.

¹¹⁰¹ See DTCC Letter at 17.

¹¹⁰² See OCC Letter at 19; and DTCC Letter at 17.

¹¹⁰³ See supra note 1100 and accompanying text.

Because reports of SCI reviews and any responses by senior management are required to be filed using Form SCI under the Exchange Act and Regulation SCI, it is unlawful for any person to willfully or knowingly make, or cause to be made, a false or misleading statement with respect to any material fact in such reports or responses.¹¹⁰⁴

The Commission recognizes that senior management certifications are used in other regulatory contexts, including in some Commission rules and regulations.¹¹⁰⁵ However, at this time, the Commission believes that, in light of the other requirements for an SCI entity, the goals of Regulation SCI can be achieved without the imposition of an additional requirement on SCI entities for senior management certification. Specifically, the Commission believes that the adopted requirements promote the responsibility and accountability of senior management of an SCI entity by helping to ensure that senior management receives and reviews reports of SCI reviews, is made aware of issues relating to compliance with Regulation SCI, and is encouraged to promptly establish plans for resolving such issues.

The Commission is also adopting a definition of “senior management” in Rule 1000 to make clear which individuals at an SCI entity must receive and review the report of the SCI review. The Commission believes that, in the context of the SCI review requirement, senior management should not be limited to a single individual or officer of an SCI entity. Thus, “senior management,” for purposes of adopted Rule 1003(b) is defined as an SCI entity’s Chief Executive Officer, Chief Technology Officer, Chief Information Officer, General Counsel, and Chief Compliance Officer, or the equivalent of such employees or officers of an SCI entity. The

¹¹⁰⁴ See, e.g., Section 32(a) of the Exchange Act, 15 U.S.C. 78ff(a).

¹¹⁰⁵ See, e.g., 17 CFR 240.15c3-5(e)(2) (chief executive officer certification under the Market Access Rule); and 17 CFR 240.13a-14 (principal executive and principal financial officer certification of disclosure in annual and quarterly reports).

Commission believes that, in order to achieve the goals of the rule to promote increased awareness and oversight of the technology infrastructure at an SCI entity by its most senior employees and officers, it is important that the SCI entity's senior management team receive and carefully review reports of SCI reviews. The Commission believes that these employees and officers, or their functional equivalent, represent the executive, technology, legal, and compliance functions that are necessary to effectively review the reports of SCI reviews. The Commission also believes that awareness by an SCI entity's senior management of SCI reviews and issues with Regulation SCI compliance should help to promote a focus by senior management on such reviews and issues, enhance communication and coordination regarding such reviews and issues among business, technology, legal, and compliance personnel, and, in turn, strengthen the capacity, integrity, resiliency, and availability of the systems of SCI entities. To help ensure that persons at the highest levels of an SCI entity are made aware of any issues raised in the SCI review, the Commission is also adopting a requirement for each SCI entity to submit to its board of directors or the equivalent of such board a report of the SCI review and any response by senior management within 60 calendar days after the submission of the report to senior management of the SCI entity.

With regard to one commenter's suggestion that SCI entities should be given 45 days rather than 30 days to submit the report of the SCI review to senior management (and that it should be only a target timeframe rather than a requirement),¹¹⁰⁶ the Commission notes that the 30-day timeframe is based on the Commission's experience with the current ARP Inspection Program that an ARP entity is able to consider the review and prepare a report for senior

¹¹⁰⁶ See supra note 1101 and accompanying text.

management consideration prior to the submission to the Commission.¹¹⁰⁷ The Commission acknowledges that a greater number of systems will be subject to the SCI review requirement than the current ARP Inspection Program given the definitions of SCI system and indirect SCI system,¹¹⁰⁸ and that the issues addressed in an SCI review may be complex. However, the Commission notes that the adopted timeframe, while based on experience with the current ARP Inspection Program, also takes into account these factors.¹¹⁰⁹ Further, the Commission believes that the complexity of the issues presented during an SCI review would more likely affect the timing of conducting and completing the SCI review, rather than the timing for submitting a report of the review to senior management. The Commission, therefore, continues to believe that this requirement is appropriate. The Commission also notes that the requirement to submit the annual report to the Commission within 60 calendar days after its submission to senior management is similarly based on the Commission's experience with the ARP Inspection Program that this time period is a sufficient period to enable senior management to consider such review or report before submitting it to the Commission.¹¹¹⁰ Because an SCI entity will already have prepared the report and any response by senior management for filing with the

¹¹⁰⁷ See Proposing Release, supra note 13, at 18123.

¹¹⁰⁸ The Commission also notes, however, that as discussed above, the scope of systems subject to Regulation SCI has been refined from what was proposed.

¹¹⁰⁹ The Commission notes that, while the ARP II Release recommended that an SRO's independent review should result in the presentation of a report to senior SRO management on the recommendations and conclusions of the independent review and such report should be made available to Commission staff, it did not provide recommended time periods for the submission of such reports. See ARP II Release, supra note 1. The adopted 30-day time period is based on experience with the ARP Inspection Program, as well as a consideration of the scope of the review required under Regulation SCI.

¹¹¹⁰ See Proposing Release, supra note 13, at 18124.

Commission, the Commission believes that an SCI entity will not need significant additional time to submit the same report and response to its board of directors or the equivalent of such board.

Contrary to the suggestion of some commenters, the Commission does not believe it is appropriate to allow an SCI entity to delay the submission of SCI review reports to the Commission in order to bundle several reports together and submit them on a quarterly or semi-annual basis. Rather, the Commission believes that it is important to receive such reports in a timely manner after completion of the SCI review, so that the Commission is made aware of potential areas of weakness in an SCI entity's systems that may pose risk to the entity or the market as a whole, as well as areas of non-compliance with the provisions of Regulation SCI, without undue delay.

With respect to clearing agencies, two commenters noted that the SCI review requirement potentially might overlap with staff guidance for clearing agencies that calls for an annual report on internal controls and recommended that the Commission consider further coordination on potential redundancies.¹¹¹¹ The Commission notes that the section in the guidance provided in the Announcement for Standards for the Registration of Clearing Agencies referenced by commenters is distinct from the adopted SCI review requirement, as such section in the guidance relates to the review and evaluation of clearing agencies' accounting controls.¹¹¹² In contrast, the SCI review requirement involves a risk assessment and assessment of internal control design and effectiveness of all of an SCI entity's SCI systems and indirect SCI systems.

¹¹¹¹ See OCC Letter at 19-20; and DTCC Letter at 18 (citing Securities Exchange Act Release No. 16900, 45 FR 41920, available at: <http://sec.gov/rules/other/34-16900.pdf>).

¹¹¹² See Securities Exchange Act Release No. 16900 (June 17, 1980), 45 FR 41920 (June 23, 1980).

Finally, it should be noted that the required review and timely reporting to the Commission will enable the Commission and Commission staff to monitor the quality of compliance with Regulation SCI, thoroughness and robustness of SCI reviews, and the responses of senior management to such reviews. Accordingly, the Commission will be in a position to consider enhancing these regulatory requirements in the future, if necessary.

6. SCI Entity Business Continuity and Disaster Recovery Plans Testing Requirements for Members or Participants – Rule 1004

Adopted Rule 1004 addresses testing of SCI entity business continuity and disaster recovery plans, including backup systems, by SCI entity members or participants. Rule 1004 corresponds to proposed Rule 1000(b)(9), and is adopted with certain modifications in response to comment, as discussed below.

a. Proposed Rule 1000(b)(9)

Proposed Rule 1000(b)(9)(i) required each SCI entity, with respect to its BC/DR plans, to require participation by designated members or participants in scheduled functional and performance testing of the operation of such plans, in the manner and frequency specified by the SCI entity, at least once every 12 months. Proposed Rule 1000(b)(9)(ii) further required each SCI entity to coordinate the testing of such plans on an industry- or sector-wide basis with other SCI entities. Proposed Rule 1000(b)(9)(iii) would have additionally required each SCI entity to designate those members or participants it deems necessary, for the maintenance of fair and orderly markets in the event of the activation of its BC/DR plans, to participate in the testing of such plans, and notify the Commission of such designations and its standards for such designation on Form SCI.

b. Comments and Commission Response

The Commission received significant comment on proposed Rule 1000(b)(9) and is adopting it with revisions, as Rule 1004. As more fully discussed below, the adopted rule requires designation of a more limited set of SCI entity members and participants for mandatory participation in BC/DR testing than the proposed rule. Further, the adopted rule does not require an SCI entity to file designation standards or member/participant designations with the Commission on Form SCI, as was proposed, but instead an SCI entity must keep records of its standards and designations. The scope, frequency, and coordination aspects of the proposed rule are adopted as proposed.

i. Mandatory BC/DR Testing Generally

Some commenters expressed general support for the goals of proposed Rule 1000(b)(9).¹¹¹³ One commenter in particular stated that “[i]t is vital that as many firms as possible participate in [market-wide] testing with conditions as realistic as possible.”¹¹¹⁴ According to this commenter, broader mandatory participation in testing would be “one of the most valuable parts of Regulation SCI and will do the most to ensure improved market network reliability.”¹¹¹⁵ Another commenter expressed support for broad participation in BC/DR testing, but also expressed concern that the testing requirement would put SCI entities at a competitive disadvantage versus non-SCI entities.¹¹¹⁶

¹¹¹³ See, e.g., Angel Letter at 9; UBS Letter at 4-5; and FIF Letter at 6-7.

¹¹¹⁴ See Angel Letter at 9.

¹¹¹⁵ See *id.* at 10.

¹¹¹⁶ See FIF Letter at 7.

Several commenters objected to the proposed mandatory testing requirement for SCI ATs.¹¹¹⁷ For example, two commenters suggested that few ATs are critical enough to warrant inclusion in the proposed mandatory testing requirement.¹¹¹⁸ One commenter urged that only SCI entities that provide market functions on which other market participants depend be subject to the requirements for separate backup and recovery capabilities.¹¹¹⁹ Another commenter stated that the added benefit of requiring fully redundant backup systems is almost impossible to measure while the cost of implementation is significant, and added further that fully redundant systems and increased testing do not guarantee a flawless backup plan.¹¹²⁰

Two commenters stated that the current voluntary coordinated testing organized by SIFMA¹¹²¹ already attracts significant participation without any mandate in place.¹¹²² However, a different commenter noted the difficulties it has encountered in fostering participation in its voluntary disaster recovery exercises, and stated that, despite encouraging users to participate in its disaster recovery exercises, participation levels were only 20 percent of its targeted high volume client base.¹¹²³ One commenter sought clarification on whether the requirements of proposed Rule 1000(b)(9) would apply only to trading and clearance systems, or would extend to

¹¹¹⁷ See SIFMA Letter at 17; BIDS Letter at 8; and ITG Letter at 15.

¹¹¹⁸ See BIDS Letter at 5, 8; and ITG Letter at 15.

¹¹¹⁹ See KCG Letter at 8.

¹¹²⁰ See Group One Letter at 3.

¹¹²¹ SIFMA organizes an annual industry-wide testing exercise for firms and exchanges to submit and process test orders using their backup facilities. Participation is voluntary. See <http://www.sifma.org/services/bcp/industry-testing/>.

¹¹²² See CME Letter at 13; and Tellefsen Letter at 7-8.

¹¹²³ See Omgeo Letter at 26 (noting also that it lacks the ability to require participation by its clients).

other SCI systems as well.¹¹²⁴ Two commenters asked whether third parties that perform critical market functions for an SCI entity, such as data vendors and service bureaus, would be subject to the proposed requirement.¹¹²⁵ One commenter stated that testing by an SCI entity of its business continuity capabilities should not be required to be coordinated with members.¹¹²⁶ According to this commenter, “[t]he entire point of [business continuity plan testing] would be to not coordinate it with customers, and assess whether operations out of [backup] facilities was seamless to members and other market participants.”¹¹²⁷ One commenter stated that it would be more appropriate for SCI entities’ members and participants to be responsible for their own business continuity plans and testing.¹¹²⁸ The Commission has carefully considered commenters’ views on the need for all SCI entities to be subject to the proposed mandatory testing requirement. The Commission continues to believe that adopted Rule 1004 should apply to all SCI entities.

Whereas adopted Rule 1001(a)(2)(v) requires that each SCI entity’s policies and procedures include BC/DR plans and specifies recovery goals and geographic diversity requirements for such plans,¹¹²⁹ adopted Rule 1004 sets forth certain minimum requirements for

¹¹²⁴ See FINRA Letter at 37.

¹¹²⁵ See FINRA Letter at 39; and MSRB Letter at 25.

¹¹²⁶ See Direct Edge Letter at 9.

¹¹²⁷ See id.

¹¹²⁸ See SIFMA Letter at 17. In addition, some commenters believed that ATs should be excluded from requiring members or participants to test, given that ATs and their broker-dealer participants are already subject to FINRA Rule 4370, which relates to BC/DR plans. See FIA PTG Letter at 5; and BIDS Letter at 9.

¹¹²⁹ See supra Section IV.B.1.b (discussing the requirement that an SCI entity have reasonable policies and procedures that include business continuity and disaster recovery plans that include maintaining backup and recovery capabilities sufficiently resilient and geographically diverse and that are reasonably designed to achieve next business day

SCI entity testing of its BC/DR plans. Adopted Rule 1004, like proposed Rule 1000(b)(9), aims to reduce the risks associated with an SCI entity's decision to activate its BC/DR plans and help to ensure that such plans operate as intended, if activated, by requiring that an SCI entity include participation by certain members and participants in testing of the SCI entity's BC/DR plans.

Although some commenters, including several ATSS, argued that ATSS should be excluded from requiring members or participants to test because, according to these commenters, ATSS are less critical to the orderly functioning of the markets than other SCI entities,¹¹³⁰ the Commission believes that eliminating any category of SCI entity—including SCI ATSS—from the testing requirement would undermine the goal of maintaining fair and orderly markets in the wake of a wide-scale disruption, and assuring the smooth and effective implementation of an SCI entity's BC/DR plans.¹¹³¹ The Commission continues to believe that a testing participation requirement will help an SCI entity to ensure that its efforts to develop effective BC/DR plans are not undermined by a lack of participation by members or participants that the SCI entity believes are necessary to the successful activation of such plans.¹¹³² As stated in the SCI Proposal, the Commission believes that a factor in the shutdown of the equities and options markets in the wake of Superstorm Sandy was the exchanges' belief regarding the inability of some market

resumption of trading and two-hour resumption of critical SCI systems following a wide-scale disruption).

¹¹³⁰ See supra note 1118 and accompanying text.

¹¹³¹ See supra Section IV.A.1 (discussing the Commission's rationale for adopting the definition of SCI entity as proposed). See supra Section IV.B.1.b (discussing the BC/DR requirements in Rule 1001(a)(2)(v) for SCI entities). See also infra Sections VI.C.1.c and VI.C.2.b.vii (discussing competitive concerns raised by requiring SCI entities to require members or participants to participate in the SCI entities' BC/DR testing).

¹¹³² See Proposing Release, supra note 13, at 18125.

participants to adequately operate from the backup facilities of all market centers.¹¹³³ And, although testing protocols were in place and the chance to participate in such testing was available, the member participation rate was low.¹¹³⁴ The Commission does not agree with comments that seamless operation of backup facilities should not require coordination of testing, or that the fact that members and participants have their own BC/DR plans and testing means that they should not be required, if designated, to participate in the testing of an SCI entity's BC/DR plans.¹¹³⁵ The Commission continues to believe that testing of the effectiveness of back-up arrangements in recovering from a wide-scale disruption is a sound principle, and that, without the participation of significant members or participants of SCI entities, the effectiveness of such testing could be undermined. Based on its experience with the ARP Inspection Program, the Commission understands that many SCI entities have already made significant investments in their backup facilities.¹¹³⁶ The Commission believes that the requirements of Rule 1004 will help to ensure that such facilities will be effective in the event they are needed.¹¹³⁷

¹¹³³ See *id.* at 18158. See also *id.* at 18091. The Commission notes that its basis for adopting a mandatory testing rule is independent of whether the market closures in the wake of Superstorm Sandy were appropriate to protect the health and safety of exchange personnel.

¹¹³⁴ See *id.* at 18158 and text accompanying n. 83 at 18091. In addition, based on the discussions of Commission staff with market participants in the months following Superstorm Sandy, the Commission understands that many market participants had previously engaged in connectivity testing with backup facilities, and yet remained uncomfortable about switching over to the use of backup facilities in advance of the storm.

¹¹³⁵ Nor does the Commission agree that Rule 1004 would be duplicative of FINRA Rule 4370, as Rule 1004 relates to participation by members or participants in the testing of an SCI entity's business continuity plans, whereas FINRA Rule 4370 relates to the testing of the member's or participant's own business continuity plan. See *supra* note 539 and accompanying text.

¹¹³⁶ See *infra* Section VI.B.2 (stating that nearly all national securities exchanges already have backup facilities that do not rely on the same infrastructure components as those

In response to commenters who questioned the need for mandatory participation by SCI entity members and participants,¹¹³⁸ the Commission believes that current voluntary industry-led testing has been useful because it annually brings together a wide variety of market participants, including many SCI entities, and involves a range of asset classes.¹¹³⁹ The current industry-led testing program coordinated by SIFMA therefore could provide a foundation for the development of the testing required by Rule 1004. However, because participation rates by members and participants in voluntary testing generally has been low, the Commission believes that a mandatory participation requirement is the best means to achieve effective and coordinated BC/DR testing with assured participation by the more significant SCI entity members and participants.¹¹⁴⁰ In addition, although the Commission generally agrees with the comment that “[i]t is vital that as many firms as possible participate in [market-wide] testing with conditions as

used by their primary facility).

¹¹³⁷ See 2003 BCP Policy Statement, supra note 512, at 56658 (stating: “The effectiveness of back-up arrangements in recovering from a wide-scale disruption should be confirmed through testing.”). See also Interagency White Paper, supra note 512, at 17811 (identifying “a high level of confidence, through ongoing use or robust testing, that critical internal and external continuity arrangements are effective and compatible” as one of three important business continuity objectives). See also supra Section IV.B.1.b (discussing adopted Rule 1001(a)(2)(v)).

¹¹³⁸ See supra notes 1117-1122 and accompanying text.

¹¹³⁹ See <http://www.sifma.org/services/bcp/industry-testing/> (in which SIFMA describes its annual BC/DR test held annually in October, which includes assets classes such as commercial paper, equities, options, futures, fixed-income, settlement, payments, Treasury auctions and market data).

¹¹⁴⁰ See supra note 1123 (noting Omgeo’s comment that voluntary participation levels are low). See also Proposing Release, supra note 13, at 18091, n. 83 and accompanying text (noting that press reports indicated that a large number of NYSE members did not participate in NYSE’s contingency plan testing that occurred seven months prior to Superstorm Sandy).

realistic as possible,”¹¹⁴¹ because of the burden and costs of requiring participation by all SCI entity members and participants, regardless of their market significance, the Commission believes it is appropriate to adopt a more measured approach to mandatory participation in BC/DR testing.¹¹⁴² The Commission is therefore adopting a BC/DR testing designation requirement that applies to all SCI entities, but does not apply to all members and participants of SCI entities, as discussed below.¹¹⁴³

ii. SCI Entity Designation of Members or Participants for Participation in BC/DR Testing – Rules 1004(a)-(c)

Several commenters raised concerns about the proposed requirement that SCI entities exercise discretion to designate members or participants for participation in coordinated BC/DR testing under proposed Rule 1000(b)(9).¹¹⁴⁴ After careful consideration of the views of commenters, the Commission is adopting the requirement that SCI entities designate certain members or participants to participate in testing BC/DR plans with certain modifications from the proposal. As proposed, the rule would have required each SCI entity to designate those members or participants it “deems necessary, for the maintenance of fair and orderly markets in the event of the activation of its business continuity and disaster recovery plans...” The

¹¹⁴¹ See supra note 1114 and accompanying text.

¹¹⁴² In addition, because the Commission recognizes that the coordination of such testing is complex and time-consuming, it has provided for a compliance date for the coordination requirement of Rule 1004(d) that is 12 months after the compliance date required for other provisions of Regulation SCI. See Section IV.F.

¹¹⁴³ In response to commenters seeking clarification on the types of systems that would be subject to the mandatory testing requirement (see supra notes 1124-1125 and accompanying text), because the required testing is BC/DR testing, all systems necessary for an SCI entity to successfully activate its BC/DR plan would be included.

¹¹⁴⁴ See NYSE Letter at 33; FIF Letter at 6-7; Omgeo Letter at 26; Fidelity Letter at 6; and Angel Letter at 10.

Commission has determined instead to require that each SCI entity designate those members or participants “that the SCI entity reasonably determines are, taken as a whole, the minimum necessary for the maintenance of fair and orderly markets in the event of the activation of such plans.” This change is broadly consistent with the suggestion of one commenter to revise the criteria for designation to those firms “critical to the operation of the SCI entity.”¹¹⁴⁵ However, the Commission believes that the adopted standard is more appropriate in that it focuses on the ability of the SCI entity to maintain fair and orderly markets under its BC/DR plan.¹¹⁴⁶

Several commenters suggested eliminating SCI entity discretion and setting forth in the rule clear, objective criteria (such as trading volume) for which members or participants would be required to participate in testing.¹¹⁴⁷ One commenter suggested that the Commission require that all members or participants that represent a meaningful percentage of the volume in the marketplace participate in the testing in order to capture the more significant market participants, while recognizing the financial burden such testing may pose for smaller entities.¹¹⁴⁸ This commenter believed that giving discretion to SCI entities in this area might lead to regulatory arbitrage and a race to the bottom regarding how many and which members or participants are designated to participate in testing.¹¹⁴⁹ On the other hand, another commenter commented that the discretion contemplated by the proposal keeps the rule flexible enough to accommodate SCI

¹¹⁴⁵ See ISE Letter at 9.

¹¹⁴⁶ As discussed more fully in Section IV.B.6.b.iv *infra*, the Commission also believes that the adopted standard could, but would be unlikely to, cause members or participants to elect to withdraw from participation in an SCI entity (particularly a smaller SCI entity) to save on the cost of connectivity fees.

¹¹⁴⁷ See NYSE Letter at 33; Omgeo Letter at 26; Angel Letter at 10; and FIF Letter at 6.

¹¹⁴⁸ See NYSE Letter at 33.

¹¹⁴⁹ See NYSE Letter at 33.

entities conducting a diverse range of business activities.¹¹⁵⁰ This commenter also suggested that SCI entities should not be required to report to the Commission who they have designated to test, and instead should only be required to keep a record of who they have designated.¹¹⁵¹

In response to commenters who were concerned about the discretionary aspect of the designation requirement,¹¹⁵² the Commission believes the SCI entity is in the best position to determine which of its members or participants collectively represent sufficient liquidity for the SCI entity to maintain fair and orderly markets in a BC/DR scenario following a wide-scale disruption. The Commission believes such determinations require the exercise of reasonable judgment by each SCI entity, and are not well-suited for a “one-size-fits-all” objective measure determined by the Commission. For example, if the Commission were to establish an objective measure (e.g., based on a specified percentage of trading volume), it might represent a meaningful percentage for some SCI entities, but not for others. Thus, the rule requires that each SCI entity establish standards for the designation of those members or participants that the SCI entity “reasonably” determines are, taken as a whole, the minimum necessary for the maintenance of fair and orderly markets in the event of the activation of its BC/DR plans. This adopted provision is in lieu of the proposed requirement, which would have required an SCI entity to designate those members or participants it “deems necessary” for the maintenance of fair and orderly markets in the event of the activation of its BC/DR plans. Because the adopted rule requires an SCI entity’s determination to be reasonable, it provides some degree of flexibility to SCI entities but also imposes a check on SCI entity discretion, which the

¹¹⁵⁰ See CME Letter at 12.

¹¹⁵¹ See *id.* at 13.

¹¹⁵² See *supra* notes 1144, 1147-1149 and accompanying text.

Commission believes should help prevent an SCI entity's designations from being overly limited. In response to concerns that a discretionary designation requirement would lead to regulatory arbitrage and a race to the bottom regarding how many and which members or participants are designated to participate in testing, the Commission believes that this is unlikely to occur because each SCI entity will be subject to the same requirement and will be required to make a reasonable determination that the designated members or participants are those that are the minimum necessary for it to maintain fair and orderly markets in the event of activation of its BC/DR plans. Further, the Commission believes that broad participation in BC/DR testing will enhance the utility of the testing, and that allowing non-designated members or participants the opportunity to participate in such testing generally will further this goal. Therefore, the Commission encourages SCI entities to permit non-designated members or participants to participate in the testing of the SCI entity's BC/DR plans if they request to do so.

Consistent with the recommendation of one commenter, however, the Commission has determined not to require that each SCI entity notify the Commission of its designations and its standards for designation on Form SCI as proposed. Instead, an SCI entity's standards, designations, and updates, if applicable, would be part of its records and therefore available to the Commission and its staff upon request.¹¹⁵³ Unlike de minimis systems disruptions and de minimis systems intrusions, which may occur with regularity (and for which a quarterly summary report would aid Commission oversight of systems whose proper functioning is central to the maintenance of fair and orderly markets), the establishment of standards for designation, the designations themselves, and updates to such standards or designations are likely to occur less frequently. Thus, the Commission believes it is sufficient for the Commission to review

¹¹⁵³ See infra Section IV.C.1 (discussing SCI entity recordkeeping requirements).

records relating to such designations when the Commission determines that it is necessary to do so to fulfill its oversight role, such as during its examination of an SCI entity.¹¹⁵⁴ More broadly, the Commission believes this revision is generally consistent with modifications that the Commission has made in response to comment that proposed Regulation SCI would have required unnecessary and burdensome notice and reporting submissions.

Some commenters questioned whether many SCI entities, particularly non-SROs and ATs, have the authority to require their members or participants to participate in such testing.¹¹⁵⁵ Another commenter more generally stated that it was unclear how an SCI entity could enforce a requirement that its customers engage in BC/DR testing.¹¹⁵⁶ In response to these comments, the Commission believes that SCI SRO rulemaking authority and non-SRO contractual arrangements would enable SCI entities to implement this requirement.¹¹⁵⁷ Specifically, SROs have the authority, and legal responsibility, under Section 6 of the Exchange Act, to adopt and enforce rules (including rules to comply with Regulation SCI's requirements relating to BC/DR testing) applicable to their members or participants that are designed to,

¹¹⁵⁴ See supra Sections IV.A.3 and IV.B.3.c (discussing the rationale for quarterly reporting of de minimis systems disruptions and de minimis systems intrusions).

¹¹⁵⁵ See Omgeo Letter at 26; MSRB Letter at 24; BIDS Letter at 8; LiquidNet Letter at 4; and SIFMA Letter at 17. See also ITG Letter at 15-16.

¹¹⁵⁶ See SIFMA Letter at 17-18 (suggesting that the Commission instead adopt a "BCP testing requirement more akin to the 'best practices' described in the Interagency White Paper").

¹¹⁵⁷ While some designated members or participants of SCI entities might choose to withdraw from membership or participation in an SCI entity if they assess the cost of participating in BC/DR testing to be too great, the Commission believes that other aspects of their involvement with the SCI entity, including an interest in maintaining a profitable business relationship, will factor significantly into any decision regarding their continued membership or participation in the SCI entity. See also infra Sections VI.C.1.c and VI.C.2.b.vii (discussing competition between SCI entities and non-SCI entities in relation to the requirements under Rule 1004).

among other things, foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.¹¹⁵⁸ Further, SCI entities that are not SROs have the ability to include provisions in their contractual agreements with their participants (such as their subscriber or participant agreements) requiring such parties to engage in BC/DR testing.

Other commenters focused on the potential impact of the rule on the members or participants designated to participate in testing. One commenter pointed out that, without clearly defined industry level coordination, some members or participants may be overburdened by being subject to multiple individual tests with various SCI entities.¹¹⁵⁹ Another commenter asked the Commission to clarify what the obligation is for firms that are members or participants at multiple SCI entities.¹¹⁶⁰ Several commenters expressed concern that the Commission underestimated the costs and burdens of the proposed testing.¹¹⁶¹ According to some of these commenters, under the proposal, certain firms, such as market makers and other firms performing important market functions, could be required to maintain connections to the backup

¹¹⁵⁸ See Section 6 of the Exchange Act, 15 U.S.C. 78f.

¹¹⁵⁹ See OCC Letter at 18.

¹¹⁶⁰ See DTCC Letter at 13.

¹¹⁶¹ See FINRA Letter at 37-39; OCC Letter at 18; Fidelity Letter at 6; Joint SROs Letter at 15-16; ISE Letter at 9; and Group One Letter at 3. See also *infra* Section VI (discussing the costs and burdens of the requirement, including the costs for members or participants to participate in BC/DR testing).

sites of a number of SCI entities, at significant cost.¹¹⁶² A group of commenters requested that the scope be targeted to only cover those instances in which an SCI entity determines to enact its disaster recovery plans.¹¹⁶³ One commenter agreed that the designation requirement could be relaxed and still achieve the provision's aim, because the bulk of the liquidity at a market center is provided by a small number of firms.¹¹⁶⁴ Another commenter asked the Commission to give designated firms the ability to opt-out if they have a good reason.¹¹⁶⁵

The Commission believes that adoption of a more focused designation requirement that requires SCI entities to exercise reasonable discretion to identify those members or participants that, taken as a whole, are the "minimum necessary" for the maintenance of fair and orderly markets in the event of the activation of such plans is likely to result in a smaller number of SCI entity members or participants being designated for participation in testing as compared to the SCI Proposal. Because the Commission believes that SCI entities have an incentive to limit the imposition of the cost and burden associated with testing to the minimum necessary to comply with the rule, it also believes that, given the option, most SCI entities would, in the exercise of reasonable discretion, prefer to designate fewer members or participants to participate in testing, than to designate more. On balance, the Commission believes that adopted rule will incentivize SCI entities to designate those members and participants that are in fact the minimum necessary

¹¹⁶² See FINRA Letter at 37-39; OCC Letter at 18; and Fidelity Letter at 6 (expressing concern an SCI entity might cast a wide net with its designation powers to include more firms than necessary).

¹¹⁶³ See Joint SROs Letter at 16 (noting the complexity of testing a scenario in which a market participant may have enacted its business continuity plan but can still access an SCI entity through the primary facility).

¹¹⁶⁴ See Tellefsen Letter at 9.

¹¹⁶⁵ See Fidelity Letter at 6.

for the maintenance of fair and orderly markets in the event of the activation of their BC/DR plans, and that this should reduce the number of designations to which any particular member or participant would be subject, as compared to the SCI Proposal, and would potentially simplify efforts for SCI entities to coordinate BC/DR testing, as required by adopted Rule 1004(d).

Despite the modifications from the proposal, it remains possible, as some commenters noted, that firms that are members of multiple SCI entities will be the subject of multiple designations, and that multiple designations could require certain firms to maintain connections to and participate in testing of the backup sites of multiple SCI entities. The Commission believes this possibility, though real, may be mitigated by the fact that multiple designations are likely to be made to firms that are already connected to one or more SCI entity backup facilities, since they represent significant members or participants of the applicable SCI entities; and that, because some SCI entity backup facilities are located in close proximity to each other, multiple connections to such backup facilities may be less costly than if SCI entity backup facilities were not so located. The Commission recognizes that there will be greater costs to a firm being designated by multiple SCI entities to participate in the testing of their BC/DR plans than to a firm designated by only one SCI entity. However, the Commission believes that these greater costs are warranted for such firms, as they represent significant participants in each of the SCI entities for which they are designated, and their participation in the testing of each such SCI entity's BC/DR plans is necessary to evaluate whether such plans are reliable and effective. The designation of a firm to participate in the BC/DR testing of an SCI entity means that such firm is significant, as the SCI entity has reasonably determined it to be included in the set of its members or participants that is, "taken as a whole, the minimum necessary for the maintenance of fair and orderly markets in the event of the activation of such plans." Nonetheless, the Commission acknowledges that there

may be instances in which an SCI entity has reasonably designated a firm to participate in BC/DR testing, and the firm is unwilling to bear the cost of participation in BC/DR testing with a given SCI entity. In such instances, there may be firms that opt out of such testing by withdrawing as a member or subscriber of one or more SCI entities, but the Commission believes that is unlikely. In particular, the Commission believes that it is unlikely that a firm determined to be significant enough to be designated to participate in testing by an SCI entity would choose to withdraw its membership or participation in an SCI entity solely because of the costs and burdens of Regulation SCI's BC/DR testing provisions. The Commission also believes that such firm is likely to be a larger firm with greater resources and a significant level of participation in such SCI entity, and is likely to already be connected to the backup facility of the SCI SRO that is designating it to test.¹¹⁶⁶ Moreover, the Commission does not agree with the suggestion made by one commenter that the Commission give designated firms the ability to "opt-out" if they have a good reason,¹¹⁶⁷ because the ability to opt-out in this manner would render participation in BC/DR testing voluntary which, as discussed above, is unlikely to result in adequate BC/DR testing.¹¹⁶⁸ The Commission continues to believe, as stated in the SCI Proposal, that "unless there is effective participation by certain of its members or participants in the testing of [BC/DR] plans, the objective of ensuring resilient and available markets in general, and the maintenance of fair and orderly markets in particular, would not be achieved."¹¹⁶⁹ Although the Commission recognizes that testing of a BC/DR plan does not guarantee flawless execution of that plan, the

¹¹⁶⁶ See infra Section IV.B.6.b.iv.

¹¹⁶⁷ See Fidelity Letter at 6.

¹¹⁶⁸ See supra note 1140 and accompanying text.

¹¹⁶⁹ See Proposing Release, supra note 13, at 18091, 18125.

Commission believes that a tested plan is likely to be more reliable and effective than an inadequately tested plan.¹¹⁷⁰

iii. Scope, Timing, and Frequency of BC/DR Testing – Rule 1004(b)

The SCI Proposal specified that the type of testing for which designees would be required to participate was “scheduled functional and performance testing of the operation of [BC/DR] plans, in the manner and frequency specified by the SCI entity, at least once every 12 months.”¹¹⁷¹ After careful consideration of the views of commenters, the Commission is adopting the scope, frequency, and timing requirements in the rule as proposed. Specifically, adopted Rule 1004(b) requires that an SCI entity’s designees participate in “scheduled functional and performance testing of the operation of [BC/DR] plans, in the manner and frequency specified by the SCI entity, provided that such frequency shall not be less than once every 12 months.”

In the SCI Proposal, the Commission noted that functional testing is commonly understood to examine whether a system operates in accordance with its specifications, whereas performance testing examines whether a system is able to perform under a particular workload.¹¹⁷² The Commission added that functional and performance testing should include not only testing of connectivity, but also testing of an SCI entity’s systems, such as order entry, execution, clearance and settlement, order routing, and the transmission and/or receipt of market

¹¹⁷⁰ Further, because the Commission believes that increased participation in BC/DR testing is likely to enhance the utility of the testing, the Commission encourages SCI entities to permit members or participants that do not meet the SCI entity’s reasonable designation standards to participate in such testing if they request to do so.

¹¹⁷¹ See proposed Rule 1000(b)(9)(i).

¹¹⁷² See Proposing Release, supra note 13, at 18125, n. 267.

data, as applicable, to determine if they can operate as contemplated by its business continuity and disaster recovery plans.¹¹⁷³ With regard to the proposed scope of testing, several commenters expressed specific concerns about the requirement for “functional and performance” testing of BC/DR plans.¹¹⁷⁴ Specifically, one commenter expressed concern about the logistical challenges of conducting functional and performance testing at the same time.¹¹⁷⁵ Two commenters expressed concern that requiring firms to perform industry-wide, end-to-end testing by processing transactions in their disaster recovery systems would introduce risk to the markets because such testing would increase the chance that test transactions could inadvertently be introduced into production systems.¹¹⁷⁶ Another commenter stated that a full functional test across all primary and recovery data centers for any significant number of members or participants would require substantial time to conduct and may require market downtime, as would a full performance test.¹¹⁷⁷ One group of commenters suggested that the scope of the

¹¹⁷³ See id. at 18126.

¹¹⁷⁴ See, e.g., FINRA Letter at 37; OCC Letter at 18; and DTCC Letter at 12.

¹¹⁷⁵ See FINRA Letter at 37 (stating that combining performance testing with functional testing on weekends would be difficult and possibly not feasible because an end-to-end functional test combined with a stress test would require much more time to accommodate processing volumes than would be afforded in an abbreviated non-business day session).

¹¹⁷⁶ See OCC Letter at 17-18 (stating that its systems and systems of many member firms are configured to prevent test activity from being processed by production or disaster recovery systems); and DTCC Letter at 12 (stating similarly that the testing proposed by Rule 1000(b)(9) (as opposed to communication and connectivity testing) would not be supported by most SCI entities’ current systems configurations, and encouraging the Commission to consider this in adopting testing requirements).

¹¹⁷⁷ See Omgeo Letter at 26-27. This commenter urged a more limited scope of testing. Specifically, this commenter urged the Commission to focus on “smoke testing,” which it characterized as a more limited form of testing to validate that system functionality is fully deployed and operational in the new recovered or resumed production environment, and with respect to the goals of performance testing, a more limited set of system

requirement should be revised to only cover “functional and operational testing” of disaster recovery plans, but requested additional guidance with regard to the scope of testing required to establish the effectiveness of disaster recovery plans.¹¹⁷⁸ This group of commenters expressed concern about the “complexity and cost associated with establishing an effective coordinated test script that captures the significant number of possibilities that may occur to each significant market participant or SCI entity” and recommended that the scope of the coordinated functional and operational testing requirements be revised to cover those instances in which an SCI entity determines to enact its disaster recovery plan.¹¹⁷⁹ Two commenters believed the tests should be “scenario-based” to recreate as closely as possible the actual conditions that would trigger widespread use of BC/DR plans.¹¹⁸⁰

Adopted Rule 1004(b) provides that the scope of required testing is “functional and performance testing of the operation of BC/DR plans.” As stated in the SCI Proposal, such functional and performance testing should include not only testing of connectivity, but also testing of an SCI entity’s systems, such as order entry, execution, clearance and settlement, order routing, and the transmission and/or receipt of market data, as applicable, to determine if they

operations to assure that the recovery system would perform those operations at roughly comparable speeds as those performed on the main production systems. This commenter further stated that, in both cases, the purpose of these tests would be to validate that the backup or recovery systems have the necessary functionality to perform the service required of the SCI systems, and have sufficient capacity to process the production workloads at roughly comparable levels of performance, rather than to test the actual functional or performance characteristics of the backup or alternate recovery systems in their own right. See Omgeo Letter at 27.

¹¹⁷⁸ See Joint SROs Letter at 15-16.

¹¹⁷⁹ See id. at 16.

¹¹⁸⁰ See FIF Letter at 7; and UBS Letter at 4.

can operate as contemplated by its business continuity and disaster recovery plans.¹¹⁸¹ In response to commenters expressing concern about the breadth of the requirement, the Commission notes that the rule requires functional and performance testing of the “operation of [BC/DR] plans.” While the type of testing required by adopted Rule 1004(b) is more rigorous than some types of testing urged by some commenters, the Commission does not believe that the requirement for “functional and performance testing of the operation of such plans” requires additional testing that is as burdensome as that feared by some of those commenters. Importantly, “functional and performance testing of the operation of [BC/DR] plans” entails testing that goes beyond communication and connectivity testing, and beyond validation testing, which are more limited types of testing urged by some commenters. But the requirement to conduct “functional and performance testing of the operation of [BC/DR] plans” does not mean that a full test of the functional and performance characteristics of each backup facility is required to be conducted all at once and in coordination with other SCI entities all at the same time, as some commenters characterized the proposed requirement.¹¹⁸² Specifically, the Commission notes that the testing of BC/DR plans, which is required by Rule 1004, is different from testing of the function and performance of backup facilities generally.¹¹⁸³ What Rule 1004 requires is coordinated testing to evaluate annually whether such backup facilities of SCI entities

¹¹⁸¹ See Proposing Release, *supra* note 13, at 18126.

¹¹⁸² Conducting the required testing is not intended to require market downtime, but permits a range of possibilities, as SCI entities determine to be appropriate, including weekend testing, as well as testing in segments over the course of a year, if SCI entities determine that, to meet the requirements of the rule, a single annual test cannot be properly conducted within a single period of time (e.g., over the course of a weekend).

¹¹⁸³ Testing of the function and performance of backup facilities generally would occur before such facilities are launched into production (such as pursuant to Rule 1001(a)), and Regulation SCI does not impose a requirement for coordinating such testing with other SCI entities.

can function and perform in accordance with the operation of BC/DR plans in the event of wide-scale disruption. In addition, the Commission notes that performance testing, which examines whether a system is able to perform under a particular workload, is not synonymous with “stress testing,” in which capacity limits are tested, and therefore should not require as much time to conduct as one commenter suggested.

In response to commenters concerned that the required testing would necessitate system reconfigurations,¹¹⁸⁴ the Commission understands that the requirement to test backup facilities may require technology adjustments to permit testing activity to be processed by BC/DR systems, and believes that such adjustments to permit testing are warranted to achieve the goal, as discussed above, of achieving reliable and effective BC/DR plans at SCI entities. The Commission also believes that such system reconfigurations would be less burdensome than a Commission rule requiring the establishment of a dedicated environment for safe end-to-end testing that accurately simulates the trading environment, which some commenters suggested might be appropriate. One group of commenters noted the “complexity and cost associated with establishing an effective coordinated test script,” and urged that the scope of the coordinated testing be “narrowed to cover those instances in which an SCI entity determines to enact its disaster recovery plan.” The Commission acknowledges that establishment of an effective coordinated test script will involve some costs and complexity, but believes that this is an important first step in establishing robust and effective testing under the rule. The Commission encourages SCI entities to develop one or more test scripts contemplating a wide-scale disruption

¹¹⁸⁴ See *supra* note 1176 and accompanying text. See also Tradebook Letter at 2-3 (stating its view that “the only way to test integration from order generation to allocation and then through to final settlement, is in the production environment” and “test tickers that operate in the production environment are the only way to reliably simulate exactly what will happen in the production environment with a live order”).

and the enactment by SCI entities in the region of the wide-scale disruption of their BC/DR plans.

Further, the Commission notes that nothing in Rule 1001(a) nor Rule 1004 requires that an SCI entity's BC/DR plan specify that its backup site must fully replicate the capacity, speed, and other features of the primary site. Similarly, SCI entity members and participants are not required by Regulation SCI to maintain the same level of connectivity with the backup sites of an SCI entity as they do with the primary sites.¹¹⁸⁵ In the event of a wide-scale disruption in the securities markets, the Commission acknowledges that an SCI entity and its members or participants may not be able to provide the same level of liquidity as on a normal trading day. In addition, the Commission recognizes that the concept of "fair and orderly markets" does not require that trading on a day when business continuity and disaster recovery plans are in effect will reflect the same levels of liquidity, depth, volatility, and other characteristics of trading on a normal trading day. Nevertheless, the Commission believes it is critical that SCI entities and their designated members or participants be able to operate with the SCI entities' backup systems in the event of a wide-scale disruption. Therefore, Rule 1004 requires that an SCI entity's BC/DR plan that meets the requirements of Rule 1001(a)(2)(v) be tested for both its functionality and performance as specified by the SCI entity's BC/DR plan.

In addition, several commenters addressed testing more generally.¹¹⁸⁶ For example, some commenters urged that comprehensive, industry-wide, end-to-end testing could be enhanced if

¹¹⁸⁵ See infra Section VI.C.2.b.vii (discussing the estimated costs of adopted Rule 1004).

¹¹⁸⁶ See Tradebook Letter at 1-3; CAST Letter at 9; FIA PTG Letter at 2; and CoreOne Letter at 3-7.

there were uniform test tickers supported by the testing infrastructure at all SCI entities.¹¹⁸⁷ Two commenters urged the establishment of principles for end-to-end, integrated testing.¹¹⁸⁸

Specifically, one of these commenters suggested that SCI entities, the Commission, and relevant third-parties think about how to establish a dedicated environment where end-to-end testing could be done safely, and where it could accurately simulate the trading environment.¹¹⁸⁹ This commenter also suggested that testing plans concentrate on high volume periods, stress testing common order types, and focusing on securities that generally experience low liquidity.¹¹⁹⁰ This commenter believed that industry-wide testing should include derivatives and cross-asset scenarios, and possibly include some involvement by foreign regulators and markets as well.¹¹⁹¹

While the suggestions of these commenters are not inconsistent with the rule's requirement for functional and performance testing of BC/DR plans, the Commission has determined not to require them because the Commission does not believe, at this time, that these suggestions are necessary in every instance to achieve reliable and effective BC/DR plans at SCI entities. However, to the extent an SCI entity believes them to be appropriate for its systems, these suggestions could be utilized in its BC/DR plans testing.

Importantly, the adopted rule does not prescribe how SCI entities are to develop plans for functional and performance testing of order entry, execution, clearance and settlement, order routing, and the transmission and/or receipt of market data, as applicable, to determine if these functions can operate as contemplated by SCI entity BC/DR plans. Thus, as with the proposed

¹¹⁸⁷ See Tradebook Letter at 2-3; CAST Letter at 9; and FIA PTG Letter at 2.

¹¹⁸⁸ See CoreOne Letter at 3; and Tradebook Letter at 1-3.

¹¹⁸⁹ See CoreOne Letter at 3.

¹¹⁹⁰ See *id.* at 3-4.

¹¹⁹¹ See *id.* at 7.

requirement, the adopted rule provides an SCI entity with discretion to determine the precise manner and content of the BC/DR testing required pursuant to Rule 1004, and SCI entities have discretion to determine, for example, the duration of the testing, the sample size of transactions tested, the scenarios tested, and the scope of the test. Therefore, while comments urging the creation of uniform test tickers, establishment of principles for end-to-end testing, mandatory types of test scripts, and cross-asset and cross-jurisdictional coordination are matters that SCI entities may wish to consider in implementing the testing required by the rule, the Commission does not believe it is appropriate to mandate such details in Regulation SCI. To do so would be more prescriptive than the Commission believes is appropriate, as this requirement is designed to provide SCI entities flexibility and discretion in determining how to meet it. The Commission believes that the adopted testing requirement will help to improve securities market infrastructure resilience by helping to ensure not only that an SCI entity can operate following an event that triggers its BC/DR plans, but also that it can do so with a greater level of confidence that its core members or participants are also ready based on experience during testing. The Commission is adopting Rule 1004(b) substantively as proposed because it gives SCI entities discretion to develop a test that meets the requirements of the rule.

One commenter recommended requiring that each entity be run entirely under its backup plan at least one day a year for a full trading day, and that the entire market run off of the backup sites at least once a year.¹¹⁹² While adopted Rule 1004 would not preclude this approach, the Commission notes that other commenters disagreed with the wisdom of it.¹¹⁹³ Specifically, one group of commenters stated that the risks of testing in a “live production environment on a

¹¹⁹² See Angel Letter at 10.

¹¹⁹³ See Joint SROs Letter at 15; and Group One Letter at 2.

periodic basis” outweigh the benefits.¹¹⁹⁴ Another commenter stated that requiring SCI entities to operate using their backup facilities would increase the risk of erroneous quotes and orders entering the marketplace.¹¹⁹⁵

After careful consideration of these comments, the Commission has determined not to prescribe the time of day or week during which testing shall occur. In addition, the adopted rule does not require an SCI entity to test its BC/DR plan in live production, but also does not prohibit an SCI entity from testing its BC/DR plans in live production, either, if an SCI entity determines such a method of testing to be appropriate. The Commission continues to believe that SCI entities are in the best position to structure the details of the test in a way that would maximize its utility.

With respect to testing frequency, one commenter agreed with the proposal that an SCI entity’s BC/DR plans, including its backup systems, be tested “at least once every 12 months.”¹¹⁹⁶ One commenter stated that the rule should explicitly set forth the required frequency of testing.¹¹⁹⁷ One commenter believed that two coordinated industry tests per year would be more appropriate.¹¹⁹⁸ One commenter believed that testing once per year is arbitrary, and suggested that a risk-based approach might justify testing certain systems with more or less frequency.¹¹⁹⁹

¹¹⁹⁴ See Joint SROs Letter at 15.

¹¹⁹⁵ See Group One Letter at 2.

¹¹⁹⁶ See DTCC Letter at 13

¹¹⁹⁷ See NYSE Letter at 33.

¹¹⁹⁸ See FIF Letter at 6.

¹¹⁹⁹ See MSRB Letter at 24.

The Commission is adopting as proposed the requirement that testing occur not less than once every 12 months. Although commenters offered differing views on the appropriate frequency for the required testing,¹²⁰⁰ the Commission continues to believe that a testing frequency of once every 12 months is an appropriate minimum frequency that encourages regular and focused attention on the establishment of meaningful and effective testing. In the context of coordinated BC/DR testing, the Commission believes the key is for testing to occur regularly enough to offer practical utility in the event of a wide-scale disruption without imposing undue cost, and that a minimum frequency of one year achieves this balance. This requirement does not prevent SCI entities from testing more frequently, but rather is intended to give SCI entities the flexibility to test their BC/DR plans, including their backup systems, at more frequent intervals if they find it appropriate to do so.

iv. Industry- or Sector-Wide Coordination – Rule 1004(d)

Proposed Rule 1000(b)(9)(a)(ii) specified that an SCI entity would be required to coordinate the testing of BC/DR plans on an industry- or sector-wide basis with other SCI entities. The Commission received significant comment on this aspect of the proposal.

Two commenters supported the coordinated testing requirement.¹²⁰¹ Specifically, one of these commenters stated that a coordination requirement targets an area where technology risks have left the markets more vulnerable, namely, the complex ways that firms interact.¹²⁰² This commenter favored market-wide testing as a way to better manage that risk.¹²⁰³ This commenter

¹²⁰⁰ See supra notes 1196-1199.

¹²⁰¹ See Angel Letter at 9; and UBS Letter at 4.

¹²⁰² See Angel Letter at 9.

¹²⁰³ See id.

also stated that coordination is vital because the more SCI entities and member firms that participate in testing, the more realistic that testing will be.¹²⁰⁴ Another commenter noted that one of the most important steps in validating and maintaining systems integrity is an effective BC/DR model and urged the Commission to promptly advance a program to introduce a new and more comprehensive BC/DR testing paradigm.¹²⁰⁵

In contrast, some commenters opposed the proposed comprehensive, coordinated testing structure.¹²⁰⁶ Some commenters stated that coordinating testing presents significant technological and logistical challenges that need to be weighed carefully.¹²⁰⁷ One commenter stated that coordinated testing is a good aspirational goal, but expressed concern that too much is outside of the control of an individual SCI entity, and therefore the rule should, at most, require SCI entities to attempt to coordinate such testing.¹²⁰⁸ Another commenter stated that the fixed-income market is so fragmented that coordinated testing is difficult to conduct and much less imperative.¹²⁰⁹

Some commenters offered suggestions on how to improve the proposed coordination requirement. One commenter urged that coordination only be required among providers of singular services in the market (*i.e.*, exchanges that list securities, exclusive processors under

¹²⁰⁴ See id.

¹²⁰⁵ See UBS Letter at 4-5. This commenter also stated that improved BC/DR testing should not be delayed until Regulation SCI is adopted. See UBS Letter at 5.

¹²⁰⁶ See DTCC Letter at 12-13; FINRA Letter at 37-39; OCC Letter at 17-18; and ISE Letter at 8.

¹²⁰⁷ See LiquidPoint Letter at 4; and SIFMA Letter at 17-18. See also supra notes 1175-1177 and accompanying text.

¹²⁰⁸ See CME Letter at 13.

¹²⁰⁹ See TMC Letter at 3.

NMS plans, and clearing and settlement agencies).¹²¹⁰ Some commenters believed that coordination would work best if it was organized by an entity with regulatory authority over SCI entities, or by an organization designated by the Commission to fulfill that role.¹²¹¹ One such commenter supported coordinating testing through a Commission-approved plan, provided SCI entities have the right to maintain the confidentiality of certain critical information.¹²¹² Another commenter recommended that the Commission work with the CFTC to adopt a coordinated approach to dealing with technology issues across financial markets, including through participation by derivatives exchanges in testing alongside their equity markets counterparts.¹²¹³

After careful consideration of the comments, the Commission has determined to adopt the coordination requirement as proposed. Specifically, Rule 1004(d) requires that an SCI entity “coordinate the testing of [BC/DR] plans on an industry- or sector-wide basis with other SCI entities.” The Commission recognizes that coordinating industry- or sector-wide testing among SCI entities and their designated members or participants may present logistical challenges. Because of these challenges, the Commission does not believe that a more prescriptive approach is warranted. Instead, the coordination requirement provides discretion to SCI entities to determine how to meet it.

The Commission does not agree with commenters suggesting that the Commission should assume leadership on the organization of coordinated testing, designate an organization to fulfill that role, or require a “Commission-approved plan” for testing, because it believes at this

¹²¹⁰ See Direct Edge Letter at 9.

¹²¹¹ See DTCC Letter at 13; OCC Letter at 18; and NYSE Letter at 33.

¹²¹² See NYSE Letter at 33.

¹²¹³ See Angel Letter at 12.

time that SCI entities can achieve coordination more quickly and efficiently without the imposition of a formal procedural framework that these suggestions would entail.¹²¹⁴ In response to comment suggesting that coordination should be aspirational rather than required, the Commission believes that, because trading in the U.S. securities markets today is dispersed among a wide variety of exchanges, ATSS, and other trading venues, and is often conducted through sophisticated trading strategies that access many trading platforms simultaneously, requiring SCI entities to coordinate testing would result in testing under more realistic market conditions.¹²¹⁵ The Commission also continues to believe that it would be more cost-effective for SCI entity members and participants to participate in testing of SCI entity BC/DR plans on an industry- or sector-wide basis than to test with each SCI entity on an individual basis because such coordination would likely reduce duplicative testing efforts.¹²¹⁶ In addition, if SCI entities that are “providers of singular services” in the markets (i.e., which the Commission believes would be synonymous with SCI entities that are providers of “critical SCI systems”) lead

¹²¹⁴ With respect to the suggestion that there be a Commission approved plan, the Commission notes that Rule 608 of Regulation NMS is designed to facilitate participation in NMS plans by self-regulatory organizations, which does not include SCI entities that are not SCI SROs, including SCI ATSS. The Commission notes that at least one commenter suggested that the Commission work with the CFTC to adopt a coordinated approach to testing. But, as discussed above, the Commission believes that Regulation SCI is an important step to reduce the risks associated with a decision to activate BC/DR plans. And, although the Commission may in the future consider additional initiatives to promote further coordination with the CFTC, in the Commission’s view, this initial step of adopting Regulation SCI should not be delayed.

¹²¹⁵ See Proposing Release, supra note 13, at 18126.

¹²¹⁶ In response to comment that coordinated BC/DR testing is not needed in the current fixed-income market, the Commission notes that it has determined to exclude ATSS trading only municipal securities or corporate debt securities from the scope of Regulation SCI. See supra notes 189-192 and accompanying text (discussing the exclusion of ATSS trading only fixed-income securities from the definition of SCI ATS).

coordination efforts on behalf of all SCI entities, such an approach would not be impermissible under Rule 1004(d), provided all SCI entities agreed to such an approach.

In response to commenters who more generally expressed concern about the rule subjecting SCI entity members and participants to multiple duplicative and costly testing requirements,¹²¹⁷ the Commission notes that the flexibility provided in the adopted coordination requirement, in tandem with the more focused adopted mandatory designation requirement should mitigate these concerns. As discussed above, adoption of a more focused designation requirement that requires SCI entities to exercise reasonable discretion is likely to reduce the extent to which SCI entity member or participant designations overlap and possibly result in a smaller number of SCI entity members or participants being designated for participation in testing than as contemplated by the SCI Proposal, and a fewer number of members or participants designated to participate in testing should simplify efforts to coordinate testing. However, as some commenters noted, it remains possible that, despite coordination, some firms that are members of multiple SCI entities may be designated to participate in testing with multiple SCI entities at greater cost than if they had been designated by only one SCI entity, and may be required to test more than once annually, as this may be necessary for each SCI entity to meet its obligations under the rule. Though the Commission recognizes that the possibility of being designated by multiple SCI entities to participate in the testing of their BC/DR plans may be costly, the Commission ultimately believes that such a cost is appropriate to help ensure that the BC/DR plan of each SCI entity is useful and effective. If, for example, a firm is designated for mandatory testing by multiple SCI entities, it would be so designated because each such SCI entity determines that such firm is necessary to the successful activation of its BC/DR plan. The

¹²¹⁷ See supra notes 1159-1160 and accompanying text.

Commission recognizes that it is conceivable that a firm that is required to participate in testing with multiple SCI entities assesses the costs and burdens of participating in every such test to be too great, and makes its own business decision to withdraw its membership or participation in one or more such SCI entities so as to avoid the costs and burdens of such testing, but believes such scenario to be unlikely. Specifically, the Commission believes that it is unlikely that a firm determined to be significant enough to be designated to participate in testing by an SCI entity (even a smaller SCI entity) would choose to withdraw its membership or participation in an SCI entity solely because of the costs and burdens of Regulation SCI's BC/DR testing provisions. The Commission also believes that such firm is likely to be a larger firm with greater resources and a significant level of participation in such SCI entity, and is likely to already be connected to the backup facility of the SCI SRO that is designating it to test. The Commission continues to believe that SCI entities are best suited to find the most efficient and effective manner in which to test its BC/DR plans.¹²¹⁸

Furthermore, the Commission is also adopting a longer compliance period with regard to the industry- or sector-wide coordinated testing requirement in adopted Rule 1004(d).¹²¹⁹ Specifically, SCI entities will have 21 months from the Effective Date to coordinate the testing of an SCI entity's business continuity and disaster recovery plans on an industry- or sector-wide basis with other SCI entities pursuant to adopted Rule 1004(d). In sum, the Commission believes that Rule 1004, as adopted, will enhance the resilience of the infrastructure of the U.S. securities markets.

¹²¹⁸ See Proposing Release, supra note 13, at 18126.

¹²¹⁹ See infra Section IV.F (discussing the delayed implementation time for adopted Rule 1004(d)).

C. Recordkeeping, Electronic Filing on Form SCI, and Access – Rules 1005-1007

Adopted Rules 1005 through 1007 specify several additional requirements of Regulation SCI relating to recordkeeping and electronic filing and submission. As discussed below, the Commission has determined not to adopt the proposed provision regarding Commission access to the systems of an SCI entity because the Commission can adequately assess an SCI entity's compliance with Regulation SCI through existing recordkeeping requirements and examination authority, as well as through the new recordkeeping requirement in Rule 1005 of Regulation SCI.

1. Recordkeeping – Rules 1005-1007

a. Recordkeeping Related to Compliance with Regulation SCI – Rule 1005

Proposed Rule 1000(c) required SCI SROs to make, keep, and preserve all documents relating to their compliance with Regulation SCI, as prescribed in Rule 17a-1 under the Exchange Act. Proposed Rule 1000(c) required SCI entities other than SCI SROs to: make, keep, and preserve at least one copy of all documents relating to their compliance with Regulation SCI; keep these documents for not less than five years, the first two years in a place that is readily accessible to the Commission or its representatives for inspection and examination; and promptly furnish to Commission representatives¹²²⁰ copies of any of these documents upon request. Further, proposed Rule 1000(c) provided that, upon or immediately prior to ceasing to do business or ceasing to be registered under the Exchange Act, an SCI entity must ensure that the required records are accessible to the Commission and its representatives in a manner required by Rule 1000(c) for the remainder of the period required by Rule 1000(c).

¹²²⁰ As discussed above, the Commission has renamed the ARP Inspection Program the Technology Controls Program. See supra note 6.

The Commission received one comment letter supporting proposed Rule 1000(c).¹²²¹
The Commission is adopting Rule 1000(c) as proposed, but re-designated as Rule 1005.¹²²²

As noted in the SCI Proposal, SCI entities are already subject to recordkeeping requirements,¹²²³ but records relating to Regulation SCI may not be specifically addressed in certain current recordkeeping rules.¹²²⁴ As adopted, Rule 1005 specifically addresses recordkeeping requirements for SCI entities with respect to records relating to Regulation SCI compliance.

With respect to SCI SROs, Rule 17a-1(a) under the Exchange Act requires every national securities exchange, national securities association, registered clearing agency, and the MSRB to keep and preserve at least one copy of all documents, including all correspondence, memoranda, papers, books, notices, accounts, and other such records as shall be made and received by it in

¹²²¹ See MSRB Letter at 25. As discussed above, some commenters suggested recordkeeping in lieu of certain Commission reporting requirements. See, e.g., *supra* note 881 and accompanying text.

¹²²² The Commission notes that adopted Rule 1005 replaces the term “SCI security systems” with “indirect SCI systems” as described in more detail in Section IV.A.2.d. Furthermore, internal cross references to Rules 1000(c)(2)(i) and (c)(2)(ii) in Rule 1000(c)(2)(iii) were updated to paragraphs (b)(1) and (b)(2) of Rule 1005 in accordance with the renumbering of the rule.

¹²²³ See, e.g., 17 CFR 240.17a-1, applicable to SCI SROs; 17 CFR 240.17a-3 and 17a-4, applicable to broker-dealers; and 17 CFR 242.301-303, applicable to ATSS.

It has been the experience of the Commission that SCI entities presently subject to the ARP Inspection Program (nearly all of whom are SCI SROs that are also subject to the recordkeeping requirements of Rule 17a-1(a)) do generally keep and preserve the types of records that would be subject to the requirements of Rule 1005. Nevertheless, the Commission continues to believe that Regulation SCI’s codification of these preservation practices will support an accurate, timely, and efficient inspection and examination process and help ensure that all types of SCI entities keep and preserve such records.

¹²²⁴ See Proposing Release, *supra* note 13, at 18128.

the course of its business as such and in the conduct of its self-regulatory activity.¹²²⁵ In addition, Rule 17a-1(b) requires these entities to keep all such documents for a period of not less than five years, the first two years in an easily accessible place, subject to the destruction and disposition provisions of Rule 17a-6.¹²²⁶ Rule 17a-1(c) requires these entities, upon request of any representative of the Commission, to promptly furnish to the possession of Commission representatives copies of any documents required to be kept and preserved by it pursuant to Rules 17a-1(a) and (b).¹²²⁷ Therefore, as noted in the SCI Proposal, the breadth of Rule 17a-1 under the Exchange Act is such that it would require SCI SROs to make, keep, and preserve records relating to their compliance with Regulation SCI.¹²²⁸ The Commission continues to believe that it is appropriate to cross-reference Rule 17a-1 in Rule 1005 to be clear that all SCI entities are subject to the same recordkeeping requirements regarding compliance with Regulation SCI. The Commission also continues to believe that it is appropriate to adopt recordkeeping requirements for SCI entities other than SCI SROs that are consistent with the recordkeeping requirements applicable to SROs under Rule 17a-1 under the Exchange Act. The

¹²²⁵ See 17 CFR 240.17a-1(a). Such records would, for example, include copies of incident reports and the results of systems testing.

¹²²⁶ See 17 CFR 240.17a-1(b). Rule 17a-6(a) under the Exchange Act states: “Any document kept by or on file with a national securities exchange, national securities association, registered clearing agency or the Municipal Securities Rulemaking Board pursuant to the Act or any rule or regulation thereunder may be destroyed or otherwise disposed of by such exchange, association, clearing agency or the Municipal Securities Rulemaking Board at the end of five years or at such earlier date as is specified in a plan for the destruction or disposition of any such documents if such plan has been filed with the Commission by such exchange, association, clearing agency or the Municipal Securities Rulemaking Board and has been declared effective by the Commission.” 17 CFR 240.17a-6(a).

¹²²⁷ See 17 CFR 240.17a-1(c).

¹²²⁸ See Proposing Release, supra note 13, at 18128.

Commission believes it is important to require such records be kept at both SCI SROs and SCI entities other than SCI SROs because such records are essential to understanding whether an SCI entity is meeting its obligations under Regulation SCI, to assess whether an SCI entity has appropriate policies and procedures with respect to its technology systems, to help identify the causes and consequences of an SCI event, and to understand the types of material systems changes occurring at an SCI entity.¹²²⁹

Further, as noted above, the definitions of SCI system and indirect SCI system include systems operated "on behalf of" an SCI entity by third parties. An SCI entity retains legal responsibility for systems operated on its behalf and, as such, is responsible for producing to Commission representatives records required to be made, kept, and preserved under Regulation SCI, even if those records are maintained by third parties, and the SCI entity is responsible for ensuring that such third parties produce those requested documents, upon examination or other request. Accordingly, the Commission believes that an SCI entity should have processes and requirements in place, such as contractual provisions with a third party, to ensure that it is able to satisfy the requirements of Regulation SCI for systems operated on its behalf by a third party, including the recordkeeping requirements in Rule 1005.¹²³⁰ The Commission believes that if an

¹²²⁹ To achieve the goals for which the recordkeeping requirements are designed, and to comply with the recordkeeping requirements of Rule 17a-1 and Rule 1005 of Regulation SCI, SCI entities must ensure that the records that they make, keep, and maintain are complete and accurate.

¹²³⁰ See also Rule 1007, which states that, if records required to be filed or kept by an SCI entity under Regulation SCI are prepared or maintained by a service bureau or other recordkeeping service on behalf of the SCI entity, the SCI entity is required to ensure that the records are available for review by the Commission and its representatives by submitting a written undertaking, in a form acceptable to the Commission, by such service bureau or other recordkeeping service, signed by a duly authorized person at such service bureau or other recordkeeping service.

SCI entity is unable to ensure compliance with Regulation SCI with regard to third party systems or recordkeeping, it should reassess its decision to outsource its systems or recordkeeping.

The Commission believes that Rule 1005 will facilitate its inspections and examinations of SCI entities and assist it in evaluating an SCI entity's compliance with Regulation SCI. In particular, Rule 1005 should facilitate Commission examination of SCI entities by helping to reduce delays in obtaining relevant records during an examination. Therefore, as noted in the SCI Proposal, the Commission's ability to examine for, and enforce compliance with, Regulation SCI could be hampered if an SCI entity were not required to adequately provide accessibility to its records for the full proposed retention period.

Further, while many SCI events may occur, be discovered, and be resolved in a short time frame, there may be other SCI events that may not be discovered until months or years after their occurrences, or may take significant periods of time to fully resolve. In such cases, having an SCI entity's records available even after it has ceased to do business or be registered under the Exchange Act would be beneficial. Because SCI events have the potential to negatively impact trade execution, price discovery, liquidity, and investor participation, the Commission believes that its ability to oversee the securities markets could be undermined if it is unable to review records to determine the causes and consequences of one or more SCI events experienced by an SCI entity that deregisters or ceases to do business. This information should provide an additional tool to help the Commission reconstruct important market events and better understand how such events impacted trade execution, price discovery, liquidity, and investor participation.

b. Service Bureau – Rule 1007

Proposed Rule 1000(e) required that, if the records required to be filed or kept by an SCI entity under Regulation SCI were prepared or maintained by a service bureau or other recordkeeping service on behalf of the SCI entity, the SCI entity ensure that the records are available for review by the Commission and its representatives by submitting a written undertaking, in a form acceptable to the Commission, by such service bureau or other recordkeeping service and signed by a duly authorized person at such service bureau or other recordkeeping service. Further, the written undertaking was required to include an agreement by the service bureau designed to permit the Commission and its representatives to examine such records at any time or from time to time during business hours, and to promptly furnish to the Commission and its representatives true, correct, and current electronic files in a form acceptable to the Commission or its representatives or hard copies of any, all, or any part of such records, upon request, periodically, or continuously and, in any case, within the same time periods as would apply to the SCI entity for such records. Proposed Rule 1000(e) also provided that the preparation or maintenance of records by a service bureau or other recordkeeping service would not relieve an SCI entity from its obligation to prepare, maintain, and provide the Commission and its representatives with access to such records.

The Commission did not receive any comments on proposed Rule 1000(e) and is adopting Rule 1000(e) as proposed, but re-designated as Rule 1007. As noted in the SCI Proposal, Rule 1007 is substantively the same as the requirement applicable to broker-dealers under Rule 17a-4(i) of the Exchange Act.¹²³¹ The Commission continues to believe that this requirement will help ensure the Commission's ability to obtain required records that are held by a third party who may not otherwise have an obligation to make such records available to the

¹²³¹ 17 CFR 240.17a-4(i). See Proposing Release, *supra* note 13, at 18129.

Commission. In addition, the Commission continues to believe that the requirement that SCI entities obtain from such third parties a written undertaking will also help ensure that such service bureau or other recordkeeping service is aware of its obligation with respect to records relating to Regulation SCI. The Commission believes that this requirement will help ensure that the Commission has prompt and efficient access to all required records, including those housed at a service bureau or any other recordkeeping service.¹²³²

2. Electronic Filing and Submission of Reports, Notifications, and Other Communications – Rule 1006

Proposed Rule 1000(d) required that, except with respect to notifications to the Commission made pursuant to proposed Rule 1000(b)(4)(i) (Commission notification of certain SCI events) or oral notifications to the Commission made pursuant to proposed Rule 1000(b)(6)(ii) (Commission notification of certain material systems changes), any notification, review, description, analysis, or report to the Commission required under Regulation SCI be submitted electronically on Form SCI and include an electronic signature. Proposed Rule 1000(d) also required that the signatory to an electronically submitted Form SCI manually sign a signature page or document, in the manner prescribed by Form SCI, authenticating, acknowledging, or otherwise adopting his or her signature that appears in typed form within the electronic filing. This document would be required to be executed before or at the time Form SCI is electronically submitted and would be required to be retained by the SCI entity in accordance with the recordkeeping requirements of Regulation SCI. The Commission is adopting Rule 1000(d) substantially as proposed, as discussed below, but re-designated as Rule 1006.

¹²³² See 17 CFR 240.17a-4(i) (records preserved or maintained by a service bureau).

One commenter supported the electronic submission of Form SCI.¹²³³ One commenter suggested that the Commission should make clear that Regulation SCI filings do not need to be made in a tagged data format such as XBRL, which could be costly.¹²³⁴ Another commenter stated that the electronic signature requirement was appropriate only if the final rule included a safe harbor for good faith reporting of SCI events.¹²³⁵ According to this commenter, the requirement that there be an electronic signature and a manual signature could put SCI entity personnel at risk if it is later determined that there were factual errors, omissions, or other flaws in the initial filing.¹²³⁶

After consideration of the comments, the Commission is adopting Rule 1000(d) substantially as proposed, and with updated internal cross references to reflect revisions to other aspects of Regulation SCI, as adopted. Specifically, Rule 1006 provides that notifications made pursuant to Rule 1002(b)(1) (immediate Commission notification of SCI events) and updates made pursuant to Rule 1002(b)(3) (updates regarding SCI events) are not required to be filed on Form SCI.¹²³⁷ As noted in the SCI Proposal, Rule 1006 is intended to provide a uniform manner in which the Commission would receive—and SCI entities would provide—written notifications,

¹²³³ See MSRB Letter at 25.

¹²³⁴ See OTC Markets Letter at 4. See also FINRA Letter at 28.

¹²³⁵ See Omgeo Letter at 20.

¹²³⁶ See *id.*

¹²³⁷ See *supra* Section IV.B.3.c (discussing the Commission notification requirement for SCI events). Adopted Rule 1006 refers to an electronically “filed” Form SCI, rather than an electronically “submitted” Form SCI as proposed in Rule 1000(d)(1). This change clarifies that notices and reports required to be submitted under Regulation SCI are filings under the Exchange Act and Regulation SCI. See proposed and adopted 17 CFR 249.1900 (stating that Form SCI shall be used to “file” notices and reports as required by Regulation SCI). See also amended Rule 24b-2 (referring to material “filed” in electronic format on Form SCI).

reviews, descriptions, analyses, or reports made pursuant to Regulation SCI.¹²³⁸ Rule 1006 should therefore allow SCI entities to efficiently draft and submit the required reports, and for the Commission to efficiently review, analyze, and respond to the information provided.¹²³⁹ In addition, the Commission believes that filing Form SCI in an electronic format would be less burdensome and more efficient for SCI entities and the Commission than mailing and filing paper forms.¹²⁴⁰ Further, after considering comments regarding the burden of submitting Form SCI in a tagged data format such as XBRL, the Commission is not requiring the use of XBRL formatting for Form SCI. Rather, certain fields in Sections I-III of Form SCI will require information to be provided by SCI entities in a format that will allow the Commission to gather information in a structured manner (e.g., the submission type and SCI event type in Section I), whereas the exhibits to Form SCI will allow SCI entities to provide narrative responses, such as through a text format. Further, the Commission also is specifying that documents filed through the EFFS system must be in a text-searchable format without the use of optical character recognition. If, however, a portion of a Form SCI submission (e.g., an image or diagram) cannot be made available in a text-searchable format, such portion may be submitted in a non-text-searchable format.¹²⁴¹ The Commission believes that requiring documents to be submitted in a text-searchable format (with the limited exception noted) is necessary to allow Commission staff to efficiently review and analyze information provided by SCI entities. In particular, a text-

¹²³⁸ See Proposing Release, supra note 13, at 18129-30.

¹²³⁹ See id. at 18130.

¹²⁴⁰ The Commission will implement Form SCI through the electronic form filing system (“EFFS”) currently used by SCI SROs to file Form 19b-4 filings. See Securities Exchange Act Release No. 50486 (October 4, 2004), 69 FR 60287 (October 8, 2004) (adopting the EFFS for use in filing Form 19b-4). See also Proposing Release, supra note 13, at 18130.

¹²⁴¹ See General Instructions to Form SCI, Item A.

searchable format allows Commission staff to better gather, analyze and use data submitted as exhibits, whereas a non-text-searchable format submission would require significantly more steps and labor to review and analyze data. The Commission notes that word processing and spreadsheet applications that are widely used by many businesses, including SCI entities, generate documents in this format.

As noted above, one commenter stated that the electronic signature requirement was appropriate only if the final rule included a safe harbor for good faith reporting of SCI events. The Commission is adopting the electronic signature requirement as proposed. The Commission notes that, as discussed above in Section IV.B.3.c, immediate Commission notification following an SCI event and updates regarding the SCI event may be given orally; the 24-hour Commission notification is required to be made on a good faith, best efforts basis; and the final Commission notification is not required until the resolution of the SCI event and the completion of the SCI entity's investigation of the SCI event. The Commission also notes that the purpose of the electronic signature requirement on Form SCI is to ensure that the person submitting the form to the Commission has been properly authorized by the SCI entity to submit the form on its behalf.¹²⁴² Therefore, the electronic signature requirement would not put SCI entity personnel at risk if the SCI entity later determines that there were factual errors, omissions, or other flaws in the initial filing. As such, the Commission does not agree with the comment that the electronic

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Additionally, similar to use of the EDFS in the context of electronic filing of Form 19b-4, by using a digital ID for each duly authorized signatory providing an electronic signature, both the Commission and an SCI entity may be assured of the authenticity and integrity of the electronic filing of Form SCI. See *infra* Section V.D.2.e (noting the necessity of completing a form to gain access to EDFS).

signature requirement was appropriate only if the final rule included a safe harbor for good faith reporting of SCI events.¹²⁴³

Amendment to Facilitate Electronic Filing Requirements

In addition, to permit implementation of Rule 1006,¹²⁴⁴ the Commission is adopting an amendment to Rule 24b-2 under the Exchange Act.¹²⁴⁵ Rule 24b-2 currently provides confidential treatment requests and the confidential portion of an electronic filing may be submitted in paper format only.¹²⁴⁶ The Commission is amending Rule 24b-2 by amending the rule's preliminary note, and paragraph (b) of the rule to clarify that under Rule 24b-2, confidential treatment requests and the confidential portion of an electronic filing may be submitted in paper format only, unless Rule 24b-2 provides otherwise. The Commission also is adding a new paragraph (g) to Rule 24b-2 to provide an electronic means by which an SCI entity may request confidential treatment of its filings on Form SCI. New paragraph (g) will provide that an SCI entity's electronic filings on Form SCI pursuant to Regulation SCI must include any information with respect to which confidential treatment is requested ("confidential portion"), and provide that, in lieu of the procedures described in Rule 24b-2b, an SCI entity may request confidential treatment of all information submitted on Form SCI by completing Section IV of Form SCI. The Commission's amendment provides an exception from Rule 24b-2's paper-only request for confidential treatment for all Form SCI filings, and specifically permits an SCI entity to electronically request confidential treatment of all information filed on Form SCI in

¹²⁴³ The same rationale also applies to the requirement for manual signature in Rule 1006.

¹²⁴⁴ See Rule 1006, 17 CFR 242.1006; see also General Instruction E to Form SCI (requiring Form SCI and exhibits to be filed electronically under Rule 1006).

¹²⁴⁵ 17 CFR 240.24b-2.

¹²⁴⁶ See 17 CFR 240.24b-2.

accordance with Regulation SCI. The Commission believes that allowing for electronic submission of confidential treatment requests will reduce the burden on SCI entities by not requiring a separate paper submission, and provided the confidential treatment request is properly made, will expedite Commission review of the requests for confidential treatment, as all information submitted on Form SCI will be deemed to be the subject of the request for confidential treatment.

If such a confidential treatment request is properly made, the Commission will keep the information collected pursuant to Form SCI confidential to the extent permitted by law.¹²⁴⁷

3. Access to the Systems of an SCI Entity

Proposed Rule 1000(f) would have required each SCI entity to provide Commission representatives reasonable access to its SCI systems and SCI security systems to assess the SCI entity's compliance with Regulation SCI.¹²⁴⁸ In the SCI Proposal, the Commission noted that the proposed rule would facilitate the access of representatives of the Commission to such systems of an SCI entity either remotely or on site, noting, for example, that with such access, Commission representatives could test an SCI entity's firewalls and vulnerability to intrusions.¹²⁴⁹ Further, the Commission noted that the proposed rule was intended to be

¹²⁴⁷ The Freedom of Information Act ("FOIA") provides at least two pertinent exemptions under which the Commission has authority to withhold certain information. FOIA Exemption 4 provides an exemption for "trade secrets and commercial or financial information obtained from a person and privileged or confidential." 5 U.S.C. 552(b)(4). FOIA Exemption 8 provides an exemption for matters that are "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." 5 U.S.C. 552(b)(8).

¹²⁴⁸ See proposed Rule 1000(f) and Proposing Release, supra note 13, at Section III.D.3.

¹²⁴⁹ See Proposing Release, supra note 13, at 18130.

consistent with the Commission's current authority with respect to access to records generally¹²⁵⁰ and could help ensure that Commission representatives have ready access to the SCI systems and SCI security systems of SCI entities in order to evaluate an SCI entity's practices with regard to the requirements of Regulation SCI.¹²⁵¹ As discussed below, the Commission has determined not to adopt the proposed requirement because it believes it can achieve the goal of the proposed rule through its existing recordkeeping requirements and examination authority, as well as through the new recordkeeping requirement in Rule 1005 of Regulation SCI.

Many commenters criticized the SCI Proposal's discussion of the proposed access requirement as permitting unfettered access by third parties that could pose significant security risks to an SCI entity's systems.¹²⁵² Potential issues identified by commenters included unauthorized access to confidential information,¹²⁵³ risk and damage to systems,¹²⁵⁴ and contractual issues with third party vendors.¹²⁵⁵ One commenter stated that the Commission should bear in mind that access to such highly sensitive environments of SCI entities carries a duty of care commensurate with the sensitivity of the access and information involved.¹²⁵⁶

¹²⁵⁰ See Proposing Release, supra note 13, at 18130 (citing Section 17(b) of the Exchange Act, as well as Sections 11A, 6(b)(1), 15A(b)(2), and 17A(b)(3)(A) of the Exchange Act).

¹²⁵¹ See Proposing Release, supra note 13, at 18130.

¹²⁵² See, e.g., NYSE Letter at 34; BATS Letter at 15; ISE Letter at 10; MSRB Letter at 25-26; Omgeo Letter at 28-29; SIFMA Letter at 18-19; FIF Letter at 7; Fidelity Letter at 5-6; LiquidPoint Letter at 4; ITG Letter at 16; KCG Letter at 20-21; Joint SROs Letter at 17-18; OCC Letter at 20; UBS Letter at 5; Tellefsen Letter at 10; and FINRA Letter at 41.

¹²⁵³ See, e.g., FINRA Letter at 41; and Omgeo Letter at 29.

¹²⁵⁴ See, e.g., Omgeo Letter at 29; and ITG Letter at 16.

¹²⁵⁵ See, e.g., SIFMA Letter at 19.

¹²⁵⁶ See OCC Letter at 20.

While several commenters advocated for the elimination of the proposed access provision,¹²⁵⁷ some commenters recommended ways to refine the proposed requirement while still achieving its goals.¹²⁵⁸ These suggestions included: limiting the category of Commission staff to whom access could be provided;¹²⁵⁹ providing the Commission with access to “configuration and information flows of the system, instead of direct access;”¹²⁶⁰ providing the Commission with reports and metrics on systems vulnerabilities rather than direct access;¹²⁶¹ requiring only that SCI entities demonstrate for Commission staff their controls and safeguards and compliance with the rule;¹²⁶² mandating training of Commission staff and supervision of Commission staff access by SCI entity personnel;¹²⁶³ and requiring that an SCI entity’s staff conduct any tests while Commission staff observed, rather than providing Commission staff with direct access.¹²⁶⁴ One commenter also noted that the concept of reasonable access was vague.¹²⁶⁵ Other commenters asked that the Commission more clearly prescribe what would constitute “reasonable access.”¹²⁶⁶ One commenter also recommended that SCI entities provide

¹²⁵⁷ See, e.g., ITG Letter at 16; and CME Letter at 11.

¹²⁵⁸ See, e.g., NYSE Letter at 34; OCC Letter at 20; ISE Letter at 10; DTCC Letter at 14; CME Letter at 11; Omgeo Letter at 29; Joint SROs Letter at 18; and MSRB Letter at 26.

¹²⁵⁹ See, e.g., NYSE Letter at 34.

¹²⁶⁰ See NYSE Letter at 34.

¹²⁶¹ See, e.g., ISE Letter at 10; DTCC Letter at 14; OCC Letter at 20; and CME Letter at 11.

¹²⁶² See, e.g., Omgeo Letter at 28-29; and DTCC Letter at 14.

¹²⁶³ See MSRB Letter at 26.

¹²⁶⁴ See OCC Letter at 20.

¹²⁶⁵ See, e.g., ITG Letter at 16.

¹²⁶⁶ See, e.g., MSRB Letter at 26; Joint SROs Letter at 18; and FINRA Letter at 41.

an individual contact for a designated Commission representative to communicate and meet with regarding an SCI entity's systems.¹²⁶⁷

A few commenters also questioned whether the proposed access requirement is authorized by Section 17(b) or Section 11A of the Exchange Act, as stated in the SCI Proposal.¹²⁶⁸ Other commenters considered the proposed access requirement unnecessary and questioned the Commission's justification for needing this authority.¹²⁶⁹ Another commenter pointed out that this type of access is authorized by other sections of the Exchange Act and an additional provision in Regulation SCI is redundant.¹²⁷⁰

After consideration of the views of commenters, the Commission has determined not to adopt the proposed reasonable access provision because it believes it can achieve its goals through existing recordkeeping requirements and its examination authority, as well as through the new recordkeeping requirement in Rule 1005 of Regulation SCI. As discussed in the SCI Proposal, the reasonable access provision was designed to help ensure that the Commission was able to evaluate an SCI entity's practices with regard to the requirements of proposed Regulation SCI.¹²⁷¹ The Commission believes that it can adequately assess an SCI entity's compliance with Regulation SCI through its authority provided by existing provisions of the Exchange Act and rules thereunder, as well as through the additional recordkeeping provisions being adopted today in Rule 1005 of Regulation SCI, as described above. In this regard, as discussed above, Section

¹²⁶⁷ See SIFMA Letter at 19.

¹²⁶⁸ See NYSE Letter at 34; BATS Letter at 15; and CME Letter at 11.

¹²⁶⁹ See FINRA Letter at 41; BATS Letter at 15; Omgeo Letter at 28-29; and Fidelity Letter at 5.

¹²⁷⁰ See Angel Letter at 18.

¹²⁷¹ See Proposing Release, supra note 13, at 18130.

17(a) of the Exchange Act provides the Commission with the authority to adopt recordkeeping rules, and the breadth of Rule 17a-1 thereunder is such that it would require SCI SROs to make, keep, and preserve records relating to their compliance with Regulation SCI, including records produced by SCI systems and indirect SCI systems.¹²⁷² Further, adopted Rule 1005 specifically imposes requirements on each SCI entity (other than SCI SROs) to, among other things: make, keep, and preserve at least one copy of all documents relating to its compliance with Regulation SCI; keep all such documents for a period of not less than five years, the first two years in a place that is readily accessible to the Commission or its representatives for inspection and examination; and upon request of any representative of the Commission, promptly furnish to the possession of such representative copies of any documents required to be kept and preserved by it pursuant to Rules 1005(b)(1) and (2).¹²⁷³ The Commission also notes that Section 17(b) of the Exchange Act authorizes the Commission to conduct reasonable periodic, special, or other examinations of all records maintained by the entities described in Section 17(a).¹²⁷⁴ These examinations can be conducted “at any time, or from time to time,” as the Commission “deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of [the Exchange Act].”¹²⁷⁵

¹²⁷² See supra note 1251 and accompanying text.

¹²⁷³ See supra Section IV.C.1 (discussing recordkeeping requirements of adopted Rule 1005). As noted above, the recordkeeping requirements also extend to records of third parties. Specifically, an SCI entity is responsible for producing to Commission representatives records required to be made, kept, and preserved under Regulation SCI, even if those records are maintained by third parties, and the SCI entity is responsible for ensuring that such third parties produce those requested documents, upon examination or other request. See id.

¹²⁷⁴ See Section 17(b) of the Exchange Act, 15 U.S.C. 78q(b).

¹²⁷⁵ Id.

Taken together, the Commission believes that these provisions afford the Commission the authority and ability to assess SCI entities' compliance with the requirements of Regulation SCI, rendering the adoption of a reasonable access provision unnecessary. Pursuant to this authority, in some circumstances, the Commission's assessment of an SCI entity's compliance may require appropriate access to certain SCI systems in coordination with the relevant SCI entity. In particular, the Commission's ability to assess the accuracy and completeness of an SCI entity's records with regard to Regulation SCI, including the written policies and procedures established and maintained pursuant to Rule 1001 and the report of the SCI review prepared in accordance with Rule 1003(b), and to evaluate whether SCI entities are otherwise complying with Regulation SCI, may necessitate the observation of SCI systems and indirect SCI systems by Commission representatives.¹²⁷⁶

The Commission believes that such access would not require an SCI entity to agree to remote or direct access by Commission personnel to an SCI entity's systems, such as by permitting Commission staff to run tests or use system scanning tools on its SCI systems or indirect SCI systems. Rather, as suggested by some commenters, access would entail allowing Commission staff to observe the SCI entity's SCI systems and indirect SCI systems with appropriate safeguards, including through systems demonstrations for Commission staff performed by the SCI entity and running tests on an SCI system with Commission staff onsite to

¹²⁷⁶ The Commission notes that, under the ARP Inspection Program, such access has been routinely requested by Commission staff and provided by ARP entities.

observe.¹²⁷⁷ The Commission believes that such access does not raise the potential security risks posed by unrestricted third party access to SCI systems.¹²⁷⁸

D. Form SCI

Pursuant to proposed Rule 1000(d), subject to certain exceptions, notices, reports, and other information required to be provided to the Commission under Regulation SCI would have been required to be submitted electronically through the EDFS on proposed Form SCI.¹²⁷⁹ Proposed Form SCI included detailed instructions regarding the specific information that SCI entities would have been required to submit to the Commission. After careful consideration of comments, the Commission is adopting Form SCI with certain modifications, as further discussed below. These modifications to proposed Form SCI correspond to the changes to the Commission notification and reporting requirements as adopted, each of which is discussed in greater detail above.¹²⁸⁰

Adopted Rule 1006 provides that, except with respect to notifications to the Commission made pursuant to Rule 1002(b)(1) or updates to the Commission made pursuant to Rule 1002(b)(3), all notifications, reviews, descriptions, analyses, or reports to the Commission required to be submitted under Regulation SCI must be filed electronically on Form SCI. Form

¹²⁷⁷ See supra notes 1262 and 1264 and accompanying text.

¹²⁷⁸ The Commission believes that the elimination of the proposed reasonable access provision addresses the other comments on this provision.

¹²⁷⁹ Proposed Rule 1000(d) provided exceptions for notifications under proposed Rule 1000(b)(4)(i) and oral notifications pursuant to proposed Rule 1000(b)(6)(ii).

¹²⁸⁰ See supra Sections IV.B.3.c, IV.B.4, and IV.B.5 (discussing the reporting requirements of the adopted regulation). See also supra Section IV.B.6 (discussing the business continuity and disaster recovery plans testing requirement for SCI entity members or participants, and elimination of the proposed Commission notification requirement related to member or participation designations).

SCI solicits information through a series of questions designed to elicit short-form answers, but also requires SCI entities to provide information and/or reports in narrative form by attaching specified exhibits. All filings on Form SCI require that an SCI entity identify itself and indicate the basis for submitting the form. Specifically, an SCI entity would indicate on the form the specific type of submission it is making: a notification regarding an SCI event pursuant to Rule 1002(b)(2); a final report or interim status report regarding an SCI event pursuant to Rule 1002(b)(4); a quarterly report on de minimis systems disruptions and de minimis systems intrusions pursuant to Rule 1002(b)(5)(ii); a quarterly report of material systems changes pursuant to Rule 1003(a)(1); a supplemental report of material system changes pursuant to Rule 1003(a)(2); or a submission of the report of an SCI review, together with any response by senior management, pursuant to Rule 1003(b)(3). In addition, Form SCI permits, but does not require, SCI entities to utilize the form to submit initial notifications of SCI events pursuant to Rule 1002(b)(1), as well as updates regarding SCI events pursuant to Rule 1002(b)(3). Moreover, if an SCI entity decides to withdraw a previously submitted Form SCI, it would complete page 1 of Form SCI and select the appropriate check box to indicate the withdrawal. A filing on Form SCI also requires that an SCI entity provide additional information on attached exhibits, as discussed below. Because Form SCI is a report that is required to be filed under the Exchange Act and Regulation SCI, it is unlawful for any person to willfully or knowingly make, or cause to be made, a false or misleading statement with respect to any material fact in Form SCI.¹²⁸¹

Several commenters addressed the information required by Form SCI as well as the submission process for the form. One commenter asked a number of questions on how the submission process would work in practice, including: (i) whether the form would be rejected by

¹²⁸¹ See, e.g., Section 32(a) of the Exchange Act, 15 U.S.C. 78ff(a).

the Commission if information was missing; (ii) whether the Commission would deem it a failure to comply with Regulation SCI if a Form SCI is rejected for incompleteness and the SCI entity is unable to resubmit within the applicable reporting time frame; (iii) how SCI entities would update or correct information previously submitted on Form SCI; (iv) will the EFFS system be available for Form SCI submissions during non-business hours and whether there is an alternative means to submit notifications if the EFFS system is down or unavailable; (v) who at the Commission would be reviewing submissions and whether they would be familiar with technical jargon; and (vi) whether the SCI entities will be expected to attach documentation supporting the descriptions provided in the exhibits.¹²⁸² The commenter also expressed several concerns, including: (i) the amount of time it would take SCI entities to master the new submission process for proposed Form SCI and suggested a delayed implementation or transition period; (ii) that the form could encourage SCI entities to guess where they are missing information if a form could be rejected for incomplete information; (iii) that a submission that needs to be updated or corrected would not be considered timely filed; (iv) that the updating procedure could become burdensome if the SCI entity needed to explain the reason for any changes to information previously provided; and (v) that submissions would be more burdensome if technical notifications and reports needed to be translated into plain English.¹²⁸³ Another commenter requested that the electronic filing system that the Commission puts in place to receive Form SCI submissions be made available on weekends and outside normal business

¹²⁸² See FINRA Letter at 28-30.

¹²⁸³ See *id.*

hours.¹²⁸⁴ This commenter also suggested that the Commission remain open to changes to Form SCI as it and SCI entities gain experience with the use of Form SCI and that the Commission should work with SCI entities to test the electronic submission system to ensure its operational capability.¹²⁸⁵

The Commission has considered these comments and has addressed many of the issues raised by commenters by revising the substantive requirements of adopted Rules 1002 and 1003, as well as making certain changes to the adopted form. With respect to a commenter's question regarding whether a Form SCI would be rejected if information was missing,¹²⁸⁶ as stated in the General Instructions for Form SCI, an SCI entity must provide all information required by the form, including the exhibits. The General Instructions for Form SCI also state that a filing that is incomplete or similarly deficient may be returned to the SCI entity, and any filing so returned will be deemed not to have been filed with the Commission.¹²⁸⁷ In response to the commenter who expressed concern that a submission that needed to be updated or corrected would not be considered timely filed, the Commission notes that an SCI entity is responsible for submitting a complete and correct Form SCI within the time period specified in the relevant provisions under

¹²⁸⁴ See MSRB Letter at 19, 25. See also FINRA Letter at 29 (questioning whether the EFFF system would be available during non-business hours for Form SCI submissions).

¹²⁸⁵ See MSRB Letter at 25-26.

¹²⁸⁶ See *supra* note 1282 and accompanying text.

¹²⁸⁷ While the Commission has the ability to reject a Form SCI filing, the Commission notes that the Form SCI submission process is different from the Form 19b-4 filing process. Specifically, SCI entities file Form SCI to provide notification to the Commission regarding SCI events and material systems changes, and reports of SCI reviews. On the other hand, SROs file Form 19b-4 for immediately effective rule changes or to seek Commission approval of rule changes. Therefore, the process for rejecting a Form 19b-4 filing does not apply to Form SCI submissions.

Regulation SCI.¹²⁸⁸ At the same time, the Commission notes that, while the SCI event notification under Rule 1002(b)(2) is required to be provided within 24 hours of any responsible SCI personnel having a reasonable basis to conclude that an SCI event occurred, information for such notifications is only required to be provided on a good faith, best efforts basis. For other types of notifications and reports required to be submitted on Form SCI, SCI entities have more time to prepare such submission, and to ensure that the information provided is complete and correct.

With respect to a commenter's question regarding how SCI entities would update or correct information previously submitted on Form SCI, the Commission notes that the rules under Regulation SCI already provide for updates for many of the Form SCI submissions. Specifically, Rule 1002(b)(2) requires certain information to be submitted on a good faith, best efforts basis within 24 hours of any responsible SCI personnel having a reasonable basis to conclude that an SCI event has occurred. Rule 1002(b)(3) requires SCI entities to provide updates regarding SCI events until the SCI event is resolved and the SCI entity's investigation of the SCI event is closed.¹²⁸⁹ As such, SCI entities may use the updates under Rule 1002(b)(3) to correct or update previously submitted information. Also, Rule 1003(a)(2) requires SCI entities

¹²⁸⁸ With respect to a commenter's concern that SCI entities may have to guess where information is missing if a form could be rejected for incomplete information, the Commission intends there to be communication between Commission staff and SCI entity personnel in instances where a Form SCI is rejected to discuss the information missing in the submission and anything else necessary to comply with the form requirements. See *supra* note 1283 and accompanying text.

¹²⁸⁹ As discussed in detail in Section IV.B.3.c above, Rule 1002(b)(3) allows SCI entities to discuss the update with Commission staff orally, rather than by completing the form, although an SCI entity may use Form SCI if it chooses to do so. To the extent an SCI entity chooses to utilize the form for such updates, the written updates can facilitate the Commission's tracking and assessment of SCI events.

to submit supplemental reports to notify the Commission of any material error in or material omission from a previously submitted material systems change report.

With respect to the Form SCI submissions where the rules do not specifically provide for updates (i.e., SCI event notifications under Rule 1002(b)(4), quarterly SCI event notifications under Rule 1002(b)(5), report of SCI reviews under Rule 1003(b)(3)), if an SCI entity discovers that a previously submitted Form SCI must be corrected or updated, the SCI entity should contact Commission staff as it corrects or updates the prior submission. In addition, an SCI entity will be able to withdraw and re-submit a previously submitted Form SCI.¹²⁹⁰ However, as noted above, an SCI entity is responsible for submitting a complete and correct Form SCI within the time period specified in the relevant provisions under Regulation SCI.¹²⁹¹

In addition, in response to comments,¹²⁹² the Commission notes that Form SCI does not require SCI entities to attach documentation supporting the descriptions in the exhibits, although SCI entities will be able to do so if they so choose by attaching the documentation as part of the relevant exhibit. Moreover, in response to the commenter who asked who at the Commission would be reviewing submissions and whether they would be familiar with technical jargon, the Commission notes that appropriate Commission staff from different offices or divisions with the

¹²⁹⁰ See General Instructions to Form SCI, Item F.

¹²⁹¹ As noted above, one commenter expressed concern that an updating procedure could become burdensome if the SCI entity needs to explain the reason for any changes to information previously provided. See supra note 1283 and accompanying text. The Commission notes that, with respect to rules under Regulation SCI that require updates, those rules specify the information that is required to be contained in an update, and do not require an explanation of the reason for the update. With respect to the Form SCI submissions where the rules do not specifically provide for updates, as noted above, the SCI entity can contact Commission staff as the SCI entity corrects or updates the prior submission.

¹²⁹² See supra notes 1282-1283 and accompanying text.

necessary expertise to understand the Form SCI submission will review it depending on the nature of the submission (i.e., legal or technical), and thus, it is not necessary for SCI entities to translate technical jargon into plain English.

In response to the commenter who expressed concern as to the amount of time it would take SCI entities to master the Form SCI submission process and suggested delayed implementation, the Commission believes that, by utilizing the EDFS system currently used by many SROs for Rule 19b-4 and Rule 19b-7 filings, it will allow for a quicker and smoother implementation of the Form SCI submission process for certain SCI entities, and allow the Commission to apply its experience with EDFS to facilitate the submissions of notifications and reports required by Regulation SCI. Nevertheless, the Commission notes that it is delaying the date for compliance with Regulation SCI, as discussed in Section IV.F below. The Commission does not expect that the Form SCI submission process will require substantial time for SCI entities to master and the delayed date for compliance with Regulation SCI provides SCI entities with more time to learn and adopt it.

With respect to commenters' question regarding whether the EDFS system will be available during non-business hours and whether there is an alternative means to submit notifications if the EDFS system is down or unavailable,¹²⁹³ the Commission notes that, as is the case with Rule 19b-4 and Rule 19b-7 filings, EDFS is available 24 hours a day. If EDFS becomes unavailable for a period of time, the Commission recognizes that SCI entities will not be able to submit any required notifications during that time period, and the Commission would expect the SCI entities to file any required notifications promptly once it becomes available. In response to the commenter who suggested that the Commission remain open to changes to Form

¹²⁹³ See supra notes 1282, 1284 and accompanying text.

SCI and that the Commission work with SCI entities to test the electronic submission system to ensure its operational capability, the Commission expects, as it has done with the SRO rule filing process, to periodically evaluate the effectiveness of the submission process for Form SCI, as well as the form itself, and may consider improvements in the future as appropriate.¹²⁹⁴ The Commission also notes that it expects, prior to the compliance date, that its staff will provide materials to SCI entities regarding the operation of the electronic filing system to submit Forms SCI. Furthermore, the Commission will perform internal testing to help ensure the operational capability of EDFS prior to the compliance date.

1. Notice of SCI Events Pursuant to Rule 1002(b)

Proposed Rule 1000(b)(4) would have required each SCI entity to submit certain information regarding SCI events to the Commission using proposed Form SCI.¹²⁹⁵ The Commission is adopting proposed Rule 1000(b)(4) as Rule 1002(b) with certain modifications, which are discussed above in Section IV.B.3.c.

With respect to Commission notifications under Rule 1002, adopted Form SCI requires an SCI entity to provide the following information in a short, standardized format: (i) whether the Commission has previously been notified of the SCI event pursuant to Rule 1002(b)(1); (ii) the type of submission (i.e., an initial notification pursuant to Rule 1002(b)(1), a notification pursuant to Rule 1002(b)(2), an update pursuant to Rule 1002(b)(3), a final report pursuant to Rule 1002(b)(4), or an interim status report pursuant to Rule 1002(b)(4)); (iii) the type(s) of SCI

¹²⁹⁴ See supra note 1285 and accompanying text.

¹²⁹⁵ Proposed Rule 1000(d) provided an exception for notifications under proposed Rule 1000(b)(4)(i).

event (i.e., systems compliance issue, systems disruption, or systems intrusion);¹²⁹⁶ (iv) the date/time the SCI event occurred; (v) the duration of the SCI event; (vi) when responsible SCI personnel had a reasonable basis to conclude that an SCI event occurred; (vii) whether the SCI event has been resolved and, if so, the date/time of resolution; (viii) whether the SCI entity's investigation of the SCI event is closed and, if so, the date of closure; (ix) the estimated number of market participants potentially impacted by the SCI event; (x) whether the SCI event is a major SCI event; (xi) the types of systems impacted (i.e., trading, clearance and settlement, order routing, market data, market regulation, market surveillance, or indirect SCI systems) and the name of such system(s); and (xii) whether any critical SCI system(s) are impacted by the SCI event and, if so, the types of such critical SCI systems (i.e., systems that directly support functionality relating to: clearance and settlement systems of clearing agencies; openings, reopenings, and closings on the primary listing market; trading halts; initial public offerings; the provision of consolidated market data; exclusively listed securities; or systems that provide functionality to the securities markets for which the availability of alternatives is significantly limited or nonexistent and without which there would be a material impact on fair and orderly markets) and a description of such systems.

If an SCI entity chooses to utilize Form SCI to submit an initial notification required by Rule 1002(b)(1), an SCI entity will be able to submit a short description of the SCI event, and be allowed to attach documents regarding such SCI event as part of Exhibit 6 of Form SCI if the SCI entity chooses to do so.

¹²⁹⁶ Some SCI events may meet the definition of more than a single SCI event type, and the form permits SCI entities to check one, two, or all three SCI event types.

For a notification required by Rule 1002(b)(2), in addition to providing the applicable standardized information on Form SCI as discussed above, an SCI entity is required to submit an Exhibit 1. An SCI entity is required to provide the following information on a good faith, best efforts basis in the Exhibit 1: (i) a description of the SCI event, including the system(s) affected; and (ii) to the extent available as of the time of notification, the SCI entity's current assessment of the types and number of market participants potentially affected by the SCI event; the potential impact of the SCI event on the market; a description of the steps the SCI entity has taken, is taking, or plans to take, with respect to the SCI event; the time the SCI event was resolved or timeframe within which the SCI event is expected to be resolved; and any other pertinent information known by the SCI entity about the SCI event.

If an SCI entity chooses to utilize Form SCI to submit an update required by Rule 1002(b)(3), an SCI entity will be able to submit a short description of the update, and be allowed to attach documents regarding such update as part of Exhibit 6 of Form SCI if the SCI entity chooses to do so.

For a submission required by Rule 1002(b)(4), in addition to providing the applicable standardized information on Form SCI as discussed above, adopted Form SCI also requires an SCI entity to indicate if it is a final report or an interim status report and submit an Exhibit 2. If an SCI event is resolved and the SCI entity's investigation of the SCI event is closed within 30 calendar days of the occurrence of the SCI event, an SCI entity must file a final report under Rule 1002(b)(4)(i)(A) within five business days after the resolution of the SCI event and closure of the investigation regarding the SCI event. However, if an SCI event is not resolved or the SCI entity's investigation of the SCI event is not closed within 30 calendar days of the occurrence of the SCI event, an SCI entity must file an interim status report under Rule 1002(b)(4)(i)(B)(1)

within 30 calendar days after the occurrence of the SCI event. For SCI events in which an interim status report is required to be filed, an SCI entity must file a final report under Rule 1002(b)(4)(i)(B)(2) within five business days after the resolution of the SCI event and closure of the investigation regarding the SCI event. For any submission required by Rule 1002(b)(4), an SCI entity is required to provide the following information in the Exhibit 2: (i) a detailed description of: the SCI entity's assessment of the types and number of market participants affected by the SCI event; the SCI entity's assessment of the impact of the SCI event on the market; the steps the SCI entity has taken, is taking, or plans to take, with respect to the SCI event; the time the SCI event was resolved; the SCI entity's rule(s) and/or governing document(s), as applicable, that relate to the SCI event; and any other pertinent information known by the SCI entity about the SCI event; (ii) a copy of any information disseminated pursuant to Rule 1002(c) by the SCI entity to date regarding the SCI event to any of its members or participants; and (iii) an analysis of parties that may have experienced a loss, whether monetary or otherwise, due to the SCI event, the number of such parties, and an estimate of the aggregate amount of such loss. As noted above, if an SCI entity submits an interim written notification under Rule 1000(b)(4)(i)(B), the SCI entity is required to provide the information specified in Exhibit 2, but only to the extent known at the time. The SCI entity is also required to subsequently submit a final report under Rule 1000(b)(4)(i)(B) and provide all the information specified in Exhibit 2.

Rule 1002(b)(5) states that the Commission notification requirements under Rules 1002(b)(1)-(4) do not apply to any SCI event that has had, or the SCI entity reasonably estimates would have, no or a de minimis impact on the SCI entity's operations or on market participants. Rule 1002(b)(5)(i) instead requires that an SCI entity make, keep, and preserve records relating

to all such SCI events and Rule 1002(b)(5)(ii) requires an SCI entity to submit to the Commission quarterly reports containing a summary description of such de minimis systems disruptions and de minimis systems intrusions. For a quarterly report required by Rule 1002(b)(5), an SCI entity is required to indicate the end date of the applicable calendar quarter for which the report is being submitted. The SCI entity is also required to submit an Exhibit 3, containing a summary description of such de minimis systems disruptions and de minimis systems intrusions, including the SCI systems and, for systems intrusions, the indirect SCI systems, affected by such de minimis systems disruptions and de minimis systems intrusions during the applicable calendar quarter.

2. Notices of Material Systems Changes Pursuant to Rule 1003(a)

Proposed Rule 1000(b)(6) would have required an SCI entity to provide advance Commission notifications of material systems changes. Proposed Rule 1000(b)(8)(ii) would have required an SCI entity to submit to the Commission semi-annual reports on material systems changes. As discussed in detail in Section IV.B.4 above, many commenters were critical of the proposed reporting framework with respect to material systems changes, including the 30-day advance notification procedure. After considering the views of commenters, the Commission is not adopting the 30-day advance notification requirement or the semi-annual reporting requirement for material systems changes. Rather, an SCI entity is required to submit quarterly reports for material systems changes under Rule 1003(a)(1). An SCI entity is also required under Rule 1003(a)(2) to promptly submit a supplemental report notifying the Commission of a material error in or material omission from a report previously submitted under Rule 1003(a).

One commenter raised a concern that an advance notification could be rejected by the Commission for inadequate description and result in a delay to a planned systems change.¹²⁹⁷ As noted above in Section IV.B.4, the Commission is adopting a quarterly reporting system that does not require the advanced notification of individual planned material systems changes required by proposed Rule 1000(b)(6). The adopted framework is intended to keep the Commission and its staff apprised of systems changes at SCI entities while reducing the burdens related to notifying the Commission of such changes and allowing for the various types of development processes used by SCI entities (including agile development processes). Also, as noted above in Section IV.B.4, Regulation SCI does not provide for a new review or approval process for SCI entities' material systems changes. As such, Commission staff will not use material systems change reports to require any approval of prospective systems changes in advance of their implementation pursuant to any provision of Regulation SCI, or to delay implementation of material systems changes pursuant to any provision of Regulation SCI.¹²⁹⁸

For a notification required by Rule 1003(a) (including supplemental reports under Rule 1003(a)(2)), an SCI entity is required to indicate the end date of the applicable calendar quarter for which the report is being submitted and submit an Exhibit 4. For a notification required by Rule 1003(a)(1), Exhibit 4, is required to contain a description of completed, ongoing, and planned material changes to its SCI systems and the security of its indirect SCI systems, during the prior, current, and subsequent calendar quarters, including the dates or expected dates of commencement and completion. For a notification required by Rule 1003(a)(2), Exhibit 4 is

¹²⁹⁷ See SIFMA Letter at 16.

¹²⁹⁸ At the same time, the Commission notes that the General Instructions for Form SCI state that a filing that is incomplete or similarly deficient may be returned to the SCI entity, and any filing so returned will be deemed not to have been filed with the Commission.

required to contain the supplemental report of a material error in or material omission from a report previously submitted under Rule 1003(a)(1).¹²⁹⁹

3. Reports of SCI Reviews Pursuant to 1003(b)

Proposed Rule 1000(b)(8)(i) would have required an SCI entity to submit to the Commission a report of the SCI review required by proposed Rule 1000(b)(7), together with any response by senior management, within 60 calendar days after its submission to senior management of the SCI entity. As discussed above in Section IV.B.5, the Commission is adopting this Commission reporting requirement as proposed. There were no comments on proposed Form SCI with respect to reports of SCI reviews.

For a notification required by Rule 1003(b), an SCI entity is required to indicate on Form SCI the date of completion of the SCI review and the date of submission of the SCI review to the SCI entity's senior management. An SCI entity is also required to submit an Exhibit 5, containing the report of the SCI review that was submitted to the SCI entity's senior management, along with any response to the report by senior management.¹³⁰⁰

4. Notification of Member or Participant Designation Standards and List of Designees

Proposed Rule 1000(b)(9) would have required an SCI entity to notify the Commission of its members or participants that have been designated for business continuity and disaster recovery plans testing, as well as the standards for such designation. Proposed Rule 1000(b)(9)

¹²⁹⁹ See General Instructions to Form SCI, Item C.

¹³⁰⁰ As discussed in Section IV.B.5, the SCI review would contain: (a) a risk assessment with respect to SCI systems and indirect SCI systems of an SCI entity; and (b) an assessment of internal control design and effectiveness of SCI systems and indirect SCI systems to include logical and physical security controls, development processes, and information technology governance, consistent with industry standards.

would have also required SCI entities to promptly update such notification after any changes to its list of designees or standards for designation. As discussed above in Section IV.B.6, the Commission is not adopting these Commission notification requirements.

5. Other Information and Electronic Signature

Proposed Form SCI would have required an SCI entity to provide the Commission with contact information for the systems personnel, regulatory personnel, and senior officer responsible for addressing an SCI event, including the name, title, telephone number, and email address of such persons. Proposed Form SCI would also have given the SCI entity an option to provide contact information for an additional systems personnel and regulatory personnel. Finally, proposed Form SCI would have required an electronic signature to help ensure the authenticity of the Form SCI submission.

Adopted Form SCI more generally requires an SCI entity to provide contact information for a person who is prepared to respond to questions for a particular submission. Form SCI continues to require an electronic signature to help ensure the authenticity of the Form SCI submission. The Commission believes that these requirements will expedite communications between Commission staff and SCI entities, because they will help identify the person or persons responsible for communicating with Commission staff about an SCI event even though one or more other persons may be responsible for addressing and resolving the SCI event, and also help ensure that only authorized personnel at each SCI entity submit filings required by adopted Regulation SCI.

E. Other Comments Received

1. Applying Regulation SCI to Security-Based Swap Data Repositories and Security-Based Swap Execution Facilities

As noted in the SCI Proposal, on July 21, 2010, the President signed the Dodd-Frank Act into law.¹³⁰¹ The Dodd-Frank Act was enacted, among other things, to promote the financial stability of the United States by improving the accountability and transparency of the nation's financial system.¹³⁰² Title VII of the Dodd-Frank Act provides the Commission and the CFTC with the authority to regulate over-the-counter derivatives.

In particular, as noted in the SCI Proposal, Section 763 of the Dodd-Frank Act amends the Exchange Act by adding new statutory provisions to govern the regulation of various entities, including security-based swap data repositories ("SB SDRs") and security-based swap execution facilities ("SB SEFs").¹³⁰³ Under the authorities of Section 13(n) of the Exchange Act, applicable to SB SDRs, and Section 3D(d) of the Exchange Act, applicable to SB SEFs, the Commission proposed rules for these entities with regard to their automated systems' capacity, resiliency, and security.¹³⁰⁴ In the SB SDR Proposing Release and the SB SEF Proposing

¹³⁰¹ The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203, H.R. 4173) ("Dodd-Frank Act").

¹³⁰² See Dodd-Frank Act Preamble.

¹³⁰³ See Dodd-Frank Act, Section 763 (adding Sections 13(n), 3C, and 3D of the Exchange Act). The Dodd-Frank Act also directs the Commission to harmonize to the extent possible Commission regulation of SB SDRs and SB SEFs with CFTC regulation of swap data repositories ("SDRs") and swap execution facilities ("SEFs") under the CFTC's jurisdiction, an endeavor that Commission staff is undertaking as it seeks to move the SB SDR and SB SEF proposals toward adoption. See Dodd-Frank Act, Section 712 (directing the Commission, before commencing any rulemaking with regard to SB SDRs or SB SEFs, to consult and coordinate with the CFTC for purposes of assuring regulatory consistency and comparability to the extent possible).

¹³⁰⁴ See Securities Exchange Act Release Nos. 63347 (November 19, 2010), 75 FR 77306 (December 10, 2010) (proposing new Rule 13n-6 under the Exchange Act applicable to SB SDRs) ("SB SDR Proposing Release"); 63825 (February 2, 2011), 76 FR 10948 (February 28, 2011) (proposing new Rule 822 under the Exchange Act applicable to SB SEFs) ("SB SEF Proposing Release"). See also Dodd-Frank Act, Section 761(a) (adding Section 3(a)(75) of the Exchange Act) (defining the term "security-based swap data repository"), and Section 761(a) (adding Section 3(a)(77) of the Exchange Act) (defining

Release, respectively, the Commission proposed Rule 13n-6 and Rule 822 under the Exchange Act, which would set forth the requirements for these entities with regard to their automated systems' capacity, resiliency, and security. In each release, the Commission stated that it was proposing standards comparable to the standards applicable to SROs, including exchanges and clearing agencies, and other registrants, pursuant to the Commission's ARP standards.¹³⁰⁵ The SCI Proposal described in detail the SB SDR and SB SEF proposals relating to systems' capacity, resiliency, and security; the comments received on those proposals; and the differences between proposed Regulation SCI and those proposals.¹³⁰⁶

In the SCI Proposal, the Commission recognized that there could be differences between Regulation SCI, as adopted, and Rules 13n-6 and 822, if adopted. Therefore, the Commission sought comment on whether it should propose to apply the requirements of Regulation SCI, in whole or in part, to SB SDRs and/or SB SEFs.¹³⁰⁷ In addition, the Commission sought comment on what—if the Commission were to propose to apply some or all of the requirements of Regulation SCI to SB SDRs or SB SEFs—would be the most appropriate way to implement such requirements for SB SDRs and SB SEFs.¹³⁰⁸ However, the Commission also noted that, should

the term “security-based swap execution facility”).

¹³⁰⁵ See SB SDR Proposing Release, supra note 1304, at 77332 and SB SEF Proposing Release, supra note 1304, at 10987.

¹³⁰⁶ See Proposing Release, supra note 13, at 18133-34.

¹³⁰⁷ See id. at 18134-37.

¹³⁰⁸ See id. at 18137-38. As noted in the SCI Proposal, although the Commission has issued a policy statement regarding the anticipated sequencing of the compliance dates of final rules to be adopted by the Commission for certain provisions of Title VII of the Dodd-Frank Act, the precise timing for adoption of or compliance with any final rules relating to SB SDRs or SB SEFs is not known at this time. See Securities Exchange Act Release No. 67177 (June 11, 2012), 77 FR 35625 (June 14, 2012) (Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based

the Commission decide to propose to apply the requirements of Regulation SCI to SB SDRs or SB SEFs, the Commission would issue a separate release discussing such a proposal.¹³⁰⁹

One commenter supported the inclusion of SB SEFs and possibly SB SDRs under proposed Regulation SCI.¹³¹⁰ Several commenters supported some form of harmonization, but were cognizant of the practical differences between options and equities, on the one hand, and derivatives, on the other.¹³¹¹

In the context of considering whether Regulation SCI should apply to SB SDRs or SB SEFs, one commenter supported principles-based rules relating to systems compliance and integrity, and generally believed that principles applicable to one type of system should be applicable to all types of systems.¹³¹² This commenter noted that the Commission should not promulgate principles-based rules that would apply different principles to different systems, unless such difference is clearly warranted by the facts and circumstances relating to and the purpose of a particular system.¹³¹³ This commenter also commented that, because technology continues to evolve at a rapid pace and because specific and technical rules may create conflicting standards, any attempt to provide specific and technical rules should be avoided, unless the context clearly warrants such specific and technical rules.¹³¹⁴ This commenter

Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act).

¹³⁰⁹ See Proposing Release, supra note 13, at 18134.

¹³¹⁰ See Tellefsen Letter at 5.

¹³¹¹ See DTCC Letter at 18-19; and NYC Bar Letter at 2-5. See also CoreOne Letter at 5-7.

¹³¹² See NYC Bar Letter at 3.

¹³¹³ See id. at 3-4.

¹³¹⁴ See id. at 4.

concluded that the similarities between certain SCI entities and SB SDRs and SB SEFs do not provide a clear justification for a different set of rules.¹³¹⁵

One commenter noted that SB SDRs should have standards that are consistent with, but not identical to, those of SCI entities.¹³¹⁶ According to this commenter, the functions that SB SDRs perform are significantly different from those performed by SCI entities.¹³¹⁷ However, this commenter supported applying to SB SDRs: proposed Rule 1000(b)(1)(i)(A)-(E);¹³¹⁸ requirements relating to Commission notification of SCI events (by adopting the notification provisions described in proposed Rule 13n-6(3)); and requirements for business continuity planning and testing (but SB SDRs should not be required to test with other SB SDRs given the structure of the proposed SB SDR Regulations).¹³¹⁹ Finally, rather than making Regulation SCI applicable to SB SDRs, this commenter recommended that these provisions be incorporated into Rule 13n-6.¹³²⁰

The Commission appreciates the comments received on the potential application of Regulation SCI to SB SDRs and SB SEFs. As noted above, should the Commission decide to propose to apply the requirements of Regulation SCI to SB SDRs or SB SEFs, the Commission

¹³¹⁵ See id. This commenter also specifically noted that important market systems should not have differing recovery requirements without a clear justification, particularly in light of a Congressional mandate in the Dodd-Frank Act to ensure regulatory consistency and comparability, to the extent possible. See NYC Bar Letter at 5.

¹³¹⁶ See DTCC Letter at 18.

¹³¹⁷ See id.

¹³¹⁸ However, this commenter noted that specific industry standards should be adopted for SB SDRs, rather than adopting existing standards that were largely developed before repositories were developed and were not intended to cover these types of entities. See id.

¹³¹⁹ See id. at 18-19.

¹³²⁰ See id. at 19.

would issue a separate release discussing such a proposal and would take these comments into account.

2. Applying Regulation SCI to Broker-Dealers Other than SCI ATSS and Other Types of Entities

Regulation SCI, as proposed and as adopted, would apply to national securities exchanges, registered securities associations, registered clearing agencies, the MSRB, SCI ATSS, plan processors, and exempt clearing agencies subject to ARP. It would not apply to other types of market participants, such as market makers or other broker-dealers. As noted in the SCI Proposal, recent events have highlighted the significance of systems integrity of a broader set of market participants than those included in the definition of SCI entity.¹³²¹ Also, as noted in the SCI Proposal, some broker-dealers have grown in size and importance to the market in recent years.¹³²² As such, the Commission recognized that systems disruptions, systems compliance issues, and systems intrusions at broker-dealers could pose a significant risk to the market.¹³²³ The Commission also noted that Rule 15c3-5 under the Exchange Act,¹³²⁴ which requires brokers or dealers with market access to implement risk management controls and supervisory procedures to limit risk, already seeks to address certain risks posed to the markets by broker-dealer systems.¹³²⁵

The Commission did not propose to apply Regulation SCI to registered broker-dealers (other than SCI ATSS) or to other types of entities not covered by the definition of SCI entity.

¹³²¹ See Proposing Release, supra note 13, at 18138, n. 334.

¹³²² See id. at 18138, n. 335.

¹³²³ See id. at 18138.

¹³²⁴ 17 CFR 240.15c3-5.

¹³²⁵ See supra note 114 and Proposing Release, supra note 13, at 18138-39.

As noted in the SCI Proposal, if the Commission were to decide to propose to apply the requirements of Regulation SCI to such entities, the Commission would issue a separate release discussing such a proposal.¹³²⁶ Nevertheless, in the SCI Proposal, the Commission sought comment on whether such entities should be subject to Regulation SCI in whole or in part.¹³²⁷

Some commenters stated that the Commission should expand the definition of SCI entity to include broker-dealers.¹³²⁸ One commenter stated that the goals of Regulation SCI could not be met without expanding the definition of SCI entity to include the following types of broker-dealers: exchange market maker, OTC market maker, and any other broker or dealer that executes orders internally by trading as a principal or crossing orders as an agent.¹³²⁹ This commenter stated that these entities should be included because they play a critical role in the markets, handle market share that exceeds that of certain SCI ATSS, and, like exchanges and ATSS, rely heavily on sophisticated automated systems.¹³³⁰ Another commenter also believed that the objectives of Regulation SCI could more readily be achieved if the regulation also

¹³²⁶ See *id.* at 18139.

¹³²⁷ See *id.* at 18139-41.

¹³²⁸ See NYSE Letter at 8-10; and Liquidnet Letter at 2-3. Another commenter expressed its view that inclusion of order routing systems within the definition of "SCI systems" puts SCI entities at a competitive disadvantage against broker-dealers that are not covered by Regulation SCI. See BATS Letter at 4. See also *supra* notes 48-50, 94-96, and 152 and accompanying text (discussing comments regarding broadening the coverage of "SCI entity" and "SCI ATS" and the effect of the adopted ATS thresholds on barriers to entry), and *infra* Section VI.C.1.c (discussing the effect of Regulation SCI on competition between SCI entities and non-SCI entities).

¹³²⁹ See NYSE Letter at 9.

¹³³⁰ See *id.*

applied to market makers, high-frequency trading firms, and other broker-dealers because the activities of these types of entities could present systemic risks to the market.¹³³¹

In connection with questions in the SCI Proposal regarding the application of Regulation SCI to broker-dealers other than SCI ATSS, one commenter urged the Commission to broaden the definition of SCI entity to include any entity with direct electronic access to equity markets because the equity markets can be disrupted by a single server.¹³³² Another commenter stated that all direct access proprietary trading market participants (including high frequency market participants) should be included as SCI entities because of their significant footprint in the markets, past incidents like Knight Capital Group's massive trading losses from a systems malfunction in August 2012,¹³³³ and flaws in the existing compliance controls and practices of such firms.¹³³⁴ One commenter stated that Regulation SCI should be extended to any trading platforms that transact significant volume, including systems that are not required to register as an ATS, because all executions are against the bids and offers of a single dealer.¹³³⁵

A few commenters further argued that Rule 15c3-5 under the Exchange Act is not sufficient by itself and therefore some broker-dealers should be treated as SCI entities.¹³³⁶ One

¹³³¹ See Liquidnet Letter at 2.

¹³³² See Lauer Letter at 3. See also *supra* notes 212-213 (explaining that the Commission believes that many systems with direct market access are captured by the adopted definition but the Commission is not expanding the scope of Regulation SCI to include other broker-dealer entities and their systems at this time).

¹³³³ See Proposing Release, *supra* note 13, at 18090, n. 70 (discussing Knight's systems malfunction in August 2012).

¹³³⁴ See Leuchtkafer Letter at 1-7. See *supra* notes 124-126 and accompanying text (discussing the Commission's determination to not apply Regulation SCI to non-ATS broker-dealers at this time).

¹³³⁵ See BlackRock Letter at 4.

¹³³⁶ See Lauer Letter at 3 and NYSE Letter at 9.

of these commenters stated that non-ATS broker-dealers should be treated as SCI entities because Rule 15c3-5, concerning the implementation of risk management and supervisory controls to limit risk associated with routing orders to exchanges or ATSS, does not address reliability or integrity of the systems that implement such controls.¹³³⁷

Many other commenters stated more generally that broker-dealers should not be captured by the definition of SCI entity.¹³³⁸ Several commenters stated that they do not support the expansion of Regulation SCI to all broker-dealers because broker-dealers generally perform functions that do not have any systemic impact on the operation of the national market system and are presently subject to numerous regulations that require the establishment of controls (such as the Market Access Rule, Rule 17a-3, and Rule 17a-4), making Regulation SCI duplicative and unduly burdensome.¹³³⁹

One commenter stated that broker-dealers are currently subject to high standards of systems compliance and integrity by FINRA and state laws, and disciplinary actions for failure to maintain sufficient protection of customer data and supervisory policies.¹³⁴⁰ Moreover, this commenter noted that, if potential systems issues could be addressed by Regulation SCI as applied to SCI entities, there would be no need to apply Regulation SCI to broker-dealers conducting activities on behalf of retail clients.¹³⁴¹ This commenter stated that additional

¹³³⁷ See NYSE Letter at 9.

¹³³⁸ See SIFMA Letter at 3; MFA Letter at 4-5; FIA PTG Letter at 5; FSI Letter at 3; WF Letter at 2; Fidelity Letter at 4; KCG Letter at 14-17; LiquidPoint Letter at 4; and FSR Letter at 2-3, n. 5.

¹³³⁹ See SIFMA Letter at 3; MFA Letter at 4-5; FIA PTG Letter at 5; WF Letter at 2; KCG Letter at 15-17; LiquidPoint Letter at 4; and FSR Letter at 2-3, n. 5.

¹³⁴⁰ See FSI Letter at 3.

¹³⁴¹ See *id.*

regulation would only be warranted after a meticulous cost-benefit analysis and implementation of the additional regulation at the lowest cost to firms and investors.¹³⁴² This commenter concluded that the inclusion of broker-dealers would raise investors' costs and is unnecessary.¹³⁴³

Another commenter believed that non-SCI ATS broker-dealers should not be included in the definition of SCI entity because, despite the longstanding practice of retail brokers routing their customers' orders to market makers for execution, those market makers are not critical.¹³⁴⁴ Moreover, this commenter believed that FINRA's rules with respect to broker-dealers are more appropriate than the SCI Proposal, and FINRA rules hold broker-dealers accountable and do not shield them from liability.¹³⁴⁵ This commenter stated that the combination of Commission and FINRA rules on broker-dealers ensures that broker-dealers are sufficiently regulated, although this commenter stated that FINRA could provide additional guidance on its rules in light of the weaknesses revealed by Superstorm Sandy.¹³⁴⁶ Similarly, another commenter stated that broker-dealers should not be regulated under Regulation SCI because broker-dealer operational regulation has been overseen almost entirely by FINRA.¹³⁴⁷ Specifically, FINRA member broker-dealers are required to create and implement written supervisory procedures covering the operation of their business.¹³⁴⁸ According to this commenter, this process allows broker-dealers

1342 See id.

1343 See id.

1344 See KCG Letter at 14.

1345 See id. at 14-15.

1346 See id. at 14-17.

1347 See OTC Markets Letter at 11.

1348 See id.

to devise procedures that keep them in-line with FINRA and Commission regulations, and allows FINRA to focus on bigger picture issues impacting the broker-dealer industry.¹³⁴⁹

In addition, one commenter stated that the Commission should not propose a requirement that SCI SROs require their members to institute policies and procedures similar to those required under Regulation SCI.¹³⁵⁰ According to this commenter, SCI SROs already impose regulatory requirements addressing similar concerns as those that Regulation SCI is designed to address.¹³⁵¹

One commenter stated that the term SCI entity should not encompass clearing broker-dealers or transfer agents because they are not involved in “real-time” trading activities and therefore there would not be any material impact on critical market functions should their systems fail.¹³⁵² Additionally, this commenter stated that because Regulation SCI “is designed to formalize the Commission’s existing ARP Program,” and clearing broker-dealers and transfer agents do not participate in ARP, those entities should not be included within the scope of Regulation SCI.¹³⁵³ Another commenter echoed these positions with respect to transfer agents, and also stated that transfer agents should not be included within the definition of SCI entity because the majority of transfer agents do not have electronic connectivity to SCI entities.¹³⁵⁴ Additionally, this commenter stated that larger transfer agents are already required to have business continuity plans and written policies and procedures to ensure that their systems are

¹³⁴⁹ See id.

¹³⁵⁰ See WF Letter at 2.

¹³⁵¹ See id. at 2-3.

¹³⁵² See Fidelity Letter at 4.

¹³⁵³ See id.

¹³⁵⁴ See STA Letter at 2.

robust and will function as intended.¹³⁵⁵ In determining whether to expand the scope of SCI entities, one commenter commented that the Commission should consider the role of an entity in the securities markets and the risks presented by that entity, and stated that transfer agents should not be covered because they raise fewer risks to the markets than the proposed SCI entities, as their systems do not directly support the functions intended to be targeted by the SCI Proposal.¹³⁵⁶ Another commenter similarly stated that transfer agents should not be covered because there is little chance that a problem with a transfer agent's operations would impact market activity.¹³⁵⁷

The Commission appreciates the comments received on the potential application of Regulation SCI to broker-dealers other than SCI ATs and other types of entities. As noted above, should the Commission decide to propose to apply the requirements of Regulation SCI to these entities, the Commission would issue a separate release discussing such a proposal and would take these comments into account.

F. Effective Date and Compliance Dates

Several commenters provided recommendations for when the requirements of Regulation SCI should go into effect and/or when SCI entities should be required to comply with the various requirements of the regulation.¹³⁵⁸ Each commenter recommended allowing what they believed

¹³⁵⁵ See id.

¹³⁵⁶ See ICI Letter at 3.

¹³⁵⁷ See Oppenheimer Letter at 2.

¹³⁵⁸ See e.g., FINRA Letter at 41-42; DTCC Letter at 3; OCC Letter at 2; MSRB Letter at 39-40; KCG Letter at 19; SIFMA Letter at 7; and OTC Markets Letter at 4, 22-23.

to be sufficient time for SCI entities to prepare for what they perceived as complex or substantial regulatory responsibilities.¹³⁵⁹

Several commenters suggested that the implementation period should vary between those entities and/or systems currently subject to the ARP Inspection Program and those that are not.¹³⁶⁰ For example, one commenter suggested an implementation period of no less than two years for SCI systems that are subject to the ARP Inspection Program and three years for all other systems.¹³⁶¹ Similarly, another commenter recommended that certain systems of non-ARP participants should be provided at least an additional one year transition period, after a six-month delayed effectiveness after final approval of Regulation SCI for SCI systems of current ARP participants that are trading, clearance and settlement, and order routing systems.¹³⁶² Another commenter stated that systems currently covered by the ARP Inspection Program should be granted two years to phase-in the rule and that non-ARP systems would need a phase-in period of at least four years.¹³⁶³ One commenter also noted more generally that the time needed to meet the new requirements of Regulation SCI will vary by the type of SCI entity and the level of its current participation in the ARP Inspection Program.¹³⁶⁴

¹³⁵⁹ See e.g., FINRA Letter at 41-42; DTCC Letter at 3; OCC Letter at 2; MSRB Letter at 39-40; KCG Letter at 19; SIFMA Letter at 7; and OTC Markets Letter at 4, 22-23.

¹³⁶⁰ See, e.g., FINRA Letter at 41-42; DTCC Letter at 3; and OTC Markets Letter at 4, 22-23.

¹³⁶¹ See FINRA Letter at 41-42.

¹³⁶² See MSRB Letter at 39-40.

¹³⁶³ See OTC Markets Letter at 4, 22-23.

¹³⁶⁴ See DTCC Letter at 3.

Some commenters requested a special phase-in period for ATSS. Specifically, two commenters suggested that ATSS should be given six months after meeting the given threshold in the definition of SCI ATS to come into compliance with Regulation SCI.¹³⁶⁵

Other commenters provided detailed suggestions for a phase-in compliance timeline for the requirements of Regulation SCI.¹³⁶⁶ For example, one commenter suggested implementing the rule in three phases so that it would apply: (1) after initial six-month delayed effectiveness, to SCI systems of current ARP participants that are trading, clearance and settlement, and order routing systems, and after one additional year, to such systems of non-ARP participants (for at least one annual cycle); (2) to indirect SCI systems relating to the systems in phase one (for at least one annual cycle); and (3) to SCI systems that are market data, regulation and surveillance systems and related indirect SCI systems.¹³⁶⁷ Another commenter believed the rule should be phased-in over four stages, where each SCI entity would: (1) review its SCI systems risk-based assessment with Commission staff; (2) review and update its policies and procedures to reasonably ensure compliance with Regulation SCI; (3) implement such policies and procedures; and (4) conduct an annual review.¹³⁶⁸

Other commenters recommended individual compliance deadlines for certain requirements of Regulation SCI.¹³⁶⁹ Specifically, two commenters suggested that phased-in compliance should be permitted for proposed Rule 1000(b)(9) addressing testing of SCI entity

¹³⁶⁵ See KCG Letter at 19; and SIFMA Letter at 7. See also adopted Rule 1000 (definition of “SCI ATS”) and supra Section IV.A.1.b (discussing definition of “SCI ATS”).

¹³⁶⁶ See MSRB Letter at 39-40; and OCC Letter at 2-3.

¹³⁶⁷ See MSRB Letter at 40.

¹³⁶⁸ See OCC Letter at 3.

¹³⁶⁹ See OCC Letter at 2-3, 11, and 18; and SIFMA Letter at 18.

business continuity and disaster recovery plans by SCI entity members or participants.¹³⁷⁰ Specifically, one commenter believed that, if end-to-end business continuity and disaster recovery plans testing were to be required, it should be phased-in to allow SCI entities to conduct testing of specific SCI systems over time, rather than be required to conduct a full end-to-end test, which it stated cannot be done within a reasonable timeframe.¹³⁷¹ The other commenter recommended a phased-in approach to implementation of broader BC/DR testing over a period of years.¹³⁷² One commenter recommended that the Commission institute an implementation period for the Commission notification requirement under proposed Rule 1000(b)(4) to allow SCI entities to prepare for what the commenter believed to be an increase in the number of notifications that would be required.¹³⁷³ This commenter also noted generally that business continuity and end-to-end testing requirements,¹³⁷⁴ the two-hour recovery time objective,¹³⁷⁵ and

¹³⁷⁰ See adopted Rule 1004 and supra Section IV.B.6 (discussing business continuity and disaster recovery plans testing requirements).

¹³⁷¹ See OCC Letter at 18.

¹³⁷² See SIFMA Letter at 18.

¹³⁷³ See OCC Letter at 11; see also adopted Rule 1002(b) and supra Section IV.B.3.c (discussing the Commission notification requirement for SCI events). One commenter also expressed concern about SCI entities being able to effectively make submissions on Form SCI upon Regulation SCI becoming effective, and urged Commission staff to work with the SCI entities in the development, testing, and implementation of the Form SCI electronic submission system, including provision of any systems requirements (e.g., supported browsers, required certificates, or authentication protocols). See MSRB Letter at 25. Another commenter requested that the Commission provide SCI entities sufficient time to learn the new Form SCI submission process, and recommended that the Commission delay implementation of Form SCI until SCI entities and Commission staff have gained experience with the Regulation SCI reporting requirements. See FINRA Letter at 28. In the alternative, this commenter recommended that the Commission provide a transition period for SCI entities to establish their processes for submission of Form SCI. See FINRA Letter at 28.

¹³⁷⁴ See adopted Rule 1004 and supra Section IV.B.6 (discussing business continuity and disaster recovery plans testing requirements).

adopting the required policies and procedures may take longer to comply with than other provisions of Regulation SCI.¹³⁷⁵

Regulation SCI will become effective 60 days after publication of the rules in the Federal Register (“Effective Date”). As proposed, SCI entities would have been required to meet the requirements of Regulation SCI on the Effective Date. However, after consideration of the views of commenters, the Commission has determined to adopt a compliance date for Regulation SCI of nine months after the Effective Date, except as described below with regard to: (1) ATSS newly meeting the thresholds in the definition of “SCI ATS;” and (2) the industry- or sector-wide coordinated testing requirement, which will have different compliance periods. The Commission believes that the importance of strengthening the technology infrastructure of key market participants, the potential significant risks posed by systems issues to the U.S. securities markets, and the significant number of recent systems issues at various trading venues, necessitates as prompt an implementation of the requirements of Regulation SCI by SCI entities as possible. At the same time, the Commission understands that SCI entities will need time to prepare for the obligations imposed by Regulation SCI and, accordingly, believes that this nine-month time frame provides SCI entities adequate time to meet the requirements of Regulation SCI. While certain commenters suggested longer compliance periods or phased-in compliance periods, the Commission understands that entities currently subject to the ARP Inspection Program may already comply with certain requirements of Regulation SCI. In addition, the

¹³⁷⁵ See adopted Rule 1001(a)(2)(v) and supra Section IV.B.1.b (discussing the policies and procedures requirement and the two-hour recovery time objective).

¹³⁷⁶ See OCC Letter at 2-3; see also adopted Rule 1001 and supra Sections IV.B.1-2 (discussing the policies and procedures requirement for operational capability and systems compliance).

Commission also believes that SCI entities that have not previously participated in the ARP Inspection Program may also currently operate in accordance with certain of the adopted requirements. For example, the Commission believes that most SCI entities generally have in place policies and procedures designed to ensure its systems' capacity, integrity, resiliency, availability, and security and that most SCI entities already take corrective actions in response to systems issues.

Further, the Commission notes that, as described above, it has further focused the scope of the requirements of Regulation SCI from the SCI Proposal and, thus, has lessened the potential burdens on SCI entities.¹³⁷⁷ Therefore, the Commission believes that many of the concerns expressed by commenters regarding the time that would be needed to prepare for the responsibilities imposed by Regulation SCI have been significantly mitigated or addressed by this overall refinement of the rules and obligations of SCI entities. For example, as discussed above, the Commission has further focused the definition of "SCI systems" and clarified the scope of "indirect SCI systems," which will result in fewer systems being subject to the requirements of Regulation SCI.¹³⁷⁸ In addition, the Commission notification provision will require immediate Commission notice of fewer SCI events than as proposed as a result of the refining of several definitions and the adoption of an exception from the immediate reporting

¹³⁷⁷ See supra Section III (providing a summary of the key modifications from the SCI Proposal) and Section IV (providing a detailed discussion of changes from the SCI Proposal).

¹³⁷⁸ See supra Sections IV.A.2.b and IV.A.2.d (discussing the definitions of "SCI systems" and "indirect SCI systems"). The Commission notes that the refining of these definitions also reduces the need to phase-in compliance based on type of system as suggested by one commenter, because fewer systems overall will be subject to the regulation than proposed and many systems for which the commenter urged a delay in compliance will not be covered by the regulation, as adopted.

requirements for de minimis SCI events, which will instead be subject to recordkeeping requirements and/or a quarterly reporting obligation, as applicable.¹³⁷⁹ Further, the Commission has clarified that an SCI entity's policies and procedures relating to the capacity, integrity, resiliency, availability, and security of its SCI systems and indirect SCI systems can to be tailored to a particular SCI system's criticality and risk, contrary to the belief of some commenters that the rule required all systems to be held to the same standards.¹³⁸⁰ The Commission also notes that it expects, prior to the compliance date, that its staff will provide information to SCI entities regarding the operation of the electronic filing system to submit Forms SCI.

With regard to some commenters' suggestions that there should be different compliance periods for SCI entities currently subject to the ARP Inspection Program and those that do not currently participate in the ARP Inspection Program (or phased-in compliance based, in part, on this distinction), as noted above, the Commission believes that both categories of entities already have some level of processes or procedures in place that are in compliance with the requirements of Regulation SCI. Further, given the voluntary nature of the current ARP Inspection Program, the Commission believes that the extent of current compliance with the requirements of adopted Regulation SCI by entities subject to the ARP Inspection Program varies for different entities. In addition, as noted above, Regulation SCI has a broader scope than the current ARP Inspection Program and imposes mandatory requirements on entities subject to the rules, and accordingly

¹³⁷⁹ See supra Section IV.B.3.c (discussing the Commission notification requirement). As discussed above, SCI entities will be required to make, keep, and preserve records relating to all de minimis SCI events and to report de minimis systems disruptions and de minimis systems intrusions quarterly.

¹³⁸⁰ See supra Section IV.B.1 (discussing the requirement for policies and procedures to achieve capacity, integrity, resiliency, availability, and security).

will require all SCI entities (both ARP entities and non-ARP entities) to take steps, including implementing necessary systems changes, to meet the requirements of Regulation SCI. For these reasons, the Commission believes that it is appropriate to provide all SCI entities nine months to become compliant with the requirements of Regulation SCI.

With regard to two commenters' suggestions that the Commission should adopt specific phased-in compliance periods based on type of entity (*i.e.*, ARP or non-ARP), type of system, or other factors, the Commission believes that such an approach is not necessary for the reasons stated above. Further, the Commission believes that having multiple phases of compliance would create unnecessary complexity and raise practical difficulties for implementation.

At the same time, the Commission believes that it is appropriate to provide additional compliance periods for limited aspects of Regulation SCI, as requested by some commenters. Specifically, the Commission believes that ATSS meeting the volume thresholds in the definition of "SCI ATS" for the first time should be provided an additional six months from the time that the ATS first meets the applicable thresholds to comply with the requirements of Regulation SCI.¹³⁸¹ The Commission believes that this additional six-month period is appropriate and necessary to allow an SCI ATS the time needed to take steps to meet the requirements of the rules, rather than requiring compliance immediately upon meeting the volume thresholds. The Commission also believes that this additional compliance period should give a new ATS entrant

¹³⁸¹ See *supra* note 1365 and accompanying text. See also *supra* Section IV.A.1.b (discussing the definition of "SCI ATS," including the applicable volume thresholds and the inclusion of a six-month compliance period within the definition). For example, if a new ATS begins operations in January 2016 and subsequently meets the volume thresholds in the definition of "SCI ATS" for four out of the six months ending December 31, 2016, it would have until June 30, 2017 to become compliant with the requirements of Regulation SCI.

the opportunity to initiate and develop its business by allowing additional time before a new ATS must incur the costs associated with compliance with Regulation SCI.¹³⁸²

The Commission is also adopting a longer compliance period with regard to the industry- or sector-wide coordinated testing requirement in adopted Rule 1004(d).¹³⁸³ Specifically, SCI entities will have 21 months from the Effective Date to coordinate the testing of an SCI entity's business continuity and disaster recovery plans on an industry- or sector-wide basis with other SCI entities pursuant to adopted Rule 1004(d). Given that the compliance date for the other requirements of Regulation SCI is nine months from the Effective Date, this will provide SCI entities an additional year (12 months) beyond the compliance date for the other requirements of Regulation SCI (for a total of 21 months) to comply with Rule 1004(d). The Commission believes that this additional time period is appropriate in light of commenters' concerns regarding the complexity and logistical challenges posed by the requirement.¹³⁸⁴ The Commission expects SCI entities to work cooperatively to address these logistical hurdles and to carefully plan such testing, and believes that the additional time for compliance should help to ensure that such testing is implemented effectively.

If any provision of Regulation SCI, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

¹³⁸² See supra note 152 and accompanying text.

¹³⁸³ See supra Section IV.B.6.b.iv (discussing the coordinated testing requirement of adopted Rule 1004(d)).

¹³⁸⁴ See id.

V. Paperwork Reduction Act

Certain rules under Regulation SCI impose new “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).¹³⁸⁵ An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. In accordance with 44 U.S.C. 3507 and 5 CFR 1320.11, the Commission submitted these collections of information to the Office of Management and Budget (“OMB”) for review. The title for the collection of information requirement is “Regulation Systems Compliance and Integrity.” The collection of information was assigned OMB Control No. 3235-0703.

In the SCI Proposal, the Commission solicited comments on the collection of information burdens associated with Regulation SCI. In particular, the Commission asked whether commenters agree with the Commission’s estimate of the number of respondents and the burden associated with compliance with Regulation SCI.¹³⁸⁶ In addition, the Commission asked whether SCI entities would outsource the work associated with compliance with Regulation SCI.¹³⁸⁷ Some commenters noted that the Commission underestimated the burdens that would be imposed by proposed Regulation SCI.¹³⁸⁸ As discussed above, the Commission received 60 comment letters on the proposal. Some of these comments relate directly or indirectly to the PRA. These comments are addressed below.

¹³⁸⁵ 44 U.S.C. 3501 et seq.

¹³⁸⁶ See Proposing Release, supra note 13, at 18155.

¹³⁸⁷ See id. at 18154-55.

¹³⁸⁸ See, e.g., Joint SRO Letter at 18-19; CME Letter at 4-5; OCC Letter at 11-12.

A. Summary of Collection of Information

Regulation SCI includes four categories of obligations that require a collection of information within the meaning of the PRA. Specifically, an SCI entity is required to: (1) establish specified written policies and procedures, and mandate participation by designated members or participants in certain testing of the SCI entity's business continuity and disaster recovery plans; (2) provide certain notifications, disseminate certain information, and create reports; (3) take corrective actions, and identify critical SCI systems, major SCI events, de minimis SCI events, and material systems changes; and (4) comply with recordkeeping requirements.

1. Requirements to Establish Written Policies and Procedures and Mandate Participation in Certain Testing

Rule 1001 requires SCI entities to establish policies and procedures with respect to various matters. Rule 1001(a) requires each SCI entity to establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems and, for purposes of security standards, indirect SCI systems, have levels of capacity, integrity, resiliency, availability, and security, adequate to maintain the SCI entity's operational capability and promote the maintenance of fair and orderly markets. Rule 1001(a)(2) specifies that such policies and procedures are required to include, at a minimum: (i) the establishment of reasonable current and future technology infrastructure capacity planning estimates; (ii) periodic capacity stress tests of such systems to determine their ability to process transactions in an accurate, timely, and efficient manner; (iii) a program to review and keep current systems development and testing methodology for such systems; (iv) regular reviews and testing, as applicable, of such systems, including backup systems, to identify vulnerabilities pertaining to internal and external threats, physical hazards, and natural or manmade disasters; (v) business

continuity and disaster recovery plans that include maintaining backup and recovery capabilities sufficiently resilient and geographically diverse and that are reasonably designed to achieve next business day resumption of trading and two-hour resumption of critical SCI systems following a wide-scale disruption; (vi) standards that result in such systems being designed, developed, tested, maintained, operated, and surveilled in a manner that facilitates the successful collection, processing, and dissemination of market data; and (vii) monitoring of such systems to identify potential SCI events. Rule 1001(a)(3) requires each SCI entity to periodically review the effectiveness of the policies and procedures required by Rule 1001(a), and take prompt action to remedy deficiencies in such policies and procedures. Rule 1001(a)(4) states that an SCI entity's policies and procedures shall be deemed to be reasonably designed if they are consistent with current SCI industry standards, which are required to be comprised of information technology practices that are widely available to information technology professionals in the financial sector and issued by an authoritative body that is a U.S. governmental entity or agency, association of U.S. governmental entities or agencies, or widely recognized organization, though compliance with current SCI industry standards is not the exclusive means to comply with the requirements of Rule 1001(a).

Rule 1001(b)(1) requires each SCI entity to establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems operate in a manner that complies with the Act and rules and regulations thereunder and the entity's rules and governing documents, as applicable. Rule 1001(b)(2) specifies that such policies and procedures are required to include, at a minimum: (i) testing of all SCI systems and any changes to SCI systems prior to implementation; (ii) a system of internal controls over changes to SCI systems; (iii) a plan for assessments of the functionality of SCI systems designed to detect systems

compliance issues, including by responsible SCI personnel and by personnel familiar with applicable provisions of the Act and the rules and regulations thereunder and the SCI entity's rules and governing documents; and (iv) a plan of coordination and communication between regulatory and other personnel of the SCI entity, including by responsible SCI personnel, regarding SCI systems design, changes, testing, and controls designed to detect and prevent systems compliance issues. Rule 1001(b)(3) requires each SCI entity to periodically review the effectiveness of the policies and procedures required by Rule 1001(b), and take prompt action to remedy deficiencies in such policies and procedures. Further, pursuant to Rule 1001(b)(4), personnel of an SCI entity is deemed not to have aided, abetted, counseled, commanded, caused, induced, or procured the violation by an SCI entity of Rule 1001(b) if the person: (i) has reasonably discharged the duties and obligations incumbent upon such person by the SCI entity's policies and procedures; and (ii) was without reasonable cause to believe that the policies and procedures relating to an SCI system for which such person was responsible, or had supervisory responsibility, were not established, maintained, or enforced in accordance with Rule 1001(b) in any material respect.

Rule 1001(c)(1) requires each SCI entity to establish, maintain, and enforce reasonably designed written policies and procedures that include the criteria for identifying responsible SCI personnel, the designation and documentation of responsible SCI personnel, and escalation procedures to quickly inform responsible SCI personnel of potential SCI events. Rule 1001(c)(2) requires each SCI entity to periodically review the effectiveness of the policies and procedures required by Rule 1001(c)(1), and take prompt action to remedy deficiencies in such policies and procedures.

Rule 1004 requires an SCI entity, with respect to its business continuity and disaster recovery plans, including its backup systems, to: (a) establish standards for the designation of those members or participants that the SCI entity reasonably determines are, taken as a whole, the minimum necessary for the maintenance of fair and orderly markets in the event of the activation of such plans; and (b) designate members or participants pursuant to such standards and require participation by such members or participants in scheduled functional and performance testing of the operation of such plans, in the manner and frequency as specified by the SCI entity, at least once every 12 months (e.g., for SCI SROs, by submitting proposed rule changes under Section 19(b) of the Exchange Act; for SCI ATSS, by revising membership or subscriber agreements and internal procedures; for plan processors, through an amendment to an SCI Plan under Rule 608 of Regulation NMS; and, for exempt clearing agencies subject to ARP, by revising participant agreements and internal procedures). Rule 1004(c) requires an SCI entity to coordinate such required testing on an industry- or sector-wide basis with other SCI entities.

2. Notification, Dissemination, and Reporting Requirements for SCI Entities

Certain rules under Regulation SCI require SCI entities to notify or report information to the Commission, or disseminate information to their members or participants. Rules 1002 and 1003 each contain notification, dissemination, or reporting requirements.¹³⁸⁹

Rule 1002(b) requires Commission notification of SCI events. Rule 1002(b)(1) requires an SCI entity to immediately notify the Commission upon any responsible SCI personnel having

¹³⁸⁹ To access EFFS, the secure Commission Web site for filing of Form SCI, an SCI entity will submit to the Commission an External Application User Authentication Form (“EAUF”) to register each individual at the SCI entity who will access the EFFS system on behalf of the SCI entity. Upon receipt and verification of the information in the EAUF process, the Commission will issue each such person a User ID and Password to permit access to the Commission’s secure Web site.

a reasonable basis to conclude that an SCI event has occurred. These notifications may be made orally or in writing.

Rule 1002(b)(2) requires an SCI entity, within 24 hours of any responsible SCI personnel, having a reasonable basis to conclude that an SCI event has occurred, to submit a written notification to the Commission on Form SCI pertaining to such SCI event.¹³⁹⁰ Rule 1002(b)(2) requires that this notification include: (i) a description of the SCI event, including the system(s) affected; and (ii) to the extent available as of the time of the notification, the SCI entity's current assessment of the types and number of market participants potentially affected by the SCI event, the potential impact of the SCI event on the market, a description of the steps the SCI entity has taken, is taking, or plans to take, with respect to the SCI event, the time the SCI event was resolved or timeframe within which the SCI event is expected to be resolved, and any other pertinent information known by the SCI entity about the SCI event.

Rule 1002(b)(3) requires an SCI entity, until an SCI event is resolved and the SCI entity's investigation of the SCI event is closed, to provide updates pertaining to such SCI event to the Commission on a regular basis, or at such frequency as reasonably requested by a representative of the Commission, to correct any materially incorrect information previously provided, or when new information is discovered (including but not limited to any of the information listed in Rule 1002(b)(2)(ii)). The updates under Rule 1002(b)(3) may be made orally or in writing.

Rule 1002(b)(4) states that, if an SCI event is resolved and the SCI entity's investigation of the SCI event is closed within 30 calendar days of the occurrence of the event, then within 5 business days after the resolution of the SCI event and closure of the investigation regarding the SCI event, the SCI entity is required to submit a final written notification to the Commission

¹³⁹⁰ This notification is required to be submitted on a good faith, best efforts basis.

pertaining to the SCI event. This notification is required to include: (i) a detailed description of the SCI entity's assessment of the types and number of market participants affected by the SCI event, the SCI entity's assessment of the impact of the SCI event on the market, the steps that the SCI entity has taken, is taking, or plans to take with respect to the SCI event, the time the SCI event was resolved, the SCI entity's rule(s) and/or governing document(s), as applicable, that relate to the SCI event, and any other pertinent information known by the SCI entity about the SCI event; (ii) a copy of any information disseminated pursuant to Rule 1002(c) by the SCI entity to date regarding the SCI event to any of its members or participants; and (iii) an analysis of parties that may have experienced a loss, whether monetary or otherwise, due to the SCI event, the number of such parties, and an estimate of the aggregate amount of such loss. Rule 1002(b)(4)(iv) further states that, if an SCI event is not resolved or the SCI entity's investigation of the SCI event is not closed within 30 days of the occurrence of the SCI event, then the SCI entity is required to submit an interim written notification pertaining to such event within 30 calendar days after the occurrence of the event, containing the information required by Rule 1002(b)(4)(ii) to the extent known at that time. Within 5 business days after the resolution of such event and closure of the investigation, the SCI entity is required to submit a final written notification to the Commission, containing the information required by Rule 1002(b)(4)(ii).

Rule 1002(b)(5) states that the requirements of Rules 1002(b)(1)-(4) do not apply to de minimis SCI events. Instead, for these types of SCI events, an SCI entity is required to make, keep, and preserve records relating to these events, and submit to the Commission quarterly reports containing a summary description of de minimis systems disruptions and de minimis systems intrusions, including the SCI systems and, for systems intrusions, indirect SCI systems,

affected by such systems disruptions and systems intrusions during the applicable calendar quarter.

Rule 1002(c) requires the dissemination of information regarding certain SCI events and specifies the nature and timing of such dissemination. Rule 1002(c)(1)(i) requires an SCI entity, promptly after any responsible SCI personnel has a reasonable basis to conclude that a systems disruption or systems compliance issue has occurred, to disseminate the following information about such SCI event: (A) the system(s) affected by the SCI event; and (B) a summary description of the SCI event. In addition, Rule 1002(c)(1)(ii) requires an SCI entity, when known, to further disseminate the following information: (A) a detailed description of the SCI event; (B) the SCI entity's current assessment of the types and number of market participants potentially affected by the SCI event; and (C) a description of the progress of its corrective action for the SCI event and when the SCI event has been or is expected to be resolved. Rule 1002(c)(1)(iii) requires that an SCI entity provide regular updates of the information required to be disseminated under Rule 1002(c)(1)(i) and (ii).

With respect to systems intrusions, Rule 1002(c)(2) states that, promptly after any responsible SCI personnel has a reasonable basis to conclude that a systems intrusion has occurred, an SCI entity is required to disseminate a summary description of the systems intrusion, including a description of the corrective action taken by the SCI entity and when the systems intrusion has been or is expected to be resolved, unless the SCI entity determines that dissemination of such information would likely compromise the security of the SCI entity's SCI

systems or indirect SCI systems, or an investigation of the systems intrusion, and documents the reasons for such determination.¹³⁹¹

Rule 1002(c)(4) provides that the information dissemination requirement does not apply to SCI events to the extent they relate to market regulation or market surveillance systems, or to any de minimis SCI events.

Rule 1003(a)(1) requires an SCI entity, within 30 calendar days after the end of each calendar quarter, to submit to the Commission a report describing completed, ongoing, and planned material changes to its SCI systems and the security of indirect SCI systems, during the prior, current, and subsequent calendar quarters, including the dates or expected dates of commencement and completion. Rule 1003(a)(2) further requires an SCI entity to promptly submit a supplemental report to notify the Commission of a material error in or material omission from a report previously submitted under Rule 1003(a).

Rules 1003(b)(1) and (2) require an SCI entity to conduct periodic SCI reviews of its compliance with Regulation SCI,¹³⁹² and to submit a report of the SCI review to senior management of the SCI entity for review no more than 30 calendar days after completion of such

¹³⁹¹ Rule 1002(c)(3) provides that the information specified in Rules 1002(c)(1) and (2) is required to be disseminated to members or participants of the SCI entity that a responsible SCI personnel has reasonably estimated may have been affected by the SCI event, and promptly disseminated to any additional members or participants that any responsible SCI personnel subsequently reasonably estimates may have been affected by the SCI event. However, information regarding major SCI events must be disseminated to all members or participants of an SCI entity.

¹³⁹² SCI entities are required to conduct an SCI review not less than once each calendar year. However, under Rule 1003(b)(1)(i), penetration test reviews of the network, firewalls, and production systems are required to be conducted not less than once every three years. Under Rule 1003(b)(1)(ii), assessments of SCI systems directly supporting market regulation or market surveillance are required to be conducted at a frequency based on risk assessment, but not less than once every three years.

SCI review. Rule 1003(b)(3) also requires an SCI entity to submit to the Commission, and to the board of directors of the SCI entity or the equivalent of such board, a report of the SCI review, together with any response by senior management, within 60 calendar days after its submission to senior management of the SCI entity.

Rule 1006 requires any notifications to the Commission required to be submitted under Regulation SCI, except notifications pursuant to Rule 1002(b)(1) or 1002(b)(3), to be filed electronically on Form SCI, include all information as prescribed in Form SCI and the instructions thereto, and contain an electronic signature. In addition, pursuant to Rule 1006(b), the signatory to an electronically filed Form SCI is required to manually sign a signature page or document authenticating, acknowledging, or otherwise adopting his or her signature that appears in typed form within the electronic filing. Such document is required to be retained by the SCI entity in accordance with Rule 1005.

3. Requirements to Take Corrective Action and Identify Critical SCI Systems, Major SCI Events, De Minimis SCI Events, and Material Systems Changes

Rule 1002(a) requires an SCI entity, upon any responsible SCI personnel having a reasonable basis to conclude that an SCI event has occurred, to begin to take appropriate corrective action, which is required to include, at a minimum, mitigating potential harm to investors and market integrity resulting from the SCI event and devoting adequate resources to remedy the SCI event as soon as reasonably practicable. The Commission believes that SCI entities are likely to work to develop a written process for ensuring that they are prepared to comply with the corrective action requirement and are likely to also periodically review this process.

In connection with the reporting of material systems changes, Rule 1003(a)(1) requires an SCI entity to establish reasonable written criteria for identifying a change to its SCI systems and the security of indirect SCI systems as material. In addition, because the Commission notification and information dissemination requirements under Rules 1002(b) and (c), respectively, apply differently to SCI events depending on whether an event is a “major SCI event” or whether the event has no or a de minimis impact on the SCI entity’s operations or on market participants, when an SCI event occurs, an SCI entity must determine whether an SCI event is a major SCI event or a de minimis SCI event. Moreover, because the business continuity and disaster recovery policies and procedures requirement under Rule 1001(a)(2)(v) imposes different resumption goals for critical SCI systems as compared to other SCI systems, an SCI entity must determine whether an SCI system is a critical SCI system.¹³⁹³ As such, SCI entities would likely work to develop a written process for ensuring that they are able to make timely and accurate determinations regarding the nature of an SCI system or SCI event, and periodically review this process.

4. Recordkeeping Requirements

Rule 1005 sets forth recordkeeping requirements for SCI entities. Under Rule 1005(a), SCI SROs are required to make, keep, and preserve all documents relating to their compliance with Regulation SCI as prescribed in Rule 17a-1 under the Exchange Act. Under Rule 1005(b), each SCI entity that is not an SCI SRO is required to make, keep, and preserve at least one copy of all documents, including correspondence, memoranda, papers, books, notices, accounts, and other such records, relating to its compliance with Regulation SCI, including, but not limited to,

¹³⁹³ Also, pursuant to the definition of “major SCI event,” in determining whether an SCI event is a major SCI event, an SCI entity is required to consider whether an SCI event can have any impact on a critical SCI system. See Rule 1000.

records relating to any changes to its SCI systems and indirect SCI systems. Each SCI entity that is not an SCI SRO is required to keep all such documents for a period of not less than five years, the first two years in a place that is readily accessible to the Commission or its representatives for inspection and examination. Upon request of any representative of the Commission, such SCI entities would be required to promptly furnish to the possession of such representative copies of any documents required to be kept and preserved by it under Rules 1005(b)(1) and (2). Under Rule 1005(c), upon or immediately prior to ceasing to do business or ceasing to be registered under the Exchange Act, an SCI entity is required to take all necessary action to ensure that the records required to be made, kept, and preserved by Rule 1005 will be accessible to the Commission and its representatives in the manner required by Rule 1005 and for the remainder of the period required by Rule 1005.

In addition, Rule 1007 provides that, if the records required to be filed or kept by an SCI entity under Regulation SCI are prepared or maintained by a service bureau or other recordkeeping service on behalf of the SCI entity, the SCI entity is required to ensure that the records are available for review by the Commission and its representatives by submitting a written undertaking, in a form acceptable to the Commission, by such service bureau or other recordkeeping service and signed by a duly authorized person at such service bureau or other recordkeeping service.

B. Use of Information

1. Requirements to Establish Written Policies and Procedures and Mandate Participation in Certain Testing

The requirement that SCI entities establish policies and procedures under adopted Rule 1001(a) should advance the goal of improving Commission review and oversight of U.S. securities market infrastructure by requiring an SCI entity's policies and procedures to be

reasonably designed to ensure its own operational capability, including the ability to maintain effective operations, minimize or eliminate the effect of performance degradations, and have sufficient backup and recovery capabilities. Because an SCI entity's own operational capability can have the potential to impact investors, the overall market, or the trading of individual securities, the Commission believes that these policies and procedures will help promote the maintenance of fair and orderly markets.

The Commission believes that Rule 1001(b), which requires each SCI entity to establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems operate in a manner that complies with the Exchange Act and the rules and regulations thereunder and the entity's rules and governing documents, as applicable, will help to prevent the occurrence of systems compliance issues. In addition, the Commission believes Rule 1001(b) will help to: ensure that SCI SROs comply with Section 19(b)(1) of the Exchange Act; reinforce existing SRO rule filing processes to assist market participants and the public in understanding how the SCI systems of SCI SROs are intended to operate; and assist SCI SROs in meeting their obligations to file plan amendments to SCI Plans under Rule 608 of Regulation NMS. It should similarly help other SCI entities to achieve operational compliance with the Exchange Act, the rules and regulations thereunder, and their governing documents.

The requirement to establish policies and procedures pursuant to Rule 1001(c) that include the designation and documentation of responsible SCI personnel should help make it clear to all employees of the SCI entity who the designated responsible SCI personnel are for purposes of the escalation procedures and so that Commission staff can easily identify such responsible SCI personnel in the course of its inspections and examinations and other interactions with SCI entities. The Commission also believes that escalation procedures to

quickly inform responsible SCI personnel of potential SCI events will help ensure that the appropriate person(s) are provided notice of potential SCI events so that any appropriate actions can be taken in accordance with the requirements of Regulation SCI without unnecessary delay.

The Commission believes that the requirement that SCI entities establish standards that require designated members or participants to participate in the testing of their business continuity and disaster recovery plans will help reduce the risks associated with an SCI entity's decision to activate its BC/DR plans and help to ensure that such plans operate as intended, if activated. The testing participation requirement should help an SCI entity to ensure that its efforts to develop effective BC/DR plans are not undermined by a lack of participation by members or participants that the SCI entity believes are necessary to the successful activation of such plans. This requirement should also assist the Commission in maintaining fair and orderly markets in a BC/DR scenario following a wide-scale disruption.

2. Notification, Dissemination, and Reporting Requirements for SCI Entities

Adopted Rule 1002(b), including adopted Rules 1002(b)(1)-(3), will foster a system for comprehensive reporting of SCI events, which should enhance the Commission's review and oversight of U.S. securities market infrastructure and foster cooperation between the Commission and SCI entities in responding to SCI events. The Commission also believes that the aggregated data that will result from the reporting of SCI events will enhance its ability to comprehensively analyze the nature and types of various SCI events and identify more effectively areas of persistent or recurring problems across the systems of all SCI entities. The information in the final report required under Rule 1002(b)(4) should provide the Commission with a comprehensive analysis to more fully understand and assess the impact caused by the SCI event. The Commission expects that the quarterly reporting required by Rule 1002(b)(5) will

better achieve the goal of keeping Commission staff informed regarding the nature and frequency of systems disruptions and systems intrusions that arise but are reasonably estimated by the SCI entity to have a de minimis impact on the entity's operations or on market participants. Further, submission and review of regular reports should facilitate Commission staff comparisons among SCI entities and thereby permit the Commission and its staff to have a more holistic view of the types of systems operations challenges that were posed to SCI entities in the aggregate.

Adopted Rule 1002(c) advances the Commission's goal of promoting fair and orderly markets by disseminating information about an SCI event to some or all of the SCI entity's members or participants, who can use such information to evaluate the event's impact on their trading and other activities and develop an appropriate response.

The quarterly material systems change reports required by Rule 1003(a) should permit the Commission and its staff to have up-to-date information regarding an SCI entity's systems development progress and plans, and help the Commission with its oversight of U.S. securities market infrastructure.

The SCI reviews under Rule 1003(b) should not only assist the Commission in improving its oversight of the technology infrastructure of SCI entities, but also each SCI entity in assessing the effectiveness of its information technology practices, helping to ensure compliance with the safeguards provided by the requirements of Regulation SCI, identifying potential areas of weakness that require additional or modified controls, and determining where to best devote resources.

Rule 1006 provides a uniform manner in which the Commission would receive—and SCI entities would provide—written notifications, reviews, descriptions, analyses, or reports made

pursuant to Regulation SCI. The Commission believes that Rule 1006 therefore allows SCI entities to efficiently draft and submit the required reports, and for the Commission to efficiently review, analyze, and respond to the information provided.

As noted above, in order to access EFFS, an SCI entity will submit to the Commission an EAUF to register each individual at the SCI entity who access the EFFS system on behalf of the SCI entity. The information provided via EAUF will be used by the Commission to verify the identity of the individual submitting Form SCI on behalf of the SCI entity and provide such individual access to the EFFS.

3. Requirements to Take Corrective Action and Identify Critical SCI Systems, Major SCI Events, De Minimis SCI Events, and Material Systems Changes

The requirement that SCI entities begin to take appropriate corrective action upon any responsible SCI personnel having a reasonable basis to conclude that an SCI event has occurred, and the policies and procedures SCI entities would likely use to implement this requirement, should help facilitate SCI entities' responses to SCI events, including taking appropriate steps necessary to remedy the problem or problems causing such SCI event and mitigate the negative effects of the SCI event, if any, on market participants and the securities markets more broadly. The requirement that each SCI entity establish written criteria for identifying material systems changes should help the Commission ensure that it is kept apprised of the systems changes that SCI entities believe to be material and aid the Commission and its staff in understanding the operations and functionality of the systems of an SCI entity and any changes to such systems. The Commission expects that the application of different requirements (e.g., Commission notification requirements and information dissemination requirements) to critical SCI systems, major SCI events, and de minimis SCI events, and the policies and procedures required by SCI

entities to make these determinations, will help to ensure that the Commission is kept apprised of SCI events, and that relevant market participants have basic information about SCI events so that those notified can better develop an appropriate response. These policies and procedures should also assist SCI entities in complying with the notification, dissemination and reporting requirements of Regulation SCI.

4. Recordkeeping Requirements

Rule 1005 requires each SCI entity to make, keep, and preserve records relating to its compliance with Regulation SCI because such records should assist the Commission in understanding whether an SCI entity is meeting its obligations under Regulation SCI, assessing whether an SCI entity has appropriate policies and procedures with respect to its technology systems, helping to identify the causes and consequences of an SCI event, and understanding the types of material systems changes occurring at an SCI entity. The Commission expects that Rule 1005 will also facilitate the Commission's inspections and examinations of SCI entities and assist it in evaluating an SCI entity's compliance with Regulation SCI. Moreover, having an SCI entity's records available even after it has ceased to do business or to be registered under the Exchange Act should provide an additional tool to help the Commission to reconstruct important market events and better understand the impact of such events.

Rule 1007 should help ensure the Commission's ability to obtain required records that are held by a third party who may not otherwise have an obligation to make such records available to the Commission.

C. Respondents

The "collection of information" requirements contained in Regulation SCI apply to SCI entities, as described below. Currently, there are 27 entities that would satisfy the definition of

SCI SRO,¹³⁹⁴ 14 entities that would satisfy the definition of SCI ATS,¹³⁹⁵ 2 entities that would satisfy the definition of plan processor,¹³⁹⁶ and 1 entity that would meet the definition of exempt clearing agency subject to ARP.¹³⁹⁷ Accordingly, the Commission estimates that there are currently 44 entities that meet the definition of SCI entity and are subject to the collection of information requirements of Regulation SCI.

D. Total Initial and Annual Reporting and Recordkeeping Burdens

The Commission notes that national securities exchanges, national securities associations, registered clearing agencies, plan processors, one ATS, and one exempt clearing agency currently participate in the ARP Inspection Program. Under the ARP Inspection Program, Commission staff conducts inspections of these entities, attends periodic technology briefings by staff of these entities, monitors planned significant systems changes, and responds to reports of systems failures, disruptions, and other systems problems of these entities.¹³⁹⁸

Under Regulation SCI, many of the principles of the ARP policy statements with which some SCI entities are familiar are codified. As such, current practices of these SCI entities already comply with certain requirements of Regulation SCI.¹³⁹⁹ However, because Regulation

¹³⁹⁴ See supra notes 74-77 and accompanying text (listing 18 registered national securities exchanges, 7 registered clearing agencies, FINRA, and the MSRB). See also supra note 80 and accompanying text.

¹³⁹⁵ See supra notes 150 and 175 and accompanying text.

¹³⁹⁶ See supra note 202 and accompanying text.

¹³⁹⁷ See supra note 203 and accompanying text.

¹³⁹⁸ See supra Section II.A.

¹³⁹⁹ In addition, some SCI entities already comply with certain requirements of Regulation SCI to some extent as a matter of prudent business practice or pursuant to other rules. For example, as noted above, FINRA Rule 4370 includes requirements for FINRA members related to business continuity plans. See supra note 115. In addition, NASD Rule 3010 and FINRA Rule 3130 include requirements for FINRA members related to

SCI has a broader scope than the current ARP Inspection Program and imposes mandatory recordkeeping obligations on SCI entities,¹⁴⁰⁰ the Commission believes Regulation SCI will impose paperwork burdens on all SCI entities.

The Commission's total burden estimates in this Paperwork Reduction Act section reflect the total burdens on all SCI entities, taking into account the extent to which some SCI entities already comply with some of the requirements of Regulation SCI. The Commission also notes that the burden estimates per SCI entity are intended to reflect the average paperwork burden for each SCI entity to comply with Regulation SCI. Therefore, some SCI entities may experience more burden than the Commission's estimates, while others may experience less. The Commission notes that the burden figures set forth in this section are the Commission's estimate of the paperwork burden for compliance with Regulation SCI based on a variety of sources, including Commission staff's experience with the current ARP Inspection Program, other similar

procedures to achieve compliance with applicable securities laws and regulations and certain SRO rules. See supra note 115. Further, FINRA Rule 4530 includes reporting requirements related to certain compliance issues. See supra note 115. Compliance with existing requirements under FINRA rules could help SCI ATSS to comply with Regulation SCI. Therefore, the Commission acknowledges that SCI ATSS may experience a lower paperwork burden in complying with certain provisions of Regulation SCI than some other SCI entities. However, unlike SCI entities that participate in the ARP Inspection Program (where in many instances the Commission has estimated a 50% reduction in SCI entity staff compliance burden as compared to other SCI entities when estimating paperwork costs with regard to Regulation SCI requirements due to participation in the ARP inspection program), the Commission believes that any reduction in burden resulting from compliance with these FINRA and NASD rules is unlikely to be significant.

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As discussed more fully in supra Section IV.C.1, SCI SROs are already subject to existing recordkeeping and retention requirements under Rule 17a-1.

estimated burdens for analogous rulemakings, and comments received on the burden estimates in the SCI Proposal.¹⁴⁰¹

1. Requirements to Establish Written Policies and Procedures and Mandate Participation in Certain Testing

The rules under Regulation SCI that would require an SCI entity to establish policies and procedures and to mandate member or participant participation in business continuity and disaster recovery plan testing are discussed more fully in Sections IV.B.1, IV.B.2, and IV.B.6 above.

a. Policies and Procedures

In the SCI Proposal, the Commission estimated that an SCI entity that has not previously participated in the ARP Inspection Program would require an average of 210 burden hours initially to develop and draft the policies and procedures required by proposed Rule 1000(b)(1) (except for the policies and procedures for standards that result in systems being designed, developed, tested, maintained, operated, and surveilled in a manner that facilitates the successful collection, processing, and dissemination of market data)¹⁴⁰² and 60 hours annually to review

¹⁴⁰¹ The Commission also notes that the allocation of burden hours between staff and managers of an SCI entity that are identified in this section is intended to reflect the Commission's estimate of the broad categories of SCI entity personnel who will be involved in compliance with Regulation SCI. The Commission recognizes that some SCI entities may have additional subcategories of staff or managers who will be involved in compliance with Regulation SCI (e.g., information security staff may be a subcategory of systems analysts), whereas other SCI entities may not have the specific categories of staff or managers that are identified in this section.

¹⁴⁰² See Proposing Release, supra note 13, at 18145. The 210 burden hours included 80 hours by a Compliance Manager (including senior management review), 80 hours by an Attorney, 25 hours by a Senior Systems Analyst, and 25 hours by an Operations Specialist. See id. at 18146. This estimate was based on Commission staff's experience with the ARP Inspection Program and the Commission's preliminary estimate in the SB SDR Proposing Release for a similar requirement. See id. at 18145, n. 365.

and update such policies and procedures.¹⁴⁰³ The Commission estimated that an SCI entity that currently participates in the ARP Inspection Program would require an average of 105 burden hours initially to develop and draft such policies and procedures¹⁴⁰⁴ and 30 hours annually to review and update such policies and procedures.¹⁴⁰⁵ With respect to the requirement in proposed Rule 1000(b)(1) for policies and procedures that provide for standards that result in systems being designed, developed, tested, maintained, operated, and surveilled in a manner that facilitates the successful collection, processing, and dissemination of market data, the Commission estimated that each SCI entity would spend 130 hours annually.¹⁴⁰⁶ In the SCI Proposal, the Commission also estimated that all SCI entities would conduct most of the work

¹⁴⁰³ See Proposing Release, *supra* note 13, at 18146. The 60 burden hours included 30 hours by a Compliance Manager and 30 hours by an Attorney. See *id.* This estimate was based on Commission staff's experience with the ARP Inspection Program and the Commission's preliminary estimate in the SB SDR Proposing Release for a similar requirement. See *id.* at 18146, n. 377.

¹⁴⁰⁴ See Proposing Release, *supra* note 13, at 18145. The 105 burden hours included 40 hours by a Compliance Manager (including senior management review), 40 hours by an Attorney, 12.5 hours by a Senior Systems Analyst, and 12.5 hours by an Operations Specialist. See *id.* at 18146. The Commission stated its belief that a fifty percent baseline for SCI entities that participate in the ARP Inspection Program is appropriate because, although these entities already have substantial policies and procedures in place, the rule would require these entities to devote substantial time to review and revise their existing policies and procedures to ensure that they are sufficiently robust. See *id.* at 18145.

¹⁴⁰⁵ See Proposing Release, *supra* note 13, at 18146. The 30 burden hours included 15 hours by a Compliance Manager and 15 hours by an Attorney. See *id.*

¹⁴⁰⁶ See Proposing Release, *supra* note 13, at 18145. The 130 burden hours included 30 hours by a Compliance Attorney and 100 hours by a Senior Systems Analyst. See *id.* at 18146. This estimate was based on Commission staff's experience with the ARP Inspection Program. See *id.* at 18145, n. 371. The Commission noted in the SCI Proposal that this proposed requirement was not addressed by the ARP Inspection Program. See *id.* at 18145.

associated with proposed Rule 1000(b)(1) internally.¹⁴⁰⁷ However, the Commission estimated that SCI entities would seek outside legal and/or consulting services in the initial preparation of the policies and procedures at an average cost of \$20,000 per SCI entity.¹⁴⁰⁸

With respect to proposed Rule 1000(b)(2), the Commission estimated that each SCI entity would elect to comply with the proposed safe harbor provisions.¹⁴⁰⁹ The Commission estimated that each SCI entity would spend 180 hours initially to design the policies and procedures accordingly.¹⁴¹⁰ The Commission estimated that each SCI SRO would spend approximately 120 hours annually to review and update such policies and procedures,¹⁴¹¹ and that each SCI entity that is not an SRO would spend approximately 60 hours to review and update such policies and procedures.¹⁴¹² In the SCI Proposal, the Commission also estimated that all SCI entities would conduct most of the work associated with proposed Rule 1000(b)(2) internally.¹⁴¹³ However, the Commission estimated that SCI entities would seek outside legal

¹⁴⁰⁷ See Proposing Release, supra note 13, at 18145.

¹⁴⁰⁸ See id.

¹⁴⁰⁹ See id. at 18146, and proposed Rules 1000(b)(2)(ii) and (iii).

¹⁴¹⁰ See id. at 18146. The 180 burden hours included 30 hours by a Compliance Attorney and 150 hours by a Senior Systems Analyst. See id. This estimate was based on Commission staff's experience with the ARP Inspection Program and OCIE examinations, which review policies and procedures of registered entities in conjunction with examinations of such entities for compliance with the federal securities laws. See id. at 18146, n. 383.

¹⁴¹¹ See id. at 18146. The 120 burden hours included 20 hours by a Compliance Attorney and 100 hours by a Senior Systems Analyst. See id. This estimate was based on Commission staff's experience with the ARP Inspection Program. See id. at 18146, n. 384.

¹⁴¹² See id. at 18146. The 60 burden hours included 10 hours by a Compliance Attorney and 50 hours by a Senior Systems Analyst. See id.

¹⁴¹³ See id. at 18145.

and/or consulting services in the initial preparation of the policies and procedures at an average cost of \$20,000 per SCI entity.¹⁴¹⁴

Several commenters noted that the Commission underestimated the paperwork burden of proposed Rules 1000(b)(1) and (b)(2). One commenter noted that the systems covered by proposed Rules 1000(b)(1) and (b)(2) are very complex and a first draft of the required policies and procedures would take far more than the estimated number of hours to complete and keep up-to-date.¹⁴¹⁵ With respect to proposed Rule 1000(b)(2), this commenter stated that the breadth of the rule is extremely comprehensive because it requires policies and procedures that are designed to ensure that SCI systems “comply with the federal securities laws and rules and regulations thereunder” and operate “in the manner intended.”¹⁴¹⁶

Another commenter noted that the hour burdens did not take into account the appropriate level of management review in connection with the development of the policies and procedures.¹⁴¹⁷ This commenter also noted that policies and procedures developed to achieve

¹⁴¹⁴ See id.

¹⁴¹⁵ See Omgeo Letter at 31-32, 34. According to this commenter, the implementation of its current information security policy framework and related standards took approximately 18 months and over 1600 work hours to put in place. See id. This commenter noted that proposed Rule 1000(b)(1) would be far more labor and resource intensive because security is just one of the proposed seven areas of policy and standards development this new rule would require. See id.

¹⁴¹⁶ See id. at 34.

¹⁴¹⁷ See MSRB Letter at 28-29. This commenter stated that the Commission placed too much reliance on its experience with the ARP Inspection Program, which was “a voluntary program that did not create potential legal liabilities for non-compliance, and may not take into account the heightened need for high-level supervision that a rule-based requirement would entail.” See id. at 29. See also infra Sections IV.B.3.c and VI.C.2.b (discussing the Commission’s view on the potential for liability resulting from requirements under Regulation SCI). See also Omgeo Letter at 32 (noting that the estimate of 210 hours for proposed Rule 1000(b)(1) is unrealistic because the estimate should include not only the drafting of the required policies and procedures, but also their

compliance with Regulation SCI can potentially impact other areas of the SCI entity and other SCI entities, and therefore an SCI entity would broadly review the policies and procedures to ensure that they do not conflict with other policies, procedures, practices, and processes and revise the policies and procedures accordingly.¹⁴¹⁸ Therefore, this commenter argued that the Commission did not include adequate estimates for the substantial amount of time required by senior management and others in the organization, as well as the persons identified in the SCI Proposal, in: understanding the breadth and depth of the requirements established by proposed Regulation SCI; determining which systems of the SCI entity fall into the various categories of systems described in proposed Regulation SCI; assessing, growing and potentially reorganizing large portions of the SCI entity's workforce to align with the requirements of proposed Regulation SCI; and establishing and conducting extensive training curriculum to ensure appropriate personnel fully understand their new or changed duties; and any number of other collateral effects of the new requirements.¹⁴¹⁹ This commenter suggested that a more accurate estimate of the paperwork burden from proposed Rule 1000(b)(1) would be three to four times the estimate in the SCI Proposal, and the allocation of the burden hours should be weighted more heavily toward more senior staff of the organization.¹⁴²⁰

One commenter stated that the 50% baseline for SCI entities that are currently under the ARP Inspection Program does not account for the significant expansion of the requirements if

review and approval by senior management) and 35 (noting that the burden estimate of proposed Rule 1000(b)(2) does not reflect the review and direction of senior managers); and CME Letter at 3, n. 5.

¹⁴¹⁸ See MSRB Letter at 29.

¹⁴¹⁹ See *id.* at 30.

¹⁴²⁰ See *id.*

the definition of SCI system is construed broadly, and as a result, the burden estimates may be too low.¹⁴²¹

One commenter agreed with the Commission that ongoing paperwork burdens for compliance with proposed Rules 1000(b)(1) and (b)(2) should be lower than the initial burden.¹⁴²² However, this commenter stated that the estimated ongoing burden is understated, but likely to a lesser extent than with respect to the initial burden.¹⁴²³ Another commenter also noted that, given the complexity of the underlying systems and the requirements of proposed Rule 1000(b)(1), significantly more effort and time will be required on an ongoing basis to comply with that rule.¹⁴²⁴

One commenter noted that the establishment of the policies and procedures under proposed Rules 1000(b)(1) and (b)(2) would not be conducive to outsourcing, although an SCI entity might incur some cost for outside counsel for consultation purposes.¹⁴²⁵ On the other hand, another commenter argued that the Commission's burden estimate for proposed Rule 1000(b)(1) "is inaccurate because of its mistaken assumption that SCI entities would not seek guidance from outside consultants and attorneys."¹⁴²⁶ This commenter noted that, given the rates charged by large law firms and consulting firms, an estimate of approximately \$100,000 for each exempt clearing agency subject to ARP is more realistic than the \$20,000 estimated in the SCI

¹⁴²¹ See FINRA Letter at 7.

¹⁴²² See MSRB Letter at 31.

¹⁴²³ See *id.*

¹⁴²⁴ See Omgeo Letter at 32, n. 63.

¹⁴²⁵ See MSRB Letter at 31.

¹⁴²⁶ See Omgeo Letter at 32.

Proposal.¹⁴²⁷ This commenter similarly noted that the burden estimate for proposed Rule 1000(b)(2) failed to account for the costs associated with using outside counsel or an outside consulting firm to help draft the policies and procedure.¹⁴²⁸

As discussed in detail above in Sections IV.B.1 and IV.B.2, the Commission is adopting proposed Rules 1000(b)(1) and (b)(2) as Rules 1001(a) and (b), respectively, with certain modifications. As adopted, Rule 1001(a)(1), consistent with the proposal, requires each SCI entity to establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems and, for purposes of security standards, indirect SCI systems, have levels of capacity, integrity, resiliency, availability, and security, adequate to maintain the SCI entity's operational capability and promote the maintenance of fair and orderly markets. Adopted Rule 1001(a)(2), consistent with the proposal, provides the minimum required elements of such policies and procedures. Some of these elements were modified from the proposal,¹⁴²⁹ and one adopted element was not included in the proposal.¹⁴³⁰

¹⁴²⁷ See *id.* at 32, n. 64.

¹⁴²⁸ See *id.* at 35.

¹⁴²⁹ See, e.g., Rules 1001(a)(2)(i) (requiring policies and procedures with respect to the establishment of reasonable current and future "technological infrastructure capacity planning estimates" rather than simply "capacity planning estimates"); 1001(a)(2)(iv) (requiring policies and procedures with respect to "regular reviews and testing, as applicable," of systems to identify vulnerabilities rather than "regular reviews and testing" of systems); and 1001(a)(2)(v) (requiring policies and procedures with respect to business continuity and disaster recovery plans that are "reasonably designed to achieve" next business day resumption of trading and two-hour resumption of "critical SCI systems" rather than "to ensure" next business day resumption of trading and two-hour resumption of "clearance and settlement services"). See also *supra* Section IV.B.1.b.ii (discussing modifications from the SCI Proposal in adopted Rule 1001(a)(2)).

¹⁴³⁰ See Rule 1001(a)(2)(vii) (requiring policies and procedures with respect to monitoring of systems to identify potential SCI events).

As compared to proposed Rule 1000(b)(2), which required written policies and procedures reasonably designed to ensure that SCI systems operate “in the manner intended, including in a manner that complies with the federal securities laws,” adopted Rule 1001(b)(1) requires an SCI entity to establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems operate in a manner that complies with the Exchange Act and the rules and regulations thereunder, and the entity’s rules and governing documents, as applicable.¹⁴³¹ Further, rather than adopting the proposed safe harbor for SCI entities, Rule 1001(b)(2) provides the minimum required elements of such policies and procedures. Some of these elements were modified from the proposed safe harbor elements,¹⁴³² and one element of the proposed safe harbor is not included in Rule 1001(b)(2).¹⁴³³

With respect to the view of a commenter that the systems covered by proposed Rules 1000(b)(1) and (2) are very complex and that the Commission underestimated the burdens associated with completing and updating the required policies and procedures,¹⁴³⁴ the

¹⁴³¹ See supra Section IV.B.2.a.

¹⁴³² See Rules 1001(b)(2)(iii) (requiring policies and procedures with respect to “a plan for assessments” of systems compliance rather than both “ongoing monitoring” and “assessments” of systems compliance) and 1001(b)(2)(iv) (requiring policies and procedures with respect to “a plan of coordination and communication between regulatory and other personnel of the SCI entity, including by responsible SCI personnel” regarding SCI systems rather than “review by regulatory personnel of SCI systems”). See also supra Section IV.B.2.c (discussing modifications from the SCI Proposal in adopted Rule 1001(b)(2)).

¹⁴³³ See proposed Rule 1000(b)(2)(ii)(A)(2) (periodic testing of all SCI systems and any changes to such systems after their implementation).

¹⁴³⁴ See supra note 1415 and accompanying text. As noted above, one commenter stated that its current information security policy framework and related standards took over 1,600 hours to put in place, and that security is just one of the seven areas of policies and standards proposed to be required. See supra note 1415. The Commission notes that, to the extent an SCI entity already has adequate policies and procedures in place with respect to systems capacity, integrity, resiliency, availability, security, and compliance,

Commission believes that most, if not all, SCI entities already have some policies and procedures related to systems capacity, integrity, resiliency, availability, security, and compliance, although such policies and procedures differ in a variety of respects from the requirements under Regulation SCI. Also, in adopting Regulation SCI, the Commission has reduced the burdens for proposed Rules 1000(b)(1) and (2) from the SCI Proposal in a variety of ways, including by, for example: refining the definition of SCI systems; more explicitly recognizing that some systems pose greater risk than others to the maintenance of fair and orderly markets and imposing obligations that allow for risk-based considerations; and providing that staff guidance on current SCI industry standards be characterized as providing examples of publications describing processes, guidelines, frameworks, or standards for an SCI entity to consider looking to in developing reasonable policies and procedures, rather than strictly as listing industry standards. At the same time, the Commission acknowledges commenters' feedback with respect to the burden of the rules and thus is doubling the burden estimates for the policies and procedures under Rules 1000(b)(1) and (2).¹⁴³⁵ The Commission notes that, as part of this approach, it doubled the ongoing burden estimates in part in response to comment stating that significantly

Rules 1001(a) and (b) will not impose significant additional paperwork burden on the entity.

¹⁴³⁵ In response to the commenter that suggested the initial burden for proposed Rule 1000(b)(1) would be three to four times that estimated in the SCI Proposal, the Commission believes that because it further focused the requirements associated with proposed Rules 1000(b)(1) and (2) in a variety of ways described above, resulting in reduced burden estimates as compared to the SCI Proposal, the commenter's estimate based on the proposal is too high. See *supra* note 1420. Based on Commission staff experience, the Commission believes it is more appropriate to double the estimated initial SCI entity staff burden and also add senior management time.

more effort and time will be required on an ongoing basis to comply with proposed Rule 1000(b)(1).¹⁴³⁶

As noted above, some commenters noted that the policies and procedures could potentially impact other areas of the SCI entity and other SCI entities, and therefore would result in more burden hours to ensure that the policies and procedures do not conflict with other policies, procedures, practices, and processes, and would require greater involvement of senior management and others in an SCI entity.¹⁴³⁷ Similarly, some commenters noted that the establishment, maintenance, and enforcement of the policies and procedures would involve senior management review.¹⁴³⁸ The Commission agrees with these comments and is adjusting the estimated paperwork burden. Specifically, in the SCI Proposal, the Commission included senior management review as part of its estimated burden hours for Compliance Managers in connection with the policies and procedures requirements under Rules 1001(a) and (b).¹⁴³⁹ However, in response to comments and based on Commission staff experience, the Commission is additionally including burden estimates for a Director of Compliance (10 hours initially, 5

¹⁴³⁶ See supra note 1424.

¹⁴³⁷ See supra notes 1418-1419 and accompanying text.

¹⁴³⁸ See supra notes 1417, 1419, and 1420 and accompanying text. According to one commenter, the Commission's burden estimates for the policies and procedures did not account for the time required to determine which systems would fall into the various categories of systems. See supra note 1419 and accompanying text. The Commission disagrees with this view and notes that the burden of identifying various types of systems and events are discussed below in Section V.D.3. In addition, this commenter expressed concern that the Commission's estimates did not account for assessing, growing, and reorganizing an SCI entity's workforce; establishing and conducting training; and other collateral effects of the new requirements. See supra note 1419 and accompanying text. As discussed throughout this section, the Commission has increased the burden estimates for Rules 1001(a) and (b) in response to comments.

¹⁴³⁹ See supra note 1402.

hours annually) and Chief Compliance Officer¹⁴⁴⁰ (20 hours initially, 10 hours annually) with respect to both Rules 1001(a) and (b).¹⁴⁴¹ The Commission reiterates that these estimates are averages across all SCI entities—some SCI entities may spend more hours in connection with the establishment, maintenance, and enforcement of the policies and procedures than the Commission's estimates, while others may spend less.¹⁴⁴² Each SCI entity is required to determine for itself what is required for its staff and senior managers to do in order for the SCI entity to comply with Rules 1001(a) and (b).

After considering the views of commenters, and because Rule 1001(a) requires an additional element to be included in the policies and procedures (i.e., monitoring of systems to identify SCI events), the Commission estimates that an SCI entity that has not previously participated in the ARP Inspection Program would require an average of 534 burden hours initially to develop and draft the policies and procedures required by that rule (except for the policies and procedures for standards that result in systems being designed, developed, tested, maintained, operated, and surveilled in a manner that facilitates the successful collection,

¹⁴⁴⁰ The Chief Compliance Officer burden estimates include the time spent by other senior officers, including Chief Information Officers and Chief Information Security Officers, as appropriate for a particular requirement under Regulation SCI.

¹⁴⁴¹ In estimating the number of burden hours to be spent by senior management, the Commission is not making a distinction between SCI entities that currently participate in the ARP Inspection Program and SCI entities that do not. In contrast to the Commission's estimate with regard to non-senior staff of SCI entities that currently participate in the ARP Inspection Program, who the Commission believes could be subject to less burden in drafting the policies and procedures because these SCI entities already have certain policies and procedures in place, the Commission believes that all senior management, regardless of whether an SCI entity participates in the ARP Inspection Program, would require a similar number of hours to review such policies and procedures to ensure compliance with Regulation SCI.

¹⁴⁴² For example, some SCI entities have more complex systems than others, and current practices of some SCI entities already comply with certain requirements of Regulation SCI to some extent.

processing, and dissemination of market data, which is discussed below),¹⁴⁴³ or 7,476 hours for all such SCI entities.¹⁴⁴⁴ The Commission estimates that an SCI entity that has not previously participated in the ARP Inspection Program would require an average of 159 hours annually to review and update such policies and procedures,¹⁴⁴⁵ or 2,226 hours for all such SCI entities.¹⁴⁴⁶

¹⁴⁴³ As noted above, the Commission is doubling its estimate of the burden for staff of SCI entities. $210 \text{ hours} \times 2 = 420 \text{ hours}$. $420 \text{ hours} \div 5 \times 6 = 504 \text{ hours}$ to establish policies and procedures that contain six elements, as opposed to the five in the SCI Proposal. The 504 burden hours include 192 hours by a Compliance Manager, 192 hours by an Attorney, 60 hours by a Senior Systems Analyst, and 60 hours by an Operations Specialist. This burden hour allocation is based on the allocation in the SCI Proposal. See Proposing Release, *supra* note 13, at 18146. As noted above, as compared to the proposal, the Commission is estimating an additional 20 hours by a Chief Compliance Officer and 10 hours by a Director of Compliance to reflect the views of commenters that compliance with the proposed policies and procedures requirements would require greater senior management involvement. See *supra* notes 1440-1441 and accompanying text. $504 \text{ hours} + \text{Chief Compliance Officer at } 20 \text{ hours} + \text{Director of Compliance at } 10 \text{ hours} = 534 \text{ hours}$.

¹⁴⁴⁴ As noted above, all of the national securities exchanges (18), national securities associations (1), registered clearing agencies (7), and plan processors (2) currently participate on a voluntary basis in the ARP Inspection Program. In addition, 1 ATS and 1 exempt clearing agency subject to ARP participate in the ARP Inspection Program, for a total of 30 SCI entities that currently participate in the ARP Inspection Program. Therefore, 14 SCI entities do not participate in the ARP Inspection Program. $534 \text{ hours} \times 14 \text{ SCI entities that do not participate in the ARP Inspection Program} = 7,476 \text{ hours}$.

¹⁴⁴⁵ As noted above, the Commission is doubling its estimate of the burden for staff of SCI entities. $60 \text{ hours} \times 2 = 120 \text{ hours}$. $120 \text{ hours} \div 5 \times 6 = 144 \text{ hours}$ annually to review and update policies and procedures that contain six elements, as opposed to the five in the SCI Proposal. The 144 burden hours include 57 hours by a Compliance Manager, 57 hours by an Attorney, 15 hours by a Senior Systems Analyst, and 15 hours by an Operations Specialist. As compared to the proposal, the Commission is additionally allocating burden hours to Senior Systems Analysts and Operations Specialists. Also, as noted above, as compared to the proposal, the Commission is estimating an additional 10 hours by a Chief Compliance Officer and 5 hours by a Director of Compliance to reflect the views of commenters that compliance with the proposed policies and procedures requirements would require greater senior management involvement. See *supra* notes 1440-1441 and accompanying text. $144 \text{ hours} + \text{Chief Compliance Officer at } 10 \text{ hours} + \text{Director of Compliance at } 5 \text{ hours} = 159 \text{ hours}$.

¹⁴⁴⁶ $159 \text{ hours} \times 14 \text{ SCI entities that do not participate in the ARP Inspection Program} = 2,226 \text{ hours}$. The Commission believes that the increases in the ongoing burden

With respect to SCI entities that currently participate in the ARP Inspection Program, the Commission continues to believe that a 50% percent baseline for these SCI entities in terms of staff burden hours is appropriate because although these entities already have substantial policies and procedures in place, the rule would require these entities to devote substantial time to review and revise their existing policies and procedures to ensure that they meet all of the rule requirements.¹⁴⁴⁷ However, the Commission does not believe that a 50% baseline would be appropriate for these SCI entities in terms of senior management review of the policies and procedures. Specifically, as noted above, Commission believes that, although these entities already have substantial policies and procedures in place, senior management of all SCI entities, regardless of whether an SCI entity currently participates in the ARP Inspection Program, would require a similar number of hours to review the SCI entity's policies and procedures to ensure compliance with the new requirements under Regulation SCI.¹⁴⁴⁸

The Commission estimates that an SCI entity that currently participates in the ARP Inspection Program would require an average of 282 burden hours initially to develop and draft the policies and procedures required by Rule 1001(a) (except for the policies and procedures for standards that result in systems being designed, developed, tested, maintained, operated, and

estimates for Rules 1001(a) and (b) are consistent with the comment that the Commission underestimated the ongoing burdens associated with proposed Rules 1000(b)(1) and (2), but to a lesser extent than with respect to the initial burden. See supra notes 1423-1424 and accompanying text.

¹⁴⁴⁷ With respect to a commenter's view that the 50% baseline does not account for the significant expansion of the requirements, the Commission notes that the 50% baseline merely indicates the difference between the level of burden imposed on SCI entities that participate in the ARP Inspection Program and SCI entities that do not. See supra note 1421 and accompanying text. As discussed above, the Commission has increased its burden estimates in response to comments.

¹⁴⁴⁸ See supra note 1441.

surveilled in a manner that facilitates the successful collection, processing, and dissemination of market data),¹⁴⁴⁹ or 8,460 hours for all such SCI entities.¹⁴⁵⁰ The Commission estimates that an SCI entity that currently participates in the ARP Inspection Program would require an average of 87 hours annually to review and update such policies and procedures,¹⁴⁵¹ or 2,610 hours for all such SCI entities.¹⁴⁵²

With respect to the requirement in Rule 1001(a)(2)(vi) for policies and procedures that provide for standards that result in systems being designed, developed, tested, maintained,

¹⁴⁴⁹ As noted above, the Commission is doubling its estimate of the burden for staff of SCI entities. $105 \text{ hours} \times 2 = 210 \text{ hours}$. $210 \text{ hours} \div 5 \times 6 = 252 \text{ hours}$ to establish policies and procedures that contain six elements, as opposed to the five in the SCI Proposal. The 252 burden hours include 96 hours by a Compliance Manager, 96 hours by an Attorney, 30 hours by a Senior Systems Analyst, and 30 hours by an Operations Specialist. This burden hour allocation is based on the allocation in the SCI Proposal. See Proposing Release, *supra* note 13, at 18146. As noted above, as compared to the proposal, the Commission is estimating an additional 20 hours by a Chief Compliance Officer and 10 hours by a Director of Compliance to reflect the views of commenters that compliance with the proposed policies and procedures requirements would require greater senior management involvement. See *supra* notes 1440-1441 and accompanying text. $252 \text{ hours} + \text{Chief Compliance Officer at } 20 \text{ hours} + \text{Director of Compliance at } 10 \text{ hours} = 282 \text{ hours}$.

¹⁴⁵⁰ $282 \text{ hours} \times 30 \text{ SCI entities that participate in the ARP Inspection Program} = 8,460 \text{ hours}$.

¹⁴⁵¹ As noted above, the Commission is doubling its estimate of the burden for staff of SCI entities. $30 \text{ hours} \times 2 = 60 \text{ hours}$. $60 \text{ hours} \div 5 \times 6 = 72 \text{ hours}$ to review and update policies and procedures that contain six elements, as opposed to the five in the SCI Proposal. The 72 burden hours include 28 hours by a Compliance Manager, 28 hours by an Attorney, 8 hours by a Senior Systems Analyst, and 8 hours by an Operations Specialist. As compared to the proposal, the Commission is additionally allocating burden hours to Senior Systems Analysts and Operations Specialists. Also, as noted above, as compared to the proposal, the Commission is estimating an additional 10 hours by a Chief Compliance Officer and 5 hours by a Director of Compliance to reflect the views of commenters that compliance with the proposed policies and procedures requirements would require greater senior management involvement. See *supra* notes 1440-1441 and accompanying text. $72 \text{ hours} + \text{Chief Compliance Officer at } 10 \text{ hours} + \text{Director of Compliance at } 5 \text{ hours} = 87 \text{ hours}$.

¹⁴⁵² $87 \text{ hours} \times 30 \text{ SCI entities that participate in the ARP Inspection Program} = 2,610 \text{ hours}$.

operated, and surveilled in a manner that facilitates the successful collection, processing, and dissemination of market data, the Commission estimates that each SCI entity would spend 160 hours initially,¹⁴⁵³ or 7,040 hours for all SCI entities.¹⁴⁵⁴ The Commission estimates that each SCI entity would spend 145 hours annually,¹⁴⁵⁵ or 6,380 hours annually for all SCI entities.¹⁴⁵⁶

As noted above, one commenter argued that, given the rates charged by large law firms and consulting firms, an estimate of \$100,000 is more appropriate for the cost of outsourcing

¹⁴⁵³ This estimate includes 130 hours by staff of an SCI entity, as estimated in the SCI Proposal, and 30 hours by senior management. The 130 burden hours include 30 hours by a Compliance Attorney and 100 hours by a Senior Systems Analyst. See Proposing Release, supra note 13, at 18146. This burden hour allocation is based on the allocation in the SCI Proposal. See Proposing Release, supra note 13, at 18146. As noted above, as compared to the proposal, the Commission is estimating an additional 20 hours by a Chief Compliance Officer and 10 hours by a Director of Compliance to reflect the views of commenters that compliance with the proposed policies and procedures requirements would require greater senior management involvement. See supra notes 1440-1441 and accompanying text. 130 hours + Chief Compliance Officer at 20 hours + Director of Compliance at 10 hours = 160 hours. Unlike the burden estimates for complying with the rest of Rule 1001(a), the Commission does not believe it would be appropriate to double its proposed 130 hour staff burden estimate for Rule 1001(a)(2)(vi). Based on Commission staff experience, the Commission believes that these policies and procedures would not be so complex as to result in doubling the proposed burden estimate. The Commission also notes that the burden estimate for Rule 1001(a)(2)(vi) is already significantly higher than the estimated burden for the other individual policies and procedures required under Rule 1001(a)(2). In particular, the Commission estimates 160 hours for this one provision and 534 hours in total for the six other provisions of Rule 1001(a)(2) for non-ARP participants (which results in approximately 89 hours for each of those six other provisions).

¹⁴⁵⁴ 160 hours × 44 SCI entities = 7,040 hours.

¹⁴⁵⁵ This estimate includes 130 hours by staff of an SCI entity, as estimated in the SCI Proposal, and 15 hours by senior management. The 130 burden hours include 30 hours by a Compliance Attorney and 100 hours by a Senior Systems Analyst. See Proposing Release, supra note 13, at 18146. 130 hours + Chief Compliance Officer at 10 hours + Director of Compliance at 5 hours = 145 hours.

¹⁴⁵⁶ 145 hours × 44 SCI entities = 6,380 hours.

under proposed Rule 1000(b)(1).¹⁴⁵⁷ After considering the view of this commenter and because the Commission is increasing its estimated burden hours for compliance with Rule 1001(a), the Commission is similarly increasing its estimate of the outsourcing cost for complying with Rule 1001(a). In particular, because the Commission doubled the non-senior staff burden estimate for Rule 1001(a) in response to comments that the Commission underestimated the burden in the proposal, the Commission believes it is appropriate to similarly double its estimate of the outsourcing cost for complying with Rule 1001(a). As noted above in the context of the burden estimate for Rule 1001(a), the Commission believes that, by doubling its outsourcing cost estimate, the Commission has incorporated the views of commenters that the Commission underestimated the burden, and at the same time accounted for changes to the proposal that reduce the burden from the SCI Proposal. Further, the Commission acknowledges that some SCI entities may have more complex systems and policies and procedures, may outsource more of the work associated with the policies and procedures,¹⁴⁵⁸ or may outsource the work to more expensive law firms and consulting firms than others. Therefore, the Commission believes that while some SCI entities may incur more outsourcing cost than the Commission's estimate, other SCI entities may incur less than the Commission's estimate. The Commission does not believe that a commenter's \$100,000 estimate is more appropriate given that there will be differences among SCI entities in the extent of outsourcing and in the rates of outside firms.

¹⁴⁵⁷ See supra note 1427 and accompanying text. This commenter also argued that the Commission mistakenly assumed that SCI entities would not seek guidance from outside consultants or attorneys. See supra note 1426 and accompanying text. However, the Commission did account for outsourcing cost in the SCI Proposal and does so here, as well.

¹⁴⁵⁸ For example, smaller SCI entities may not have the same level of in-house expertise as larger SCI entities.

Because Rule 1001(a) requires an additional element to be included in the policies and procedures as compared to proposed Rule 1000(b)(1) (i.e., monitoring of systems to identify SCI events), the Commission now estimates that on average, each SCI entity would seek outside legal and/or consulting services in the initial preparation of the policies and procedures at a cost of approximately \$47,000,¹⁴⁵⁹ or \$2,068,000 for all SCI entities.¹⁴⁶⁰

With respect to the view of a commenter that the Commission underestimated the paperwork burden under proposed Rule 1000(b)(2) because that rule is extremely extensive,¹⁴⁶¹ the Commission notes that, as adopted, Rule 1001(b) requires policies and procedures to be reasonably designed to ensure, in part, that SCI systems “operate in a manner that complies with the Act and the rules and regulations thereunder.” As adopted, this rule no longer refers to compliance with “the federal securities laws and rules and regulations thereunder” and operation “in the manner intended.” Nevertheless, as noted above, after considering the views of commenters that the Commission underestimated the paperwork burden under proposed Rule 1000(b)(2), the Commission is doubling its estimates from the proposal (which were focused on the burden for SCI entity staff), and is increasing its estimates to account for senior management review of the policies and procedures.

¹⁴⁵⁹ As noted above, the Commission is doubling its estimate of the outsourcing cost for SCI entities. $\$20,000 \times 2 = \$40,000$. The Commission is also revising this cost estimate to reflect that Rule 1001(a) requires seven specific elements to be included in the policies and procedures, as opposed to the six in the proposed rule. $\$40,000 \div 6 \times 7 = \$46,667$.

¹⁴⁶⁰ $\$47,000 \times 44$ SCI entities = \$2,068,000.

¹⁴⁶¹ See supra note 1416.

The Commission now estimates that each SCI entity would spend 270 hours initially to design the systems compliance policies and procedures,¹⁴⁶² or 11,880 hours for all SCI entities.¹⁴⁶³ The Commission estimates that each SCI SRO would spend approximately 175 hours annually to review and update such policies and procedures,¹⁴⁶⁴ or 4,725 hours for all SCI SROs.¹⁴⁶⁵ The Commission estimates that each SCI entity that is not an SRO would spend approximately 95 hours to review and update such policies and procedures,¹⁴⁶⁶ or 1,615 hours for all such SCI entities.¹⁴⁶⁷

¹⁴⁶² As noted above, the Commission is doubling its estimate of the burden for staff of SCI entities. $180 \text{ hours} \times 2 = 360 \text{ hours}$. $360 \text{ hours} \div 6 \times 4 = 240 \text{ hours}$ to establish policies and procedures that contain four elements at a minimum, as opposed to the six in the SCI Proposal. The 240 burden hours include 40 hours by a Compliance Attorney and 200 hours by a Senior Systems Analyst. This burden hour allocation is based on the allocation in the SCI Proposal. See Proposing Release, supra note 13, at 18146. As noted above, as compared to the proposal, the Commission is estimating an additional 20 hours by a Chief Compliance Officer and 10 hours by a Director of Compliance to reflect the views of commenters that compliance with the proposed policies and procedures requirements would require greater senior management involvement. See supra notes 1440-1441 and accompanying text. $240 \text{ hours} + \text{Chief Compliance Officer at } 20 \text{ hours} + \text{Director of Compliance at } 10 \text{ hours} = 270 \text{ hours}$.

¹⁴⁶³ $270 \text{ hours} \times 44 \text{ SCI entities} = 11,880 \text{ hours}$.

¹⁴⁶⁴ As noted above, the Commission is doubling its estimate of the burden for staff of SCI entities. $120 \text{ hours} \times 2 = 240 \text{ hours}$. $240 \text{ hours} \div 6 \times 4 = 160 \text{ hours}$ to review and update policies and procedures that contain four elements at a minimum, as opposed to the six in the SCI Proposal. The 160 burden hours include 26 hours by a Compliance Attorney and 134 hours by a Senior Systems Analyst. This burden hour allocation is based on the allocation in the SCI Proposal. See Proposing Release, supra note 13, at 18146. As noted above, as compared to the proposal, the Commission is estimating an additional 10 hours by a Chief Compliance Officer and 5 hours by a Director of Compliance to reflect the views of commenters that compliance with the proposed policies and procedures requirements would require greater senior management involvement. See supra notes 1440-1441 and accompanying text. $160 \text{ hours} + \text{Chief Compliance Officer at } 10 \text{ hours} + \text{Director of Compliance at } 5 \text{ hours} = 175 \text{ hours}$.

¹⁴⁶⁵ $175 \text{ hours} \times 27 \text{ SCI SROs} = 4,725 \text{ hours}$.

¹⁴⁶⁶ As noted above, the Commission is doubling its estimate of the burden for staff of SCI entities. $60 \text{ hours} \times 2 = 120 \text{ hours}$. $120 \text{ hours} \div 6 \times 4 = 80 \text{ hours}$ to review and update

As noted above, similar to the burden estimates for proposed Rule 1000(b)(1), one commenter argued that the Commission underestimated the outsourcing cost under proposed Rule 1000(b)(2).¹⁴⁶⁸ Similar to the discussion above related to Rule 1001(a),¹⁴⁶⁹ after considering the view of this commenter and because the Commission is increasing its estimated burden hours for compliance with Rule 1001(b), the Commission is doubling its estimate of the outsourcing cost for complying with Rule 1001(b). The Commission now estimates that on average, each SCI entity would seek outside legal and/or consulting services in the initial preparation of the policies and procedures at a cost of approximately \$27,000,¹⁴⁷⁰ or \$1,188,000 for all SCI entities.¹⁴⁷¹

Adopted Rules 1001(a)(3) and (b)(3) explicitly require each SCI entity to periodically review the effectiveness of the policies and procedures required by Rules 1001(a) and (b), respectively, and to take prompt action to remedy deficiencies in such policies and procedures. The Commission notes that the paperwork burden related to the review of the policies and

policies and procedures that contain four elements at a minimum, as opposed to the six in the SCI Proposal. The 80 burden hours include 14 hours by a Compliance Attorney and 66 hours by a Senior Systems Analyst. This burden hour allocation is based on the allocation in the SCI Proposal. See Proposing Release, supra note 13, at 18146. 80 hours + Chief Compliance Officer at 10 hours + Director of Compliance at 5 hours = 95 hours.

¹⁴⁶⁷ 95 hours × 17 non-SRO SCI entities = 1,615 hours.

¹⁴⁶⁸ See supra note 1428 and accompanying text.

¹⁴⁶⁹ See supra notes 1457-1458 and accompanying text.

¹⁴⁷⁰ As noted above, the Commission is doubling its estimate of the outsourcing cost for SCI entities. $\$20,000 \times 2 = \$40,000$. The Commission is also revising this cost estimate to reflect that Rule 1001(b) will result in the inclusion of at least four elements in the policies and procedures, as opposed to the six in the proposed rule. $\$40,000 \div 6 \times 4 = \$26,667$.

¹⁴⁷¹ $\$27,000 \times 44$ SCI entities = \$1,188,000.

procedures, and remedying deficiencies in policies and procedures, is included in the estimated annual ongoing burden of Rules 1001(a) and (b).

Rule 1001(c)(1), which was not included in the proposal, requires each SCI entity to establish, maintain, and enforce reasonably designed written policies and procedures that include the criteria for identifying responsible SCI personnel, the designation and documentation of responsible SCI personnel,¹⁴⁷² and escalation procedures to quickly inform responsible SCI personnel of potential SCI events. Like adopted Rules 1001(a)(3) and (b)(3), Rule 1001(c) requires each SCI entity periodically to review the effectiveness of these policies and procedures and to take prompt action to remedy deficiencies in policies and procedures. The Commission estimates that each SCI entity would require 114 hours initially to establish the criteria for identifying responsible SCI personnel and the escalation procedures,¹⁴⁷³ or 5,016 hours for all

¹⁴⁷² The paperwork burden associated with the documentation of responsible SCI personnel is included in the Commission's estimate of the recordkeeping burden, as discussed in Section V.D.4 below.

¹⁴⁷³ This estimate is based on the Commission's burden estimate for Rule 1001(a), because Rule 1001(a) and Rule 1001(c) both require policies and procedures or processes. Because Rule 1001(a) (excluding Rule 1001(a)(2)(vi)) requires the establishment of six policies and procedures at a minimum and Rule 1001(c) requires the establishment of two policies and procedures, the Commission estimates that the initial burden to draft the policies and procedures required by Rule 1001(c) is one-third of the initial burden to draft the policies and procedures required by Rule 1001(a) (excluding Rule 1001(a)(2)(vi)). Further, the Commission believes that, even though Rule 1001(c) will impose paperwork burdens on SCI entities, most, if not all, SCI entities, regardless of whether they participate in the ARP Inspection Program, already have some processes in place for the designation of persons responsible for particular systems and escalation procedures. Therefore, the Commission believes it is appropriate to assume a 50% baseline for all SCI entities (as compared to the burden estimate for Rule 1001(a) for SCI entities that do not participate in the ARP Inspection Program) in terms of the staff burden for compliance with Rule 1001(c). $252 \text{ hours} \div 3 = 84 \text{ hours}$. The 84 burden hours include 32 hours by a Compliance Manager, 32 hours by an Attorney, 10 hours by a Senior Systems Analyst, and 10 hours by an Operations Specialist. This burden hour allocation is based on the allocation for Rule 1001(a) (excluding Rule 1001(a)(2)(vi)). See *supra* note 1443. The Commission also estimates that a Chief Compliance Officer will spend

SCI entities.¹⁴⁷⁴ The Commission also estimates that each SCI entities would require 39 hours annually to review and update the criteria and the escalation procedures,¹⁴⁷⁵ or 1,716 hours for all SCI entities.¹⁴⁷⁶ The Commission believes that SCI entities will internally establish and maintain the policies and procedures required by Rule 1001(c) because these policies and procedures relate to internal personnel designations and internal processes.

b. Mandate Participation in Certain Testing

In the SCI Proposal, the Commission estimated that each SCI entity (other than plan processors) would spend approximately 130 hours initially to meet the requirements of proposed

20 hours and a Director of Compliance will spend 10 hours reviewing the policies and procedures required by Rule 1001(c). 84 hours + Chief Compliance Officer at 20 hours + Director of Compliance at 10 hours = 114 hours.

The Commission notes that, in the SCI Proposal, it also estimated the burden hours for other policies and procedures based on its burden estimate under proposed Rule 1000(b)(1). See, e.g., Proposing Release, supra note 13, at 18152, n. 442. One commenter stated that it was appropriate to base the burden estimate for proposed Rule 1000(b)(3), which would likely result in SCI entities revising their policies, on the burden estimate under proposed Rule 1000(b)(1). See infra note 1700 and accompanying text.

¹⁴⁷⁴ 114 hours × 44 SCI entities = 5,016 hours.

¹⁴⁷⁵ This estimate is based on the Commission's burden estimate for Rule 1001(a), because Rule 1001(a) and Rule 1001(c) both require policies and procedures or processes. Because Rule 1001(a) (excluding Rule 1001(a)(2)(vi)) requires the maintenance of six policies and procedures at a minimum and Rule 1001(c) requires the maintenance of two policies and procedures, the Commission estimates that the ongoing staff burden under Rule 1001(c) is one-third of the ongoing staff burden under Rule 1001(a) (excluding Rule 1001(a)(2)(vi)). As noted above, the Commission believes it is appropriate to assume a 50% baseline for all SCI entities in terms of the staff burden for compliance with Rule 1001(c). 72 hours ÷ 3 = 24 hours. The 24 burden hours include 9.5 hours by a Compliance Manager, 9.5 hours by an Attorney, 2.5 hours by a Senior Systems Analyst, and 2.5 hours by an Operations Specialist. This burden hour allocation is based on the allocation for Rule 1001(a) (excluding Rule 1001(a)(2)(vi)). See supra note 1445. The Commission also estimates that a Chief Compliance Officer will spend 10 hours and a Director of Compliance will spend 5 hours reviewing the policies and procedures required by Rule 1001(c). 24 hours + Chief Compliance Officer at 10 hours + Director of Compliance at 5 hours = 39 hours.

¹⁴⁷⁶ 39 hours × 44 SCI entities = 1,716 hours.

Rules 1000(b)(9)(i) and (ii) (i.e., the requirement to mandate participation by designated members or participants in testing and the requirement that an SCI entity coordinate required testing with other SCI entities).¹⁴⁷⁷ The 130-hour estimate included 35 hours to write a proposed rule, or revise a membership/subscriber agreement or participant agreement to establish the participation requirement for designated members or participants.¹⁴⁷⁸ It also included 95 hours of follow-up work (e.g., notice and schedule coordination) to ensure implementation.¹⁴⁷⁹ The Commission estimated that each SCI entity (other than plan processors) would spend approximately 95 hours annually to comply with proposed Rules 1000(b)(9)(i) and (ii).¹⁴⁸⁰

In the SCI Proposal, the Commission estimated that each SCI entity (other than plan processors) would spend approximately 35 hours initially to meet the requirements of proposed Rule 1000(b)(9)(iii) (i.e., establishing standards for designating members or participants and filing such standards with the Commission, and determining, compiling, and submitting the list of designated members or participants).¹⁴⁸¹ The Commission estimated that each SCI entity

¹⁴⁷⁷ See Proposing Release, supra note 13, at 18147.

¹⁴⁷⁸ See id. The 35 burden hours included 10 hours by a Compliance Manager, 15 hours by an Attorney, and 10 hours by a Compliance Clerk. See id. In establishing this estimate, the Commission considered its estimate of the burden for an SRO to file an average proposed rule change under Rule 19b-4. See id. at 18147, n. 389.

¹⁴⁷⁹ See Proposing Release, supra note 13, at 18147. The 95 burden hours included 10 hours by a Compliance Manager, 15 hours by an Attorney, and 70 hours by an Operations Specialist. See id.

¹⁴⁸⁰ See id. The 95 burden hours included 10 hours by a Compliance Manager, 15 hours by an Attorney, and 70 hours by an Operations Specialist. See id. The Commission noted that, although the initial burden included 35 hours to write a proposed rule, revise an agreement, or amend an SCI Plan, the Commission did not believe the 35-hour burden would be applicable on an ongoing basis. See id. at 18147, n. 393.

¹⁴⁸¹ See Proposing Release, supra note 13, at 18148. The 35 burden hours included 10 hours by a Compliance Manager, 15 hours by an Attorney, and 10 hours by a Compliance Clerk. See id. In establishing this estimate, the Commission considered its estimate of

(other than plan processors) would spend approximately 3 hours annually to comply with proposed Rule 1000(b)(9)(iii) (i.e., to review the designation standards to ensure that they remain up-to-date and to prepare any necessary amendments, to review the list of designated members or participants, and to update prior Commission notifications with respect to standards for designation and the list of designees).¹⁴⁸² The Commission also estimated that all SCI entities, other than plan processors, would conduct the work associated with proposed Rule 1000(b)(9) internally.¹⁴⁸³

For plan processors, the Commission estimated that proposed Rules 1000(b)(9)(i) and (ii) would carry an initial cost of \$52,000 per plan processor¹⁴⁸⁴ and an annual cost of \$38,000 per plan processor.¹⁴⁸⁵ The Commission also estimated that proposed Rule 1000(b)(9)(iii) would carry an initial cost of \$14,000 per plan processor¹⁴⁸⁶ and an annual cost of \$1,200 per plan processor.¹⁴⁸⁷

With respect to the Commission's estimate of the burdens under proposed Rule 1000(b)(9), one commenter noted that the estimate was effectively limited to ministerial tasks of producing a rule filing and of undertaking follow-up work in connection with implementation

the burden for an SRO to file an average proposed rule filing under Rule 19b-4. See id. at 18148, n. 397.

¹⁴⁸² See Proposing Release, supra note 13, at 18148. The 3 burden hours included 1.5 hours by a Compliance Manager and 1.5 hours by an Attorney. See id. In establishing this estimate, the Commission has considered its estimate of the burden for an SRO to amend a Form 19b-4 rule filing. See id. at 18148, n. 401.

¹⁴⁸³ See id. at 18145.

¹⁴⁸⁴ 130 hours × \$400 per hour for outside legal service = \$52,000. See Proposing Release, supra note 13, at 18147.

¹⁴⁸⁵ 95 hours × \$400 per hour for outside legal service = \$38,000. See id.

¹⁴⁸⁶ 35 hours × \$400 per hour for outside legal service = \$14,000. See id. at 18148.

¹⁴⁸⁷ 3 hours × \$400 per hour for outside legal service = \$1,200. See id.

and does not take into account significant activities relating to the SRO rule change process (e.g., board or directors briefing and deliberation, potential notice for comment, responses to comment letters received on such notice, responses to comment letters received by the Commission on a rule filing, etc.) and understates the activities necessary to implement testing with industry participants.¹⁴⁸⁸ Another commenter argued that it has contractual relationships with thousands of clients, and contract negotiations always require a great deal of time and commitment from its legal personnel.¹⁴⁸⁹ This commenter also noted that while a certain significant percentage of its clients may sign the contracts without any negotiation, many do not.¹⁴⁹⁰ According to this commenter, the requirements under proposed Rule 1000(b)(9) would create for it many thousands of burden hours because it would require the commenter to re-negotiate contracts with “the many thousands of clients it has already signed up.”¹⁴⁹¹

One commenter noted that the requirements under proposed Rule 1000(b)(9) would not be conducive to outsourcing.¹⁴⁹²

As discussed in detail above in Section IV.B.6, the Commission is adopting proposed Rule 1000(b)(9) as Rule 1004, with certain modifications. Rule 1004 requires each SCI entity to establish standards for the designation of certain members or participants for business continuity and disaster recovery plan testing, to designate members or participants in accordance with these standards, to require participation by designated members or participants in such testing at least

¹⁴⁸⁸ See MSRB Letter at 38.

¹⁴⁸⁹ See Omgeo Letter at 46. This commenter noted that its relationships with clients are often based on negotiated agreements and that clients do not automatically agree to all terms stated in the standard contract. See *id.* at 45.

¹⁴⁹⁰ See *id.* at 46.

¹⁴⁹¹ See *id.*

¹⁴⁹² See MSRB Letter at 38.

annually, and to coordinate such testing on an industry- or sector-wide basis with other SCI entities. However, adopted Rule 1004 does not require an SCI entity to notify and update the Commission of its designated members or participants and its standards for designation on Form SCI, as proposed.

Considering commenters' view that the Commission had underestimated the burden hours associated with proposed Rule 1000(b)(9), the Commission now estimates that the requirements under Rules 1004(a) (*i.e.*, establishment of standards for the designation of members and participants) and (c) (*i.e.*, coordination of testing on an industry- or sector-wide basis) will initially require 360 hours for each SCI entity that is not a plan processor (*e.g.*, establishing designation criteria by writing a proposed rule; revising a membership/subscriber agreement or participant agreement; providing notice to members or participants; scheduling the coordinated testing),¹⁴⁹³ or 15,120 hours for all such SCI entities.¹⁴⁹⁴ Further, the Commission

¹⁴⁹³ This estimate includes 90 hours to comply with Rule 1004(a) and 270 hours to comply with Rule 1004(c). The 90 hours include 30 hours by an Attorney, 20 hours by a Compliance Manager, 10 hours by an Assistant General Counsel, 6 hours by a Chief Compliance Officer, 4 hours by a Director of Compliance, and 20 hours by a Senior Operations Manager. The Commission is substantially increasing the estimated burden over that estimated for proposed Rule 1000(b)(9)(i), and is estimating an additional 10 hours by an Assistant General Counsel, 6 hours by a Chief Compliance Officer, 4 hours by a Director of Compliance, and 20 hours by a Senior Operations Manager to reflect senior management review of the standards for designation. With respect to the comment that the estimates in the proposal did not take into account significant activities relating to the SRO rule change process, the Commission notes that the paperwork burden associated with SRO rule filings are included as part of the burden associated with Rule 19b-4. See *supra* note 1488 and accompanying text. The 270 hours include 30 hours by an Attorney, 20 hours by a Compliance Manager, 10 hours by an Assistant General Counsel, 20 hours by a Chief Compliance Officer, 10 hours by a Director of Compliance, 140 hours by an Operations Specialist, and 40 hours by a Senior Operations Manager. The Commission is substantially increasing the estimated burden over that estimated for proposed Rule 1000(b)(9)(ii), and is estimating an additional 10 hours by an Assistant General Counsel, 20 hours by a Chief Compliance Officer, 10 hours by a Director of Compliance, and 40 hours by a Senior Operations Manager, in response to the view of a

estimates that the requirements under Rules 1004(a) and (c) will require 135 hours annually for each SCI entity that is not a plan processor,¹⁴⁹⁵ or 5,670 hours for all such SCI entities.¹⁴⁹⁶ The Commission continues to believe that SCI entities (other than plan processors) would handle internally the work associated with the requirements of Rule 1004.¹⁴⁹⁷

With respect to a commenter's statement that it has contractual relationships with thousands of clients and that proposed Rule 1000(b)(9) would create many thousands of burden hours,¹⁴⁹⁸ the Commission notes that adoption of a more focused designation requirement is likely to result in a smaller number of SCI entity members or participants being designated for participation in testing as compared to the SCI Proposal. Specifically, as adopted, Rule 1004(a) requires an SCI entity to designate "members or participants that the SCI entity reasonably

commenter that the estimates in the SCI Proposal underestimated the activities necessary to implement testing with industry participants. See supra note 1488 and accompanying text. The estimate of 360 hours includes the burden for designating members or participants for testing, as required by Rule 1004(b).

¹⁴⁹⁴ 360 hours × 42 SCI entities other than plan processors = 15,120 hours.

¹⁴⁹⁵ As noted in the SCI Proposal, the Commission does not believe that there would be significant annual burden under Rule 1004(a), as the Commission believes that the designation standards will likely not change substantially on an annual basis. See Proposing Release, supra note 13, at 18147, n. 393. The 135 hours include 15 hours by an Attorney, 10 hours by a Compliance Manager, 5 hours by an Assistant General Counsel, 10 hours by a Chief Compliance Officer, 5 hours by a Director of Compliance, 70 hours by an Operations Specialist, and 20 hours by a Senior Operations Manager. As compared to the estimated ongoing burden for proposed Rule 1000(b)(9)(ii), the Commission is estimating an additional 5 hours by an Assistant General Counsel, 10 hours by a Chief Compliance Officer, 5 hours by a Director of Compliance, and 20 hours by a Senior Operations Manager, consistent with the Commission's estimate for the initial burden for Rule 1004.

¹⁴⁹⁶ 135 hours × 42 SCI entities other than plan processors = 5,670 hours.

¹⁴⁹⁷ See supra note 1492 (discussing a commenter's view that the requirements under proposed Rule 1000(b)(9) would not be conducive to outsourcing).

¹⁴⁹⁸ See supra notes 1489-1491 and accompanying text.

determines are, taken as a whole, the minimum necessary for the maintenance of fair and orderly markets” in the event of the activation of the business continuity and disaster recovery plans. On the other hand, proposed Rule 1000(b)(9) required participation by members or participants the SCI entity deemed necessary “for the maintenance of fair and orderly markets in the event of the activation of its business continuity and disaster recovery plans.”¹⁴⁹⁹ The Commission believes that SCI entities have an incentive to limit the imposition of the cost and burden associated with testing to the minimum necessary to comply with the rule, and it also believes that, given the option, most SCI entities would, in the exercise of reasonable discretion, prefer to designate few members or participants to participate in testing, than to designate more. Thus, even if an SCI entity individually negotiates contract modifications with certain designated members or participants, the Commission believes that the burden would be substantially less than suggested by the commenter.¹⁵⁰⁰ Moreover, as noted above, taking into account commenters’ view that the Commission underestimated the burden for proposed Rule 1000(b)(9), the Commission increased its estimate for initial burden hours from 130 hours for the proposed rule to 360 hours

¹⁴⁹⁹ The Commission notes that, because Rule 1004 would not require all members or participants of an SCI entity to participate in business continuity and disaster recovery plan testing, Rule 1004 will not affect all of an SCI entity’s contractual relationships with clients or members or participants. Further, the Commission notes that its estimated burden for compliance with Rule 1004 is intended to reflect the average burden for all SCI entities (other than plan processors).

¹⁵⁰⁰ As discussed in the Economic Analysis, the Commission estimates that each SCI entity would designate an average of 40 members or participants to participate in the necessary testing. See *infra* note 2065. Therefore, an SCI entity will not be required to re-negotiate contracts with “the many thousands of clients it has already signed up.” See *supra* note 1491 and accompanying text. Moreover, this commenter recognized that a significant percentage of its clients may sign the contracts without any negotiation. See *supra* note 1491 and accompanying text. As a result, the Commission does not expect that an SCI entity will need to negotiate with all of the estimated 40 members or participants.

for adopted Rule 1004. The average burden estimate associated with Rule 1004 applies to SCI entities that would need to negotiate contract modifications with members or participants.

Based on its experience with plan processors, the Commission continues to believe that plan processors will outsource the work related to compliance with Rule 1004. The Commission estimates that Rule 1004 will carry an initial cost of \$144,000 per plan processor,¹⁵⁰¹ or \$288,000 for all plan processors.¹⁵⁰² The Commission estimates that Rule 1004 will carry an annual cost of \$54,000 per plan processor,¹⁵⁰³ or \$108,000 for all plan processors.¹⁵⁰⁴

2. Notification, Dissemination, and Reporting Requirements for SCI Entities

The rules under Regulation SCI that would require an SCI entity to notify the Commission of SCI events, disseminate information regarding certain SCI events, and notify the Commission of certain systems changes are discussed more fully in Sections IV.B.3.c, IV.B.3.d, and IV.B.4 above.

a. Commission Notification of SCI Events

¹⁵⁰¹ 360 hours × \$400 per hour for outside legal service = \$144,000. This is based on an estimated \$400 per hour cost for outside legal services. This is the same estimate used by the Commission for these services in the “Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than \$150 Million Under Management, and Foreign Private Advisers” final rule: SEC Release No. IA-3222 (June 22, 2011); 76 FR 39646 (July 6, 2011).

¹⁵⁰² \$144,000 × 2 plan processors = \$288,000.

¹⁵⁰³ 135 hours × \$400 per hour for outside legal service = \$54,000. The Commission increased from its estimate in the proposal the estimated hours for the outsourced work for plan processors to be equivalent to the number of burden hours it estimated for an SCI entity that is not a plan processor (i.e., increasing the initial burden estimate from 130 hours to 360 hours and the annual burden estimate from 95 to 135 hours).

¹⁵⁰⁴ \$54,000 × 2 plan processors = \$108,000.

In the SCI Proposal, the Commission estimated that each SCI entity would experience an average of 40 immediate notification SCI events¹⁵⁰⁵ per year (i.e., 40 notifications under proposed Rule 1000(b)(4)(i)), and that one-fourth of the notifications under proposed Rule 1000(b)(4)(i) would be in writing (i.e., 10 written notifications and 30 oral notifications).¹⁵⁰⁶ The Commission estimated that each written notification would require 0.5 hours to prepare and submit to the Commission.¹⁵⁰⁷ The Commission also estimated that each SCI entity would experience an average of 65 SCI events each year and therefore would submit 65 Commission notifications each year under proposed Rule 1000(b)(4)(ii).¹⁵⁰⁸ The Commission estimated that each such notification would require an average of 20 burden hours.¹⁵⁰⁹ In addition, the Commission estimated that on average, each SCI entity would submit 5 updates per year under proposed Rule 1000(b)(4)(iii), and that each update would require an average of 3 burden hours.¹⁵¹⁰ Finally, the Commission estimated that SCI entities would handle internally the work associated with the notification requirement under proposed Rule 1000(b)(4).¹⁵¹¹

¹⁵⁰⁵ Immediate notification SCI events included systems disruptions that an SCI entity reasonably estimated would have a material impact on its operations or on market participants, all systems compliance issues, and all systems intrusions.

¹⁵⁰⁶ See Proposing Release, supra note 13, at 18148.

¹⁵⁰⁷ See id. The 0.5 burden hour would be spent by an Attorney. See id. at 18149.

¹⁵⁰⁸ See id. at 18148-49.

¹⁵⁰⁹ See id. at 18149. The 20 burden hours included 10 hours by an Attorney and 10 hours by a Compliance Manager. See id. This estimate was based on Commission staff's experience with the ARP Inspection Program. In determining this estimate, the Commission also considered its estimate of the burden to complete a Form 19b-4 filing, although the Commission noted that, unlike a Form 19b-4 filing, the information contained in Form SCI would only be factual. See id. at 18149, n. 410.

¹⁵¹⁰ See id. at 18149. The 3 burden hours included 1.5 hours by an Attorney and 1.5 hours by a Compliance Manager. See id. This estimate was based on Commission staff's experience with the ARP Inspection Program. In determining this estimate, the

Several commenters stated that the Commission underestimated the number of SCI events.¹⁵¹² One commenter stated that, because the proposed definition of SCI event was broad and would include minor or immaterial events, it is likely that each SCI entity could have hundreds if not thousands of SCI events on an annual basis.¹⁵¹³ Similarly, another commenter stated that each SCI entity could be required to report hundreds of systems disruption events each year, although the vast majority of such events would be virtually unnoticed by market participants.¹⁵¹⁴ Another commenter stated that, based on its best reading of the more expansive definitions of disruptions and intrusions, a more accurate estimate could be between 200 to 500 events per year per exchange.¹⁵¹⁵ Several commenters noted that the Commission significantly underestimated the number of updates that would be required under Rule 1000(b)(4)(iii).¹⁵¹⁶

Commission also considered its estimate of the burden for an SRO to amend a Form 19b-4. See id. at 18149, n. 410.

¹⁵¹¹ See id. at 18148-49, n. 408, n. 411, and n. 413.

¹⁵¹² See Omgeo Letter at 35; BATS Letter at 11; Joint SRO Letter at 18; OTC Markets Letter at 6; and NYSE Letter at 18. However, commenters did not specify estimates for the number of systems compliance issues an SCI entity would experience each year.

¹⁵¹³ See Omgeo Letter at 35. According to this commenter, many of these SCI events would require written notification even though the vast majority of them would be minor and immaterial. See id.

¹⁵¹⁴ See BATS Letter at 11. This commenter also noted that the Commission did not break down the anticipated reportable events into systems disruptions, systems intrusions, and systems compliance issues. See id.

¹⁵¹⁵ See NYSE Letter at 18. See also FINRA Letter at 18, n. 32 (stating that depending on the interpretation of what constitutes a systems intrusion, it would be required to notify the Commission either: several times a day under the broadest interpretation; three or four times per month under a narrower interpretation; or one or two times per year if limited to intrusions where there is a material impact).

¹⁵¹⁶ See Joint SRO Letter at 19; NYSE Letter at 24 (noting that it is not realistic, with respect to over 90% of SCI events, that all required activity is complete and reportable on Form SCI within 24 hours). See also FINRA Letter at 19 (noting that some complex outages can take up to several days to triage, isolate, and begin to resolve, and that based on its

With respect to the Commission's estimate of the burden for Commission notification generally, one commenter noted that preparation of Form SCI will take a fair amount of time, not just to compile information about the SCI event, but also to review and edit the submission.¹⁵¹⁷ According to this commenter, further impediments to timely reporting may arise where an issue requires cross-department coordination or coordination with a joint facility or RSA client.¹⁵¹⁸ This commenter stated that the Commission notification process will take even more time where a third party's technical and data personnel are relied on to provide initial drafts or where an RSA client requests that it have the opportunity to review all written notices before they are submitted.¹⁵¹⁹ Another commenter noted that senior management of SCI entities would want an SCI event to be investigated before it is reported to the Commission.¹⁵²⁰ This commenter also noted that any responsible Chief Administrative Officer, Chief Financial Officer, Chief Operations Officer, Chief Compliance Officer, Chief Information Security Officer, General Counsel, and compliance attorneys and officers would want to review any report on an SCI event

experience with ARP outage reporting, it can take several days to confirm the root cause of an outage and even longer to determine the appropriate resolution and how long it will take to complete).

¹⁵¹⁷ See FINRA Letter at 19. Similarly, another commenter noted that notifications to the Commission for SCI events and material systems changes would be considered a serious matter, and a diligent and properly considered notification would require the time and effort of numerous staff in different departments. See UBS Letter at 6.

¹⁵¹⁸ See FINRA Letter at 19.

¹⁵¹⁹ See *id.*

¹⁵²⁰ See Omgeo Letter at 35.

prior to submission to the Commission.¹⁵²¹ In addition, this commenter noted that the SCI entity would need to engage outside counsel and possibly other parties to review such reports.¹⁵²²

With respect to the Commission's estimate of the burden for written Commission notification under proposed Rule 1000(b)(4)(i), one commenter noted that considerable amounts of activities may be necessary to gather the information needed, to have appropriate confirmations from persons with knowledge and authority with respect to the applicable SCI system, to provide for senior management review where appropriate, and to otherwise be in a position to draft the notification.¹⁵²³ Another commenter noted that Commission notification required by proposed Rule 1000(b)(4)(i) would require substantive input from personnel outside of the legal and compliance departments, including IT analysts and managers as well as impacted business analysts and managers.¹⁵²⁴ This commenter estimated that each notification under proposed Rule 1000(b)(4)(i) would require 12 hours.¹⁵²⁵ This commenter also noted that the Commission erroneously assumed that verbal notifications under proposed Rule 1000(b)(4)(i) would not consume the time of any employee.¹⁵²⁶

With respect to the estimated burden under proposed Rule 1000(b)(4)(ii), one commenter noted that the estimate did not take into account the considerable amounts of activities to be undertaken by other personnel, including persons with knowledge and authority with respect to

¹⁵²¹ See id.

¹⁵²² See id. at 35-36. This commenter also noted that the Commission's estimated cost for consulting outside experts is too low. See id. at 35, n. 69.

¹⁵²³ See MSRB Letter at 33.

¹⁵²⁴ See UBS Letter at 6. This commenter expressed the same concern with respect to proposed Rule 1000(b)(4)(ii). See id.

¹⁵²⁵ See id.

¹⁵²⁶ See id.

the applicable SCI system and the SCI event as well as senior management where appropriate, in order to collect and assess the appropriate information and to properly inform the attorney and compliance manager of such information in order to allow them to produce an accurate notification in compliance with proposed Rule 1000(b)(4)(ii).¹⁵²⁷ This commenter had similar concerns with the burden estimates for proposed Rule 1000(b)(4)(iii).¹⁵²⁸ Another commenter noted that, with respect to proposed Rule 1000(b)(4)(ii), no provision was made for the time burden that would be placed on technology personnel in the notification process.¹⁵²⁹ Similarly, one commenter noted that the 20-hour burden estimate failed to take into account technology staff and business operations personnel who spend considerable time gathering facts and circumstances of a systems issue.¹⁵³⁰ Another commenter estimated that each report under proposed Rule 1000(b)(4)(ii) will require approximately 5 hours of senior management time (including review and discussions between the Chief Administrative Officer, the Chief Compliance Officer, the Chief Information Officer, the Chief Operating Officer, and the General Counsel).¹⁵³¹ In addition, this commenter estimated that middle managers from its Compliance, Legal, Technology, Product, and Information Security functions would spend on average

¹⁵²⁷ See MSRB Letter at 33.

¹⁵²⁸ See id. at 33-34.

¹⁵²⁹ See Joint SRO Letter at 18. This commenter also opined that, in other sections, the Commission either incorrectly assumes that no legal or outside counsel would be used, or significantly underestimates the amount of legal or outside counsel expenses. See id. at 18-19.

¹⁵³⁰ See OCC Letter at 12. See also NYSE Letter at 18 and 34 (stating that a significant number of full time staff, including legal, compliance, technical, and operations staff, would be required to comply with the Commission notification process under proposed Rule 1000(b)(4), and that no estimate is provided for a technology staff member under Rule 1000(b)(4)(ii)).

¹⁵³¹ See Omgeo Letter at 36.

approximately 31 hours per report.¹⁵³² Further, this commenter estimated that associates from Compliance, Legal, Technology, Product, and Information Security functions would spend approximately 53.5 hours per report.¹⁵³³ With respect to the burden estimates for proposed Rule 1000(b)(4)(iii), this commenter believed that proposed Rule 1000(b)(4)(iii) could conceivably require it to update the Commission approximately half of the time it files Form SCI.¹⁵³⁴ According to this commenter, each update would result in 1 hour of senior management time, 17 hours of middle management time, and 9 hours of associate time.¹⁵³⁵

One commenter stated its belief that none of the activities arising under proposed Rule 1000(b)(4) would be conducive to outsourcing.¹⁵³⁶

As discussed above in Section IV.B.3.c, the Commission is adopting the Commission notification requirements in Rule 1002(b), with certain modifications from the proposal. As adopted, the Commission notification requirements under Rules 1002(b)(1)-(4) do not apply to SCI events that had, or the SCI entity reasonably estimates would have, no or a de minimis impact on the SCI entity's operations or on market participants.¹⁵³⁷ Rather, each SCI entity is required to make, keep, and preserve records relating to all such SCI events, and submit quarterly reports to the Commission regarding such de minimis systems disruptions and de minimis systems intrusions.¹⁵³⁸

1532 See id.

1533 See id.

1534 See id.

1535 See id.

1536 See MSRB Letter at 34-35.

1537 See Rule 1002(b)(5).

1538 See id.

Rule 1002(b)(1), similar to the proposal, requires immediate Commission notification upon any responsible SCI personnel having a reasonable basis to conclude that an SCI event has occurred. Rule 1002(b)(2), similar to the proposal, requires a written Commission notification within 24 hours of any responsible SCI personnel having a reasonable basis to conclude that the SCI event has occurred. Rule 1002(b)(2) also specifically states that the 24-hour report is required to be made on a good faith, best efforts basis. In addition, the information required to be disclosed to the Commission under Rule 1002(b)(2) is less comprehensive than as proposed.¹⁵³⁹ Rule 1002(b)(3), similar to the proposal, requires SCI entities to provide updates pertaining to an SCI event on a regular basis, or at such frequency as reasonably requested by a representative of the Commission, until the event is resolved and the SCI entity's investigation of the event is closed. However, Rule 1002(b)(3), unlike the proposal, does not require these updates to be in writing. Finally, Rule 1002(b)(4) includes requirements for SCI entities to submit interim written notifications, as necessary, and final written notifications regarding SCI events.¹⁵⁴⁰ Specifically, if an SCI event is resolved and the SCI entity's investigation of the SCI

¹⁵³⁹ For example, an SCI entity is not required to provide the Commission a detailed description of the SCI event; a discussion of whether the SCI event is a dissemination SCI event; a description of the SCI entity's rules and/or governing documents, as applicable, which relate to the SCI event; or an analysis of parties that may have experienced a loss due to the SCI event.

¹⁵⁴⁰ The written notification is required to include (i) a detailed description of: the SCI entity's assessment of the types and number of market participants affected by the SCI event; the SCI entity's assessment of the impact of the SCI event on the market; the steps the SCI entity has taken, is taking, or plans to take, with respect to the SCI event; the time the SCI event was resolved; the SCI entity's rule(s) and/or governing document(s), as applicable, that relate to the SCI event; and any other pertinent information known by the SCI entity about the SCI event; (ii) a copy of any information disseminated pursuant to Rule 1002(c) by the SCI entity to date regarding the SCI event to any of its members or participants; and (iii) an analysis of parties that may have experienced a loss, whether monetary or otherwise, due to the SCI event, the number of such parties, and an estimate of the aggregate amount of such loss. The information required to be included in the

event is closed within 30 calendar days of the occurrence of the SCI event, then within five business days after the resolution of the SCI event and closure of the investigation regarding the SCI event, the SCI entity is required to submit a final written notification. If an SCI event is not resolved or the SCI entity's investigation of the SCI event is not closed within 30 calendar days of the occurrence of the SCI event, then the SCI entity is required to submit an interim written notification within 30 calendar days after the occurrence of the SCI event. Within five business days after the resolution of such SCI event and closure of the investigation regarding such SCI event, the SCI entity is required to submit a final written notification.

As noted above, some commenters expressed their view that the Commission underestimated the number of SCI events because they considered the definition of SCI event to be broad and would include minor or immaterial events.¹⁵⁴¹ These commenters estimated hundreds and even thousands of SCI events annually for each SCI entity, but noted that the majority of such events would have no effect on market participants.¹⁵⁴² As discussed above in Section IV.B.3.c, the Commission notification requirements under adopted Rule 1002(b)(1)-(4) do not apply to any SCI event that has had, or the SCI entity reasonably estimates would have, no or a de minimis impact on the SCI entity's operations or on market participants.¹⁵⁴³ Rather, each SCI entity would be required to keep records related to such events and submit quarterly reports that only contain a summary description of such de minimis systems disruptions and de

Rule 1002(b)(4) notifications is similar to the information required under proposed Rule 1000(b)(4)(iv)(A), which was related to the proposed 24-hour Commission notification.

¹⁵⁴¹ See supra notes 1513-1515 and accompanying text.

¹⁵⁴² See id.

¹⁵⁴³ See Rule 1002(b)(5).

minimis systems intrusions.¹⁵⁴⁴ Further, as noted above in Section IV.A, the Commission has refined the definition of SCI systems and SCI events in various respects.¹⁵⁴⁵ Therefore, the Commission does not believe that the number of SCI events subject to Rules 1002(b)(1)-(4) would be substantially higher than the Commission's estimate in the SCI Proposal.

After considering the views of commenters and in light of the more focused scope of the immediate Commission notification requirement, the Commission now estimates that each SCI entity will experience an average of 45 SCI events each year that are not de minimis SCI events, resulting in 45 written notifications under Rule 1002(b)(2) and 45 written notifications under Rule 1002(b)(4). The estimated 45 SCI events comprise 24 systems disruptions, 20 systems compliance issues, and one systems intrusion. These estimates are derived in part from the number of systems incidents reported to the Commission under the ARP Inspection Program and the number of compliance-related issues reported to the Commission by SROs.¹⁵⁴⁶

In particular, the Commission notes that approximately 360 ARP incidents were reported to the Commission in 2013 by 29 entities that participated in the ARP Inspection Program.¹⁵⁴⁷

¹⁵⁴⁴ See *id.*

¹⁵⁴⁵ See Rule 1000 (defining "SCI systems" and "SCI event").

¹⁵⁴⁶ The Commission notes that only one ATS currently participates in the ARP Inspection Program and other ATSS generally do not self-report system incidents to the Commission. At the same time, the Commission acknowledges that, to the extent that some ATSS have less complex systems or perform fewer functions than other SCI entities, it is possible that these ATSS will experience fewer SCI events per year than other SCI entities. Also, as discussed more fully below, many ATSS do not have rulebooks and thus may experience fewer systems compliance issues than other SCI entities. Nevertheless, the Commission believes that an average of 45 SCI events per year (excluding de minimis SCI events) is an appropriate average across all SCI entities, including ATSS.

¹⁵⁴⁷ In the SCI Proposal, the Commission noted that each entity reported an average of approximately 6 incidents under the ARP Inspection Program in 2011, and estimated that

Thus, on average, each entity reported approximately 12 incidents in 2013, although some entities reported fewer than 12 incidents, and some entities reported significantly more than 12 incidents (i.e., over 100). By defining “systems disruption” for purposes of Regulation SCI and requiring Commission notification of systems disruptions, the Commission expects that more incidents will be reported pursuant to Regulation SCI than pursuant to the voluntary ARP Inspection Program. Therefore, the Commission estimates that each SCI entity will report an average of 24 systems disruptions each year that are not de minimis systems disruptions, which is double the average number of systems incidents reported by each participant under the ARP Inspection Program in 2013.

Further, based on notifications received by Commission staff regarding certain SROs, each of these SROs experienced an average of 17 systems compliance-related issues in 2013. The notifications received by Commission staff indicate that some SROs experienced fewer than 17 systems compliance-related issues, and others experienced more than 17. The Commission believes that very few, if any, of the notifications received in 2013 would qualify as de minimis systems compliance issues under Regulation SCI. By defining “systems compliance issue” for purposes of Regulation SCI and requiring Commission notification of systems compliance issues, the Commission expects that more issues will be reported pursuant to Regulation SCI than pursuant to self-reporting. Therefore, the Commission estimates that each SCI entity will experience an average of 20 systems compliance issues each year that are not de minimis systems compliance issues.¹⁵⁴⁸

there would be an average of 65 SCI event notices per year for each SCI entity. See Proposing Release, *supra* note 13, at 18148.

¹⁵⁴⁸ The Commission acknowledges that SCI entities other than SCI SROs may experience fewer systems compliance issues than SCI SROs because they may not have rulebooks,

Based on the Commission's experience with the ARP Inspection Program, the Commission believes each SCI entity will experience on average less than one non-de minimis systems intrusion per year. However, for purposes of the PRA, the Commission estimates one non-de minimis systems intrusion per SCI entity per year.¹⁵⁴⁹

With respect to the notification requirement under Rule 1002(b)(1), the Commission notes that the notification can be made orally or in writing. As with the SCI Proposal, the Commission estimates that one-fourth of the notifications under Rule 1002(b)(1) will be submitted in writing (i.e., approximately 11 events per year for each SCI entity),¹⁵⁵⁰ and three-fourths will be provided orally (i.e., approximately 34 events per year for each SCI entity).¹⁵⁵¹ The Commission also estimates that each written notification under Rule 1002(b)(1) will require 2 hours¹⁵⁵² for each SCI entity.¹⁵⁵³ The Commission is not significantly increasing its burden

and thus, one aspect of the definition of systems compliance issue would not apply to such SCI entities (i.e., operating in a manner that does not comply with the entity's rules).

¹⁵⁴⁹ This estimate is lower than those provided by commenters (see supra note 1515 and accompanying text) because the adopted definitions of SCI systems and indirect SCI systems have been refined from the proposal, and because de minimis systems intrusions are required to be reported in summary format on a quarterly basis.

¹⁵⁵⁰ $45 \text{ SCI events} \div 4 = 11.25 \text{ SCI events reported in writing}$. One commenter noted that most SCI entities would submit a writing to document that they had satisfied the notice requirement of proposed Rule 1000(b)(4)(i). See Omgeo Letter at 16. However, the Commission continues to estimate that one-fourth of the notifications under Rule 1002(b)(1) will be submitted in writing and that the rest will be provided orally. The Commission believes that it is less burdensome for an SCI entity to provide oral notification than to provide written notification and, given the requirement of Rule 1002(b)(2) to provide a written notification to the Commission within 24 hours, the Commission believes it is likely that most initial notifications submitted under Rule 1002(b)(1) would be done orally. Moreover, based on Commission staff experience, ARP participants generally provide initial notifications of systems issues orally.

¹⁵⁵¹ $45 \text{ SCI events} - 11 \text{ SCI events reported in writing} = 34 \text{ SCI events reported orally}$.

¹⁵⁵² The burden estimates for each rule under Regulation SCI that involves the filing of Form SCI include the burden associated with completing and electronically submitting Form

estimate for proposed Rule 1000(b)(4)(i) because Rule 1002(b)(1) requires the immediate notification of SCI events and does not specify the minimum information that must be submitted to the Commission. The Commission believes that, for many SCI events, an SCI entity will simply notify the Commission that an SCI event has occurred, often in a single phone call, and may not provide the Commission with additional information because it is not yet available to the SCI entity. For these reasons, contrary to the view of some commenters,¹⁵⁵⁴ the Commission does not expect that the SCI entity will need to gather a considerable amount of information or significantly confer with interested parties across the entity. In particular, while the Commission estimates some burden for legal and technology personnel of SCI entities in complying with Rule 1002(b)(1), it does not believe that Rule 1002(b)(1) will result in significant burden for such personnel.¹⁵⁵⁵

SCI, and for manually signing a signature page or document, pursuant to the requirements of Rule 1006.

¹⁵⁵³ The 2 hours include 0.5 hours by an Attorney, 0.5 hours by a Compliance Manager, 0.5 hours by a Senior Systems Analyst, and 0.5 hours by a Senior Business Analyst. As compared to the estimated burden for proposed Rule 1000(b)(4)(i), the Commission is estimating an additional 0.5 hours by Compliance Managers, 0.5 hours by Senior Systems Analysts, and 0.5 hours by Senior Business Analysts to reflect that legal personnel may need to confer with technology and business personnel before contacting the Commission regarding an SCI event, in response to the views of commenters. See supra notes 1523-1525 and accompanying text. The Commission notes that the General Counsel, Director of Compliance, Chief Compliance Officer, or other senior employees or officers of certain SCI entities may review Commission notifications under Rule 1002(b)(1) before they are submitted (orally or in writing) to the Commission. However, the Commission estimates that on average, the General Counsel, Director of Compliance, Chief Compliance Officer, or other senior employees or officers may spend a small amount of time reviewing each Rule 1002(b)(1) notification. Rather, they will spend more time reviewing the other notifications required by Rule 1002(b).

¹⁵⁵⁴ See supra notes 1523-1526 and accompanying text.

¹⁵⁵⁵ Given that there is not a minimum amount of information that must be submitted to the Commission, the Commission believes its estimated burden hours is more appropriate

The Commission agrees with the view of a commenter that oral notifications would also result in burdens on an SCI entity,¹⁵⁵⁶ although it expects the burden for legal and compliance personnel to be lower than in the case of written notifications because they would not need to draft and review a written document for submission to the Commission. The Commission estimates that the burden for systems and business analysts would remain the same as for written notifications because the SCI entity will still need to gather the same type of information in order to prepare an oral notification. The Commission therefore estimates that each oral notification under Rule 1002(b)(1) will require 1.5 hours for each SCI entity.¹⁵⁵⁷ The Commission estimates that each SCI entity would require an average of 73 hours annually to comply with Rule 1002(b)(1),¹⁵⁵⁸ or 3,212 hours for all SCI entities.¹⁵⁵⁹

The Commission estimates that each written notification under Rule 1002(b)(2) will require 24 hours for each SCI entity.¹⁵⁶⁰ Contrary to the views of a commenter that each

than the 12 hours suggested by a commenter. See supra note 1525 and accompanying text.

¹⁵⁵⁶ See supra note 1526 and accompanying text.

¹⁵⁵⁷ The 1.5 hours include 0.25 hours by an Attorney, 0.25 hours by a Compliance Manager, 0.5 hours by a Senior Systems Analyst, and 0.5 hours by a Senior Business Analyst.

¹⁵⁵⁸ 11 written notifications each year × 2 hours per notification + 34 oral notifications each year × 1.5 hours per notification = 73 hours.

¹⁵⁵⁹ 73 hours × 44 SCI entities = 3,212 hours.

¹⁵⁶⁰ The 24 hours include 5 hours by an Attorney, 5 hours by a Compliance Manager, 6 hours by a Senior Systems Analyst, 1 hour by an Assistant General Counsel, 1 hour by a Chief Compliance Officer, and 6 hours by a Senior Business Analyst. Given the modifications from proposed Rule 1000(b)(4)(ii) identified below, the Commission estimates that legal and compliance personnel will have less work in drafting the written notifications under Rule 1002(b)(2), and accordingly reduced the burden hours for Attorneys and Compliance Managers from 10 to 5. Further, as compared to the estimated burden for proposed Rule 1000(b)(4)(ii), the Commission is estimating an additional 6 hours by a Senior Systems Analyst, 1 hour by an Assistant General Counsel, 1 hour by a Chief Compliance Officer, and 6 hours by a Senior Business Analyst to reflect that legal

notification under proposed Rule 1000(b)(4)(ii) would require approximately 90 burden hours between senior management, middle managers, and associates from various functions (e.g., legal, compliance, technology),¹⁵⁶¹ the Commission is not significantly increasing its estimate of the burden hours from its estimate for proposed Rule 1000(b)(4)(ii) because Rule 1002(b)(2) requires less information than proposed Rule 1000(b)(4)(ii), although the Commission has revised its estimated burden hours to account for the various functions and multiple levels of review suggested by the commenter.¹⁵⁶² Also, because Rule 1002(b)(2) explicitly permits information to be submitted on a good faith, best efforts basis, the Commission believes that SCI entities will be able to expend less resources in reviewing each notification. Therefore, the Commission estimates that each SCI entity would require an average of 1,080 hours annually to comply with Rule 1002(b)(2),¹⁵⁶³ or 47,520 hours for all SCI entities.¹⁵⁶⁴

With respect to the number of updates required under Rule 1002(b)(3), the Commission estimates that each SCI entity will submit 6 written updates and 18 oral updates each year under that rule. These estimates are based on Commission staff's experience with the ARP Inspection Program, systems compliance-related issues at SROs, and views of commenters. Specifically, most of the systems incidents reported to the Commission in 2013 were reported as resolved within 24 hours. Further, as discussed above, de minimis SCI events are not subject to the

personnel may need to confer with technology and business personnel and senior management, as well as the multiple levels of review (e.g., attorney, compliance manager, chief compliance officer), before submitting a report regarding an SCI event, in response to the views of commenters. See supra notes 1520-1521, 1527, and 1529-1533 and accompanying text.

¹⁵⁶¹ See supra notes 1531-1533 and accompanying text.

¹⁵⁶² See supra notes 1539 and 1560.

¹⁵⁶³ 45 written notifications each year × 24 hours per notification = 1,080 hours.

¹⁵⁶⁴ 1,080 hours × 44 SCI entities = 47,520 hours.

update requirement under Rule 1002(b)(3). Moreover, the Commission believes that, for some SCI events, an SCI entity will not need to provide an update under Rule 1002(b)(3), because the SCI entity will be able to quickly submit a final report under Rule 1002(b)(4). However, after considering the views of a commenter that some complex outages can take up to several days to triage, isolate, and begin to resolve,¹⁵⁶⁵ and the views of another commenter that proposed Rule 1000(b)(4)(iii) could conceivably require it to update the Commission approximately half the time it files Form SCI,¹⁵⁶⁶ the Commission is increasing its estimate of the number of updates from 5 to 24.¹⁵⁶⁷ Because Rule 1002(b)(3) does not require SCI entities to submit updates in writing or on Form SCI, the Commission estimates that one-fourth of the updates will be submitted in writing, and three-fourths will be provided orally.¹⁵⁶⁸ Because the SCI entity will still need to gather the same type of information in order to prepare an oral or a written update, the Commission expects that the burden for systems and business analysts will be the same for either type of update. The Commission, however, expects that the burden for legal and compliance personnel would be less in the case of oral updates because in that case, an SCI entity would not need to draft and review a written document for submission to the Commission.

¹⁵⁶⁵ See supra note 1516.

¹⁵⁶⁶ See also supra note 1534 and accompanying text.

¹⁵⁶⁷ The Commission's estimate of 24 updates is slightly above half of the 45 written notifications estimated for Rule 1002(b)(2). See supra note 1534 (stating that the rule could conceivably require the commenter to update the Commission approximately half of the time it files Form SCI).

¹⁵⁶⁸ The Commission similarly estimated one-fourth written notifications and three-fourths oral notifications in the SCI Proposal for proposed Rule 1000(b)(4)(i). See Proposing Release, supra note 13, at 18148; see also supra note 1550 and accompanying text.

The Commission estimates that each written update under Rule 1002(b)(3) will require 6 hours¹⁵⁶⁹ and each oral update will require 4.5 hours.¹⁵⁷⁰ The Commission is not significantly increasing its burden estimate from proposed Rule 1000(b)(4)(iii). The Commission believes that each update will likely only reflect some of the information listed under Rules 1002(b)(1) and (2) because certain information about SCI events may not yet be available at the time the SCI entity submits such update or may not need to be updated. Therefore, contrary to one commenter's view that each update would require 27 hours,¹⁵⁷¹ the Commission does not believe that a Rule 1002(b)(3) update will require significantly more time than as estimated in the SCI Proposal. The Commission estimates that each SCI entity would require an average of 117 hours annually to comply with Rule 1002(b)(3),¹⁵⁷² or 5,148 hours for all SCI entities.¹⁵⁷³

¹⁵⁶⁹ The 6 hours include 1.5 hours by an Attorney, 1.5 hours by a Compliance Manager, 1.5 hours by a Senior Systems Analyst, and 1.5 hours by a Senior Business Analyst. As compared to the estimated burden for proposed Rule 1000(b)(4)(iii), the Commission is estimating an additional 1.5 hours by a Senior Systems Analyst and 1.5 hours by a Senior Business Analyst to reflect that legal personnel may need to confer with technology and business personnel before contacting the Commission regarding an SCI event, in response to the view of a commenter. See *supra* note 1528 and accompanying text. The Commission notes that the General Counsel, Director of Compliance, Chief Compliance Officer, or other senior employees or officers of certain SCI entities may review the updates under Rule 1002(b)(3) before they are submitted (orally or in writing) to the Commission. However, the Commission estimates that on average, the General Counsel, Director of Compliance, Chief Compliance Officer, or other senior employees or officers may spend a small amount of time reviewing each Rule 1002(b)(3) notification because it is not the final report to the Commission on an SCI event, and the SCI entity can subsequently submit additional updates. See *supra* note 1535 and accompanying text (noting a commenter's burden estimate for proposed Rule 1000(b)(4)(iii), which includes estimates for senior management review).

¹⁵⁷⁰ The 4.5 hours include 0.75 hours by an Attorney, 0.75 hours by a Compliance Manager, 1.5 hours by a Senior Systems Analyst, and 1.5 hours by a Senior Business Analyst.

¹⁵⁷¹ See *supra* note 1535 and accompanying text.

¹⁵⁷² 6 written updates each year × 6 hours per notification + 18 oral updates each year × 4.5 hours per notification = 117 hours.

The Commission estimates that compliance with Rule 1002(b)(4) for a particular SCI event (which includes a final report under Rule 1002(b)(4)(i)(A) and, as applicable, an interim report under Rule 1002(b)(4)(i)(B)) will require 35 hours.¹⁵⁷⁴ The Commission notes that the information required to be provided under Rule 1002(b)(4) is similar to the information required to be provided in a notification submitted under proposed Rule 1000(b)(4)(ii). As noted above, in the SCI Proposal, the Commission estimated that each notification under proposed Rule 1000(b)(4)(ii) would require an average of 20 burden hours,¹⁵⁷⁵ and some commenters argued that the Commission underestimated this burden.¹⁵⁷⁶ The Commission is estimating a higher burden for Rule 1002(b)(4) as compared to proposed Rule 1000(b)(4)(ii) (i.e., 35 hours as compared to 20 hours) because the reports under Rule 1002(b)(4) constitute final reports regarding SCI events, and SCI entities will likely confer with technology and business personnel and senior management to ensure that the information provided is accurate. For the same reason, and because Rule 1002(b)(4) (final report) requires more information than Rule 1002(b)(2), the

¹⁵⁷³ 117 hours × 44 SCI entities = 5,148 hours.

¹⁵⁷⁴ The 35 hours include 8 hours by an Attorney, 8 hours by a Compliance Manager, 7 hours by a Senior Systems Analyst, 2 hours by an Assistant General Counsel, 1 hour by a General Counsel, 2 hours by a Chief Compliance Officer, and 7 hours by a Senior Business Analyst. As compared to proposed Rule 1000(b)(4)(ii), the Commission expects the legal and compliance personnel to have less work in drafting the written notifications under Rule 1002(b)(4) because some of the information required by Rule 1002(b)(4) may already have been provided in a prior notification to the Commission, and accordingly reduced the burden hours for Attorneys and Compliance Managers from 10 to 8. Further, as compared to the estimated burden for proposed Rule 1000(b)(4)(ii), the Commission is estimating an additional 7 hours by a Senior Systems Analyst, 2 hours by an Assistant General Counsel, 1 hour by a General Counsel, 2 hours by a Chief Compliance Officer, and 7 hours by a Senior Business Analyst to reflect that legal personnel may need to confer with technology and business personnel and senior management before submitting a final report regarding an SCI event.

¹⁵⁷⁵ See supra note 1509 and accompanying text.

¹⁵⁷⁶ See supra notes 1527, 1529-1533 and accompanying text.

Commission's burden estimate for Rule 1002(b)(4) is higher than the burden estimate for Rule 1002(b)(2) (i.e., 35 hours as compared to 24 hours).¹⁵⁷⁷ Nevertheless, the Commission is not substantially increasing the burden estimate as compared to proposed Rule 1000(b)(4)(ii) or adopted Rule 1002(b)(2) because it recognizes that some of the information required by Rule 1002(b)(4) may already have been provided in a prior notification to the Commission and, thus, its burden has been included in the burden estimate for Rule 1002(b)(2). Therefore, the Commission estimates that each SCI entity would require an average of 1,575 hours annually to comply with Rule 1002(b)(4),¹⁵⁷⁸ or 69,300 hours for all SCI entities.¹⁵⁷⁹

Finally, the quarterly notification under Rule 1002(b)(5) is required only to include "a summary description" of the SCI events. The Commission's estimated burden reflects the Commission's belief that most, if not all, SCI entities already have some internal documentation

¹⁵⁷⁷ As compared to the Commission's burden estimate for Rule 1002(b)(2), the Commission is estimating an additional 3 hours by an Attorney, 3 hours by a Compliance Manager, 1 hour by a Senior Systems Analyst, 1 hour by an Assistant General Counsel, 1 hour by a General Counsel, 1 hour by a Chief Compliance Officer, and 1 hour by a Senior Business Analyst. The type of personnel involved in compliance with Rule 1002(b)(4) is the same as those involved in compliance with Rule 1002(b)(2), except for the addition of the General Counsel.

¹⁵⁷⁸ 45 written notifications each year × 35 hours per notification = 1,575 hours.

¹⁵⁷⁹ 1,575 hours × 44 SCI entities = 69,300 hours. The Commission notes that this burden estimate includes the burden for submitting the one interim Commission notification required under Rule 1002(b)(4)(i)(B) (if necessary). In particular, the Commission notes that the interim notification requires SCI entities to include the same information as required to be included in a final notification under Rule 1002(b)(4)(i)(A), except that SCI entities are only required to provide the information to the extent known at the time of the interim notification. If an SCI entity submits an interim notification, it would also be required to submit a final notification, which is required to include all of the remaining information that was not provided in the interim notification. Because all SCI entities are required to provide the same amount of information in total for a particular SCI event under Rule 1002(b)(4), regardless of whether they submit an interim notification, the estimated burden for Rule 1002(b)(4) includes the burden for both the interim notification and the final notification related to a particular SCI event.

of de minimis SCI events. Rule 1002(b)(5) would impose more burden on SCI entities if they do not already have such internal documentation. The Commission estimates that the initial and ongoing burden to comply with the quarterly report requirement would be 40 hours per report per SCI entity,¹⁵⁸⁰ or 160 hours annually per SCI entity,¹⁵⁸¹ and 7,040 hours annually for all SCI entities.¹⁵⁸²

The Commission estimates that while SCI entities would handle internally most of the work associated with Rule 1002(b), SCI entities would seek outside legal advice in the preparation of certain Commission notifications, at an average annual cost of \$45,000 per SCI entity,¹⁵⁸³ or \$1,980,000 for all SCI entities.¹⁵⁸⁴

b. Dissemination of Information Regarding SCI Events

¹⁵⁸⁰ The 40 burdens hours include 7.5 hours by an Attorney, 7.5 hours by a Compliance Manager, 2 hours by a Chief Compliance Officer, 2 hours by an Assistant General Counsel, 1 hour by a General Counsel, 10 hours by a Senior Business Analyst, and 10 hours by a Senior Systems Analyst.

¹⁵⁸¹ 40 hours × 4 reports each year = 160 hours.

¹⁵⁸² 160 hours × 44 SCI entities = 7,040 hours.

¹⁵⁸³ See supra note 1522 and accompanying text (discussing the view of a commenter that SCI entities would need to engage outside parties to review the Commission notifications). But see supra note 1536 and accompanying text (discussing the view of a commenter that none of the activities arising under proposed Rule 1000(b)(4) would be conducive to outsourcing). The Commission's estimate represents an average of \$1,000 of outsourced cost for each SCI event that is not a de minimis SCI event. The \$1,000 estimate is consistent with the Commission's estimated outsourcing cost for each SCI event that is subject to the dissemination requirements under Rule 1002(c). 45 SCI events × \$1,000 = \$45,000.

¹⁵⁸⁴ \$45,000 × 44 SCI entities = \$1,980,000.

In the SCI Proposal, the Commission estimated that each SCI entity would experience an average of 14 dissemination SCI events¹⁵⁸⁵ each year that are not systems intrusions, resulting in an average of 14 information disseminations per year for each SCI entity under proposed Rule 1000(b)(5)(i).¹⁵⁸⁶ The Commission estimated that each information dissemination under proposed Rule 1000(b)(5)(i)(A) would require an average of 3 hours to prepare and make available to members or participants.¹⁵⁸⁷ The Commission estimated that each information update under proposed Rule 1000(b)(5)(i)(B) would require an average of 5 hours to prepare and make available to members or participants.¹⁵⁸⁸ The Commission also estimated that, on average, each SCI entity would provide one regular update per year per dissemination SCI event under proposed Rule 1000(b)(5)(i)(C).¹⁵⁸⁹ The Commission estimated that each regular update would require an average of 1 hour to prepare and make available to members or participants.¹⁵⁹⁰

In the SCI Proposal, the Commission estimated that each SCI entity would experience an average of 1 dissemination SCI event that is a systems intrusion each year, resulting in 1

¹⁵⁸⁵ Dissemination SCI events included systems compliance issues, systems intrusions, and systems disruptions that resulted, or the SCI entity reasonably estimates would result, in significant harm or loss to market participants.

¹⁵⁸⁶ See Proposing Release, supra note 13, at 18149.

¹⁵⁸⁷ See id. The 3 burden hours included 2.67 hours by an Attorney and 0.33 hours by a Webmaster. See id. This estimate was based on Commission staff's experience with the ARP Inspection Program. See id. at 18149, n. 416.

¹⁵⁸⁸ See id. at 18150. The 5 burden hours included 4.67 hours by an Attorney and 0.33 hours by a Webmaster. See id. This estimate was based on Commission staff's experience with the ARP Inspection Program. See id. at 18150, n. 420.

¹⁵⁸⁹ See id. at 18150.

¹⁵⁹⁰ See id. The 1 burden hour included 0.67 hours by an Attorney and 0.33 hours by a Webmaster. See id. This estimate was based on the estimated burden to complete and submit a written update for an SCI event on Form SCI and on Commission staff's experience with the ARP Inspection Program. See id. at 18150, n. 422 and n. 423.

information dissemination per year under proposed Rule 1000(b)(5)(ii). The Commission estimated that each information dissemination would require an average of 3 hours to prepare and make available to members or participants.¹⁵⁹¹ This burden estimate included any burden for an SCI entity to document its reason for determining that dissemination of information regarding a systems intrusion would likely compromise the security of the SCI entity's SCI systems or SCI security systems, or an investigation of the systems intrusion.¹⁵⁹²

In the SCI Proposal, the Commission estimated that while SCI entities would internally handle most of work associated with compliance with proposed Rule 1000(b)(5), SCI entities would seek outside legal advice in the preparation of the disseminations at an average annual cost of \$15,000 per SCI entity.¹⁵⁹³

With respect to the estimated burden under proposed Rule 1000(b)(5), one commenter noted that since most of the work entailed in producing a notification relating to a dissemination SCI event would occur in connection with the Commission notification requirements under proposed Rule 1000(b)(4), the Commission's estimate of the burden of proposed Rule 1000(b)(5) is fairly accurate.¹⁵⁹⁴

Another commenter stated that the Commission underestimated the burden associated with information dissemination.¹⁵⁹⁵ In connection with expressing its concern that almost any

¹⁵⁹¹ See id. at 18150. The 3 burden hours included 2.67 hours by an Attorney and 0.33 hours by a Webmaster. See id. This estimate was based on Commission staff's experience with the ARP Inspection Program, and the Commission's burden estimate for proposed Rule 1000(b)(5)(i)(A). See id. at 18150, n. 426.

¹⁵⁹² See id.

¹⁵⁹³ See id. at 18150-51.

¹⁵⁹⁴ See MSRB Letter at 35.

minor or immaterial systems issue would fall under the proposed definition of SCI event, this commenter estimated that there would be at a minimum a ten-fold increase in reportable events from the 175 incidents in 2011 under the ARP Inspection Program.¹⁵⁹⁶

With respect to the estimated burden associated with information dissemination, this commenter argued that the Commission incorrectly assumed that such communications would be drafted only by a single attorney and a webmaster.¹⁵⁹⁷ This commenter believed that properly drafting such communications will require a concerted effort by a number of individuals, including subject matter experts and mid-level and senior managers.¹⁵⁹⁸ This commenter also noted that SCI entities would draft different dissemination notices designed to address the particular concerns of the different client segments it services (e.g., broker-dealers, custodian banks, investment managers, hedge funds).¹⁵⁹⁹ As such, this commenter estimated that proposed Rule 1000(b)(5)(i)(A) would result in a burden of approximately 30 hours to create the dissemination¹⁶⁰⁰ and 100 hours to review.¹⁶⁰¹ Further, this commenter disagreed that SCI entities are likely to handle internally most of the work associated with information

¹⁵⁹⁵ See Omgeo Letter at 37. This commenter argued that the Commission mistakenly relied upon experience with the ARP Inspection Program as a basis for the estimates. See id.

¹⁵⁹⁶ See id. at 37-38.

¹⁵⁹⁷ See id. at 38.

¹⁵⁹⁸ See id. According to this commenter, subject matter experts would include associates from functions such as Technology, Client Support, Information Security, Legal, Compliance, Product Management, and Sales and Relationship Management. See id. at 38, n. 75.

¹⁵⁹⁹ See Omgeo Letter at 38.

¹⁶⁰⁰ This commenter noted that major incidents would require far more resources. See id.

¹⁶⁰¹ See id. This commenter noted that the 100-hour estimate does not include any follow up communications. See id. at 38, n. 76.

dissemination.¹⁶⁰² This commenter believed that, to the extent a dissemination SCI event raises the possibility of litigation or reputational damage for an SCI entity, the SCI entity will likely engage outside counsel to review the facts and prepare the required materials.¹⁶⁰³ This commenter also argued that the Commission's estimate did not take into account the burden associated with addressing responses from an SCI entity's participants, members, or clients, which, according to this commenter, would be hundreds of hours of SCI entity associate and management time.¹⁶⁰⁴ This commenter expressed similar concerns respect to the burden estimates for proposed Rules 1000(b)(5)(i)(B) and (C) and noted that each follow-up notice would impose a burden far greater than 5 hours.¹⁶⁰⁵ This commenter also noted that the Commission underestimated that each SCI entity would only have to provide one update each year under proposed Rule 1000(b)(5)(i)(C), and that each dissemination would only be prepared by an attorney and a webmaster.¹⁶⁰⁶

With respect to the burden estimates for proposed Rule 1000(b)(5)(ii), this commenter expressed similar concern, and noted that each dissemination under proposed Rule 1000(b)(5)(ii) would require hundreds of burden hours.¹⁶⁰⁷

¹⁶⁰² See id. at 39. However, another commenter stated its belief that none of the activities arising under proposed Rule 1000(b)(5) would be conducive to outsourcing. See MSRB Letter at 34-35.

¹⁶⁰³ See Omgeo Letter at 39. This commenter also expressed concern that SCI entities would be forced to send their clients and participants a constant stream of communications detailing minor, inconsequential events that have no impact on them, which would cause reputational damage to SCI entities. See id.

¹⁶⁰⁴ See id.

¹⁶⁰⁵ See id. at 40-41.

¹⁶⁰⁶ See id. at 41.

¹⁶⁰⁷ See id. at 41-42.

As discussed above in Section IV.B.3.d, the Commission is adopting the information dissemination requirements in Rule 1002(c), with certain modifications from the proposal. As adopted, an SCI entity is required to disseminate certain information to its members or participants that may have been affected by an SCI event.¹⁶⁰⁸ However, for major SCI events, an SCI entity must disseminate the required information to all of its member or participants.¹⁶⁰⁹ Rule 1002(c)(4) further provides that the information dissemination requirement does not apply to SCI events to the extent they relate to market regulation or market surveillance systems, or any SCI event that has had, or the SCI entity reasonably estimates would have, no or a de minimis impact on the SCI entity's operations or on market participants.

Similar to proposed Rule 1000(b)(5), adopted Rule 1002(c)(1) requires SCI entities to promptly disseminate certain information regarding systems disruptions and systems compliance issues, to further disseminate certain information when such information becomes known,¹⁶¹⁰ and to provide regular updates of such information until the SCI event is resolved. In addition, similar to proposed Rule 1000(b)(5), adopted Rule 1002(c)(2) requires SCI entities to promptly disseminate certain information regarding systems intrusions,¹⁶¹¹ and provides an exception when the SCI entity determines that dissemination of such information would likely compromise the security of its SCI systems or indirect SCI systems, or an investigation of the systems intrusion, and documents the reasons for such determination.

¹⁶⁰⁸ See Rule 1002(c)(3).

¹⁶⁰⁹ See id.

¹⁶¹⁰ The information required to be disseminated under Rule 1002(c)(1) remains unchanged from the proposal.

¹⁶¹¹ The information required to be disseminated under Rule 1002(c)(2) remains unchanged from the proposal.

With respect to a commenter's concern that because almost any minor or immaterial systems issue would fall under the proposed definition of SCI event, there would be at a minimum a ten-fold increase in reportable events as compared to the reported incidents under the ARP Inspection Program,¹⁶¹² as noted above, Rule 1002(c)(4) provides exceptions to certain SCI events from the information dissemination requirement. Specifically, SCI events that relate to market regulation or market surveillance systems and de minimis SCI events would not be subject to the information dissemination requirement.¹⁶¹³ Further, as noted above in Section IV.A, the Commission has refined the definition of SCI systems and SCI event in various respects.¹⁶¹⁴ Given these changes, the Commission believes that the commenter's suggestion that there would be at a minimum a ten-fold increase in reportable events as compared to the reported incidents under the ARP Inspection Program is not an appropriate estimate. The Commission now estimates that each SCI entity would disseminate information regarding 36 SCI events each year under Rule 1002(c),¹⁶¹⁵ including 1 non-de minimis systems intrusion each year.¹⁶¹⁶ Therefore, the Commission now estimates that each SCI entity would disseminate

¹⁶¹² See supra note 1596 and accompanying text.

¹⁶¹³ These exceptions should address a commenter's concern that proposed Rule 1000(b)(5) would result in SCI entities being forced to send their clients and participants a constant stream of communications detailing minor, inconsequential events that have no impact on them. See id.

¹⁶¹⁴ See Rule 1000 (defining "SCI systems" and "SCI event").

¹⁶¹⁵ As discussed above, the Commission estimates that each SCI entity will experience an average of 45 SCI events each year that are not de minimis SCI events. The Commission estimates that approximately one-fifth of these SCI events relate to market regulation and market surveillance systems. Therefore, the Commission estimates that the number of SCI events subject to the requirements of Rule 1002(c) would be 36 per year for each SCI entity (45 SCI events \div 5 \times 4 = 36 SCI events).

¹⁶¹⁶ Based on Commission's experience with the ARP Inspection Program, the Commission believes each SCI entity will experience on average less than one non-de minimis

information regarding 35 SCI events each year under Rule 1002(c)(1)(i). The Commission estimates that each SCI entity would disseminate 3 updates for each such SCI event under Rules 1002(c)(1)(ii) and (iii),¹⁶¹⁷ or 105 updates each year.¹⁶¹⁸ Further, the Commission estimates that each SCI entity would disseminate information regarding 1 systems intrusion each year under Rule 1002(c)(2).

The Commission estimates that each information dissemination under Rule 1002(c)(1)(i) will require 7 hours.¹⁶¹⁹ The Commission is not significantly increasing its burden estimate from

systems intrusion per year. However, for purposes of the PRA, the Commission estimates one non-de minimis systems intrusion per SCI entity per year.

¹⁶¹⁷ The Commission notes that Rule 1002(c)(1)(ii) requires each SCI entity, when known, to promptly further disseminate for each SCI event three types of information: (A) a detailed description of the SCI event; (B) the SCI entity's current assessment of the types and number of market participants potentially affected by the SCI event; and (C) a description of the progress of its corrective action for the SCI event and when the SCI event has been or is expected to be resolved. The Commission believes that one or more of these types of information may become known to an SCI entity at different times, and therefore the Commission estimates that each SCI entity will submit two updates per SCI event under Rule 1002(c)(1)(ii). Rule 1002(c)(1)(iii) requires each SCI entity to provide regular updates of any information required to be disseminated under Rules 1002(c)(1)(i) and (ii). The Commission estimates that each SCI entity will submit one regular update under Rule 1002(c)(1)(iii) before the SCI event is resolved. The Commission believes that the number of updates under Rules 1002(c)(1)(ii) and (iii) will vary depending on how quickly information is discovered and how quickly the SCI event is resolved, but believes that a total of three updates for the two provisions is an appropriate estimate.

¹⁶¹⁸ 35 SCI events × 3 updates per SCI event = 105 updates.

¹⁶¹⁹ The 7 hours include 2.67 hours by an Attorney, 1 hour by a Compliance Manager, 0.5 hours by a Chief Compliance Officer, 0.5 hours by a General Counsel, 0.5 hours by a Director of Compliance, 1 hour by a Senior Systems Analyst, 0.5 hours by a Corporate Communications Manager, and 0.33 hours by a Webmaster. As compared to the estimated burden for proposed Rule 1000(b)(5)(i)(A), the Commission is estimating an additional 1 hour by a Compliance Manager, 0.5 hours by a General Counsel, 0.5 hours by a Chief Compliance Officer, 0.5 hours by a Director of Compliance, 1 hour by a Senior Systems Analyst, and 0.5 hours by a Corporate Communications Manager to reflect the view of commenters that the preparation for information dissemination would require the involvement of subject matter experts and mid-level and senior managers. See supra notes 1597-1598 and accompanying text.

the proposal because the Commission believes that the information required to be disseminated under Rule 1002(c)(1)(i) would likely already be collected for Commission notification under Rule 1002(b)(1) or (2).¹⁶²⁰ Therefore, contrary to the view of a commenter,¹⁶²¹ the Commission does not believe that Rule 1002(c)(1)(i) will result in significantly higher burden for SCI entities than as estimated in the proposal. With respect to the view of a commenter that SCI entities would create different dissemination notices designed to address the concerns of different client segments,¹⁶²² the Commission notes that Rule 1002(c) only specifies the general information that must be disseminated and does not require that SCI entities provide different information to different clients, even though SCI entities can decide to tailor the information dissemination for their clients.¹⁶²³ Based on the foregoing, the Commission estimates that each SCI entity would

¹⁶²⁰ See also supra note 1594 and accompanying text (discussing the view of a commenter that since most of the work entailed in producing a notification relating to a dissemination SCI event would occur in connection with the Commission notification requirements under proposed Rule 1000(b)(4), the Commission's estimate of the burden of proposed Rule 1000(b)(5) is fairly accurate).

¹⁶²¹ See supra notes 1600-1601 and 1607 and accompanying text.

¹⁶²² See supra notes 1599-1601 and accompanying text.

¹⁶²³ This commenter also noted that the Commission did not take into account the burden associated with addressing responses from an SCI entity's participants, members, or clients. See supra note 1604 and accompanying text. The Commission believes that currently, SCI entities already notify affected members or participants of certain systems issues. The Commission also believes that information regarding many systems issues that fall under the definition of major SCI event is already made available to members or participants of an SCI entity, and often to the public through the press or otherwise. Therefore, the Commission does not believe that the burden to respond to members or participants will be significantly higher than SCI entities' current practices in the absence of Regulation SCI. The Commission also notes that Rule 1002(c) does not impose any requirements related to responding to inquiries about the information dissemination.

require an average of 245 hours annually to comply with Rule 1002(c)(1)(i),¹⁶²⁴ or 10,780 hours for all SCI entities.¹⁶²⁵

The Commission estimates that each update under Rules 1002(c)(1)(ii) and (iii) will require 13 hours.¹⁶²⁶ The Commission is not significantly increasing its burden estimate for proposed Rules 1000(b)(5)(i)(B) and (C) because the Commission believes that the information required to be disseminated under Rules 1002(c)(1)(ii) and (iii) would likely already be collected for Commission notification under Rules 1002(b)(2)-(4).¹⁶²⁷ Therefore, contrary to the view of a commenter,¹⁶²⁸ the Commission does not believe that Rules 1002(c)(1)(ii) and (iii) will result in significantly higher burden for SCI entities than as estimated in the SCI Proposal. Based on the foregoing, the Commission estimates that each SCI entity would require an average of 1,365 hours annually to comply with Rules 1002(c)(1)(ii) and (iii),¹⁶²⁹ or 60,060 hours for all SCI entities.¹⁶³⁰

¹⁶²⁴ 35 information dissemination each year \times 7 hours per dissemination = 245 hours.

¹⁶²⁵ 245 hours \times 44 SCI entities = 10,780 hours.

¹⁶²⁶ The 13 hours include 4.67 hours by an Attorney, 2 hours by a Compliance Manager, 1 hour by a Chief Compliance Officer, 1 hour by a General Counsel, 1 hour by a Director of Compliance, 2 hours by a Senior Systems Analyst, 1 hour by a Corporate Communications Manager, and 0.33 hours by a Webmaster. As compared to the estimated burden for proposed Rule 1000(b)(5)(i)(B), the Commission is estimating an additional 2 hours by a Compliance Manager, 1 hour by a General Counsel, 1 hour by a Chief Compliance Officer, 1 hour by a Director of Compliance, 2 hours by a Senior Systems Analyst, and 1 hour by a Corporate Communications Manager to reflect the view of commenters that the preparation for information dissemination would require the involvement of subject matter experts and mid-level and senior managers. See supra notes 1597-1598 and accompanying text.

¹⁶²⁷ See supra notes 1594 and 1620 accompanying text.

¹⁶²⁸ See supra notes 1605-1606 and accompanying text.

¹⁶²⁹ 105 updates each year \times 13 hours per update = 1,365 hours.

¹⁶³⁰ 1,365 hours \times 44 SCI entities = 60,060 hours.

The information required to be disseminated under Rule 1002(c)(2) for systems intrusions is similar to the information required to be disseminated under Rule 1002(c)(1)(i) in that both provisions require the dissemination of a summary description of an SCI event. Therefore, the Commission is using the burden estimate for Rule 1002(c)(1)(i) as the basis for its estimate for Rule 1002(c)(2). However, the Commission believes that Rule 1002(c)(2) will impose more burden than Rule 1002(c)(1)(i) because it also requires that the SCI entity determine whether dissemination of information regarding a particular systems intrusion would compromise the security of its SCI systems or indirect SCI systems, or an investigation of the systems intrusion, and if the SCI entity determines that it would, to document the reason for such determination.¹⁶³¹ Therefore, the Commission estimates that each SCI entity will spend an average of 10 hours to comply with Rule 1002(c)(2),¹⁶³² or 440 hours for all SCI entities.¹⁶³³

The Commission estimates that while SCI entities would handle internally some or most the work associated with compliance with Rule 1002(c),¹⁶³⁴ SCI entities would seek outside legal

¹⁶³¹ See Rule 1002(c)(2).

¹⁶³² The 10 hours include 3.67 hours by an Attorney, 1.5 hours by a Compliance Manager, 0.75 hours by a Chief Compliance Officer, 0.75 hours by a General Counsel, 0.75 hours by a Director of Compliance, 1.5 hour by a Senior Systems Analyst, 0.75 hours by a Corporate Communications Manager, and 0.33 hours by a Webmaster. See *supra* note 1619. The burden estimate for Rule 1002(c)(2) is approximately one and a half times the Commission's burden estimate for Rule 1002(c)(1)(i). (7 hours × 1.5 = 10.5 hours.)

¹⁶³³ 10 hours × 44 SCI entities = 440 hours.

¹⁶³⁴ The Commission recognizes that some SCI entities, such as certain SCI SROs, may have the in-house expertise to complete the work associated with compliance with Rule 1002(c), while other SCI entities may not and would therefore need to outsource some of the work associated with compliance with Rule 1002(c).

advice in the preparation of the information dissemination, at an average annual cost of \$36,000 per SCI entity,¹⁶³⁵ or \$1,584,000 for all SCI entities.¹⁶³⁶

c. Commission Notification of Material Systems Changes

In the SCI Proposal, the Commission estimated that each SCI entity would have an average of 60 planned material systems changes each year, resulting in 60 advance notifications per year.¹⁶³⁷ The Commission estimated that each notification would require 2 hours to prepare and submit.¹⁶³⁸ For SCI entities that currently participate in the ARP Inspection Program, the Commission estimated that these entities would start from a baseline of fifty percent.¹⁶³⁹ The Commission also estimated that the initial and ongoing burden to submit semi-annual reports to

¹⁶³⁵ The Commission is increasing its estimate of the outsourcing cost for compliance with Rule 1002(c) from its estimate in the proposal because its estimate of the number of information dissemination is higher than the estimated number in the proposal (i.e., from 15 to 36). In the SCI Proposal, the Commission estimated an outsourcing cost of \$15,000 for 15 SCI events, which results in an average cost of \$1,000 per SCI event. The Commission is continuing to estimate an average cost of \$1,000 per SCI event subject to information dissemination, but is increasing the total outsourcing cost to \$36,000 based on the increase in the number of estimated SCI events to 36. See also supra notes 1602-1603 and accompanying text (discussing the view of a commenter that SCI entities will likely engage outside counsel to review the facts and prepare the required documents to the extent an SCI event raises the possibility of litigation or reputational damage). But see supra note 1602 and accompanying text (discussing the view of a commenter that none of the activities arising under proposed Rule 1000(b)(5) would be conducive to outsourcing).

¹⁶³⁶ $\$36,000 \times 44 \text{ SCI entities} = \$1,584,000.$

¹⁶³⁷ See Proposing Release, supra note 13, at 18151. This estimate included instances where the information previously provided to the Commission regarding any planned material systems change becomes inaccurate. See id. at 18151, n. 431.

¹⁶³⁸ See id. at 18151. The 2 burden hours included 0.33 hours by an Attorney and 1.67 hours by a Senior Systems Analyst. See id. This estimate was based on Commission staff's experience with the ARP Inspection Program. In determining this estimate, the Commission also considered its burden estimate for the same reporting requirement that was proposed for SB SEFs. See id. at 18151, n. 432.

¹⁶³⁹ See id. at 18151.

the Commission pursuant to proposed Rule 1000(b)(8)(ii) would be 60 hours per report for each SCI entity.¹⁶⁴⁰

With respect to the estimated burden under proposed Rule 1000(b)(6), some commenters noted that the Commission underestimated the number of material systems changes.¹⁶⁴¹ For example, one commenter stated that, based on the proposed definition of material systems changes, each SCI entity could be reporting 60 material systems changes each week.¹⁶⁴² One commenter noted that the burden estimate was effectively limited to ministerial tasks of producing material systems change notifications and did not take into account activities necessary to gather the information needed, to have appropriate confirmations from persons with knowledge of the material systems change, to provide for senior management review where appropriate, and to otherwise be in a position to draft the notification.¹⁶⁴³ One commenter stated that the Commission's estimate of 2 hours for each material systems change notice is too low because describing systems changes "involves the work of a tech-writer, who needs to collaborate with multiple groups on a project team, including the project manager, application

¹⁶⁴⁰ See *id.* at 18152. The 60 burden hours included 10 hours by an Attorney and 50 hours by a Senior Systems Analyst. See *id.* This estimate was based on Commission staff's experience with the ARP Inspection Program. See *id.* at 18152, n. 440.

¹⁶⁴¹ See BATS Letter at 14. See also NYSE Letter at 26 (stating that if "material" were interpreted broadly to cover any functional change to an SCI system, the number of material systems changes could measure in the thousands); and OTC Markets Letter at 21 (stating that it estimated it had a minimum of 430 reportable changes to its production systems over a ten-month time frame based on the proposed notification standards for material systems changes).

¹⁶⁴² See BATS Letter at 14.

¹⁶⁴³ See MSRB Letter at 35.

development team and the testing and implementation teams.”¹⁶⁴⁴ Similarly, one commenter noted that material systems change notifications would require substantial review by IT management, relevant business supervisors, as well as compliance staff, which would increase the burden estimate at least three-fold.¹⁶⁴⁵ One commenter noted that, based on its experience under the ARP Inspection Program, each notice under proposed Rule 1000(b)(6) would require at least 62 hours.¹⁶⁴⁶ This commenter also opined that the Commission mistakenly assumed that only a senior systems analyst and an attorney would be involved in the drafting of the notice.¹⁶⁴⁷ According to this commenter, a number of subject matter experts would need to be involved in drafting and reviewing these notices (i.e., Project Management, Developments, Quality Assurance, Performance Testing, Systems Engineering, Systems Architecture, Capacity Planning, Information Security, Business Continuity, Disaster Recovery, Legal, and Compliance).¹⁶⁴⁸

¹⁶⁴⁴ See OCC Letter at 15. This commenter stated that a large amount of information needs to be assembled from different groups and consolidated into a single report, which would include, for example: (i) a high-level description of the functionality and configuration of the affected systems; (ii) a description of the systems development process; (iii) the relationship to other systems; (iv) changes to production schedules due to the planned system change; (v) any effects on capacity; (vi) a description of test results; (vii) a summary of test results; (viii) contingency protocols (i.e., fallback options and disaster recovery measures); (ix) vulnerability assessments and security measures; and (x) whether an SEC rule filing under Rule 19b-4 has been made in connection with the system change notification. See *id.* at 15-16. According to this commenter, unless the Commission intends for the scope of information provided with these notices to be limited to high level descriptions and generally less detailed, the preparation of material systems change notices generally requires considerably more time than estimated. See *id.* at 16.

¹⁶⁴⁵ See UBS Letter at 6.

¹⁶⁴⁶ See Omgeo Letter at 42.

¹⁶⁴⁷ See *id.*

¹⁶⁴⁸ See *id.* at 42-43.

On the other hand, one commenter stated that the Commission's estimate of the burden of proposed rule 1000(b)(8)(ii) is fairly accurate.¹⁶⁴⁹

One commenter stated its belief that none of the activities arising under proposed Rules 1000(b)(6) and (b)(8) would be conducive to outsourcing.¹⁶⁵⁰

As discussed in detail above in Section IV.B.4, the Commission is not adopting the requirement for SCI entities to provide 30-day advance notifications or semi-annual reports of material systems changes. Also as discussed in detail above in Section IV.B.4, the Commission is not adopting the proposed definition of material systems change. Adopted Rule 1003(a) requires each SCI entity to submit quarterly reports describing completed, ongoing, and planned material changes to its SCI systems and security of indirect SCI systems during the prior, current, and subsequent calendar quarters. Adopted Rule 1003(b) additionally requires each SCI entity to promptly submit a supplemental report notifying the Commission of a material error in or material omission from a report previously submitted under Rule 1003(a).

With respect to the comment that, based on the proposed definition of material systems change, each SCI entity could be reporting 60 material systems changes each week (rather than each year), the Commission notes that it has not adopted the proposed definition of material systems change.¹⁶⁵¹ Rather, as discussed above in Section IV.B.4, Rule 1003(a)(1) requires each SCI entity to establish reasonable criteria for identifying a change to its SCI systems and the security of indirect SCI systems as material. Because Rule 1003(a)(1) allows each SCI entity to identify material systems changes, it is responsive to commenters' concern that the proposed

¹⁶⁴⁹ See MSRB Letter at 37.

¹⁶⁵⁰ See *id.* at 36-37.

¹⁶⁵¹ See *supra* notes 1641-1642 and accompanying text.

definition was too broad and would result in an excessive number of notifications, and to commenters' suggestion that the definition should be revised. In particular, an SCI entity will have reasonable discretion in establishing the written criteria in order to capture the systems changes that it believes are material. Relatedly, with respect to commenters who specifically discussed the 30-day advance Commission notification requirement for material systems changes,¹⁶⁵² the Commission notes that it is not adopting a 30-day advance notification requirement for each material systems change and is instead adopting a quarterly reporting requirement. Therefore, the Commission does not believe that it is necessary to estimate the number of material systems changes that each SCI entity will experience each year in order to estimate the burden associated with Rule 1003(a).

As discussed above in Section IV.B.4, Rule 1003(a) requires quarterly reports on material systems changes and supplemental reports under certain circumstances. Specifically, the quarterly reports are required to include a description of the completed, ongoing, and planned material changes to SCI systems and the security of indirect SCI systems, during the prior, current, and subsequent calendar quarters, including the dates or expected dates of commencement and completion.¹⁶⁵³ The Commission notes that the quarterly reports under Rule

¹⁶⁵² See supra notes 1643-1648 and accompanying text.

¹⁶⁵³ Contrary to the views of a commenter, these quarterly reports are limited in scope and do not require a detailed description of each systems change that the SCI entity determines to be material. See supra note 1644 (discussing the concerns of a commenter that a large amount of information would need to be assembled and consolidated into a single report, and that unless the Commission intends for the scope of the information provided to be limited to high level descriptions and generally less detailed, the preparation of material systems change notices will require considerably more time than estimated). The Commission notes that it intends for the quarterly report to only require the information necessary to allow the Commission and its staff to gain a sufficient understanding of the relevant material systems changes, which would aid the Commission and its staff in understanding the operations and functionality of the systems of an SCI entity and

1003(a) are required to include similar information as the information required under proposed Rule 1000(b)(8)(ii).¹⁶⁵⁴ However, because the Commission is not requiring 30-day advance notification of each material systems change, SCI entities may need to spend more time to gather the information required to be included in the quarterly reports and to prepare the quarterly reports than the burden estimated for proposed Rule 1000(b)(8)(ii).¹⁶⁵⁵ Therefore, the Commission estimates that the initial and ongoing burden to comply with the quarterly reporting requirement would be 125 hours per report per SCI entity,¹⁶⁵⁶ or 500 hours annually per SCI

changes to such systems. Specifically, Rule 1003(a)(1) requires the quarterly report to “describe” the material systems changes and gives each SCI entity reasonable flexibility in how to describe it.

¹⁶⁵⁴ Proposed Rule 1000(b)(8)(ii) required semi-annual reports that include a summary description of the progress of any material systems changes during the six-month period ending on June 30 or December 31, and the date, or expected date, of completion of implementation of such changes.

¹⁶⁵⁵ At the same time, the Commission believes that most, if not all, SCI entities already have some internal procedures for documenting all systems changes.

¹⁶⁵⁶ In the SCI Proposal, the Commission preliminarily estimated 60 hours per semi-annual report. See Proposing Release, supra note 13, at 18152. The Commission believes that, although Rule 1003(a)(1) requires quarterly reports rather than semi-annual reports, the reporting burden should not be reduced because the quarterly reports would cover material systems changes during the prior, current, and subsequent calendar quarters. On the other hand, the proposed semi-annual reports would have only covered material systems changes during the previous 6 months. In addition, because the Commission is not requiring 30-day advance notification of each material systems change, SCI entities may need more time to gather the information required to be included in the quarterly reports and to prepare the quarterly reports. Therefore, the Commission believes that it is appropriate to increase by fifty percent its estimate for the proposed semi-annual reporting requirement and to add additional personnel in response to comment. But see supra note 1649 and accompanying text (discussing a commenter’s view that the Commission’s estimate of the burden under proposed Rule 1000(b)(8)(ii) is fairly accurate). The 125 burdens hours include 7.5 hours by an Attorney, 7.5 hours by a Compliance Manager, 5 hours by a Chief Compliance Officer, 30 hours by a Senior Business Analyst, and 75 hours by a Senior Systems Analyst. In addition to adding fifty percent to the estimated burden for proposed Rule 1000(b)(8)(ii), the Commission is estimating an additional 7.5 hours by a Compliance Manager (and decreasing the proposed burden estimate for Attorney from 10 hours to 7.5 hours), 5 hours by a Chief

entity¹⁶⁵⁷ and 22,000 hours annually for all SCI entities.¹⁶⁵⁸

With respect to the requirement under Rule 1003(a)(2) for supplemental material systems change reports, for purposes of this PRA analysis, the Commission estimates that most quarterly reports will not contain material errors or material omissions. Therefore, the Commission estimates that each SCI entity will submit 2 supplemental reports each year under Rule 1003(a)(2), in order to account for the few instances where a quarterly report must be corrected. The Commission estimates that the initial and ongoing burden to comply with the supplemental reporting requirement would be 15 hours per report per SCI entity,¹⁶⁵⁹ or 30 hours annually per SCI entity¹⁶⁶⁰ and 1,320 hours annually for all SCI entities.¹⁶⁶¹ The Commission believes that

Compliance Officer, and 30 hours by a Senior Business Analyst to address commenters' view that the estimates in the SCI Proposal did not take into account the activities to gather the information needed, to have appropriate confirmations from persons with knowledge of the material systems change, and to provide for senior management review where appropriate (even though some of these commenters commented on the burden estimate for proposed Rule 1000(b)(6) only). See supra notes 1643, 1645, 1647, and 1648 and accompanying text. The Commission notes that the inclusion of Senior Business Analyst and Senior Systems Analyst is intended to cover subject matter experts for material systems changes, as suggested by a commenter. See supra note 1648 and accompanying text.

¹⁶⁵⁷ 125 hours × 4 reports each year = 500 hours. The Commission recognizes that, to the extent an SCI entity develops a template for quarterly material systems change reports, the burden associated with creating future quarterly reports may be reduced.

¹⁶⁵⁸ 500 hours × 44 SCI entities = 22,000 hours.

¹⁶⁵⁹ The 15 burdens hours include 2 hours by an Attorney, 2 hours by a Compliance Manager, 1 hour by a Chief Compliance Officer, 3 hours by a Senior Business Analyst, and 7 hours by a Senior Systems Analyst. The Commission believes that the burden associated with supplemental material systems change reports will be substantially lower than the burden associated with quarterly material systems change reports, but the same type of personnel will be involved the supplemental report as the quarterly report.

¹⁶⁶⁰ 15 hours × 2 reports each year = 30 hours.

¹⁶⁶¹ 30 hours × 44 SCI entities = 1,320 hours.

SCI entities would handle internally the work associated with reports required under Rule 1003(a).¹⁶⁶²

d. SCI Review

In the SCI Proposal, the Commission estimated that the initial and ongoing burden of conducting an SCI review and submitting the SCI review to senior management for review would be approximately 625 hours for each SCI entity.¹⁶⁶³ The Commission also estimated that each SCI entity would spend 1 hour to submit the SCI review to the Commission pursuant to proposed Rule 1000(b)(8)(i).¹⁶⁶⁴

With respect to the burden associated with SCI reviews, one commenter stated that the Commission's estimate of the burden of proposed Rule 1000(b)(7) is fairly accurate.¹⁶⁶⁵ According to this commenter, although the burden estimate of proposed Rule 1000(b)(7) did not require the inclusion of senior management's response, the Commission's estimate is sufficient to cover the burden on senior management to produce such response.¹⁶⁶⁶

Another commenter noted that the Commission's estimate of the burden associated with SCI review is too low and that the SCI review will require over 1,200 burden hours.¹⁶⁶⁷ In connection with advocating for a risk-based approach for SCI reviews, one commenter noted that

¹⁶⁶² See *supra* note 1650 and accompanying text,

¹⁶⁶³ See *Proposing Release*, *supra* note 13, at 18151. The 625 burden hours included 80 hours by an Attorney, 170 hours by a Manager Internal Auditor, and 375 hours by a Senior Systems Analyst. See *id.* This estimate was the Commission's preliminary best estimate and was based on Commission staff's experience with the ARP Inspection Program. This estimate was also the same as the Commission's burden estimate for internal audits of SB SEFs. See *id.* at 18151, n. 437.

¹⁶⁶⁴ See *id.* at 18151. The 1 burden hour would be spent by an Attorney. See *id.*

¹⁶⁶⁵ See *MSRB Letter* at 36.

¹⁶⁶⁶ See *id.* at 37.

¹⁶⁶⁷ See *ISE Letter* at 12.

if it were to attempt to conduct all of the market-related technology application reviews that it currently conducts over four years during one year (excluding regulatory technology applications such as those related to member regulation), it would require approximately 6,400 to 8,320 hours.¹⁶⁶⁸ According to this commenter, significantly more resources would be required to conduct SCI reviews if the definition of SCI systems includes non-market regulatory and surveillance systems, and development and testing systems.¹⁶⁶⁹ One commenter noted that significant portions of the SCI review could be outsourced and that the Commission's estimate for the overall cost of outsourcing is reasonable, although some of the assumed hourly rates used in the SCI Proposal appear to be too low in the context of the current market environment.¹⁶⁷⁰

One commenter noted that the Commission's estimate did not take into account the additional work that would be required by many different SCI entity associates, including managers and subject matter experts, in order to satisfy the requirements of proposed Rule 1000(b)(7).¹⁶⁷¹ This commenter stated that the Commission incorrectly assumed that only an attorney, manager internal audit, and systems analyst would be required to work on the SCI review.¹⁶⁷² According to this commenter, subject matter expertise that would be needed to perform such a review includes Product Managers, Project Managers, Developers, Quality Assurance staff, Systems Engineers, Systems Architects, Capacity Planners, Information

¹⁶⁶⁸ See FINRA Letter at 40. According to this commenter, it currently spends approximately 160 hours for each review of a technology application in connection with its regulatory audits, and currently it reviews between 10 and 13 market-related technology applications annually. See id.

¹⁶⁶⁹ See id.

¹⁶⁷⁰ See MSRB Letter at 36.

¹⁶⁷¹ See Omgeo Letter at 44.

¹⁶⁷² See id.

Security experts, Business Continuity and Disaster Recovery staff, Compliance staff, and management.¹⁶⁷³ This commenter estimated that the annual burden under proposed Rule 1000(b)(7) would be 4,670 hours.¹⁶⁷⁴ According to this commenter, if the Commission intended SCI entities to conduct a broader scope review beyond those now required by the ARP Inspection Program, then the annual burden would be 11,199 hours.¹⁶⁷⁵ With respect to the burden estimate for proposed Rule 1000(b)(8)(i), one commenter stated that the estimate did not address the burden on senior management for reading, analyzing, and perhaps responding to the SCI review.¹⁶⁷⁶

As discussed above in Section IV.B.5, the Commission is adopting SCI review-related requirements in Rule 1003(b), with some modifications from the proposal. Specifically, Rule 1003(b)(1) requires each SCI entity to conduct an SCI review of its compliance with Regulation SCI not less than once each calendar year, with an exception for penetration test reviews, which are required to be conducted not less than once every three years.¹⁶⁷⁷ As adopted, Rule 1003(b)(1)(ii) provides an exception for assessments of SCI systems directly supporting market regulation or market surveillance, which are required to be reviewed at a frequency based on the risk assessment conducted as part of the SCI review, but in no case less than once every three

¹⁶⁷³ See id.

¹⁶⁷⁴ See id.

¹⁶⁷⁵ See id.

¹⁶⁷⁶ See id.

¹⁶⁷⁷ As proposed, the rule would have required penetration test reviews of the SCI entity's network, firewalls and development, testing, and production systems. However, consistent with modifications to the definition of SCI systems, references to development and test systems have been deleted in adopted Rule 1003(b)(1)(i).

years.¹⁶⁷⁸ Rules 1003(b)(2) and (3) require each SCI entity to submit a report of the SCI review to senior management no more than 30 calendar days after completion of the review, and to submit the report to the Commission and to the board of directors of the SCI entity or the equivalent of such board, together with any response by senior management, within 60 calendar days after its submission to senior management.

After considering the views of commenters, the Commission is not significantly increasing the burden estimate for compliance with Rules 1003(b)(1) and (2) from its estimates in the SCI Proposal. In particular, one commenter noted that the Commission's burden estimate for proposed Rule 1000(b)(7) was fairly accurate.¹⁶⁷⁹ Further, while other commenters advocated higher burden estimates for the SCI review requirement,¹⁶⁸⁰ the Commission notes that it has refined the definition of SCI systems (e.g., by eliminating development and testing systems, and focusing on market regulation and market surveillance systems) and has incorporated a risk-based approach to the frequency of testing for market regulation and market surveillance systems. The Commission estimates that the initial and ongoing burden of conducting an SCI review and submitting the SCI review to senior management of the SCI entity

¹⁶⁷⁸ These exceptions, along with the exclusion of development and testing systems from the definition of SCI systems, would address, at least in part, some commenters' concern regarding the scope of the definition of SCI systems and consequently the burden of the SCI review requirement. See *supra* notes 1669 and 1675 and accompanying text.

¹⁶⁷⁹ See *supra* note 1665 and accompanying text.

¹⁶⁸⁰ See *supra* notes 1667-1668 and 1675 and accompanying text. These commenters estimated a range of 1,200 to 8,320 burden hours. In response to the commenter that stated that it currently spends approximately 160 hours for each review of a technology application and it reviews between 10 and 13 market-related technology applications annually, the Commission notes that the burden estimates in this section only include the incremental burden associated with the rule above what the Commission estimates that SCI entities are already performing. To the extent an SCI entity already reviews certain of its systems, the additional burden imposed by Rule 1003(b) will be lower than for other SCI entities.

for review would be approximately 690 hours for each SCI entity,¹⁶⁸¹ and 30,360 hours annually for all SCI entities.¹⁶⁸² The Commission estimates that while SCI entities would handle internally some or most of the work associated with compliance with Rule 1003(b),¹⁶⁸³ SCI entities would outsource some of the work associated with an SCI review, at an average annual cost of \$50,000 per SCI entity,¹⁶⁸⁴ or \$2,200,000 for all SCI entities.¹⁶⁸⁵

¹⁶⁸¹ The 690 hours include 80 hours by an Attorney, 35 hours by a Compliance Manager, 5 hours by a General Counsel, 20 hours by a Chief Compliance Officer, 5 hours by a Director of Compliance, 170 hours by a Manager Internal Audit, and 375 hours by a Senior Systems Analyst. As compared to the estimated burden for proposed Rule 1000(b)(7), the Commission is estimating an additional 35 hours by a Compliance Manager, 5 hours by a General Counsel, 20 hours by a Chief Compliance Officer, and 5 hours by a Director of Compliance, to reflect the view of commenters that managers would be involved in satisfying the requirements related to SCI review. See supra notes 1671-1675 and accompanying text. The Commission notes that the 20-hour burden estimate for the Chief Compliance Officer includes the time spent by other members of the senior management team (other than the General Counsel, who has a separate burden estimate). See supra Section IV.B.5 (discussing senior management involvement in compliance with Rule 1003(b)). The Commission notes that the inclusion of Manager Internal Audit and Senior Systems Analyst is intended to cover subject matter experts related to systems review (e.g., information security experts, systems engineers, quality assurance staff). See supra notes 1671-1675 and accompanying text. The Commission also believes that some SCI entities already conduct annual reviews of its systems, and therefore may incur less burden than other SCI entities in complying with Rule 1003(b).

¹⁶⁸² 690 hours × 44 SCI entities = 30,360 hours.

¹⁶⁸³ As noted above, one commenter suggested that significant portions of the SCI review may be outsourced. This commenter also noted that the Commission's estimate of the overall cost of outsourcing is reasonable, although it believed some of the assumed hourly rates appear to be too low in the context of current market environment. See supra note 1670 and accompanying text. The Commission acknowledges that some SCI entities may outsource work related to SCI review to more expensive outside firms than others. On average, the Commission believes its hourly rate of \$400 for outsourcing continues to be appropriate.

¹⁶⁸⁴ 125 hours × \$400 = \$50,000. The Commission believes that SCI entities may outsource some of the legal and audit work associated with an SCI review. In particular, the Commission estimates that, on average, an SCI entity will outsource 40 hours of legal work and 85 hours of audit work (or half of the hour burden estimates for Attorney and Manager Internal Audit). See supra note 1681.

With respect to the comment that the burden estimate for proposed Rule 1000(b)(8)(i) failed to account for the burden on senior management for reviewing and responding to the report of the SCI review,¹⁶⁸⁶ the Commission notes that proposed Rule 1000(b)(8)(i) and adopted Rule 1003(b)(3) do not require senior management to respond to the report of the SCI review. Rather, Rule 1003(b)(3) only requires an SCI entity to submit the already prepared report of the SCI review, and response by senior management if there was any, to the Commission and to the board of directors of the SCI entity or the equivalent of such board. Moreover, the Commission is including in its burden estimate for Rules 1003(b)(1) and (2) the burden for senior management review of the report for the SCI review. Therefore, with respect to Rule 1003(b)(3), the Commission estimates that each SCI entity would require 1 hour per year to submit the report of the SCI review and any response by senior management to the Commission and to the board of directors of the SCI entity or the equivalent of such board,¹⁶⁸⁷ for a burden of 44 hours for all SCI entities.¹⁶⁸⁸

e. Access to EFFS

¹⁶⁸⁵ \$50,000 × 44 SCI entities = \$2,200,000

¹⁶⁸⁶ See supra notes 1666 and 1676 and accompanying text. One of these commenters, however, noted that the Commission's estimated burden for proposed Rule 1000(b)(7) is fairly accurate, even though it did not include senior management's response. See supra notes 1665-1666 and accompanying text.

¹⁶⁸⁷ The 1 hour would be spent by an Attorney. This estimate is unchanged from the burden estimate for proposed Rule 1000(b)(8)(i), which only required submission of the report and any response by senior management to the Commission. The Commission believes that the additional burden for submitting the same report and response to the SCI entity's board of directors or the equivalent of such board would be modest, and thus the estimate of one hour remains unchanged from the burden estimate for proposed Rule 1000(b)(8)(i), which required submission of the report and response by senior management only to the Commission.

¹⁶⁸⁸ 1 hour × 44 SCI entities = 44 hours.

As noted above, to access EFFS, an SCI entity will submit to the Commission an EAUF to register each individual at the SCI entity who will access the EFFS system on behalf of the SCI entity. The Commission is including in its burden estimates the burden for completing the EAUF for each individual at an SCI entity that will request access to EFFS. The Commission estimates that initially, on average, two individuals at each SCI entity will request access to EFFS through the EAUF, and each EAUF would require 0.15 hours to complete and submit. Therefore, each SCI entity would initially require 0.3 hours to complete the requisite EAUFs,¹⁶⁸⁹ or approximately 13 hours for all SCI entities.¹⁶⁹⁰ The Commission also estimates that annually, on average, one individual at each SCI entity will request access to EFFS through EAUF.¹⁶⁹¹ Therefore, the ongoing burden to complete the EAUF would be 0.15 hours annually for each SCI entity,¹⁶⁹² or approximately 7 hours annually for all SCI entities.¹⁶⁹³

In addition, the Commission estimates that each SCI entity will designate two individuals to sign Form SCI each year. An individual signing a Form SCI must obtain a digital ID, at the

¹⁶⁸⁹ 0.15 hours per EAUF × 2 individuals = 0.3 hours per SCI entity. These estimates are based on Commission staff's experience with EFFS and EAUFs pursuant to Rule 19b-4 under the Exchange Act. The 0.15 hours would be spent by an Attorney. The Commission acknowledges that an SCI SRO may initially submit fewer than two EAUFs because certain individuals at SCI SROs currently already have access to EFFS, whereas an SCI entity other than an SCI SRO may submit more than two EAUFs initially because it has not previously submitted filings through EFFS. Therefore, the Commission believes it is appropriate to estimate that, on average, each SCI entity will submit two EAUFs initially.

¹⁶⁹⁰ 0.30 hours × 44 SCI entities = 13.2 hours.

¹⁶⁹¹ The Commission estimates that annually, on average, one individual at each SCI entity will request access to EFFS through EAUF to account for the possibility that an individual who previously had access to EFFS may no longer be designated as needing such access.

¹⁶⁹² 0.15 hours per EAUF × 1 individual = 0.15 hours.

¹⁶⁹³ 0.15 hours × 44 entities = 6.6 hours.

cost of approximately \$25 each year. Therefore, each SCI entity would require approximately \$50 annually to obtain digital IDs for the individuals with access to EFFS for purposes of signing Form SCI,¹⁶⁹⁴ or approximately \$2,200 for all SCI entities.¹⁶⁹⁵

3. Requirements to Take Corrective Actions and Identify Critical SCI Systems, Major SCI Events, De Minimis SCI Events, and Material Systems Changes

The rules under Regulation SCI that would result in SCI entities establishing additional processes for compliance are discussed more fully in Sections IV.A, IV.B.3.b, and IV.B.4 above.

a. Corrective Actions

In the SCI Proposal, the Commission noted that, although SCI entities already take corrective action in response to systems issues, proposed Rule 1000(b)(3) would likely result in SCI entities revising their policies regarding taking corrective actions.¹⁶⁹⁶ The Commission estimated that the initial burden would be 42 hours per SCI entity,¹⁶⁹⁷ and the ongoing burden would be 12 hours annually per SCI entity.¹⁶⁹⁸ The Commission estimated that SCI entities would establish the process for compliance with proposed Rule 1000(b)(3) internally.¹⁶⁹⁹

¹⁶⁹⁴ \$25 per digital ID × 2 individuals = \$50 per SCI entity.

¹⁶⁹⁵ \$50 × 44 SCI entities = \$2,200.

¹⁶⁹⁶ See Proposing Release, *supra* note 13, at 18152.

¹⁶⁹⁷ See *id.* The 42 burden hours included 16 hours by a Compliance Manager, 16 hours by an Attorney, 5 hours by a Senior Systems Analyst, and 5 hours by an Operations Specialist. See *id.* This estimate was based on the Commission's burden estimate for proposed Rule 1000(b)(1). See *id.* at 18152, n. 442.

¹⁶⁹⁸ See *id.* at 18152. The 12 burden hours included 6 hours by a Compliance Manager and 6 hours by an Attorney. See *id.* This estimate was based on the Commission's burden estimate for proposed Rule 1000(b)(1). See *id.* at 18152, n. 443.

¹⁶⁹⁹ See *id.* at 18152, n. 442.

One commenter stated its belief that basing the estimate for proposed Rule 1000(b)(3) on the percentage of the burden estimate under proposed Rule 1000(b)(1) is appropriate.¹⁷⁰⁰ This commenter also noted that while the taking of corrective action might be wholly or partially outsourced with regard to systems development activities, the establishment of policies and procedures with respect to corrective action would not be conducive to outsourcing.¹⁷⁰¹

As discussed in detail above in Section IV.B.3.b, the Commission continues to require each SCI entity to begin to take appropriate corrective action in Rule 1002(a), but the corrective action requirement is triggered when any responsible SCI personnel has a reasonable basis to conclude that an SCI event has occurred.¹⁷⁰² The Commission continues to believe that all SCI entities, regardless of whether they participate in the ARP Inspection Program, already take corrective action in response to systems issues and have some internal processes with respect to corrective action.¹⁷⁰³ The Commission also continues to believe that Rule 1002(a) will likely result in SCI entities revising their policies, which will help to ensure that their information technology staff has the ability to access systems in order to take appropriate corrective actions.¹⁷⁰⁴ The Commission therefore believes that Rule 1002(a) may impose a one-time implementation burden on SCI entities associated with developing such a process, and periodic burdens in reviewing that process. The Commission estimates that the initial burden to

¹⁷⁰⁰ See MSRB Letter at 31-32.

¹⁷⁰¹ See id. at 32.

¹⁷⁰² See Rule 1002(a).

¹⁷⁰³ See Proposing Release, supra note 13, at 18152.

¹⁷⁰⁴ See id.

implement such a process would be 114 hours per SCI entity,¹⁷⁰⁵ or 5,016 hours for all SCI entities.¹⁷⁰⁶ The Commission also estimates that the ongoing burden to review such a process would be 39 hours annually per SCI entity,¹⁷⁰⁷ or 1,716 hours annually for all SCI entities.¹⁷⁰⁸

¹⁷⁰⁵ This estimate is based on the Commission's burden estimate for Rule 1001(a), because Rule 1001(a) and Rule 1002(a) both would result in policies and procedures or processes. As noted above, one commenter stated that basing the burden estimate for proposed Rule 1000(b)(3) on the burden estimate under proposed Rule 1000(b)(1) is appropriate. See supra note 1700 and accompanying text. Because Rule 1001(a) (excluding Rule 1001(a)(2)(vi)) requires the establishment of six policies and procedures at a minimum and Rule 1002(a) would result in the establishment of one set of policies and procedures, the Commission estimates that the initial staff burden to draft the policies and procedures for Rule 1002(a) is one-sixth of the initial staff burden to draft the policies and procedures required by Rule 1001(a) (excluding Rule 1001(a)(2)(vi)). $504 \text{ hours} \div 6 = 84 \text{ hours}$. The 84 burden hours include 32 hours by a Compliance Manager, 32 hours by an Attorney, 10 hours by a Senior Systems Analyst, and 10 hours by an Operations Specialist. This burden hour allocation is based on the allocation for Rule 1001(a) (excluding Rule 1001(a)(2)(vi)). See supra note 1443. The Commission also estimates that a Chief Compliance Officer will spend 20 hours and a Director of Compliance will spend 10 hours reviewing the policies and procedures required by Rule 1002(a). $84 \text{ hours} + \text{Chief Compliance Officer at } 20 \text{ hours} + \text{Director of Compliance at } 10 \text{ hours} = 114 \text{ hours}$.

¹⁷⁰⁶ $114 \text{ hours} \times 44 \text{ SCI entities} = 5,016 \text{ hours}$.

¹⁷⁰⁷ This estimate is based on the Commission's burden estimate for Rule 1001(a), because Rule 1001(a) and 1002(a) both would result in policies and procedures or processes. See supra note 1700 and accompanying text (stating that basing the burden estimate for proposed Rule 1000(b)(3) on the burden estimate under proposed 1000(b)(1) is appropriate). Because Rule 1001(a) (excluding Rule 1001(a)(2)(vi)) requires the maintenance of six policies and procedures at a minimum and 1002(a) would result in the maintenance of one set of policies and procedures, the Commission estimates that the ongoing staff burden under 1002(a) is one-sixth of the ongoing staff burden under Rule 1001(a) (excluding Rule 1001(a)(2)(vi)). $144 \text{ hours} \div 6 = 24 \text{ hours}$. The 24 burden hours include 9 hours by a Compliance Manager, 9 hours by an Attorney, 3 hours by a Senior Systems Analyst, and 3 hours by an Operations Specialist. This burden hour allocation is based on the allocation for Rule 1001(a) (excluding Rule 1001(a)(2)(vi)). See supra note 1445. The Commission also estimates that a Chief Compliance Officer will spend 10 hours and a Director of Compliance will spend 5 hours reviewing the policies and procedures required by Rule 1002(a). $24 \text{ hours} + \text{Chief Compliance Officer at } 10 \text{ hours} + \text{Director of Compliance at } 5 \text{ hours} = 39 \text{ hours}$.

¹⁷⁰⁸ $39 \text{ hours} \times 44 \text{ SCI entities} = 1,716 \text{ hours}$.

The Commission continues to believe that SCI entities will conduct internally most of the work related to their corrective action procedures. As noted by a commenter, the establishment of policies and procedures with respect to corrective action would not be conducive to outsourcing.¹⁷⁰⁹

b. Identification of Critical SCI Systems, Major SCI Events, De Minimis SCI Events, and Material Systems Changes

In the SCI Proposal, the Commission estimated that requirements under the proposal with respect to immediate notification SCI events and dissemination SCI events may impose burdens on SCI entities in developing and reviewing a process to ensure that they are able to quickly and correctly make a determination regarding the nature of an SCI event.¹⁷¹⁰ For SCI entities that do not participate in the ARP Inspection Program, the Commission estimated that the initial burden would be 42 hours per SCI entity¹⁷¹¹ and the ongoing burden would be 12 hours annually per SCI entity.¹⁷¹² For SCI entities that currently participate in the ARP Inspection Program, the Commission estimated that the initial burden would be 21 hours per SCI entity¹⁷¹³ and the

¹⁷⁰⁹ See supra note 1701 and accompanying text.

¹⁷¹⁰ See Proposing Release, supra note 13, at 18152.

¹⁷¹¹ See id. at 18153. The 42 burden hours included 16 hours by a Compliance Manager, 16 hours by an Attorney, 5 hours by a Senior Systems Analyst, and 5 hours by an Operations Specialist. See id. This estimate was based on the Commission's burden estimate for proposed Rule 1000(b)(1). See id. at 18153, n. 448.

¹⁷¹² See id. at 18153. The 12 burden hours included 6 hours by a Compliance Manager and 6 hours by an Attorney. See id. This estimate was based on the Commission's burden estimate for proposed Rule 1000(b)(1). See id. at 18153, n. 452.

¹⁷¹³ See id. at 18153. The 21 burden hours included 8 hours by a Compliance Manager, 8 hours by an Attorney, 2.5 hours by a Senior Systems Analyst, and 2.5 hours by an Operations Specialist. See id.

ongoing burden would be 6 hours annually per SCI entity.¹⁷¹⁴ The Commission believed that SCI entities would internally establish the process for determining whether an SCI event is an immediate notification SCI event or dissemination SCI event.¹⁷¹⁵

One commenter stated its belief that the Commission's burden estimate for policies and procedures to identify an SCI event as an immediate notification SCI event or dissemination SCI event was effectively limited to ministerial tasks of producing such policies and procedures in isolation from other organizational activities and needs, and took into account only minimal supervisory or decision-making activities, therefore significantly underestimated the total burden of compliance with this provision.¹⁷¹⁶ This commenter urged the Commission to adjust the estimate in a manner similar to this commenter's suggestion with regard to proposed Rules 1000(b)(1) and (2).¹⁷¹⁷

As discussed above in Section IV.B.4, Rule 1003(a)(1) requires each SCI entity to establish reasonable written criteria for identifying a change to its SCI systems and the security of indirect SCI systems as material. As noted in the SCI Proposal, because the ARP Inspection Program already provides for the reporting "significant systems changes" to Commission staff, the Commission believes that, as compared to entities that do not participate in the ARP Inspection Program, entities that currently participate in the ARP Inspection Program would already have some internal processes for determining the significance of a systems issue or systems change. Therefore, the Commission continues to estimate a 50% baseline for the staff

¹⁷¹⁴ See *id.* The 6 burden hours included 3 hours by a Compliance Manager and 3 hours by an Attorney. See *id.*

¹⁷¹⁵ See *id.* at 18153, n. 448, n. 450, n. 452, and n. 454.

¹⁷¹⁶ See MSRB Letter at 32.

¹⁷¹⁷ See *id.*

burden estimates for SCI entities that currently participate in the ARP Inspection Program.¹⁷¹⁸ However, the Commission does not believe that a 50% baseline would be appropriate for these SCI entities in terms of senior management review. The Commission believes that, although these entities already have some internal processes for determining the significance of a systems change, their senior management would require the same number of hours as other SCI entities to review and ensure that the process is reasonable, as required by Rule 1003(a)(1). The Commission continues to believe that SCI entities will internally establish and maintain the policies and procedures required by Rule 1003(a)(1).

The Commission estimates that each SCI entity that does not participate in the ARP Inspection Program would require 114 hours initially to establish the criteria for identifying material systems changes,¹⁷¹⁹ or 1,596 hours for all such SCI entities.¹⁷²⁰ The Commission also

¹⁷¹⁸ The 50% baseline for ARP participants is consistent with the baseline for the Rule 1001(a) burden estimates.

¹⁷¹⁹ This estimate is based on the Commission's burden estimate for Rule 1001(a), because Rule 1001(a) and Rule 1003(a)(1) both require policies and procedures or processes. See supra note 1700 and accompanying text (stating, in the context of proposed Rule 1000(b)(3), that basing the burden estimate for a set of policies and procedures or processes on the burden estimate under proposed 1000(b)(1) is appropriate). Because Rule 1001(a) (excluding Rule 1001(a)(2)(vi)) requires the establishment of six policies and procedures at a minimum and Rule 1003(a)(1) requires the establishment of one set of criteria, the Commission estimates that the initial staff burden to draft the criteria required by Rule 1003(a)(1) is one-sixth of the initial staff burden to draft the policies and procedures required by Rule 1001(a) (excluding Rule 1001(a)(2)(vi)). $504 \text{ hours} \div 6 = 84 \text{ hours}$. The 84 burden hours include 32 hours by a Compliance Manager, 32 hours by an Attorney, 10 hours by a Senior Systems Analyst, and 10 hours by an Operations Specialist. This burden hour allocation is based on the allocation for Rule 1001(a) (excluding Rule 1001(a)(2)(vi)). See supra note 1443. The Commission also estimates that a Chief Compliance Officer will spend 20 hours and a Director of Compliance will spend 10 hours reviewing the policies and procedures required by Rule 1003(a)(1). $84 \text{ hours} + \text{Chief Compliance Officer at } 20 \text{ hours} + \text{Director of Compliance at } 10 \text{ hours} = 114 \text{ hours}$.

estimates that each SCI entity that does not participate in the ARP Inspection Program would require 39 hours annually to review and update the criteria for identifying material systems changes,¹⁷²¹ or 546 hours for all such SCI entities.¹⁷²² The Commission estimates that each SCI entity that currently participates in the ARP Inspection Program would require 72 hours initially to establish the criteria for identifying material systems changes,¹⁷²³ or 2,160 hours for all such SCI entities.¹⁷²⁴ The Commission also estimates that each SCI entity that currently participates

¹⁷²⁰ 114 hours × 14 SCI entities that do not participate in the ARP Inspection Program = 1,596 hours.

¹⁷²¹ This estimate is based on the Commission's burden estimate for Rule 1001(a), because Rule 1001(a) and Rule 1003(a)(1) both require policies and procedures or processes. See supra note 1700 and accompanying text (stating, in the context of proposed Rule 1000(b)(3), that basing the burden estimate for a set of policies and procedures or processes on the burden estimate under proposed 1000(b)(1) is appropriate). Because Rule 1001(a) (excluding Rule 1001(a)(2)(vi)) requires the maintenance of six policies and procedures at a minimum and Rule 1003(a)(1) requires the maintenance of one set of criteria, the Commission estimates that the ongoing staff burden under 1003(a)(1) is one-sixth of the ongoing staff burden under Rule 1001(a) (excluding Rule 1001(a)(2)(vi)). 144 hours ÷ 6 = 24 hours. The 24 burden hours include 9 hours by a Compliance Manager, 9 hours by an Attorney, 3 hours by a Senior Systems Analyst, and 3 hours by an Operations Specialist. This burden hour allocation is based on the allocation for Rule 1001(a) (excluding Rule 1001(a)(2)(vi)). See supra note 1445. The Commission also estimates that a Chief Compliance Officer will spend 10 hours and a Director of Compliance will spend 5 hours reviewing the policies and procedures required by Rule 1003(a)(1). 24 hours + Chief Compliance Officer at 10 hours + Director of Compliance at 5 hours = 39 hours.

¹⁷²² 39 hours × 14 SCI entities that do not participate in the ARP Inspection Program = 546 hours.

¹⁷²³ 84 hours ÷ 2 = 42 hours. The 42 burden hours include 16 hours by a Compliance Manager, 16 hours by an Attorney, 5 hours by a Senior Systems Analyst, and 5 hours by an Operations Specialist. The Commission also estimates that a Chief Compliance Officer will spend 20 hours and a Director of Compliance will spend 10 hours reviewing the policies and procedures required by Rule 1003(a)(1). 42 hours + Chief Compliance Officer at 20 hours + Director of Compliance at 10 hours = 72 hours.

¹⁷²⁴ 72 hours × 30 SCI entities that participate in the ARP Inspection Program = 2,160 hours.

in the ARP Inspection Program would require 27 hours annually to review and update the criteria,¹⁷²⁵ or 810 hours for all such SCI entities.¹⁷²⁶

As adopted, Regulation SCI requires SCI entities to identify certain types of events, systems, and changes. Specifically, Rule 1000 defines “critical SCI systems” as any SCI systems of, or operated by or on behalf of, an SCI entity that: (a) directly support functionality relating to (1) clearance and settlement systems of clearing agencies; (2) openings, reopenings, and closings on the primary listing market; (3) trading halts; (4) initial public offerings; (5) the provision of consolidated market data; or (6) exclusively-listed securities; or (b) provide functionality to the securities markets for which the availability of alternatives is significantly limited or nonexistent and without which there would be a material impact on fair and orderly markets. Rule 1000 defines “major SCI event” as an SCI event that has had, or the SCI entity reasonably estimates would have any impact on a critical SCI system or a significant impact on the SCI entity’s operations or on market participants. Because Rule 1001(a)(2)(v) requires business continuity and disaster recovery plans that are reasonably designed to achieve two-hour resumption of critical SCI systems following a wide-scale disruption, each SCI entity needs to identify its critical SCI systems. In addition, each SCI entity needs to identify its critical SCI systems because the definition of major SCI event includes an SCI event that has had, or the SCI entity reasonably estimates would have, any impact on a critical SCI system. Further, when an

¹⁷²⁵ 24 hours ÷ 2 = 12 hours. The 12 burden hours include 4.5 hours by a Compliance Manager, 4.5 hours by an Attorney, 1.5 hours by a Senior Systems Analyst, and 1.5 hours by an Operations Specialist. The Commission also estimates that a Chief Compliance Officer will spend 10 hours and a Director of Compliance will spend 5 hours reviewing the policies and procedures required by Rule 1003(a)(1). 12 hours + Chief Compliance Officer at 10 hours + Director of Compliance at 5 hours = 27 hours.

¹⁷²⁶ 27 hours × 30 SCI entities that participate in the ARP Inspection Program = 810 hours.

SCI event occurs, an SCI entity needs to determine whether the event is a major SCI event, because Rule 1002(c)(3) requires an SCI entity to disseminate information regarding major SCI events to all of its member or participants. In addition, Rules 1002(b) and (c) provide certain exceptions from the Commission notification and information dissemination requirements for any SCI event that has had, or the SCI entity reasonably estimates would have, no or a de minimis impact on the SCI entity's operations or on market participants. Therefore, when SCI events occur, an SCI entity needs to determine whether they are de minimis SCI events.

The Commission believes that the identification of critical SCI systems, major SCI events, and de minimis SCI events will impose an initial one-time implementation burden on SCI entities in developing processes to quickly and correctly identify the nature of a system or event.¹⁷²⁷ The identification of these systems and events may also impose periodic burdens on SCI entities in reviewing and updating the processes. As noted in the SCI Proposal, because the ARP Inspection Program already provides for the reporting "significant systems changes" and "significant systems outages" to Commission staff, the Commission believes that, as compared to entities that do not participate in the ARP Inspection Program, entities that currently participate in the ARP Inspection Program would already have some internal processes for determining the significance of a systems issue or systems change. Therefore, the Commission estimates a 50% baseline for the staff burden for SCI entities that currently participate in the ARP Inspection Program.¹⁷²⁸ However, the Commission does not believe that a 50% baseline

¹⁷²⁷ The Commission's approach with respect to SCI events and SCI systems is responsive to some commenters' suggestion for a risk-based regime. See, e.g., supra notes 784-789 and accompanying text (discussing commenters' suggestions for revising the Commission reporting requirement).

¹⁷²⁸ The 50% baseline for ARP participants is consistent with the baseline for the Rule 1001(a) burden estimates.

would be appropriate for these SCI entities in terms of senior management review. The Commission believes that SCI entities will internally establish and maintain the policies and procedures regarding the identification of critical SCI systems, major SCI events, and de minimis SCI events.

The Commission estimates that each SCI entity that does not participate in the ARP Inspection Program would require 198 hours initially to establish the criteria for identifying certain systems and events,¹⁷²⁹ or 2,772 hours for all such SCI entities.¹⁷³⁰ The Commission also estimates that each SCI entity that does not participate in the ARP Inspection Program would require 63 hours annually to review and update such criteria,¹⁷³¹ or 882 hours for all such SCI

¹⁷²⁹ This estimate is based on the Commission's burden estimate for Rule 1001(a), because Rule 1001(a) and the identification of certain systems and events both would result in policies and procedures or processes. See *supra* note 1700 and accompanying text (stating, in the context of proposed Rule 1000(b)(3), that basing the burden estimate for a set of policies and procedures or processes on the burden estimate under proposed 1000(b)(1) is appropriate). Because Rule 1001(a) (excluding Rule 1001(a)(2)(vi)) requires the establishment of six policies and procedures at a minimum and the identification of certain systems and events could result in the establishment of two policies and procedures (*i.e.*, one for systems and one for events), the Commission estimates that the initial staff burden to draft the policies and procedures to identify certain systems and events is one-third of the initial staff burden to draft the policies and procedures required by Rule 1001(a) (excluding Rule 1001(a)(2)(vi)). $504 \text{ hours} \div 3 = 168 \text{ hours}$. The 168 burden hours include 64 hours by a Compliance Manager, 64 hours by an Attorney, 20 hours by a Senior Systems Analyst, and 20 hours by an Operations Specialist. This burden hour allocation is based on the allocation for Rule 1001(a) (excluding Rule 1001(a)(2)(vi)). See *supra* note 1443. The Commission also estimates that a Chief Compliance Officer will spend 20 hours and a Director of Compliance will spend 10 hours reviewing the policies and procedures to identify certain systems and events. $168 \text{ hours} + \text{Chief Compliance Officer at } 20 \text{ hours} + \text{Director of Compliance at } 10 \text{ hours} = 198 \text{ hours}$.

¹⁷³⁰ $198 \text{ hours} \times 14 \text{ SCI entities that do not participate in the ARP Inspection Program} = 2,772 \text{ hours}$.

¹⁷³¹ This estimate is based on the Commission's burden estimate for Rule 1001(a), because Rule 1001(a) and the identification of certain systems and events both would result in policies and procedures or processes. See *supra* note 1700 and accompanying text

entities.¹⁷³² The Commission estimates that each SCI entity that currently participates in the ARP Inspection Program would require 114 hours initially to establish the criteria for identifying certain systems and events,¹⁷³³ or 3,420 hours for all such SCI entities.¹⁷³⁴ The Commission also estimates that each SCI entity that currently participates in the ARP Inspection Program would require 39 hours annually to review and update such criteria,¹⁷³⁵ or 1,170 hours for all such SCI

(stating, in the context of proposed Rule 1000(b)(3), that basing the burden estimate for a set of policies and procedures or processes on the burden estimate under proposed 1000(b)(1) is appropriate). Because Rule 1001(a) (excluding Rule 1001(a)(2)(vi)) requires the maintenance of six policies and procedures at a minimum and the identification of certain systems and events could result in the maintenance of two policies and procedures, the Commission estimates that the ongoing staff burden to draft the policies and procedures to identify certain systems and events is one-third of the ongoing staff burden under Rule 1001(a) (excluding Rule 1001(a)(2)(vi)). $144 \text{ hours} \div 3 = 48 \text{ hours}$. The 48 burden hours include 18 hours by a Compliance Manager, 18 hours by an Attorney, 6 hours by a Senior Systems Analyst, and 6 hours by an Operations Specialist. This burden hour allocation is based on the allocation for Rule 1001(a) (excluding Rule 1001(a)(2)(vi)). See *supra* note 1445. The Commission also estimates that a Chief Compliance Officer will spend 10 hours and a Director of Compliance will spend 5 hours reviewing the policies and procedures for identifying certain systems and events. $48 \text{ hours} + \text{Chief Compliance Officer at } 10 \text{ hours} + \text{Director of Compliance at } 5 \text{ hours} = 63 \text{ hours}$.

¹⁷³² $63 \text{ hours} \times 14 \text{ SCI entities that do not participate in the ARP Inspection Program} = 882 \text{ hours}$.

¹⁷³³ $168 \text{ hours} \div 2 = 84 \text{ hours}$. The 84 burden hours include 32 hours by a Compliance Manager, 32 hours by an Attorney, 10 hours by a Senior Systems Analyst, and 10 hours by an Operations Specialist. The Commission also estimates that a Chief Compliance Officer will spend 20 hours and a Director of Compliance will spend 10 hours reviewing the policies and procedures for identifying certain systems and events. $84 \text{ hours} + \text{Chief Compliance Officer at } 20 \text{ hours} + \text{Director of Compliance at } 10 \text{ hours} = 114 \text{ hours}$.

¹⁷³⁴ $114 \text{ hours} \times 30 \text{ SCI entities that participate in the ARP Inspection Program} = 3,420 \text{ hours}$.

¹⁷³⁵ $48 \text{ hours} \div 2 = 24 \text{ hours}$. The 24 burden hours include 9 hours by a Compliance Manager, 9 hours by an Attorney, 3 hours by a Senior Systems Analyst, and 3 hours by an Operations Specialist. The Commission also estimates that a Chief Compliance Officer will spend 10 hours and a Director of Compliance will spend 5 hours reviewing the policies and procedures for identifying certain systems and events. $24 \text{ hours} + \text{Chief Compliance Officer at } 10 \text{ hours} + \text{Director of Compliance at } 5 \text{ hours} = 39 \text{ hours}$.

entities.¹⁷³⁶ The Commission believes that the revised burden estimates for establishing policies and procedures to identify certain systems and events are responsive to a commenter's concern that the estimate in the SCI Proposal only included ministerial tasks and minimal supervisory activities.¹⁷³⁷ Specifically, the Commission increased from the proposal the estimated burden hours for the personnel involved in establishing such policies and procedures, and included senior level review by adding burden estimates for the Chief Compliance Officer and Director of Compliance. Moreover, because these revised burden estimates are based on the revised burden estimates for Rule 1001(a), these estimates are responsive to a commenter's suggestion that they be revised in a manner similar to its suggestions with respect to proposed Rules 1000(b)(1) and (2).¹⁷³⁸

4. Recordkeeping Requirements

In the SCI Proposal, the Commission noted that it is not proposing a new recordkeeping requirement for SCI SROs because the documents relating to compliance with proposed Regulation SCI are subject to their existing recordkeeping and retention requirements under Rule 17a-1 under the Act.¹⁷³⁹ The Commission therefore noted its belief that the proposed recordkeeping requirements would not result in any burden that is not already accounted for in the Commission's burden estimates for Rule 17a-1.¹⁷⁴⁰ With respect to SCI entities other than SCI SROs, the Commission estimated that the initial and ongoing burdens to make, keep, and preserve records relating to compliance with proposed Regulation SCI would be approximately

¹⁷³⁶ 39 hours × 30 SCI entities that participate in the ARP Inspection Program = 1,170 hours.

¹⁷³⁷ See supra note 1716 and accompanying text.

¹⁷³⁸ See supra note 1717 and accompanying text.

¹⁷³⁹ See Proposing Release, supra note 13, at 18153.

¹⁷⁴⁰ See id.

25 hours annually per SCI entity.¹⁷⁴¹ The Commission also estimated that each SCI entity other than an SCI SRO would incur a one-time burden to set up or modify an existing recordkeeping system to comply with the proposed recordkeeping requirements.¹⁷⁴² Specifically, the Commission estimated that for each SCI entity other than an SCI SRO, setting up or modifying a recordkeeping system would create an initial burden of 170 hours and \$900 in information technology costs for purchasing recordkeeping software.¹⁷⁴³ Further, the Commission noted its belief that proposed Rule 1000(c)(3), which would require an SCI entity, upon or immediately prior to ceasing to do business or ceasing to be registered under the Exchange Act, to take all necessary action to ensure that the records required to be made, kept, and preserved by Rules 1000(c)(1) and (2) remain accessible to the Commission and its representatives in the manner and for the remainder of the period required by Rule 1000(c), would not result in any additional paperwork burden that is not already accounted for in the Commission's burden estimates for proposed Rules 1000(c)(1) and (2).¹⁷⁴⁴

One commenter noted that while proposed Rule 1000(c) does not create new recordkeeping requirements for SCI SROs, the number of records to be retained by an SRO

¹⁷⁴¹ See id. at 18154. The 25 burden hours would be spent by a Compliance Clerk. See id. This estimate was based on Commission staff's experience with examinations of registered entities, the Commission's estimated burden for an SRO to comply with Rule 17a-1, and the Commission's estimated burden for a SB SEF to keep and preserve documents made or received in the conduct of its business. See id. at 18154, n. 458.

¹⁷⁴² See id. at 18154.

¹⁷⁴³ See id. These estimates were based on the Commission's experience with examinations of registered entities and the Commission's estimated burden for an SB SEF to keep and preserve documents made or received in the conduct of its business. See id. at 18154, n. 460.

¹⁷⁴⁴ See id. at 18154.

would increase due to proposed Regulation SCI.¹⁷⁴⁵ This commenter stated that such additional recordkeeping is not costless and should be considered by the Commission.¹⁷⁴⁶

As discussed in detail above in Section IV.C.1.a, the Commission is adopting the recordkeeping requirements substantially as proposed. The Commission notes that the burden associated with creating such records, as required of all SCI entities, including SCI SROs, by Regulation SCI, are discussed and accounted for throughout this Section V.

With respect to SCI SROs, the breadth of Rule 17a-1 under the Exchange Act¹⁷⁴⁷ is such that it requires SCI SROs to make, keep, and preserve records relating to their compliance with Regulation SCI.¹⁷⁴⁸ SCI entities that participate in the ARP Inspection Program (nearly all of whom are SCI SROs) do generally keep and preserve the types of records that are subject to the requirements of Rule 1005. However, because Regulation SCI imposes new requirements on SROs, as noted by a commenter, the number of records to be retained by an SRO may increase.¹⁷⁴⁹ The Commission believes that existing recordkeeping systems and processes of SCI SROs will be used to retain the records required to be created pursuant to Regulation SCI. As a result, the Commission believes that the burden associated with retaining these additional records is an incrementally small increase in the burden currently incurred by SROs to retain

¹⁷⁴⁵ See MSRB Letter at 39.

¹⁷⁴⁶ See id.

¹⁷⁴⁷ “Every national securities exchange, national securities association, registered clearing agency and the Municipal Securities Rulemaking Board shall keep and preserve at least one copy of all documents, including all correspondence, memoranda, papers, books, notices, accounts, and other such records as shall be made or received by it in the course of its business as such and in the conduct of its self-regulatory activity.” Exchange Act Rule 17a-1(a), 17 CFR 240.17a-1(a).

¹⁷⁴⁸ See also Rule 1005(a).

¹⁷⁴⁹ See supra notes 1745-1746 and accompanying text.

records as required by Rule 17a-1 and that the burden associated with retaining records related to Regulation SCI is already accounted for in the Commission's burden estimates for Rule 17a-1.¹⁷⁵⁰

The Commission continues to believe that for SCI entities other than SCI SROs, the initial and ongoing burden to make, keep, and preserve records relating to compliance with Regulation SCI, as required by Rule 1005(b), would be approximately 25 hours annually per SCI entity that is not an SCI SRO.¹⁷⁵¹ Therefore, the Commission estimates a total annual burden of 425 hours for all such SCI entities.¹⁷⁵² The Commission also continues to estimate that each SCI entity other than an SCI SRO would incur a one-time burden to set up or modify an existing recordkeeping system to comply with Rule 1005. Specifically, the Commission estimates that, for each SCI entity other than an SCI SRO, setting up or modifying a recordkeeping system would create an initial burden of 170 hours and \$900 in information technology costs for purchasing software.¹⁷⁵³ Therefore, the Commission estimates a total initial burden of 3,315 hours¹⁷⁵⁴ and a total initial cost of \$15,300 for all such SCI entities.¹⁷⁵⁵

¹⁷⁵⁰ See Supporting Statement for the Paperwork Reduction Act Information Collection Submissions for Rule 17a-1, available at: <http://www.reginfo.gov>.

¹⁷⁵¹ See Proposing Release, *supra* note 13, at 18154, n. 458.

¹⁷⁵² 25 hours × 17 non-SRO SCI entities = 425 hours.

¹⁷⁵³ See Proposing Release, *supra* note 13, at 18154, n. 460. The Commission believes that this burden estimate includes the burden imposed by Rule 1007. Specifically, Rule 1007 provides that, if the records required to be filed or kept by an SCI entity under Regulation SCI are prepared or maintained by a service bureau or other recordkeeping service on behalf of the SCI entity, the SCI entity would be required to ensure that the records are available for review by the Commission and its representatives by submitting a written undertaking, in a form acceptable to the Commission, by such service bureau or other recordkeeping service, which is signed by a duly authorized person at such service bureau or other recordkeeping service.

¹⁷⁵⁴ (170 hours + 25 hours) × 17 non-SRO SCI entities = 3,315 hours.

Finally, the Commission continues to believe that Rule 1005(c), which requires an SCI entity, upon or immediate prior to ceasing to do business or ceasing to be registered under the Exchange Act, to take all necessary action to ensure that the records required to be made, kept, and preserved by Rule 1005 remain accessible to the Commission and its representatives in the manner and for the remainder of the period required by Rule 1005, would not result in any additional paperwork burden that is not already accounted for in the Commission's burden estimates for Rule 1005(b).¹⁷⁵⁶

5. Total Paperwork Burden under Regulation SCI

Based on the foregoing, the Commission estimates that the total one-time initial burden for all SCI entities to comply with Regulation SCI would be 330,508 hours¹⁷⁵⁷ and the total one-time initial cost would be approximately \$9.3 million.¹⁷⁵⁸ The Commission estimates that the total annual ongoing burden for all SCI entities to comply with Regulation SCI would be 287,722 hours¹⁷⁵⁹ and the total annual ongoing cost would be approximately \$5.9 million.¹⁷⁶⁰

¹⁷⁵⁵ \$900 × 17 non-SRO SCI entities = \$15,300.

¹⁷⁵⁶ The Commission believes that SCI entities will comply with Rule 1005(c) by, for example, a contractual arrangement with a recordkeeping service.

¹⁷⁵⁷ 330,508 hours = 54,992 hours (policies and procedures, mandate participation in certain testing) + 257,237 (notification, dissemination, reporting) + 14,964 hours (corrective action, identification of certain systems and events, identification of material systems changes) + 3,315 hours (recordkeeping).

¹⁷⁵⁸ \$9,325,500 = \$3,544,000 (policies and procedures, mandate participation in certain testing) + \$5,766,200 (notification, dissemination, reporting) + \$15,300 (recordkeeping).

¹⁷⁵⁹ 287,722 hours = 24,942 hours (policies and procedures, mandate participation in certain testing) + 257,231 (notification, dissemination, reporting) + 5,124 hours (corrective action, identification of certain systems and events, identification of material systems changes) + 425 hours (recordkeeping).

¹⁷⁶⁰ \$5,874,200 = \$108,000 (mandate participation in certain testing) + \$5,766,200 (notification, dissemination, reporting). One commenter noted that majority of the estimated paperwork burden in the SCI Proposal relate to notifications of SCI events,

E. Collection of Information is Mandatory

All collections of information pursuant to Regulation SCI is a mandatory collection of information.

F. Confidentiality

The Commission expects that the written policies and procedures, processes, criteria, standards, or other written documents developed or revised by SCI entities pursuant to Regulation SCI will be retained by SCI entities in accordance with, and for the periods specified in Exchange Act Rule 17a-1 and Rule 1005, as applicable. Should such documents be made available for examination or inspection by the Commission and its representatives, they would be kept confidential subject to the provisions of applicable law.¹⁷⁶¹ In addition, the information submitted to the Commission pursuant to Regulation SCI that is filed on Form SCI, as required by Rule 1006, will be treated as confidential, subject to applicable law, including amended Rule 24b-2.¹⁷⁶² The information disseminated by SCI entities pursuant to Rule 1002(c) under Regulation SCI to their members or participants will not be confidential.

rather than the writing and maintenance of the policies and procedures. See NYSE Letter at 18. This commenter noted that creating and maintaining reasonable policies and procedure to seek to ensure that important market systems have adequate levels of capacity, integrity, resiliency, availability, and security should be the main focus of the regulation, not the reporting provisions. See NYSE Letter at 18. The Commission notes that the burden estimates in this section relate solely to the paperwork burden of compliance with Regulation SCI. The Commission discusses other costs associated with compliance with Regulation SCI in the Economic Analysis section below.

¹⁷⁶¹ See, e.g., 15 U.S.C. 78x (governing the public availability of information obtained by the Commission); 5 U.S.C. 552 et seq.

¹⁷⁶² See, e.g., 15 U.S.C. 78x (governing the public availability of information obtained by the Commission); 5 U.S.C. 552 et seq. See also supra Section IV.C.2 (discussing confidentiality treatment for Form SCI filings).

G. Reduced Burden from Amendment of Rule 301(b)(6) (OMB Control Number 3235-0509)

Adopted Regulation SCI amends Rule 301(b)(6) of Regulation ATS.¹⁷⁶³ Amendment of Rule 301(b)(6) would eliminate certain collection of information requirements within the meaning of the PRA, which the Commission had submitted to OMB in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11 and OMB had approved. The approved collection of information is titled "Rule 301: Requirements for Alternative Trading Systems and Form ATS; ATS-R," and the OMB control number for this collection of information is 3235-0509.¹⁷⁶⁴

Some of the information collection burdens imposed by Regulation ATS would be reduced by the amendment of Rule 301(b)(6). Specifically, the paperwork burdens that would be eliminated by the amendment of Rule 301(b)(6) would be: (i) burdens on ATSS that trade NMS stocks and non-NMS stocks associated with the requirement to make records relating to any steps taken to comply with systems capacity, integrity and security requirements under Rule

¹⁷⁶³ See 17 CFR 242.301(b)(6). See also Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) ("ATS Release"). In the SCI Proposal, the Commission proposed that Regulation SCI would replace and supersede Rule 301(b)(6) in its entirety. As discussed above, the Commission is now amending Rule 301(b)(6) to remove paragraphs (i)(A) and (i)(B) so that Rule 301(b)(6) will no longer apply to ATSS that trade NMS stocks and non-NMS stocks. However, as described above, the Commission has determined to exclude ATSS that trade only municipal securities or corporate debt securities from the scope of Regulation SCI, and such ATSS will remain subject to the requirements of Rule 301(b)(6) if they meet the volume thresholds therein. The Commission estimates that no ATS that trade only municipal securities or corporate debt securities currently meet the thresholds of Rule 301(b)(6).

¹⁷⁶⁴ See Rule 301: Requirements for Alternative Trading Systems and Form ATS; ATS-R, OMB Control No: 3235-0509 (Rule 301 supporting statement), available at: <http://www.reginfo.gov>. This approval has an expiration date of April 30, 2017.

301(b)(6) (estimated to be 20 hours);¹⁷⁶⁵ and (ii) burdens on ATSS that trade NMS stocks and non-NMS stocks associated with the requirement to provide notices to the Commission to report systems outages (estimated to be 2.5 hours).¹⁷⁶⁶ The Commission received no comments regarding the reduced paperwork burdens from the proposal to repeal Rule 301(b)(6) of Regulation ATS.

VI. Economic Analysis

A. Overview

The Commission is sensitive to the economic effects, including the costs and benefits, of its rules. When engaging in rulemaking pursuant to the Exchange Act that requires the Commission to consider or determine whether an action is necessary or appropriate in the public interest, Section 3(f) of the Exchange Act requires the Commission to consider, in addition to the

¹⁷⁶⁵ The Commission estimated that two alternative trading systems that register as broker-dealers and comply with Regulation ATS would trigger this requirement, and that the average compliance burden for each response would be 10 hours of in-house professional work at \$379 per hour. Thus, the total compliance burden per year was estimated to be 20 hours (2 respondents × 10 hours = 20 hours). See Rule 301: Requirements for Alternative Trading Systems OMB Control No: 3235-0509 (Rule 301 supporting statement), available at: <http://www.reginfo.gov>. As discussed above, the Commission is amending Rule 301(b)(6) so that it will no longer apply to ATSS that trade NMS stocks and non-NMS stocks. ATSS that trade only municipal securities or corporate debt securities will remain subject to the requirements of Rule 301(b)(6), but the Commission estimates that no such ATS currently meets the thresholds of Rule 301(b)(6).

¹⁷⁶⁶ The Commission estimated that two alternative trading systems that register as broker-dealers and comply with Regulation ATS would meet the volume thresholds that trigger systems outage notice obligations approximately 5 times a year, and that the average compliance burden for each response would be .25 hours of in-house professional work at \$379 per hour. Thus, the total compliance burden per year was estimated to be 2.5 hours (2 respondents × 5 responses each × .25 hours = 2.5 hours). See *id.* As discussed above, the Commission is amending Rule 301(b)(6) so that it will no longer apply to ATSS that trade NMS stocks and non-NMS stocks. ATSS that trade only municipal securities or corporate debt securities will remain subject to the requirements of Rule 301(b)(6), but the Commission estimates that no such ATS currently meets the thresholds of Rule 301(b)(6).

protection of investors, whether the action will promote efficiency, competition, and capital formation.¹⁷⁶⁷ In addition, Section 23(a)(2) of the Exchange Act requires the Commission in making rules pursuant to the Exchange Act to consider the impact any such rule would have on competition. The Exchange Act prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.¹⁷⁶⁸

In the SCI Proposal, the Commission solicited comment on the economic effects of the proposed rules, including any effects that the proposed rules may have on efficiency, competition, and capital formation. The Commission also solicited comment on its representation of current practices and its characterization of the relevant markets in which SCI entities participate. In addition, the Commission solicited comment on reasonable alternatives to the proposed rules and their economic effects. The Commission encouraged commenters to identify, discuss, analyze, and supply relevant data, information, or statistics regarding any economic effects.

The Commission received many comment letters that addressed the Commission's economic analysis of the proposed rules.¹⁷⁶⁹ As described further below, some commenters stated that the Commission underestimated the costs (including, for example, the proposed rules'

¹⁷⁶⁷ 15 U.S.C. 78c(f).

¹⁷⁶⁸ 15 U.S.C. 78w(a)(2).

¹⁷⁶⁹ See, e.g., Tellefsen Letter; Angel Letter; MSRB Letter; OCC Letter; BIDS Letter; ISE Letter; Leuchtkafer Letter; Better Markets Letter; CAST Letter; FINRA Letter; CISQ Letter; Fidelity Letter; CME Letter; Omgeo Letter; Lauer Letter; SIFMA Letter; SunGard Letter; NYSE Letter; BATS Letter; FIA PTG Letter; ITG Letter; KCG Letter; UBS Letter; Joint SROs Letter; and TMC Letter.

potential to impact innovation and create barriers to entry) of compliance with Regulation SCI.¹⁷⁷⁰ Other commenters believed that the costs are justified by the benefits of the rules.¹⁷⁷¹

As discussed above in Section I, a confluence of factors has contributed to the Commission's determination that it is necessary and appropriate at this time to address the technological vulnerabilities, and improve Commission oversight, of the core technology of key U.S. securities markets entities, including national securities exchanges and associations, significant ATSS, clearing agencies, and plan processors. These considerations include: the evolution of the markets to become significantly more dependent on sophisticated, complex, and interconnected technology; the current successes and limitations of the ARP Inspection Program; the significant number of, and lessons learned from, recent systems issues at exchanges and other trading venues,¹⁷⁷² including increased concerns over "single points of failure" in the securities markets; and the views of a wide variety of commenters received in response to the SCI Proposal.

Regulation SCI codifies, updates, and expands the existing ARP Inspection Program in an effort to further the goals of the national market system. Regulation SCI is intended to help to ensure the capacity, integrity, resiliency, availability, and security of the automated systems of entities important to the functioning of the U.S. securities markets. Regulation SCI is also

¹⁷⁷⁰ See, e.g., BIDS Letter at 2-3; NYSE Letter at 2; UBS Letter at 5; and Omgeo Letter at 2.

¹⁷⁷¹ See, e.g., Lauer Letter at 7 (commenting that cost burden should not be an appropriate reason to omit an SCI entity and that, if the burden to ensure secure, stable systems is too high for an entity, that entity should not be allowed to be in a position to impact the market); and Better Markets Letter at 9-12 (commenting that the Commission's preeminent duty when promulgating rules is to protect investors and the public interest, and these goals should not be subordinate to industry concerns over the cost of regulation).

¹⁷⁷² See supra note 15 and accompanying text.

intended to strengthen the U.S. securities market infrastructure and improve the resilience of the U.S. securities markets when technological issues arise. Moreover, Regulation SCI is intended to reinforce the requirement that SCI entities operate their systems in compliance with the Exchange Act and the rules and regulations thereunder.

As adopted, Regulation SCI will apply to SCI SROs (including national securities exchanges,¹⁷⁷³ national securities associations,¹⁷⁷⁴ registered clearing agencies, and the MSRB), SCI ATSS, plan processors, and certain exempt clearing agencies.¹⁷⁷⁵ As such, Regulation SCI covers the trading of NMS stocks, OTC equities, and listed options. As discussed below, Regulation SCI also will impact multiple markets for services, including the markets for trading services, listing services, regulation and surveillance services, clearance and settlement services, and market data.

B. Economic Baseline

The Commission recognizes that any economic effects, including costs and benefits and effects on efficiency, competition, and capital formation, should be compared to a baseline that accounts for current practices. The description of current practices below is based, among other things, on the Commission's understanding of the current practices under the ARP Inspection Program (including current practices influenced by staff guidance related to the ARP Inspection Program), the requirements under Regulation ATS, rules of SROs, information provided by

¹⁷⁷³ Regulation SCI will not apply to an exchange that lists or trades security futures products that is notice-registered with the Commission as a national securities exchange pursuant to Section 6(g) of the Exchange Act, including security futures exchanges. See supra note 78 and accompanying text.

¹⁷⁷⁴ Regulation SCI will not apply to limited purpose national securities associations registered with the Commission pursuant to Section 15A(k) of the Exchange Act. See supra note 78 and accompanying text.

¹⁷⁷⁵ See supra Section IV.A.1 (discussing the definition of SCI entities).

commenters, and current practices and staff guidance related to systems compliance-related issues.

As noted above, all active registered clearing agencies, all registered national securities exchanges, FINRA, two plan processors, one ATS, and one exempt clearing agency currently participate in the ARP Inspection Program. Under the ARP Policy Statements and through the ARP Inspection Program, these entities, among other things, are expected to establish current and future capacity estimates; conduct capacity stress tests; and conduct annual reviews that cover significant elements of the operations of the automation process, including the capacity planning and testing process, contingency planning, systems development methodology, and vulnerability assessments. When conducting an ARP inspection, Commission staff also evaluates whether an ARP entity's controls over its information technology resources in nine general areas, or information technology "domains," is consistent with ARP and industry guidelines.¹⁷⁷⁶ The ARP Policy Statements and staff letters also address, among other things, the reporting of certain systems changes, intrusions, and outages, and the need to comply with relevant laws and rules.¹⁷⁷⁷ Many participants in the ARP Inspection Program have developed current practices that to some extent overlap with the requirements of Regulation SCI. These practices are discussed in more detail throughout this economic analysis.

The ARP Policy Statements and the ARP Inspection Program address systems that directly support trading, clearance and settlement, order routing, and market data, which are a

¹⁷⁷⁶ See supra Section II.A (discussing the ARP Policy Statements and Commission staff letters).

¹⁷⁷⁷ See id.

subset of the systems covered by Regulation SCI.¹⁷⁷⁸ Additionally, Commission staff currently inspects all the categories of systems that are included in the adopted definition of “SCI systems” to varying degrees.¹⁷⁷⁹ In general, the Commission believes that, to varying degrees, entities participating in the ARP Inspection Program establish current and future capacity estimates, conduct periodic capacity stress tests, and conduct an annual independent assessment of whether their automated systems can perform adequately at their estimated capacity levels and whether these systems have adequate protection against threats.¹⁷⁸⁰ Additionally, entities participating in the ARP Inspection Program provide to the Commission and its staff reports relating to system changes and reviews, as well as information regarding systems outages.

In addition, as discussed above, pursuant to Rule 301(b)(6) of Regulation ATS, certain aspects of the ARP Policy Statements apply to ATSS that meet the thresholds set forth in that rule.¹⁷⁸¹ Currently, the Commission believes that only one ATS meets such thresholds and, thus, is required by Commission rule to implement systems safeguard measures. There is also one ATS that voluntarily participates in the ARP Inspection Program. Rule 301(b)(6) of Regulation

¹⁷⁷⁸ See infra note 1900 and accompanying text.

¹⁷⁷⁹ Commission staff inspects systems that are not directly related to trading, clearance and settlement, order routing, or market data if staff detects red flags. See Proposing Release, supra note 13, at 18158.

¹⁷⁸⁰ See ARP I Release and ARP II Release, supra note 1.

¹⁷⁸¹ Specifically, Rule 301(b)(6) of Regulation ATS applies to ATSS that, during at least four of the preceding six months, had: (A) with respect to any NMS stock, 20 percent or more of the average daily volume reported by an effective transaction reporting plan; (B) with respect to equity securities that are not NMS stocks and for which transactions are reported to a self-regulatory organization, 20 percent or more of the average daily volume as calculated by the self-regulatory organization to which such transactions are reported; (C) with respect to municipal securities, 20 percent or more of the average daily volume traded in the United States; or (D) with respect to corporate debt securities, 20 percent or more of the average daily volume traded in the United States. See 17 CFR 242.301(b)(6)(i).

ATS includes requirements that are similar to the requirements underlying the policies and procedures required by Rule 1001(a)(2) of Regulation SCI. Specifically, Rule 301(b)(6) under Regulation ATS requires relevant ATSs to establish certain capacity estimates, conduct periodic capacity stress tests of critical systems, develop and implement reasonable procedures to review and keep current systems development and testing methodology, review the vulnerability of their systems and data center computer operations to specified threats, establish adequate contingency and disaster recovery plans, conduct an independent review of its systems controls annually for ensuring that Rules 301(b)(6)(ii)(A)-(E) are met and conduct a review by senior management of a report of the independent review, and promptly notify the Commission of certain systems outages and systems changes. Rule 301(b)(6) of Regulation ATS, however, applies only to systems that support order entry, order routing, order execution, transaction reporting, and trade comparison,¹⁷⁸² which is more targeted than the adopted definition of “SCI system.”

The Commission recognizes that market participants that do not participate in the ARP Inspection Program and are not subject to Regulation ATS also take measures consistent with certain aspects of Regulation SCI to avoid systems disruptions, compliance issues, and intrusions. For example, the Commission believes that many market participants document systems events as prudent and standard business practice, even when the entity is not an ARP participant or does not report the incident as an ARP participant. Additionally, commenters provided information about their practices for maintaining suitable levels of systems capacity, integrity, resiliency, availability, and security. As discussed in Section IV.B.1, the Commission understands that some SCI entities are already following technology standards such as ISO

¹⁷⁸² See 17 CFR 242.301(b)(6)(ii).

27000 and COBIT.¹⁷⁸³ One commenter also stated that NFPA-1600 or BS 25999 was useful for contingency planning.¹⁷⁸⁴ Commenters also provided less specific information on current practices that allow the Commission to gauge current practices. For example, one commenter stated that SCI entities commonly review a variety of different standards for frameworks or best practices, and then adopt a derivative of multiple standards, customizing them for the systems at issue.¹⁷⁸⁵ In addition, another commenter stated that the financial services industry currently uses processes for software development that are more “nimble” than the frameworks listed in Table A, such as the NIST publication under the Systems Development Methodology domain.¹⁷⁸⁶

FINRA members, including ATSS, are also subject to FINRA rules that are generally related to certain aspects of Regulation SCI.¹⁷⁸⁷ For example, 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. However, this NASD rule does not specifically address compliance of the systems of FINRA members and does not cover more broadly policies

¹⁷⁸³ See text accompanying supra note 606.

¹⁷⁸⁴ See ISE Letter at 11.

¹⁷⁸⁵ See NYSE Letter at 20.

¹⁷⁸⁶ See BATS Letter at 6-7 (commenting that the NIST publication reflects a burdensome staged process to software development that favors the “waterfall methodology” over “agile” software development).

¹⁷⁸⁷ See supra note 115. As noted above, although these rules have some broad relation to certain aspects of Regulation SCI, the Commission is not persuaded that the rules, even when taken together, are an appropriate substitute for the comprehensive approach in Regulation SCI with respect to technology systems and system issues. See id.

and procedures relating to operational capability. Additionally, FINRA Rule 3130 requires a member's chief compliance officer to certify that the member has in place written policies and procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules, and federal securities laws and regulations. Again, this FINRA rule does not specifically address compliance of the systems of FINRA members and does not cover more broadly policies and procedures relating to operational capability. Further, FINRA Rule 4530 imposes a reporting regime for, among other things, compliance issues and other events where a member has concluded or should have reasonably concluded that a violation of securities or other enumerated law, rule, or regulation of any domestic or foreign regulatory body or SRO has occurred. However, the reporting requirements of FINRA Rule 4530 are different in several respects from the Commission notification requirements under Regulation SCI relating to systems compliance issues (e.g., scope, timing, content, the recipient of the reports) and would not cover reporting of systems disruptions or systems intrusions that did not also involve a violation of a securities law, rule, or regulation. In addition, FINRA Rule 4370 generally requires that a member maintain a written continuity plan identifying procedures relating to an emergency or significant business disruption. However, as compared to adopted Rules 1001(a)(2)(v) and 1004, this FINRA rule does not include a requirement that the business continuity and disaster recovery plans be reasonably designed to achieve next business day resumption of trading and two-hour resumption of critical SCI systems following a wide-scale disruption, nor does it require the functional and performance testing and coordination of industry or sector-testing of such plans.

Commenters addressed the Commission's consideration of current practices under the ARP Inspection Program as part of the baseline. According to a commenter, the ARP Inspection

Program was implemented many years ago in a series of policy statements setting out guidance for voluntary compliance, and was supplemented with informal Commission staff guidance over the years, in many cases before the relevant systems existed.¹⁷⁸⁸ This commenter also noted that Regulation SCI is a mandatory regulation with a more expansive nature, differentiating the proposed regulation from the voluntary, targeted scope of the ARP Inspection Program.¹⁷⁸⁹ Some commenters believed that the Commission performed the economic analysis from a faulty premise by assuming that SCI entities that participate in the ARP Inspection Program have been in compliance with the voluntary standards and that the cost of compliance with Regulation SCI would merely be incremental as compared with the current baseline cost of voluntary compliance with the ARP regime.¹⁷⁹⁰ One commenter noted that there is no publicly available information on voluntary compliance under the ARP Inspection Program, and the Commission should calculate the actual cost based on its knowledge of the extent to which SCI entities currently participating in the ARP Inspection Program are actually in compliance with ARP, rather than simply assuming full compliance.¹⁷⁹¹

In response to these comments, the Commission believes that current practices under the ARP Inspection Program continue to be relevant in an economic assessment of Regulation SCI and the current baseline. In particular, as described in more detail throughout the economic

¹⁷⁸⁸ See NYSE Letter at 2, 6-7. This commenter noted that the ARP Inspection Program was never subject to Commission rulemaking, including notice and public comment, and a cost-benefit analysis. See *id.* at 6. This commenter further stated that if the Commission were to move forward with Regulation SCI, it should first engage in a detailed public analysis of the costs and benefits of the existing ARP Inspection Program. See *id.* at 2.

¹⁷⁸⁹ See *id.* at 6.

¹⁷⁹⁰ See ISE Letter at 11; and Joint SROs Letter at 18.

¹⁷⁹¹ See ISE Letter at 11.

analysis, based on comments and staff experience, the Commission believes that ARP entities have developed practices that to some extent overlap with the requirements of Regulation SCI. Accordingly, the Commission believes that, for some entities, the economic effects associated with compliance with Regulation SCI will be less significant as these entities will need to make incremental adjustments to their current practices to comply with many of the requirements.

The Commission recognizes that there is no publicly available information on voluntary compliance under the ARP Inspection Program. At the same time, the Commission and its staff have overseen the ARP Inspection Program for over two decades and notes that participants in the ARP Inspection Program generally follow the ARP Policy Statements. The Commission also notes that, in the ARP II Release, it stated that Commission staff and the SROs have discussed the independent review process, "taking into account that the SROs already engage in testing and quality assurance reviews of new or modified systems, and that there are other significant controls in place to prevent, detect or correct problems in such areas as capacity planning, testing, systems development, vulnerability and contingency planning."¹⁷⁹² The Commission is not assuming in the economic analysis that each SCI entity is fully in compliance with the ARP Inspection Program. Rather, the Commission's and its staff's experience informs the Commission's view regarding the range of existing practices of SCI entities. The Commission recognizes that some participants in the ARP Inspection Program may also have adopted practices that are not precisely in line with the standards articulated in the ARP Policy Statements and other Commission policy statements. As discussed throughout this economic analysis, the Commission has considered what the economic effects, including the costs and benefits of complying with Regulation SCI, will be for those entities that may not have practices

¹⁷⁹² See ARP II, *supra* note 1, at 22491.

consistent with the standards articulated in the ARP Policy Statements. For example, some SRO backup facilities may be less geographically dispersed from the primary facilities than articulated in the 2003 BCP Policy Statement.¹⁷⁹³ Further, some SROs may report systems issues or changes to the Commission in a manner different from what is articulated in the ARP Policy Statements and Commission staff letters. Instead of assuming full compliance with the ARP Inspection Program, throughout the economic analysis the Commission notes that some SCI entities that participate in the ARP Inspection Program have current practices that already satisfy some of the requirements of Regulation SCI and considers the details of those current practices when assessing the economic effects of the rules.

Finally, in using the ARP Inspection Program as a component of the baseline, the Commission also recognizes that Regulation SCI is more expansive than the ARP Inspection Program and has taken this fact into consideration throughout the economic analysis. For example, among other things, Regulation SCI includes more expansive requirements compared to the ARP Inspection Program for the establishment of policies and procedures regarding systems capacity, integrity, resiliency, availability, security, and compliance; and annual business continuity and disaster recovery plans testing. In addition, the Commission is aware that more entities will be subject to Regulation SCI than are currently participating in the ARP Inspection Program, including a higher number of ATSS. The Commission has considered these differences in the economic analysis.

The sections below describe in more detail the Commission's understanding of current practices related to areas covered by Regulation SCI, as informed by its experience with the ARP Inspection Program, the OCIE examination program, as well as by commenters. In particular,

¹⁷⁹³ See 2003 BCP Policy Statement, supra note 504, at 56658.

the sections below provide an overview of the frequency and the types of systems issues addressed by Regulation SCI (i.e., systems disruptions, systems intrusions, and systems compliance issues) and current practices related to these events, as well as current practices related to business continuity and disaster recovery, and material systems changes notifications. Additionally, the sections below include a summary of the current competitive landscape in various markets for services related to Regulation SCI and why the markets for these services do not provide an adequate competitive incentive to prevent the occurrence of these market events and reduce the duration and severity when they occur.¹⁷⁹⁴ Details regarding the baseline for certain specific current practices relevant to specific provisions of Regulation SCI are discussed throughout the consideration of costs and benefits and the effect on efficiency, competition, and capital formation below.

1. SCI Events

a. Systems Disruptions and Intrusions

Currently, market participants use an array of preventive and corrective measures to avoid systems disruptions and to restore systems when disruptions occur, including escalation procedures to notify management of disruptions. The range of preventive and corrective measures varies among market participants and SCI entities, and also differs among the systems employed by SCI entities. For instance, clearing systems and order matching engines generally are given higher priority by SCI entities than other SCI entity systems.

Also, as noted by a commenter, exchanges, member firms, and ATSS conduct regular and ad hoc testing of mission critical systems for the introduction of new software releases, new

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Throughout this Economic Analysis, the general concept of a reduction of SCI events may refer to fewer events, shorter duration of events, and/or less severe events.

features and functions, and systems upgrades, among other things.¹⁷⁹⁵ This commenter also noted that the internal IT staff of exchanges, ATSS, trading platform providers, and clearing houses conduct regular systems testing, regression testing, stress testing, and failover testing to ensure the availability, capacity, resilience, and readiness of newly introduced systems, applications, products, and system functions.¹⁷⁹⁶ However, industry practices are not codified as requirements for SCI entities and systems, except as may be the case in an entity's rulebook or subscriber agreement.

Market participants also employ a wide variety of measures to prevent and respond to systems intrusions, including escalation procedures to notify management of intrusions. Generally, market participants use measures such as firewalls to prevent systems intrusions, and use detection software to identify systems intrusions. Once an intrusion has been identified, the affected systems typically would be isolated and quarantined, and forensics would be performed.

While there have been instances in which SCI entities revealed systems issues (including disruptions and intrusions) to their members or participants and to the public in the past,¹⁷⁹⁷ there currently is no requirement applicable to SCI entities that includes the level of specificity in

¹⁷⁹⁵ See Tellefsen Letter at 11.

¹⁷⁹⁶ See id.

¹⁷⁹⁷ One instance of a publicly reported systems intrusion at an SCI entity occurred in February 2011, when NASDAQ OMX Group, Inc. revealed that hackers had penetrated certain of its computer networks, though Nasdaq reported that at no point did this intrusion compromise Nasdaq's trading systems. See Proposing Release, supra note 13, at 18089. One commenter also stated that when systems issues arise that impact subscriber access, functionality, or security, each potential SCI entity informs its subscribers of the problem and the expected solution, and generally follows with a post mortem. According to this commenter, some entities provide this notice pursuant to a contract or general agreement with subscribers, while others do so in order to maintain and grow their subscriber base. See OTC Markets Letter at 19. See also supra Section II.B (describing recent events involving systems-related issues, which have been made public).

Regulation SCI for dissemination of information regarding systems disruptions and systems intrusions, as those terms are defined in Regulation SCI, to affected members or participants or to all members or participants of an SCI entity.

In 2013, entities that participated in the ARP Inspection Program, including at least one of each type of such participants (*i.e.*, national securities exchange, national securities association, registered clearing agency, plan processor, ATS, and exempt clearing agency), reported a total of approximately 357 systems disruptions to the Commission.¹⁷⁹⁸ These incidents had durations ranging from under one hour to well over several hours, with most incidents having a duration of less than three hours.¹⁷⁹⁹ The Commission has also tracked the percentage of market outages at SROs and electronic communications networks, which were self-reported to the Commission or identified by Commission staff, that were corrected within targeted timeframes. Specifically, in fiscal year 2013, 80% of outages were resolved within 2 hours, 86% were resolved within 4 hours, and 98% were resolved within 24 hours.¹⁸⁰⁰

b. Systems Compliance Issues

¹⁷⁹⁸ One commenter believes that ATSS have not contributed to the recent major systems issues that have impacted the market. See ITG letter at 4. However, as the Commission has noted, FINRA halted trading for over 3 ½ hours in all OTC equity securities due to a lack of availability of quotation information resulting from a connectivity issue experienced by OTC Markets Group Inc.'s OTC Link ATS. See supra note 33 and accompanying text.

¹⁷⁹⁹ The Commission acknowledges that the number of systems incidents reported to the Commission by entities that participated in the ARP Inspection Program represents the lower end of expected SCI events under Regulation SCI because the definition of "SCI event" is broader than the types of events covered by the current ARP Inspection Program. See supra Section V.D.2.a.

¹⁸⁰⁰ See U.S. Securities and Exchange Commission FY 2015 Annual Performance Plan, at 26 (March 7, 2014), available at: <http://www.sec.gov/about/reports/secfy15congbudgjust.pdf>.

Currently, systems compliance issues are not covered by the ARP Inspection Program. However, the Commission notes that all SROs are required to comply with the Exchange Act, the rules and regulations thereunder, and their own rules and governing documents, as applicable,¹⁸⁰¹ and securities information processors and ATs are subject to similar requirements.¹⁸⁰²

Further, SROs currently take steps to ensure that their systems' operations are consistent with the federal securities laws and rules and their own rules, and some SROs notify Commission staff of certain systems compliance issues.¹⁸⁰³ In particular, the Commission understands that SCI SROs generally have procedures to escalate a compliance issue upon discovery, to include legal and compliance personnel in the review of systems changes, and to periodically review rulebooks. However, although some SCI entities currently notify the Commission of certain systems compliance issues, the Commission does not receive comprehensive data regarding such issues.

Similar to systems disruptions and systems intrusions, while there have been instances in which SCI entities revealed systems compliance-related issues to their members or participants and to the public in the past,¹⁸⁰⁴ there currently is no requirement applicable to SCI entities that

¹⁸⁰¹ See, e.g., 15 U.S.C. 78s(g) (requiring each SRO to comply with the Exchange Act, the rules and regulations thereunder, and its own rules).

¹⁸⁰² See, e.g., 15 U.S.C. 78k-1(b)(6); 15 U.S.C. 78k-1(c)(1); and FINRA Rule 3130. Moreover, ATs are registered broker-dealers and may be subject to Commission sanctions if they fail to comply with relevant federal securities laws and rules and regulations thereunder.

¹⁸⁰³ See Proposing Release, *supra* note 13, at 18087, n. 36. As part of the Commission's oversight of SROs, OCIE reviews systems compliance issues reported to Commission staff.

¹⁸⁰⁴ See *supra* Section II.B (describing recent events involving systems-related issues, which have been made public).

includes the level of specificity in Regulation SCI for dissemination of information regarding systems compliance issues, as that term is defined in Regulation SCI, to affected members or participants, or to all members or participants of an SCI entity.

In the SCI Proposal, based on Commission staff's experience with SROs and the rule filing process, the Commission estimated that there are likely approximately seven systems compliance issues per SCI entity per year. No commenter provided additional information regarding the frequency of systems compliance issues. However, Commission staff received notifications indicating that certain SROs experienced an average of 17 systems compliance-related issues in 2013. The Commission believes that its staff received notification of a larger number of systems compliance issues in 2013 for a variety of reasons, including the proposal of Regulation SCI, recent Commission enforcement actions relating to systems compliance issues, as well as related press reports, all of which the Commission believes increased attention on systems compliance issues.¹⁸⁰⁵

2. Business Continuity and Disaster Recovery

The Commission recognizes that SCI entities already have business continuity and disaster recovery plans. For example, nearly all national securities exchanges already have backup facilities that do not rely on the same infrastructure components as those used by their primary facility.¹⁸⁰⁶ Additionally, most participants in the ARP Inspection Program have strived to adhere to the recovery timeframes in the Interagency White Paper and the 2003 BCP Policy

¹⁸⁰⁵ See id.

¹⁸⁰⁶ See, e.g., CBOE Regulatory Circular RG14-001 (Back-Up Data Center Test on January 25, 2014).

Statement.¹⁸⁰⁷ Some SCI entities also already require some of their members or participants to connect to their backup systems.¹⁸⁰⁸ Further, some SCI entities already provide their members or participants with the opportunity to test the SCI entity's business continuity and disaster recovery plans, including its backup systems.¹⁸⁰⁹ However, because participation in BC/DR testing, including backup systems, is not always required by SCI entities, the Commission understands that not all market participants participate in testing.¹⁸¹⁰ In addition, based on the discussions between Commission staff and market participants in the months following Superstorm Sandy, the Commission understands that many market participants had previously engaged in connectivity testing with backup facilities, and yet remained uncomfortable about switching to the use of backup facilities in advance of the storm.

Commenters also provided information regarding current practices surrounding business continuity and disaster recovery. One commenter noted that the major equity and options exchanges and numerous ATs already regularly augment IT testing with other business continuity management exercises (e.g., they conduct annual business continuity and disaster recovery plan updates, building evacuation drills, and business disruption scenario planning workshops).¹⁸¹¹ This commenter also noted that all of the U.S. exchanges and clearinghouses have participated in the planning and execution of the annual disaster recovery test initiative

¹⁸⁰⁷ See supra note 504 and accompanying text.

¹⁸⁰⁸ See, e.g., CBOE Regulatory Circular RG13-110 (Connectivity to the CBOE Back-Up Data Center). See also Proposing Release, supra note 13, at n. 641.

¹⁸⁰⁹ For example, SIFMA organizes industry-wide business continuity tests. See Industry Testing, <http://www.sifma.org/services/bcp/industry-testing/>.

¹⁸¹⁰ See, e.g., Angel Letter at 9-10.

¹⁸¹¹ See Tellefsen Letter at 7.

conducted and coordinated by the FIA and SIFMA.¹⁸¹² This commenter noted that, in 2012, for example, the annual FIA industry test involved 18 exchanges and clearinghouses, 68 futures commission merchants, and 46 trading participant firms.¹⁸¹³ This commenter also noted that the exchanges reported that the firms engaged in testing represented approximately 80% of their clearing members and that these firms reflected approximately 85% of the exchanges' 2012 volumes.¹⁸¹⁴

3. Material Systems Changes Notifications

Many entities that participate in the ARP Inspection Program already voluntarily provide material systems change notifications to the Commission on an annual and ad hoc basis. In particular, the ARP II Release stated that SROs should notify Commission staff of significant additions, deletions, or other changes to their automated systems.¹⁸¹⁵ Moreover, in the 2001 Staff ARP Interpretive Letter, Commission staff provided guidance to ARP entities on how they should report planned systems changes to the Commission.¹⁸¹⁶ In addition, Rule 301(b)(6) under Regulation ATS requires that ATSs that meet the thresholds in that rule notify Commission staff of significant systems changes,¹⁸¹⁷ and Rule 301(b)(2) under Regulation ATS requires each ATS

¹⁸¹² See id.

¹⁸¹³ See id. at 8.

¹⁸¹⁴ See id. See also CME Letter at 12.

¹⁸¹⁵ See ARP II Release, supra note 1, at 22491.

¹⁸¹⁶ See supra note 21 and accompanying text. The 2001 Staff ARP Interpretive Letter provided guidance on what Commission staff considers significant systems changes to include.

¹⁸¹⁷ 17 CFR 242.301(b)(6)(ii)(G).

that is subject to Rule 301, regardless of activity level, to file an amendment on Form ATS at least 20 days prior to implementing a material change to the operation of the ATS.¹⁸¹⁸

4. Potential for Market Solutions

The current competitive landscape in various markets for services related to Regulation SCI affect current incentives to prevent the occurrence of SCI events in these markets.¹⁸¹⁹ The Commission outlined and examined this competitive landscape and potential for market solutions to reduce SCI events and their shortcomings in the SCI Proposal.¹⁸²⁰ In particular, the Commission evaluated current limitations to competition and potential market solutions in the markets for trading services, listing services, regulatory services, clearance and settlement services, and market data.

The discussion below responds to comments received regarding the Commission's discussion of the potential for market solutions in the markets for trading services and market data. The Commission did not receive specific comments regarding its analysis of the markets for listing services, regulatory services, and clearance and settlement services. Therefore, the Commission believes that its analysis of these markets in the SCI Proposal continues to apply. Specifically, the Commission believes that, while the market for listing services provides some discipline, it has limitations related to a disconnect between trading location and listing market (*i.e.*, while a company can be listed on a certain exchange, trading does not necessarily occur on that exchange), to switching costs if an issuer wishes to change its listing exchange, and to

¹⁸¹⁸ 17 CFR 242.301(b)(2)(ii) (requiring an amendment to Form ATS not solely for material systems changes, but also for any material change to the operation of an ATS).

¹⁸¹⁹ This section evaluates competition as it currently exists. The Commission analyzes the economic effects of Regulation SCI, including potential effects on competition, in Section VI.C.

¹⁸²⁰ See Proposing Release, *supra* note 13, at 18159-61.

market power deriving from the “prestige” of a listing exchange.¹⁸²¹ Further, the Commission believes that the market for regulatory and surveillance services is concentrated in a few competitors and that the market for clearance and settlement services is currently characterized by specialization and limited competition.¹⁸²²

The Commission has considered the views of commenters and the Commission’s analysis of markets not addressed by commenters, and continues to believe that market forces alone are insufficient to significantly reduce SCI events in the markets that it evaluated and that a regulatory solution is needed. In particular, the Commission continues to believe that SCI entities do not fully internalize the costs associated with systems issues, SCI events pose significant negative externalities on the market—*i.e.*, systems issues have ramifications on the securities markets beyond the impact on the entity responsible for the systems issues—and, as discussed above, significant technology issues continue to occur in the absence of regulation.

Some commenters broadly addressed the potential for market solutions evaluated in the SCI Proposal. According to one commenter, SCI entities (*e.g.*, ATSS) are highly motivated to provide uninterrupted order matching services for economic reasons.¹⁸²³ On the other hand, another commenter noted that, as indicated by the 2008 financial crisis and the technology incidents over the past few years, market participants do not have the right economic incentives to protect themselves.¹⁸²⁴ Another commenter stated that, in the past, “disruptive or deviant

¹⁸²¹ See *id.* at 18160.

¹⁸²² See *id.* at 18160-61.

¹⁸²³ See ITG Letter at 4 (stating also that sponsors of ATSS have a “compelling business incentive to avoid systems issues”). See also Angel Letter at 5-6 (commenting that firms have sufficient motivation to take every precaution against catastrophic failures, although the interaction between firms may result in a catastrophic event).

¹⁸²⁴ See Lauer Letter at 3-4.

behavior in the markets was disciplined not just by regulators but also by trading crowds,” but anonymity and fully automated price/time matching made it impossible for the trading crowd to attribute and sanction disruptive behavior.¹⁸²⁵ This commenter also noted that market incentives can drive the industry in the opposite direction (i.e., short-term market incentives can drive the industry to minimize risk controls).¹⁸²⁶ According to this commenter, the only practical source of discipline left is government regulation.¹⁸²⁷

The Commission believes that all SCI entities have some incentives to maintain robust systems in order to maximize long-term revenue. However, as evidenced by the various systems issues that have occurred prior to and since publication of the SCI Proposal, economic motivations alone have not been sufficient to significantly reduce systems issues.¹⁸²⁸ In addition, although SCI entities may suffer an economic and reputational burden if a systems issue becomes apparent to the trading community or the public, the Commission believes that SCI entities are not sufficiently incentivized to improve the robustness of these systems to prevent systems issues, as described in more detail below.¹⁸²⁹ Further, SCI entities may fail to internalize the risk of catastrophic failure associated with systems issues.

¹⁸²⁵ See Leuchtkafer Letter at 1-2.

¹⁸²⁶ See *id.* at 6. This commenter stated that it is far cheaper for firms to implement new trading strategies “in a matter of minutes” than it is for them to rigorously test a new strategy before deployment, and that it is more profitable for firms to skimp on risk controls because controls take time. See *id.* Further, this commenter noted that the exchanges know, or should know, who “misbehaves,” but they are tangled in mixed incentives of their own, dependent on firms for the next quarter’s profits and, at the same time, expected to moderate the firms’ behavior. See *id.*

¹⁸²⁷ See *id.* at 6-7.

¹⁸²⁸ See *supra* Section II.B (discussing recent events involving systems-related issues).

¹⁸²⁹ As noted above, the Commission acknowledges that the nature of technology and the level of sophistication and automation of current market systems prevent any measure,

As noted above, systems issues have ramifications on the securities markets beyond the impact on the entity responsible for or experiencing the systems issues (an “economic externality”). That is, a systems issue not only affects the entity responsible for the issue, but also directly affects other entities that use that entity. Often, when an SCI entity experiences a systems issue, all market participants that use that entity incur costs. For example, if market data systems fail, it affects anyone requiring such market data to make informed decisions. Also, when a matching engine fails, securities cannot be traded via that functionality. As discussed in greater detail below, the failure of a trading system not only forces the venue to forgo revenue, but also can diminish trading in financial instruments during the disruption. Additionally, the failure of a trading system can impose costs on market participants that have optimized their strategy so that trading costs are minimized. If the strategy of these market participants assumes that all trading venues are fully operational, then the failure of a trading system could impose additional transaction costs. The Commission believes that, in part because the costs of such externalities are not fully borne by SCI entities in the form of lost business, market forces alone are insufficient to significantly reduce SCI events.

Market for Trading Services

In the proposing release, the Commission identified many competitors in the market for trading services, including equities exchanges, options exchanges, ATSS, OTC market makers, and broker-dealers.¹⁸³⁰ Competitors for listed-equity (NMS) trading services include 11 national

regulatory or otherwise, from completely eliminating all systems disruptions, intrusions, or other systems issues. See supra Section III.

¹⁸³⁰ See Proposing Release, supra note 13, at 18159.

securities exchanges, none having an overall market share of 20 percent,¹⁸³¹ 44 ATSS, which account for 18% of dollar volume, and several hundred OTC market makers and broker-dealers, which account for 15.8% of dollar volume.¹⁸³² In the SCI Proposal, the Commission recognized that all providers of trading services compete and have incentives to avoid systems disruptions, systems compliance issues, and systems intrusions because, for example, brokers and other entities will be inclined to route orders away from trading venues that have frequent systems problems. However, the Commission noted several limitations on competition, including market participants misjudging the quality of trading services because of incomplete information regarding SCI events and the limited number of competitors (in some cases only one competitor) that may offer trading services in a particular product.¹⁸³³

With respect to the market for trading services, one commenter stated that the current competitive market for trading services provides sufficient redundancies that make a disruption at any particular service provider minor.¹⁸³⁴ Another commenter noted that exchanges compete vigorously with one another and against broker-dealer execution platforms and cannot afford to

¹⁸³¹ See supra note 106 and accompanying text.

¹⁸³² Calculated by Commission staff using market volume statistics reported by BATS and data from Form ATS-R for the second quarter of 2014. See supra notes 106 and 150. In 2012, 255 OTC market makers and broker-dealers accounted for 17% of volume. See DERA staff white papers, "Alternative Trading Systems: Description of ATS Trading in National Market System Stocks" by Laura Tuttle (<http://www.sec.gov/marketstructure/research/alternative-trading-systems-march-2014.pdf>) and "OTC Trading: Description of Non-ATS OTC Trading in National Market System Stocks" by Laura Tuttle (http://www.sec.gov/marketstructure/research/otc_trading_march_2014.pdf).

¹⁸³³ For example, a number of listed options and NMS stocks trade on only one venue.

¹⁸³⁴ See KCG Letter at 6-8.

develop a reputation for technology problems.¹⁸³⁵ This commenter also noted that the incidence of self-help declarations¹⁸³⁶ has been reduced, which reflects technology enhancements by exchanges that are a direct result of the competitive environment in which exchanges operate.¹⁸³⁷ Similarly, another commenter stated that, apart from any regulatory standards, no organization has a greater stake in assuring the effective operation of its systems than the owners and operators of the entities that participate in the market structure.¹⁸³⁸ Moreover, one commenter stated that ATSS already have incentives to avoid any systems disruptions for competitive reasons and also perform numerous tests and employ best practices.¹⁸³⁹

Again, the Commission acknowledges that all providers of trading services compete and have some incentives to avoid systems issues. However, the Commission continues to believe that there are limits to the extent to which competition mitigates systems problems associated with trading services because providers of trading services compete on a variety of measures—for example, providing the best prices, deep quotes, and fast executions—not just the quality of their systems. As a result, an issue with trading systems might not significantly harm the SCI entity that experienced the issue. Additionally, competition in the market for trading services may also not sufficiently mitigate the occurrence and effects of SCI events because market

¹⁸³⁵ See BATS Letter at 2.

¹⁸³⁶ Rule 611(b) under Regulation NMS provides a number of exceptions from the general requirement to prevent trade-throughs of protected quotations. In particular, Rule 611(b)(1) provides the “self-help” exception, which applies when the “transaction that constituted the trade-through was effected when the trading center displaying the protected quotation that was traded through was experiencing a failure, material delay, or malfunction of its systems or equipment.” See 17 CFR 242.611(b)(1).

¹⁸³⁷ See BATS Letter at 2-3.

¹⁸³⁸ See BIDS Letter at 2.

¹⁸³⁹ See ITG Letter at 4.

participants may lack information about SCI events. The Commission believes that it is important for affected SCI entity members or participants and, in some cases, all members or participants of an SCI entity, to know about SCI events at a particular service provider.¹⁸⁴⁰

Moreover, even in markets where significant competition exists—such as the market for trading NMS securities, which has many competitors including exchanges and ATSS—entities that experience significant outages may temporarily lose market share, but may quickly regain the lost market share.¹⁸⁴¹ The Commission believes that this further suggests that competition alone will not significantly reduce systems issues.

In addition, some entities that face little competition in one security may impose significant externalities on the market with little competitive recourse. For example, even though there may be multiple trading venues for the majority of securities, trading service providers may have limited means to transact in particular securities (*e.g.*, certain index options exclusively traded on one options exchange) and thus, if systems issues persist at certain venues, brokers, investors, and other entities will not be able to trade the security until the venue that lists the security recovers. In this particular case, not only does the venue lose revenue from forgone volume, but market participants also incur costs because they are not able to trade the security. As a result, the Commission believes that competition alone in the market for trading services is not sufficient to reduce SCI events at entities providing these services.

¹⁸⁴⁰ See *supra* Section VI.B.1 (discussing current practices of SCI entities regarding dissemination of information on systems-related issues).

¹⁸⁴¹ For example, on November 12, 2012, the NYSE experienced a failure in a matching engine that forced it to stop trading 216 stocks. See NYSE Market Status Alert, <http://markets.nyx.com/nyse/market-status/view/11558>. The NYSE lost market share on the day of the outage but regained its market share the next day. See generally http://www.batstrading.com/market_summary/ (compiling data on market share).

As mentioned by one commenter,¹⁸⁴² competitive forces among trading venues may also lead to “underinvestment and cutting corners.” For example, the incentive to migrate software from testing to the production environment to improve trading services (and thereby the entity’s profitability) may promote an environment where software that has not been adequately tested is launched into production, thus increasing the potential for systems issues to develop.

Market for Market Data

One commenter stated that Regulation SCI, as applied to market data, is unnecessary and will have “zero benefits” because the revenue from the sale of market data is an important revenue source for an SRO.¹⁸⁴³ Therefore, according to this commenter, SROs already have the right incentives to successfully collect, process, and disseminate market data.¹⁸⁴⁴

As noted above, the Commission has, on numerous occasions, emphasized the importance of market data, including the consolidated data feed.¹⁸⁴⁵ The Commission believes that consolidated market data is an important part of the investment and trading process as it helps market participants to make well-informed investment and trading decisions, and also helps investors to monitor the quality of execution of orders by their brokers. In addition, exchanges rely on accurate consolidated market data for many of their real-time functions. Even though demand is great, a total of only two SIPs collect, process, and distribute consolidated

¹⁸⁴² See Lauer Letter at 4 (stating that “[e]very firm in every industry is constantly balancing the cost of safety with scarcity of resources...[and t]he Commission’s job in this regard is to compel these firms to act in their own long-term interests, and the interests of the public at-large, rather than any short-term interests that may be better served by underinvestment and cutting corners”).

¹⁸⁴³ See Angel Letter at 18-19.

¹⁸⁴⁴ See *id.*

¹⁸⁴⁵ See *supra* note 249 and accompanying text.

market data in NMS securities, and only a single SIP collects, processes, and distributes consolidated market data for any given security. Further, other providers of market data in markets other than NMS securities (e.g., municipal securities) may also be the sole providers of their data. Therefore, the Commission believes that the market data consolidators are not subject to significant competitive market forces. Further, because the demand for market data from the SIPs is inelastic,¹⁸⁴⁶ there is little incentive to improve reliability as few alternatives exist. Thus, the Commission believes that competition alone is not sufficient to reduce SCI events for market data consolidators. Because an SCI event in connection with market data can significantly disrupt markets, the Commission believes that regulation is needed and, as discussed below, will provide significant benefits.¹⁸⁴⁷

C. Consideration of Costs and Benefits and the Effect on Efficiency, Competition, and Capital Formation

1. Broad Economic Considerations

The Commission has considered the economic effects of Regulation SCI as a whole as well as the specific effect of each rule. This section provides an overview of the broad economic considerations relevant to Regulation SCI and the economic effects, including the costs, benefits, and effects on efficiency, competition, and capital formation that are attributable to Regulation SCI as a whole. Additional economic effects, including benefits and costs, related to specific

¹⁸⁴⁶ Demand is inelastic when demand does not diminish as price increases.

¹⁸⁴⁷ For example, as discussed above, on August 22, 2013, Nasdaq halted trading in all Nasdaq-listed securities for more than three hours after the Nasdaq SIP, the single source of consolidated market data for Nasdaq-listed securities, became unable to process quotes from exchanges for dissemination to the public. See supra note 32 and accompanying text.

requirements in Regulation SCI and reasonable alternatives are discussed in Section VI.C.2 below.

The Commission has attempted, where possible, to quantify the benefits and costs anticipated to flow from Regulation SCI. The Commission notes, however, that many of the costs and benefits of Regulation SCI are difficult to quantify with any degree of certainty, especially as the current practices of market participants vary and are expected to evolve and adapt to changes in technology and market developments. For example, in some cases, quantification depends heavily on factors outside of the control of the Commission, particularly because Regulation SCI provides flexibility to an SCI entity to tailor its policies and procedures to the nature of its business, technology, and the relative criticality of each of its SCI systems. Additionally, in some cases, the Commission is unable to quantify the benefits and costs associated with Regulation SCI because the Commission lacks the information necessary to provide a reasonable estimate. For example, the Commission does not have sufficient information upon which to base an estimate of all costs associated with the various specific systems changes that may be required as the result of Regulation SCI. Accordingly, much of the discussion of economic effects is qualitative in nature but, again, where possible, the Commission has provided quantified information.

a. Benefits

The Commission believes that the adoption of, and compliance by SCI entities with Regulation SCI, will further the goals of the national market system as a result of each SCI entity establishing, maintaining, and enforcing written policies and procedures reasonably designed to ensure that its SCI systems and, for purposes of security standards, indirect SCI systems, have levels of capacity, integrity, resiliency, availability, and security, adequate to maintain the SCI

entity's operational capability and promote the maintenance of fair and orderly markets. In this respect, Regulation SCI will promote the capacity, integrity, resiliency, availability, and security of the automated systems of entities important to the functioning of the U.S. securities markets, as well as reinforce the requirement that such systems operate in compliance with the Exchange Act and rules and regulations thereunder, thus strengthening the infrastructure of the U.S. securities markets and improving their resilience when technological issues arise. Regulation SCI also establishes an updated and formalized regulatory framework, thereby helping to ensure more effective Commission oversight of such systems. Although the Commission acknowledges that Regulation SCI likely will not eliminate all systems issues, the Commission believes that Regulation SCI will change and strengthen the practices of SCI entities, and should result in a number of benefits, including those summarized below.¹⁸⁴⁸

The Commission believes that adopting Regulation SCI will result in fewer market disruptions due to systems issues, which could lead to fewer interruptions in the price discovery process¹⁸⁴⁹ and liquidity flows and, thus, may result in fewer periods with pricing inefficiencies. Specifically, the Commission believes that Regulation SCI would improve systems up-time for SCI entities and also would promote more robust systems that directly support execution facilities, order matching, and the dissemination of market data. Systems issues that directly

¹⁸⁴⁸ As noted above, in the SCI Proposal, the Commission encouraged commenters to identify, discuss, analyze, and supply relevant data, information, or statistics regarding benefits. The Commission notes that it is unable to quantify the benefits associated with Regulation SCI as a whole because quantitative data regarding each of the benefits is not readily available to the Commission, and commenters did not provide sufficient quantitative data to allow the Commission to do so.

¹⁸⁴⁹ The price discovery process involves trading—buyers and sellers arriving at a transaction price for a specific asset at a given time. Thus, generally, any trading interruptions would interfere with the price discovery process.

inhibit execution facilities, order matching, and dissemination of market data could cause slow executions and result in delaying the incorporation of information into prices, and thus could harm price efficiency and price discovery. System issues could also result in unfilled orders, depriving traders of an execution. The Commission believes that Regulation SCI would reduce the frequency, severity, and duration of such effects resulting from systems issues. Moreover, decreasing the number of trading interruptions could improve price discovery and liquidity because interruptions in trading interfere with the process in which relevant information gets incorporated into security prices and, thus, temporarily disrupt liquidity flows and lower the quality of the price discovery process. Further, because interruptions in liquidity flows and the price discovery process in one security can affect securities trading in other markets, reducing trading interruptions could have broad effects. For example, an interruption in the market for securities that underlie derivative securities (e.g., index options and futures) would harm the price discovery process for those products and potentially restrict liquidity flows between the stock market and the derivative markets.

The Commission also believes that Regulation SCI has the potential to reduce widespread SCI events. Given the speed and interconnected nature of the U.S. securities markets, a seemingly minor systems problem at a single entity can quickly create losses and liability for market participants, and spread rapidly across the national market system, potentially creating widespread damage and harm to market participants, including investors. By reducing systems issues, Regulation SCI also has the potential to decrease the risk of these catastrophic events.

In addition, other benefits may derive from the additional information provided to the Commission and to members or participants of an SCI entity resulting from Regulation SCI. In particular, the information provided to the Commission should enhance the Commission's

review and oversight of U.S. securities market infrastructure and foster cooperation between the Commission and SCI entities in responding to SCI events. Also, as noted in Section IV.B.3.c, the Commission believes that the aggregated data that will result from the reporting of SCI events will enhance its ability to comprehensively analyze the nature and types of various SCI events and identify more effectively areas of persistent or recurring problems across the systems of all SCI entities. Moreover, as discussed in Section IV.A.3, the Commission notification requirements for SCI events will help to focus the Commission's and SCI entities' resources on the more significant SCI events, as the Commission has determined to distinguish the timing of its receipt of information regarding SCI events based on their impact, with SCI events estimated to have a greater impact being subject to "immediate" Commission notification, and SCI events having no or a de minimis impact being subject to recordkeeping obligations, and for de minimis systems disruptions and de minimis systems intrusions, a quarterly summary notification. Moreover, the increased dissemination of information about SCI events to SCI entity members or participants could reduce search costs for market participants when they are gathering information to make a decision with respect to the use of an entity's services. As discussed more thoroughly below, by lowering search costs, the information dissemination requirement could provide SCI entities additional competitive incentives to ensure and maintain robust policies and procedures to promote systems capacity, integrity, resiliency, availability, security and compliance.

Some commenters addressed how the availability of Commission resources may affect the benefits and costs of Regulation SCI. One commenter argued that Regulation SCI would

result in misallocation of Commission resources.¹⁸⁵⁰ This commenter stated that it is likely that Regulation SCI would not reduce in a material manner the occurrence of systems issues at SCI entities, and Commission staff resources would be better devoted to working with the industry to develop best practices (not legal requirements) for all regulated entities in the areas of systems capacity, security, and integrity.¹⁸⁵¹ Similarly, one commenter noted that unless the Commission and Congress devote sufficient resources to hiring enough skilled technical staff, Regulation SCI will devolve into a paperwork exercise with little added benefit to the markets.¹⁸⁵² Another commenter stated that there is insufficient evidence regarding the resources and capacity of Commission staff to assess and analyze the data required to be provided under Regulation SCI.¹⁸⁵³ This commenter urged the Commission to consider its resources as the Commission accommodates new initiatives.¹⁸⁵⁴

As described throughout this release, the Commission believes that Regulation SCI will have significant benefits and that a regulatory solution is necessary because market forces alone are insufficient to significantly reduce SCI events in the relevant markets. The Commission has significant experience with the ARP Inspection Program, and thus has developed expertise in this

¹⁸⁵⁰ See ITG Letter at 6-7. This commenter noted that Commission staff resources used to oversee Regulation SCI compliance would dwarf those used for the ARP Inspection Program and that Commission staff would have to analyze and act upon notifications from SCI entities, including systems change notifications. See *id.* This commenter also noted that substantial examination resources from the Commission and FINRA would be assigned to Regulation SCI oversight. See *id.* Similarly, another commenter noted that proposed Regulation SCI would result in a dramatic increase in the number of Commission notifications and would require substantial resources for Commission staff to process them in a responsible fashion. See Omgeo Letter at 8, n. 14.

¹⁸⁵¹ See ITG Letter at 7.

¹⁸⁵² See Angel Letter at 2.

¹⁸⁵³ See SunGard Letter at 2.

¹⁸⁵⁴ See *id.* at 5.

area that it will apply to implementing and monitoring compliance with Regulation SCI. In light of this experience, the Commission believes that it can devote sufficient resources to carry out its obligations associated with Regulation SCI so that the benefits of Regulation SCI can be realized.

b. Costs

Some of the costs associated with Regulation SCI are compliance costs. Compliance costs include, for example, documentation and mandatory reporting and dissemination of SCI events, and reports that include material systems changes. SCI entities will also incur costs in complying with the SCI review requirement, as well as in implementing the policies and procedures related to systems capacity, integrity, resiliency, availability, security, and compliance. Moreover, SCI entities will incur costs related to recordkeeping. Additional costs will also result from member/participant participation in the testing of SCI entity business continuity and disaster recovery plans. Also, market participants (including institutional and retail investors) in the securities markets may face increased transaction costs from SCI entities, to the extent that increased compliance costs are passed on to market participants.

Many, but not all, of the quantifiable costs of Regulation SCI involve a collection of information, and these costs and burdens are discussed in the Paperwork Reduction Act section of this release.¹⁸⁵⁵ When the PRA burdens are monetized, the estimated paperwork related compliance burdens for SCI entities as a result of Regulation SCI total approximately \$117

¹⁸⁵⁵

See supra Section V. The Commission provides below quantified estimates of other costs imposed by Regulation SCI beyond the PRA burdens, to the extent the Commission can quantify such costs.

million initially and approximately \$100 million annually.¹⁸⁵⁶ The Commission notes that the monetized PRA burdens have increased from those contained in the SCI Proposal. Although many of the adopted rules are more targeted and impose fewer requirements on SCI entities than the proposed rules, the monetized PRA burdens have changed in part due to modifications made to the PRA estimates as a result of recommendations from commenters, revisions to the rule text, and the revised estimate of the number of SCI events, which resulted from incorporating the Commission's review of the number of systems compliance-related issues and ARP incidents reported to Commission staff in 2013.

In addition, the Commission has quantified non-paperwork related costs for SCI entities that total between approximately \$14 million¹⁸⁵⁷ and \$106 million¹⁸⁵⁸ in initial costs and between \$9 million¹⁸⁵⁹ and \$70 million¹⁸⁶⁰ in annual ongoing costs. In addition to the costs to SCI entities, the Commission also estimates the total connectivity costs to members or participants of SCI entities associated with the testing of business continuity and disaster recovery plans to be \$18 million annually.¹⁸⁶¹ Thus, the Commission estimates total quantified costs for SCI entities

¹⁸⁵⁶ The monetized PRA cost reflects the paperwork cost estimated for all of Regulation SCI, as discussed in Section V.

¹⁸⁵⁷ See infra note 1943 (estimating cost for complying with the policies and procedures required by Rules 1001(a) and (b)).

¹⁸⁵⁸ See infra note 1944 (estimating cost for complying with the policies and procedures required by Rules 1001(a) and (b)).

¹⁸⁵⁹ See infra note 1945 (estimating cost for complying with the policies and procedures required by Rule 1001(a) and (b)).

¹⁸⁶⁰ See infra note 1946 (estimating cost for complying with the policies and procedures required by Rule 1001(a) and (b)).

¹⁸⁶¹ See infra note 2065.

and members or participants of SCI entities to be between approximately \$149 million¹⁸⁶² and \$241 million¹⁸⁶³ in initial costs and between \$127 million¹⁸⁶⁴ and \$188 million¹⁸⁶⁵ in annual ongoing costs.

Several commenters provided broad comments regarding the costs of proposed Regulation SCI.¹⁸⁶⁶ According to one commenter, Regulation SCI as proposed is “too universal in its application, too ambitious in its scope and too costly in its implementation to achieve the

¹⁸⁶² \$149 million = \$117 million (PRA cost) + \$14 million (other costs for SCI entities) + \$18 million (connectivity costs for members or participants of SCI entities).

¹⁸⁶³ \$241 million = \$117 million (PRA cost) + \$106 million (other costs for SCI entities) + \$18 million (connectivity costs for members or participants of SCI entities).

¹⁸⁶⁴ \$127 million = \$100 million (PRA cost) + \$9 million (other costs for SCI entities) + \$18 million (connectivity costs for members or participants of SCI entities).

¹⁸⁶⁵ \$188 million = \$100 million (PRA cost) + \$70 million (other costs for SCI entities) + \$18 million (connectivity costs for members or participants of SCI entities).

¹⁸⁶⁶ One commenter provided “conservative and preliminary” estimates for the cost of compliance with Regulation SCI. See FINRA Letter at 42-43. This commenter estimated that its one-time cost to comply with Regulation SCI would be between approximately \$1.1 million and \$1.3 million, and its ongoing annual costs would be between approximately \$4.5 million and \$5.5 million, if Regulation SCI is adopted as proposed (e.g., if SCI systems is defined to apply to non-market regulatory and surveillance systems, and development and testing environments). See id. at 42. As discussed above, the definition of SCI systems does not include non-market regulation and non-market surveillance systems, or development and testing systems. Therefore, the Commission believes these estimates are too high. This commenter estimated that, under a narrower Regulation SCI (e.g., if non-market systems and development and testing environments are excluded from the definition of SCI systems), its one-time compliance costs would be between approximately \$675,000 and \$825,000 and its annual costs would be between approximately \$2.2 million and \$2.6 million. See id. This commenter also stated that, monetizing its hour estimates for annual SCI reviews, its compliance costs would increase by between approximately \$600,000 and \$900,000, and higher if more systems than currently in scope under ARP would be subject to annual SCI reviews. See id. at 42. The Commission notes that, other than the costs for SCI reviews, these estimates do not distinguish paperwork costs from non-paperwork costs. If the commenter’s estimates are intended to include all costs for compliance with Regulation SCI, these estimates are close to or within the Commission’s estimated total quantified cost ranges for SCI entities. See supra notes 1862-1865 and accompanying text.

hoped for reduction in risk to the markets without simultaneously diminishing other important SEC accomplishments, such as increased competition, improved innovation, increased consumer choice, lower barriers to entry into the industry and reduced transaction costs to the customer.”¹⁸⁶⁷ Another commenter noted that proposed Regulation SCI would impose an unreasonably burdensome technology and controls standard on automated systems of SCI entities, which could lead to allocative inefficiencies in the marketplace and therefore have a stifling effect on innovation in the U.S. equity markets.¹⁸⁶⁸ Another commenter stated that the ultimate result of proposed Regulation SCI will be to limit or suppress the execution choice of buy-side investors, meaning investors will have less ability to effectively manage their trading strategies and diminished opportunities to seek better execution, lower transaction costs, and achieve price improvement and investment performance.¹⁸⁶⁹

As discussed throughout this release, the Commission believes that Regulation SCI will change and strengthen the practices of SCI entities, and should result in a number of benefits. Further, the Commission believes that these benefits should result without diminishing the Commission’s accomplishments in other areas, stifling innovation, or suppressing the execution choice of investors. In particular, although costs associated with Regulation SCI could adversely impact competition and increase barriers to entry, the Commission believes that the adverse effect on competition and heightened barriers for SCI entities that provide venues for trading, including ATSS and exchanges, would be mitigated and therefore the Commission does not

¹⁸⁶⁷ See BIDS Letter at 2-3.

¹⁸⁶⁸ See ITG Letter at 2.

¹⁸⁶⁹ See UBS Letter at 7-8.

expect that investor choice on trading venues would be significantly limited.¹⁸⁷⁰ The Commission also believes that any such effects would be warranted in light of the expected benefits of Regulation SCI. Additionally, as discussed below, the dissemination of information regarding certain major SCI events to all members or participants of an SCI entity can promote competitive incentives to prevent systems issues. The Commission also believes that the reduction in systems issues resulting from Regulation SCI could result in fewer interruptions in the price discovery process and liquidity flows and thus result in fewer periods with pricing inefficiencies. Furthermore, Regulation SCI could improve system uptime for SCI entities, and therefore reduce latency as market participants will not be forced to reroute orders or change execution strategies associated with situations in which an SCI entity is not operational.

Moreover, the Commission notes that it has revised the proposed rules after considering the comments received. The Commission believes that many of the revisions to the proposed rules would reduce burdens on SCI entities and significantly address commenters' concerns regarding potential negative effects on allocative inefficiency and innovation. For example, because the Commission is adopting a quarterly reporting requirement for material systems changes instead of the proposed 30-day advance notification requirement, adopted Regulation SCI would impose lower burdens on SCI entities compared to the proposal and allow SCI entities more flexibility when they implement material systems changes.¹⁸⁷¹

c. Effects on Efficiency, Competition, and Capital Formation

¹⁸⁷⁰ See *infra* Section VI.C.1.c (addressing potential effects on efficiency, competition, and capital formation, including effects on other SCI entities).

¹⁸⁷¹ See *supra* Section IV.B.4.b.i.

Along with the effects on efficiency, competition, and capital formation discussed below with regard to specific provisions of Regulation SCI, the Commission believes that Regulation SCI as a whole could affect efficiency, competition, and capital formation in several ways.

By increasing the robustness of SCI systems and indirect SCI systems of SCI entities, Regulation SCI may improve efficiency—in particular, price efficiency—and the improvement in pricing efficiency could promote capital formation. In particular, as discussed in VI.C.1, disruptions to SCI systems and the resulting trading interruptions can degrade pricing efficiency, price discovery, and liquidity. Regulation SCI may reduce the frequency, severity, and duration of market disruptions (e.g., trading interruptions) that may otherwise prevent market participants from impounding information into security prices through market activity (e.g., order submission) and, thus, improve price efficiency in the markets. Such disruptions also impose liquidity costs and harm the price discovery process. The quality of the price discovery process has important implications for efficiency and capital formation, as prices that accurately convey information about fundamental value improve the efficiency with which capital is allocated across projects and firms.

The Commission also believes that Regulation SCI could affect competition in several ways. The Commission believes that the existing competition among the markets has not sufficiently mitigated the occurrence of SCI events.¹⁸⁷² Regulation SCI requires SCI entities to disseminate information regarding certain SCI events to affected members or participants or to all members or participants of an SCI entity. As discussed more thoroughly in Section VI.C.2.b.iv below, the Commission believes that requiring the dissemination of information regarding certain SCI events could further incentivize SCI entities to maintain more robust SCI

¹⁸⁷² See supra Section VI.B.4.

systems and indirect SCI systems and would enhance competition among SCI entities with respect to the maintenance of robust SCI systems and indirect SCI systems.

Additionally, the Commission believes that Regulation SCI may have an impact on competition among SCI entities, in part because the compliance costs of Regulation SCI will be different among SCI entities. Specifically, some SCI entities already satisfy some of the requirements of Regulation SCI because those provisions codify certain aspects of the ARP Policy Statements. The Commission believes that these current ARP participants will incur direct compliance costs that are incremental relative to the current cost of participating in the ARP Inspection Program and current practices outside of the scope of ARP. But Regulation SCI also applies to some entities that currently do not participate in the ARP Inspection Program such as the MSRB and most SCI ATSS. These SCI entities may incur higher initial compliance costs, compared to current ARP participants, in modifying their current practices to comply with Regulation SCI.¹⁸⁷³ To the extent that SCI entities with different initial compliance costs compete, Regulation SCI could alter the competitive relationship and give SCI entities that are currently in compliance with certain provisions of Regulation SCI a competitive advantage.¹⁸⁷⁴

In addition to competition among SCI entities, the compliance costs imposed by Regulation SCI could have an effect on competition between SCI entities and non-SCI entities in the markets for trading services. Specifically, in part because non-SCI entities do not have to incur the compliance costs associated with Regulation SCI, these entities may have a competitive

¹⁸⁷³ The Commission notes that the SCI entities incurring the lower initial compliance costs previously incurred such costs to participate in the ARP Inspection Program.

¹⁸⁷⁴ However, given the voluntary nature of the current ARP Inspection Program, the extent of current compliance with the requirements of adopted Regulation SCI by entities subject to the ARP Inspection Program varies.

advantage in the markets for trading services over SCI entities that they compete with. The adverse competitive effects, however, are likely to be minor when considering only ATSS because an SCI ATS is likely to be larger and have more of an established customer base than other ATSS. The Commission recognizes that broker-dealers also compete with SCI entities in the market for trading services and that some broker-dealers are larger than some ATSS and exchanges. However, broker-dealers cannot offer the same services as ATSS or exchanges without becoming ATSS or exchanges.

The costs imposed by Regulation SCI could also affect barriers to entry for new ATSS and exchanges and, thus, could adversely affect competition.¹⁸⁷⁵ Specifically, the Commission acknowledges that Regulation SCI will increase the costs for those that meet the definition of SCI entity. This will increase the expected costs of market entrants who expect to eventually be SCI entities. If an increase in these costs reduces the number of potential new entrants, the potential competition from new entrants will be lower.

As noted above, however, the Commission believes that the heightened barriers to entry for ATSS would be mitigated to some degree because the compliance period would provide a new ATS entrant the opportunity to initiate and develop its business before the ATS would need to comply with Regulation SCI.¹⁸⁷⁶ In particular, the Commission believes that few new ATSS would likely initially meet the threshold to be covered under Regulation SCI and a new ATS could trade for at least three months (i.e., less than four of the preceding six months) and conduct

¹⁸⁷⁵ While Regulation SCI could also increase start-up costs for SIPs and registered clearing agencies, SIPs provide exclusive services and registered clearing agencies are currently characterized by specialization and limited competition. Clearing and settlement services exhibit high barriers to entry and economies of scale. See Clearing Agency Standards Release, supra note 76, at 66263 and 66265.

¹⁸⁷⁶ See supra note 152.

such trading at any level without being subject to Regulation SCI. The Commission also notes that ATSS meeting the volume thresholds in the definition of "SCI ATS" for the first time will also be provided six months from the time that the ATS first meets the applicable thresholds to comply with the requirements of Regulation SCI.¹⁸⁷⁷ This compliance period should also provide such ATSS with time to plan on how they would meet the requirements of Regulation SCI, and could also potentially allow SCI ATSS to become more equipped to bear the cost of Regulation SCI once compliance is required, and thus not significantly discourage new ATSS from entering the market and growing. For newly registered exchanges, the Commission believes the costs associated with Regulation SCI would not represent a significant increased barrier to entry, as the costs would represent a small portion of total costs associated with creating and registering an exchange.

The compliance costs associated with participating in business continuity and disaster recovery plan testing may affect competition among members or participants of SCI entities and also could raise barriers to entry for new members or participants. In particular, Regulation SCI imposes compliance costs on certain members or participants of SCI entities that are designated to participate in business continuity and disaster recovery plans testing. Because some members or participants may incur compliance costs associated with Rule 1004 and others may not, it could negatively impact the ability for some to compete and could raise barriers to entry. As discussed more thoroughly in Section VI.C.2.b.vii below, the Commission expects the compliance costs associated with the business continuity and disaster recovery plans testing requirements in Rule 1004 to be limited for larger members or participants who already maintain

¹⁸⁷⁷ See supra Section IV.F (discussing effective date and compliance dates for Regulation SCI).

connections to backup facilities, including for testing purposes, than for smaller members or participants. Furthermore, the Commission believes that new members or participants are less likely to be designated immediately to participate in business continuity and disaster recovery plan testing than existing significant members or participants because new members may not initially satisfy the SCI entity's designation standards as they establish their businesses. Thus, the Commission believes the adverse effect on competition may be mitigated to some extent as the most likely members or participants to be designated for testing are those comprising the largest market share as ranked by volume by the SCI entity, and that these firms will have more limited compliance costs.¹⁸⁷⁸

2. Analysis of Final Rules

a. Definitions – Rule 1000

In general, the definitions in Rule 1000 either clarify a provision or circumscribe the scope of a provision in Regulation SCI. Therefore, many of the costs and benefits associated with the impacts of the definitions are incorporated in the discussion of the substantive requirements of Regulation SCI. This section contains a discussion of the economic effects of the scope of Regulation SCI resulting from the definitions adopted by the Commission.

i. SCI Entities

The Commission estimates that the definition of SCI entity in Rule 1000 currently covers 44 entities. This includes 30 current participants in the ARP Inspection Program (i.e., 18 registered national securities exchanges, seven registered clearing agencies, FINRA, two plan

¹⁸⁷⁸ The Commission also notes that SCI entities have an incentive to limit the imposition of the cost and burden associated with testing to the minimum necessary to comply with Rule 1004, and that, given the option, most SCI entities would, in the exercise of reasonable discretion, prefer to designate fewer members or participants to participate in testing, than to designate more. See supra Section IV.B.6.b.

processors, one ATS trading NMS stocks, and one exempt clearing agency). The definition of SCI entity also includes one ATS that currently exceeds the relevant threshold in Rule 301(b)(6)(i) of Regulation ATS and is subject to the systems safeguard requirements of Regulation ATS. In addition to these entities, the definition of SCI entity includes the MSRB and an estimated 12 additional SCI ATSs.

Generally, by including certain entities that do not currently participate in the ARP Inspection Program or meet the current threshold for the systems safeguard requirements of Regulation ATS in the definition of SCI entity, the Commission believes that Regulation SCI will not only enhance systems resiliency at such entities, but also reduce the potential for incidents at these entities to have broader, disruptive effects across the securities markets more generally on other SCI entities, and attendant costs to investors. Although the Commission believes that the requirements of Regulation SCI will reduce the impact of SCI events, the Commission is unable to quantify the economic effects of the reduction because the degree to which adherence to the requirements of Regulation SCI will reduce the impact of SCI events is unknown.

As discussed throughout the economic analysis, the Commission also expects that SCI entities will incur costs for complying with the requirements of Regulation SCI and that these costs could affect the competitiveness of entities incurring such costs. For example, the section summarizing the effects of Regulation SCI on efficiency, competition, and capital formation, Section VI.C.1.c, discusses several ways that Regulation SCI might affect the competitiveness of SCI entities, including the competitiveness of SCI entities versus non-SCI entities, the relative initial competitiveness of SCI entities needing to make more changes to comply with Regulation SCI, and barriers to entry for SCI entities.

As discussed in detail in Section IV.A.1, many commenters addressed the scope of the definition of SCI entity. Many of these comments related to the inclusion of certain ATSS in the definition.¹⁸⁷⁹ Commenters presented mixed views on the inclusion of ATSS, with some commenters believing that all ATSS should be covered by Regulation SCI,¹⁸⁸⁰ and other commenters arguing that no ATSS should be covered by Regulation SCI.¹⁸⁸¹ The commenters who supported including all ATSS in the scope of the definition of SCI entity argued that any ATSS can impact the market and one of these commenters also stated that any participant on any ATSS can have disproportionate impact on the market.¹⁸⁸² One of the main points of commenters that suggested no ATSS should be covered was that ATSS are redundant of exchanges and other ATSS and that, in case an ATSS fails, other ATSS or exchanges can service investors and absorb trading volume.¹⁸⁸³ Additionally, some commenters suggested applying higher thresholds in the definition of SCI ATSS such that fewer ATSS would be covered under Regulation SCI.¹⁸⁸⁴ Many of these commenters who advocated for applying higher thresholds in the definition of SCI ATSS stated that the inclusion of smaller ATSS in the definition of SCI ATSS does not justify what they believed to be the significant compliance costs imposed by Regulation SCI.¹⁸⁸⁵

The Commission believes that certain ATSS should be required to comply with rules regarding systems capacity, integrity, resiliency, availability, security, and compliance. ATSS

¹⁸⁷⁹ See supra Section IV.A.1.b.

¹⁸⁸⁰ See, e.g., NYSE Letter at 8-10; and Lauer Letter at 4.

¹⁸⁸¹ See, e.g., BIDS Letter at 3; ITG Letter at 2-4; and OTC Markets Letter at 9.

¹⁸⁸² See, e.g., NYSE Letter at 8-10; and Lauer Letter at 4.

¹⁸⁸³ See, e.g., BIDS Letter at 7-8; and ITG Letter at 3.

¹⁸⁸⁴ See, e.g., Direct Edge Letter at 2; ITG Letter at 10.

¹⁸⁸⁵ See, e.g., ITG Letter at 9-10.

now collectively represent a significant source of liquidity for NMS stocks.¹⁸⁸⁶ Given this level of activity on ATSS, coupled with the increasingly inter-connected and complex nature of the markets and heavy reliance on automated systems, the Commission recognizes that a systems issue even at one ATS could result in a market-wide impact. Further, some ATSS execute a larger portion of consolidated volume than smaller exchanges. In this respect, an outage at one or more of these ATSS, which serve as markets to bring buyers and sellers together in the national market system, could disrupt the entire market and could pose even greater risks to the market as a whole than certain smaller exchanges. Accordingly, the Commission believes that the exclusion of all ATSS from the definition of SCI entity would significantly reduce the benefits of Regulation SCI discussed in Section VI.C.1. On the other hand, the Commission believes that including all ATSS in the definition of SCI entity would heighten barriers to entry and restrict competition in the markets for trading services and, thus, could stifle innovations. As discussed in Section IV.A.1.b, the Commission believes that the adopted thresholds for SCI ATSS result in the inclusion of ATSS that can play a significant role in the securities markets and, given their heavy reliance on automated systems, have the potential to impact investors, the overall market, and the trading of individual securities should an SCI event occur. With respect to comments calling for higher or lower volume thresholds, the Commission believes that higher thresholds would increase the risk of significant market disruptions due to SCI events relative to the adopted thresholds and lower thresholds would serve to increase barriers to entry. In setting the levels in the thresholds for SCI ATS, the Commission has considered the trade-offs between barriers to entry and the risk of significant market disruptions.

¹⁸⁸⁶ See supra note 148 and accompanying text. See also text accompanying supra note 1832.

In adopting the thresholds in the definition of SCI ATS, the Commission also considered alternative thresholds, including the threshold used in Regulation ATS. The adopted thresholds in the definition of SCI ATS differ from the thresholds that subject an ATS to the systems safeguard requirements under Rule 301(b)(6) of Regulation ATS in several ways.¹⁸⁸⁷ First, for ATSS that trade NMS stocks or non-NMS stocks, the adopted thresholds are based on dollar trading volume instead of share trading volume. The Commission believes that the application of dollar trading volume thresholds better reflects the potential economic impact of a systems issue at a significant ATS as it more accurately measures the value of trading activity compared to a threshold based on share trading volume.¹⁸⁸⁸ Second, the adopted volume thresholds for NMS stocks and non-NMS stocks are lower than the volume thresholds in Rule 301(b)(6) of Regulation ATS. As discussed in IV.A.1.b, securities trading has evolved significantly since the adoption of Regulation ATS; today, trading activity in stocks is more dispersed among a larger number of trading venues. Because trading activity in stocks is now dispersed among a larger number of trading venues and markets today are so inter-connected and complex, the Commission believes that the application of lower volume thresholds would more effectively capture multiple sources of potential systems issues that could significantly disrupt the market for a single security or for the market as a whole. Third, with respect to ATSS that trade NMS stocks, the Commission is adopting the two-fold dollar volume thresholds in the first prong—a single NMS stock threshold and an all NMS stocks threshold. The Commission believes that

¹⁸⁸⁷ See also supra Section IV.A.1.b.

¹⁸⁸⁸ See text accompanying supra note 161; see also Proposing Release, supra note 13, at 18094 (stating that the use of dollar thresholds may better reflect the economic impact of trading activity).

such thresholds would appropriately account for the significance of an ATS in both overall trading of NMS stocks and for a single NMS stock.

With regard to commenters that stated no ATSs should be covered because ATSs are redundant of exchanges and other ATS, the Commission acknowledges that, to some extent, certain services provided by any trading venue, including exchanges and ATSs, are redundant in the sense that these facilities execute and process trades. However, the Commission notes that each ATS provides different services in terms of, among other things, order types, matching rules, and the speed of execution to meet investors' specific needs. If an ATS outage interferes with the supply of certain services that investors demand, it would impose costs on investors. For example, market participants may program their routing algorithms assuming that all market centers are operational. If one of those venues is not available, rerouting order flow may increase costs to the market participant seeking execution as time required for executing orders may increase, order fill rates may decrease, and slippage¹⁸⁸⁹ may also increase, which would further increase transaction costs.¹⁸⁹⁰

The Commission also received comments regarding the inclusion of fixed-income ATSs. One commenter suggested the use of par value traded rather than volume.¹⁸⁹¹ Further, in noting that fixed-income ATSs should not be subject to Regulation SCI, this commenter noted that retail fixed-income ATSs operate on a vastly different scale than institutional equity markets.¹⁸⁹²

¹⁸⁸⁹ Slippage refers to the difference between the expected price of a trade and the actual trade price due to the passage of time.

¹⁸⁹⁰ See supra Section VI.B.4 for a discussion of why market incentives do not seem to reduce these costs.

¹⁸⁹¹ See TMC Letter at 1-3.

¹⁸⁹² See id. at 2.

According to this commenter, the costs of compliance for a retail fixed-income ATS would be several orders of magnitude higher than for an exchange in the equity market, and would overwhelm revenues for retail fixed-income ATSs.¹⁸⁹³

The Commission, after considering the views of commenters, has determined to exclude ATSs that trade only municipal securities or corporate debt securities from the definition of SCI ATS at this time.¹⁸⁹⁴ Accordingly, such fixed-income ATSs will not be subject to the requirements of Regulation SCI. Rather, fixed-income ATSs will continue to be subject to the existing requirements in Rule 301(b)(6) of Regulation ATS regarding systems capacity, integrity and security if they meet the twenty percent threshold for municipal securities or corporate debt securities provided by that rule.¹⁸⁹⁵ Because no such ATS is subject to Regulation SCI at this time, it is possible that the municipal security and corporate debt markets may be affected by SCI events that otherwise may have been prevented with more robust systems that would result from Regulation SCI. However, the Commission believes that this loss in potential benefit relative to the proposed approach would be minimal as fixed-income securities trading is generally significantly less automated than trading in equities.¹⁸⁹⁶ Further, as commenters pointed out, the cost of the requirements of Regulation SCI could be significant for fixed-income ATSs relative to their size, scope of operations, and more limited potential for systems risk. Therefore,

¹⁸⁹³ See id.

¹⁸⁹⁴ See supra Section IV.A.1.b.

¹⁸⁹⁵ See 17 CFR 242.301(b)(6).

¹⁸⁹⁶ The Commission notes that the corporate debt and municipal securities markets are primarily voice markets with little automation. See also supra note 185 (discussing the view of commenters that the inclusion of fixed-income ATSs and/or the adoption of the proposed thresholds would impose unduly high costs on these entities given their size, scope of operations, lack of automation, low speed, and resulting low potential to pose risk to systems).

lowering the current threshold applicable to fixed-income ATs in Regulation ATS and subjecting such ATs to the requirements of Regulation SCI could have potentially discouraged the growth of automation that could benefit investors in these markets. However, as the Commission monitors the evolution of automation in this market, the Commission may reconsider the benefits and costs of extending the requirements of Regulation SCI to fixed-income ATs in the future.

The adopted definition of SCI SRO includes all national securities exchanges regardless of their volume share. The Commission received one comment letter stating that the rule should also include volume thresholds for exchanges.¹⁸⁹⁷ The Commission is not persuaded that applying a volume threshold is appropriate for SCI SROs that are exchanges, but instead believes that Regulation SCI should cover all exchanges. In particular, the Commission recognizes that all exchanges play an important role in the securities markets. As discussed above in Section IV.A.1.a, all stock exchanges are subject to a variety of specific public obligations under the Exchange Act, including the requirements of Regulation NMS which, among other things, designates the best bid or offer of such exchanges to be protected quotations. Accordingly, every exchange may have a protected quotation that can obligate market participants to send orders to that exchange if such exchange is displaying the best bid or offer. Among other reasons, given that market participants may be required to send orders to any one of the exchanges at any given time if such exchange is displaying the best bid or offer, the Commission believes that it is important that the safeguards of Regulation SCI apply equally to all exchanges irrespective of trading volume. As market participants may be required to send orders to the exchange displaying the best prices, systems issues at such exchange could force market participants to re-

¹⁸⁹⁷ See supra note 81 and accompanying text.

route their orders and, thus, could increase execution time and slippage, imposing additional transaction costs to investors.

With respect to options exchanges, the Commission additionally believes that it would be inappropriate to exclude them from the definition of SCI SRO because technology risks are equally applicable to such exchanges, as evidenced by recent technology incidents affecting the options markets.¹⁸⁹⁸ While there are many options that trade on multiple venues, systems issues resulting in trading disruptions at an options exchange could lower the quality of pricing efficiency and disrupt the price discovery process for singly-listed options (e.g., certain index options only trade on one options exchange). As such, systems issues at options exchanges can pose significant risks to the markets, and the Commission believes that the inclusion of options exchanges within the scope of Regulation SCI is necessary to achieve the goals of Regulation SCI.

The definition of SCI entity also includes the MSRB. The Commission believes that the inclusion of the MSRB as an SCI entity will provide several significant benefits. In particular, the MSRB collects and consolidates municipal securities data and makes it available to market participants. The Commission believes that any event that could affect the market data collected and consolidated by the MSRB could significantly disrupt the municipal bond market. Also, the municipal securities data collected by the MSRB is provided to FINRA and made available to the Commission and the bank regulators, and serves as a key resource for monitoring the municipal bond market. Therefore, the inclusion of the MSRB will help ensure the robustness of the MSRB's systems and reduce the likelihood of systems issues that could harm investors in the municipal bond market.

¹⁸⁹⁸ See supra note 84.

As discussed above in Section IV.A.1, several commenters advocated the adoption of a “risk-based” approach in the definition of SCI entity based on the criticality of the functions performed.¹⁸⁹⁹ In effect, these commenters suggested that the Commission apply provisions of Regulation SCI based on the entity’s risk to the operations of the U.S. securities markets based on the entity’s functional role in the market (e.g., a primary listing market, the sole venue of the security, a monopoly or utility type role with no redundancy). The Commission has considered these factors in developing the definition of SCI entity and believes that the adopted definition, in part, captures the intent of the commenters’ suggestions in that it includes entities in the definition that play a significant role in the securities markets. In particular, as discussed in Section IV.A.1.a in detail, the Commission included all exchanges in the definition of SCI SRO because exchanges play a significant role in the functioning of securities markets. With respect to the comments that suggested including only those entities that are essential to continuous market-wide operation, the Commission believes that the specific criteria suggested by commenters, in effect, could lead to the exclusion of significant ATSS. As discussed above, the Commission continues to believe that significant ATSS that trade NMS and non-NMS stocks should be included in Regulation SCI. ATSS collectively represent a significant source of liquidity for stocks. Furthermore, as today’s markets are increasingly inter-connected and complex with heavy reliance on automated systems, the Commission recognizes that a systems issue at an ATS could result in a market-wide impact. Consequently, the Commission believes that re-defining SCI entities according to commenters’ “risk-based” approach could exclude certain entities that the Commission believes have the potential to pose significant risks to the

¹⁸⁹⁹ See supra notes 53-57 and accompanying text.

securities markets should an SCI event occur, and thus limit the potential benefits from Regulation SCI, which are discussed throughout this economic analysis.

ii. SCI Systems

Regulation SCI expands on current practice, and applies to a broader range of systems than the current ARP Inspection Program. In particular, the ARP Policy Statements are focused on specific types of automated systems.¹⁹⁰⁰ The ARP Policy Statements and the ARP Inspection Program address systems that directly support trading, clearance and settlement, order routing, and market data. The definition of "SCI systems" would include these systems, as well as those that directly support market regulation and market surveillance, systems that serve an essential function for investor protection and market integrity.

The inclusion of market regulation and market surveillance systems under Regulation SCI could reduce systems compliance issues that result from disruptions in systems that support market regulation and market surveillance. The Commission believes that including market regulation and market surveillance systems under the definition of SCI systems should help ensure the robustness of the systems used by SCI entities to monitor compliance with relevant laws, rules, and their own rules, and detect any violations of such laws or rules by members or participants. The reduction in market regulation and market surveillance systems issues could help ensure investor protection and preserve market integrity.

¹⁹⁰⁰ See supra Section II.A and Proposing Release, supra note 13, at Section I.A (discussing in more detail the ARP Policy Statements and the ARP Inspection Program). According to the ARP I Release, the term "automated systems" or "automated trading systems" means computer systems for listed and OTC equities, as well as options, that electronically route orders to applicable market makers and systems that electronically route and execute orders, including the data networks that feed the systems. These terms also encompass systems that disseminate transaction and quotation information and conduct trade comparisons prior to settlement, including the associated communication networks. See ARP I Release, supra note 1, at 48706, n. 21.

The Commission also believes that the inclusion of market data systems in the definition of SCI systems will benefit the market. Currently, SIAC, Nasdaq, and the MSRB¹⁹⁰¹ process, collect, and disseminate market data on equities, options, and municipal securities to investors. While SIAC and Nasdaq are part of the ARP Inspection Program, the MSRB is not. The Commission believes that consolidated market data is an important part of the investing and trading process as it helps market participants to make well-informed investment and trading decisions, and also helps investors to monitor the quality of execution of orders by their brokers. Thus, any SCI events that affect market data processed, collected, and disseminated by the MSRB could reduce pricing efficiency and, consequently, could significantly disrupt the municipal bond market. Further, with respect to NMS securities, the Commission understands that many trading algorithms make trading decisions based primarily on market data and rely on that data being current and accurate.

In addition, as noted in Section IV.A.2.b, market data as used in the definition of “SCI systems” does not refer exclusively to consolidated market data, but also includes proprietary market data generated by SCI entities as well. The Commission notes that proprietary market data is widely used and relied upon by a broad array of market participants, including institutional investors, to make trading decisions. Therefore, if a proprietary market data feed

¹⁹⁰¹ As discussed above, in 2008, the Commission amended Rule 15c2-12 to designate the MSRB as the single centralized disclosure repository for continuing municipal securities disclosure. In 2009, the MSRB established EMMA, which serves as the official repository of municipal securities disclosure and provides the public with free access to relevant municipal securities data, and is the central database for information about municipal securities offerings, issuers, and obligors. Additionally, the MSRB’s RTRS, with limited exceptions, requires municipal bond dealers to submit transaction data to the MSRB within 15 minutes of trade execution, and such near real-time post-trade transaction data can be accessed through the MSRB’s EMMA website. See *supra* note 77. The MSRB is an SCI entity by virtue of being an SRO, rather than a plan processor.

became unavailable or otherwise unreliable, it could interfere with market participants making trading decisions and impose additional transaction costs on market participants.

The Commission has limited information on the extent to which the ARP Policy Statements guide ARP participants' practices with respect to their proprietary market data systems because this information is not reported to the Commission. To the extent that the ARP Policy Statements guide ARP participants with respect to certain of their proprietary market data systems, the potential benefits from including proprietary market data systems in Regulation SCI could be incremental given current practice. The Commission also notes that entities have competitive incentives to limit the number of systems issues with their proprietary market data systems, as those SCI entities with minimum latency and the most robust proprietary market data systems may attract more trading volume. While proprietary market data systems have experienced systems issues, because these issues are not reported to the Commission, the Commission has limited information on the frequency and severity of such systems issues and, in addition, does not have information about how proprietary market data systems issues affect the demand to subscribe to a particular proprietary market data feed. Although the Commission is unable to estimate the benefits and costs of subjecting proprietary market data systems to Regulation SCI, the Commission believes that if a proprietary market data feed became unavailable or otherwise unreliable, it could have a significant impact on the trading of the securities to which it pertains, and could interfere with the maintenance of fair and orderly markets.¹⁹⁰²

To the extent that proprietary market data systems and consolidated market data systems share common infrastructure, the compliance costs associated with proprietary market data

¹⁹⁰² See *supra* Section IV.A.2.b.

systems could be incremental to those costs associated with consolidated market data systems. In addition, to the extent the ARP Policy Statements guide ARP participants with respect to their proprietary market data systems, the initial compliance costs associated with proprietary market data systems will be lower for these participants with respect to the relevant proprietary market data systems.

As adopted, a subset of SCI systems are defined as critical SCI systems. Critical SCI systems are defined as SCI systems of, or operated by or on behalf of, an SCI entity that directly support functionality relating to clearance and settlement systems of clearing agencies; openings, reopenings, and closings on the primary listing exchange; trading halts; initial public offerings; the provision of consolidated market data; and exclusively listed securities.¹⁹⁰³ In addition, critical SCI systems include systems that provide functionality to the securities markets for which the availability of alternatives is significantly limited or nonexistent, and without which there would be a material impact on fair and orderly markets.¹⁹⁰⁴ Critical SCI systems include systems that represent potential “single points of failure” in the securities markets—if they were to experience systems issues, the Commission believes they would be the most likely to have a widespread and significant impact on the U.S. securities markets. Critical SCI systems are subject to certain heightened resilience and information dissemination requirements under Regulation SCI. In addition, because an SCI entity may tailor its policies and procedures based on the relative criticality of a given system to the SCI entity and to the securities markets generally, an SCI entity may subject its critical SCI systems to higher standards than other SCI systems.

¹⁹⁰³ See Rule 1000.

¹⁹⁰⁴ See *id.*

By adopting a defined term “critical SCI systems” (which is not defined for purposes of the ARP Inspection Program or Regulation ATS), along with the heightened requirements associated with critical SCI systems, the Commission expects fewer disruptions in critical SCI systems, and therefore fewer SCI events involving potential “single points of failure” that could cause wide-scale disruptions across the securities markets. As explained in Section VI.C.1, this could reduce the likelihood and duration of systems issues, thereby helping to avoid pricing inefficiencies and reduce interruptions in liquidity flow, which may occur during times when systems disruptions can make systems unavailable or unreliable.

The Commission also notes that, by distinguishing critical SCI systems from other SCI systems, and because an SCI entity may tailor its policies and procedures based on the relative criticality of a given system to the SCI entity and to the securities markets generally, an SCI entity may subject its critical SCI systems to higher standards than other SCI systems. In addition, critical SCI systems are subject to a goal of two-hour recovery following a wide-scale disruption, and a requirement for information dissemination to all members or participants of an SCI entity in the case of an SCI event impacting critical SCI systems (unless the SCI event qualifies as a de minimis SCI event). As result, the designation of critical SCI systems may result in additional costs as compared to the proposal. However, by distinguishing critical systems, Regulation SCI is consistent with a risk-based approach that targets areas that would generate the most benefits.

Regulation SCI defines “indirect SCI systems”¹⁹⁰⁵ to mean any systems of, or operated by or on behalf of, an SCI entity that, if breached, would be reasonably likely to pose a security

¹⁹⁰⁵ As discussed in Section IV.A.2.d, “SCI security systems” have been renamed “indirect SCI systems” and its definition has been revised in response to commenters who

threat to SCI systems.¹⁹⁰⁶ As discussed above in Section IV.A.2.d, the adopted definition excludes systems that are effectively physically or logically separated from SCI systems because the Commission believes that the benefit of including systems that can effectively be “walled off” may be limited, as “walled off” systems are less likely to serve as potential vulnerable entry points to SCI systems in the event of a security breach.¹⁹⁰⁷ Regulation SCI will expressly impose new requirements on systems that fall within the definition of “indirect SCI systems” (which is not defined for purposes of the ARP Inspection Program or Regulation ATS). These new requirements for indirect SCI systems should help ensure the robustness and resiliency of SCI systems by reducing the occurrence of security-related issues at SCI systems. Moreover, the application of Regulation SCI to indirect SCI systems could encourage SCI entities to isolate certain non-SCI systems from SCI systems (thereby removing these non-SCI systems from the scope of indirect SCI systems), which would decrease the risk that non-SCI systems provide vulnerable points of entry into SCI systems and cause security-related issues at SCI systems. The reduction in security-related SCI systems issues could lead to fewer interruptions in the price discovery process and liquidity flows and thus result in fewer periods with pricing inefficiencies as discussed in Section VI.C.1.

expressed concern about the breadth of the proposed definition. Because the definition of indirect SCI systems has been refined from the proposal, the compliance costs associated with indirect SCI systems (discussed below) would be lower relative to the compliance costs associated with the proposed rules.

¹⁹⁰⁶ As proposed, “SCI security systems” means any systems that share network resources with SCI systems that, if breached, would be reasonably likely to pose a security threat to SCI systems.

¹⁹⁰⁷ Some SCI entities currently employ a wide variety of means to separate their systems, including logical and physical separation.

Regulation SCI specifies the obligations SCI entities would have with respect to SCI systems and indirect SCI systems. As mentioned above, the definition of SCI systems includes more systems than the ARP Inspection Program traditionally covered, and “indirect SCI systems” is not defined for purposes of the ARP Inspection Program or Regulation ATS. Because Regulation SCI applies to SCI systems and indirect SCI systems, SCI entities will incur compliance costs, discussed in detail further below in Section VI.C.2, which include, among other things, costs associated with policies and procedures related to such systems. Furthermore, as mentioned above, the definition of SCI systems includes systems that directly support trading, clearance and settlement, order routing, and market data, which are covered by the ARP Inspection Program. Accordingly, the Commission believes that initial compliance costs associated with SCI systems will be higher for SCI entities that are not currently participating in the ARP Inspection Program (e.g., some SCI ATSS) as compared to ARP Inspection Program participants that have established practices consistent with the ARP Policy Statements. Although the Commission believes that some SCI ATSS will generally incur higher initial compliance costs associated with the requirements of Rule 1001 compared to other SCI entities that are current participants in the ARP Inspection Program, the difference in initial compliance costs could be limited because, as currently constituted, relative to the systems of SCI SROs, the systems of SCI ATSS generally would not fall within the category of critical SCI systems, and thus such SCI ATSS would not be subject to the more stringent requirements that would be applicable to the critical SCI systems of other SCI entities. Further, as discussed in Section VI.C.1, the Commission believes that Regulation SCI could have an impact on competition among SCI entities in part because the initial compliance costs associated with SCI systems and indirect SCI systems will vary across SCI entities.

In the SCI Proposal, the Commission defined SCI systems more broadly than it has in the adopted rule. Specifically, the proposed definition of SCI systems would have included all regulation and surveillance systems, as well as development and testing systems. As discussed above in Section IV.A.2.b, after considering, among other things, the views of commenters that the definition of SCI systems was overbroad and, thus, could cover nearly all systems of an SCI entity, the Commission refined the definition of SCI systems.¹⁹⁰⁸ Specifically, the scope of adopted Regulation SCI does not cover member regulation or member surveillance systems such as those, for example, relating to member registration, capital requirements, or dispute resolution, because issues relating to such systems are unlikely to have the same level of impact on the maintenance of fair and orderly markets or an SCI entity's operational capability as those systems identified in the definition of SCI systems. Consequently, the Commission does not believe that the exclusion of member regulation and member surveillance systems will significantly reduce the benefits of Regulations SCI discussed in Section VI.C.1. Furthermore, the Commission believes that the exclusion of member regulation and member surveillance systems from the adopted definition of SCI systems will substantially reduce the costs of compliance with Regulation SCI relative to the proposal because it reduces the potential number of SCI events that would be subject to the Commission notification requirements compared to the proposal.

As discussed above in Section IV.A.2.b, many commenters also opposed the inclusion of development and testing systems in the definition of SCI system, stating that issues in development and testing systems would have little or no impact on the operations of SCI

¹⁹⁰⁸ See supra Section IV.A.2.b (discussing the definition of SCI systems).

entities.¹⁹⁰⁹ The Commission agrees that issues with development and testing systems generally have less of an impact on the SCI entity's operations than production systems that directly support trading, clearance and settlements, order routing, market data, market regulation, and market surveillance. In response to comment letters, the adopted definition of SCI systems is limited to systems that directly support trading, clearance and settlement, order routing, market data, market regulation, and market surveillance, and does not include development and testing systems. Consequently, the requirements of Regulation SCI that are triggered by the definition of SCI systems do not apply to development and testing systems. However, the Commission recognizes that there would be benefits from maintaining robust development and testing systems because these systems are important in ensuring the reliability and resiliency of systems of SCI entities. As discussed in Section IV.A.2.b, in order to have policies and procedures reasonably designed to ensure capacity, integrity, resiliency, availability, and security for SCI systems (and indirect SCI systems, as applicable) in accordance with adopted Rule 1001(a), an SCI entity will be required to have policies and procedures that include a program to review and keep current systems development and testing methodology for such systems.¹⁹¹⁰

A few commenters advocated that SCI entities should be permitted to conduct their own risk-based assessment in determining the scope of SCI systems.¹⁹¹¹ As discussed in Section IV.A.2.b, rather than limiting the definition of SCI systems to systems that pose a greater risk to

¹⁹⁰⁹ See supra note 234 and accompanying text.

¹⁹¹⁰ Further, as discussed above, the definition of SCI review and the corresponding requirement for an annual SCI review require an assessment of internal control design and effectiveness, which includes development processes. In addition, if development and testing systems are not appropriately walled off from production systems, such systems could be captured under the definition of indirect SCI systems and be subject to the requirements of Regulation SCI.

¹⁹¹¹ See DTCC Letter at 3-5; Omgeo Letter at 5-6; and OCC Letter at 3-4.

the markets in the event of a systems issue or that are of paramount importance to the functioning of the U.S. securities market, the Commission is subjecting those systems that meet the definition of “critical SCI systems” to certain heightened requirements under Regulation SCI. The Commission continues to believe that any systems issues involving systems that directly support one of the six functions (trading, clearance and settlement, order routing, market data, market regulation, or market surveillance) listed in the definition of SCI systems could also cause significant market disruptions and, thus, including such systems and imposing heightened requirements on a subset of such systems—critical SCI systems—should help realize the benefits of Regulation SCI discussed in Section VI.C.1.a.

As discussed above in Section IV.A.2.b, the definition of SCI systems includes any system that is operated by a third-party on behalf of an SCI entity and directly supports one of the six key functions (trading, clearance and settlement, order routing, market data, market regulation, or market surveillance) listed in the definition of SCI systems. The Commission understands that many SCI entities and many SROs, in particular, rely heavily on outsourcing to help test, operate, and run various systems in their daily operations and that they outsource networks, data center operations, and many of the products and systems that support their trading and/or clearing systems. The Commission also notes that its staff already discusses with ARP entities their use of certain third-party systems as necessary under the ARP Inspection Program. Because of this reliance on outsourcing to third party systems, the Commission believes that including any system that directly supports one of the six functions listed in the definition of SCI system, regardless of whether it is operated by the SCI entity directly or by a third party, is important in reducing systems issues and, thus, promoting pricing efficiency and price discovery process.

Several commenters stated that the definition of SCI systems should not include systems operated on behalf of an SCI entity by a third-party.¹⁹¹² These commenters expressed concerns about potential difficulties with meeting the requirements of Regulation SCI with regard to third-party systems.¹⁹¹³ Another commenter questioned whether the Commission considered the costs and benefits of including third-party systems within the definition.¹⁹¹⁴ This commenter also noted that the inclusion of third-party systems may force SCI entities to insource functions that are more efficiently performed by vendors, and the cost of insourcing will be passed along to members and market participants and may degrade competition.¹⁹¹⁵

As discussed above, the Commission believes that, among other reasons, allowing systems operated on behalf of an SCI entity by a third-party to be excluded from the requirements of Regulation SCI would reduce the effectiveness of the regulation in promoting the national market system by ensuring the capacity, integrity, resiliency, availability, and security of those systems important to the functioning of the U.S. securities markets.¹⁹¹⁶ The Commission acknowledges that ensuring compliance of systems operated by a third-party with Regulation SCI may be more costly than ensuring compliance of internal systems with Regulation SCI because of search costs associated with employing adequate third-party systems or services and the additional communication needed with the third-party service provider. The Commission acknowledges that higher compliance costs associated with managing third-party systems could be passed on to market participants.

¹⁹¹² See, e.g., Omgeo Letter at 5-6; and BATS Letter at 4.

¹⁹¹³ See, e.g., Omgeo Letter at 5-6; and BATS Letter at 4.

¹⁹¹⁴ See BATS Letter at 4-5.

¹⁹¹⁵ See *id.* at 5.

¹⁹¹⁶ See *supra* Section IV.A.2.b (discussing the definition of “SCI systems”).

Moreover, the Commission recognizes that the inclusion of systems operated by a third-party on behalf of an SCI entity in the scope of SCI systems may in certain cases make it more difficult for an SCI entity to utilize third parties because the SCI entity is required to ensure that SCI systems and indirect SCI systems operated on its behalf by a third party are operated in compliance with Regulation SCI. In particular, the SCI entity might not be able to ensure that systems operated by certain third parties are in compliance with Regulation SCI and therefore might not be able to utilize such third-party service providers. Limitations on the choice of third-party systems could lower the quality of employable third-party systems because the employable third-party systems may not be best suited for the SCI entity or be the best available of its type. At this time, however, it is difficult to estimate the extent to which inclusion of systems operated by third parties on behalf of an SCI entity in the definition of SCI systems will alter outsourcing arrangements in a manner that would result in reducing an SCI entity's ability to maintain its operational capability and promote the maintenance of fair and orderly markets. While the Commission understands that SROs outsource some systems, the Commission lacks sufficient information regarding the specific contractual relationships between SCI entities and third-party service providers.

Furthermore, if—due to limited options on employable third-parties—an SCI entity decides to insource systems that could be more cost-effectively provided by third parties with relevant expertise, the quality of such systems may be adversely affected, while the cost to the SCI entity may be increased. As such, Regulation SCI could impose higher costs on SCI entities that are currently more dependent on third-party systems for their operations than SCI entities that primarily employ their own systems and therefore could potentially have adverse effects on competition among SCI entities. In addition, the requirements of Regulation SCI could force

some third-party vendors out of the market for SCI systems or indirect SCI systems. In this respect, Regulation SCI could negatively impact such vendors and reduce the ability for some third-party vendors to compete in the market for SCI systems and indirect SCI systems, with attendant costs to SCI entities. However, Regulation SCI, over time, could result in quality improvements for systems or services provided by such third-party vendors as vendors that primarily provide services to SCI entities may compete in part on the quality of their systems in light of the requirements of Regulation SCI.

iii. SCI Events

Rule 1000 defines SCI events to include systems disruptions, systems compliance issues, and systems intrusions. Further, for purposes of the information dissemination requirement under Rule 1002(c), the Commission defines the new term, major SCI event, to mean an SCI event that has had, or the SCI entity reasonably estimates would have, any impact on a critical SCI system, or a significant impact on the SCI entity's operations or on market participants. As discussed further below, Regulation SCI requires SCI entities to take appropriate corrective actions in response to SCI events (Rule 1002(a)), notify the Commission of SCI events (Rule 1002(b)), and disseminate information regarding certain major SCI events to all members or participants of an SCI entity and certain other SCI events to affected members or participants (Rule 1002(c)).

Prior to the adoption of Regulation SCI, "systems disruption" was not defined by Commission rule. Rather, in the 2001 Staff ARP Interpretive Letter, Commission staff provided guidance on examples of significant systems outages that should be reported to Commission

staff.¹⁹¹⁷ The Commission understands that ARP participants currently exercise a level of discretion in determining what systems issues constitute significant systems outages.

As adopted, “systems disruption” is defined to mean an event in an SCI entity’s SCI systems that disrupts, or significantly degrades, the normal operation of an SCI system. The Commission believes the revised definition sets forth a standard that SCI entities can apply in a wide variety of circumstances to determine in their discretion whether a systems issue should be appropriately categorized as a systems disruption. The adopted definition of systems disruption potentially covers types of events that were not articulated as part of Commission staff guidance regarding significant systems outages, and at the same time potentially excludes types of systems events that were articulated as part of such guidance. The Commission, however, believes that the adopted definition of systems disruptions would more appropriately capture material or significant systems issues than the 2001 Staff ARP Interpretive Letter. Accordingly, the inclusion of systems disruptions in the definition of SCI event, along with the requirements of taking timely corrective actions, Commission notification, information dissemination, and recordkeeping on these systems issues, should help effectively reduce the severity and duration of events that harm pricing efficiency, price discovery, and liquidity and help Commission oversight of the securities markets. The Commission also acknowledges that SCI entities will incur some costs to determine whether a systems disruption has occurred. The Commission notes that these costs should be lower compared to the proposed definition, in part, because the adopted definition of systems disruption sets forth a standard that permits SCI entities to more effectively identify such systems issues.

¹⁹¹⁷ See 2001 Staff ARP Interpretive Letter, supra note 21.

As discussed in Section IV.A.3.a, after considering the views of commenters that the proposed definition of systems disruption was too prescriptive, insufficiently flexible, and should be limited to material systems disruptions, the Commission has taken a different approach. Instead of the proposed seven-prong prescriptive definition representing the effects caused by a disruption of an SCI entity's systems, the adopted definition focuses on whether a system is halted or degraded in a manner that is outside of its normal operation. The proposed definition had the potential to incorporate certain types of minor events that should more appropriately fall outside the purview of the regulation. Similarly, the prescriptive approach of the proposed definition also had the potential to exclude certain types of events that were significant enough to warrant inclusion, but may otherwise have gone unreported because they were not one of the seven enumerated types of systems malfunctions.

Currently, "systems intrusion" is not defined by Commission rule or Commission staff guidance. The Commission believes that regulated entities exercise a level of discretion in determining what systems intrusions to report to Commission staff. By adopting a definition of systems intrusion, the Commission is specifying the criteria for SCI entities to use to identify systems intrusions that would be subject to Regulation SCI. The definition of systems intrusion covers successful unauthorized entry to SCI systems and indirect SCI systems. Unauthorized access, destruction, and manipulation of SCI systems and indirect SCI systems could adversely affect the markets and market participants because intruders could force systems to operate in unintended ways that could create significant disruptions in securities markets. Therefore, the inclusion of systems intrusions in the definition of SCI events can help reduce the risk of such adverse effects. The Commission believes that the inclusion of systems intrusion in the definition of SCI event should help ensure consistent compliance with the requirements of taking

timely corrective actions, Commission notification, information dissemination, and recordkeeping and, thus, should help realize the benefits of those requirements discussed in sections below. The Commission also acknowledges that SCI entities will incur some costs to determine whether a systems intrusion has occurred.

Currently, “systems compliance issue” is also not defined by Commission rule or Commission staff guidance and the Commission believes that regulated entities exercise a level of discretion in determining what systems compliance-related issues to report to Commission staff. While the ARP Policy Statements do not address systems compliance issues, some SCI entities notify the Commission of certain systems compliance-related issues.¹⁹¹⁸ As noted above, however, the Commission does not receive comprehensive data regarding such issues. By adopting a definition of systems compliance issue, the Commission is specifying the criteria for SCI entities to use to identify systems compliance issues that would be subject to Regulation SCI.

By defining SCI events to include systems compliance issues, the Commission believes Regulation SCI should further assist the Commission in its oversight of SCI entities and in the protection of investors. Specifically, the Commission believes that inclusion of systems compliance issues in the definition of SCI event and the resulting applicability of the Commission reporting, information dissemination, and recordkeeping requirements are important to help ensure that SCI systems are operated by SCI entities in compliance with the Exchange Act, rules thereunder, and their own rules and governing documents.¹⁹¹⁹ In addition, the

¹⁹¹⁸ See supra note 1803 and accompanying text. As part of the Commission’s oversight of SROs, OCIE reviews systems compliance issues reported to Commission staff.

¹⁹¹⁹ See supra Section IV.A.3.b.

Commission believes that, as part of its oversight of the securities markets, it should learn of a non-de minimis systems compliance issue immediately upon an SCI entity having a reasonable basis to conclude that such a systems compliance issue has occurred so that the Commission may consider whether there has been any resulting harm to investors or market participants. The Commission also acknowledges that SCI entities could incur some costs to determine whether a systems compliance issue has occurred.

The Commission notes that it has refined the definition of systems compliance issue as compared to the proposal by replacing the phrase “federal securities laws” with “the Act.”¹⁹²⁰ Accordingly, the number of systems compliance issues subject to Regulation SCI could be no greater and possibly lower than if the Commission adopted the definition of systems compliance issue as proposed and there could be a corresponding reduction in benefits, compared to the proposal, as a result of adopting a targeted definition.¹⁹²¹

Regulation SCI also defines “major SCI event.” The addition of the definition of major SCI event allows the requirement for dissemination of information to all members or participants of an SCI entity to be consistent with a tiered, risk-based approach. As discussed in Section VI.C.2.b.iv below and in Section VI.C.1 above, dissemination of information regarding SCI events to all members or participants of an SCI entity can result in benefits and affect competitive incentives to prevent systems issues. The Commission acknowledges, however, that the benefits of information dissemination to all members or participants of an SCI entity would not be realized if SCI entities were required to disseminate too many events, creating confusion

¹⁹²⁰ See id.

¹⁹²¹ For example, the adopted definition of systems compliance issue makes explicit that the requirements of Regulation SCI do not apply to any obligations that an SCI entity has under the Securities Act of 1933.

about which events are meaningful, or if SCI entities were required to disseminate too few events. The definition of major SCI events provides a targeted approach to determining which events are appropriately disseminated to all members or participants of an SCI entity. The Commission also acknowledges that, as discussed in Section VI.C.2.b.iv below, SCI entities would incur compliance costs associated with developing a process for determining major SCI events and de minimis SCI events.

SCI entities will incur compliance costs with regard to the requirements of Regulation SCI. As noted above, the definition of SCI event includes systems disruptions and systems intrusions, terms that are not defined under the ARP Inspection Program, but which are contemplated by the ARP Inspection Program's attention to systems failures, disruptions, and other systems problems, including systems vulnerability.¹⁹²² To this extent, the initial compliance costs associated with SCI events may be higher for SCI entities that are not currently participating in the ARP Inspection Program than for those currently participating in the ARP Inspection Program. Similarly, the initial compliance costs associated with SCI events will be higher for SCI entities that do not currently self-report systems compliance-related issues to the Commission than those that do. As discussed in Section VI.C.1, the Commission believes that Regulation SCI will have an impact on competition among SCI entities because the initial compliance costs stemming from the definition of SCI events will be different among SCI entities. However, all SCI entities, regardless of current participation in the ARP Inspection Program or self-reporting of systems compliance-related issues, could incur costs associated with the inclusion of major SCI events as a definition.

¹⁹²² See supra Section II.A (discussing the ARP Inspection Program).

As an alternative to the adopted definitions of SCI event, several commenters suggested that the definition of SCI event include a materiality threshold such that certain Regulation SCI requirements would apply only to events that exceed the threshold, as determined by the SCI entity.¹⁹²³ The Commission is not persuaded that incorporating a materiality threshold into the definition of SCI event would appropriately capture SCI events. Some systems issues, which may initially seem insignificant to an SCI entity, may later prove to be the source of significant systems issues at the SCI entity. Furthermore, there could be incidences in which systems issues cause minor disruptions for one particular SCI entity but result in significant disruptions for another SCI entity or market participant. Under the use of the suggested materiality threshold, such systems issues could be overlooked and timely corrective action may not be taken.

b. Requirements for SCI Entities – Rules 1001-1004

i. Policies and Procedures – Rules 1001(a), (b), and (c)

Rules 1001(a), (b), and (c) set forth requirements relating to the written policies and procedures that SCI entities are required to establish, maintain, and enforce. Rule 1001(a) requires an SCI entity to establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems and, for purposes of security standards, indirect SCI systems, have levels of capacity, integrity, resiliency, availability, and security, adequate to maintain the SCI entity's operational capability and promote the maintenance of fair and orderly markets. Rule 1001(b) requires an SCI entity to establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems operate in a manner that complies with the Exchange Act and the rules regulations thereunder and the entity's rules and governing documents, as applicable. Rule 1001(c) requires an SCI entity to establish,

¹⁹²³ See supra note 334 and accompanying text.

maintain, and enforce reasonably designed written policies and procedures that include the criteria for identifying responsible SCI personnel, the designation and documentation of responsible SCI personnel, and escalation procedures to quickly inform responsible SCI personnel of potential SCI events. This section discusses the economic effects of requiring these policies and procedures, both individually and as a whole.

The Commission believes the policies and procedures requirements as a whole should reduce the risk and incidences of SCI events because they are requirements under Commission rules rather than voluntary guidelines, and require SCI entities to establish, maintain, and enforce written policies and procedures related to capacity, integrity, resiliency, availability, security, compliance, responsible SCI personnel, and escalation. Also, policies and procedures requirements as a whole should reduce the risk and incidences of SCI events by imposing requirements on entities that are not currently participating in the ARP Inspection Program, and by covering areas not currently within the scope of the ARP Inspection Program, such as policies and procedures regarding systems compliance.¹⁹²⁴ The policies and procedures requirements in Regulation SCI should help ensure faster recoveries from systems disruptions, systems compliance issues, and systems intrusions. As discussed in Section VI.C.1, reducing the risk, incidence, and duration of SCI events could reduce interruptions in the price discovery process and liquidity flows and thus result in reduced periods with pricing inefficiencies.

¹⁹²⁴ With respect to NASD and FINRA rules identified by commenters, although they have some broad relation to certain aspects of the policies and procedures provisions under Regulation SCI, the Commission is not persuaded that these rules, even when taken together, are an appropriate substitute for the comprehensive approach in Regulation SCI with respect to technology systems and system issues. See NASD Rule 3010(b)(1) and FINRA Rule 3130. See also *supra* note 115.

The Commission also recognizes that the policies and procedures requirements of Regulation SCI will impose certain costs. In general, the Commission believes that some SCI entities that participate in the ARP Inspection Program already comply with some of the requirements of Rule 1001 and thus would incur lower initial costs to comply with the requirements of Rule 1001 than SCI entities that do not participate in the ARP Inspection Program. Additionally, some SCI entities that currently participate in the ARP Inspection Program are large and have complex systems and, therefore, will incur more costs to comply with Rule 1001 than others. Furthermore, SCI entities that do not currently participate in the ARP Inspection Program will also face costs to comply with Rule 1001 if they do not already have policies and procedures similar to those required by Rule 1001. These costs are discussed further below.

Quantifiable Costs

In the SCI Proposal, based on discussion with industry participants, the Commission estimated that, to comply with all requirements underlying the policies and procedures required by proposed Rules 1000(b)(1) and (2) other than paperwork burdens, on average, each SCI entity would incur an initial cost of between approximately \$400,000 and \$3 million.¹⁹²⁵ Based on this estimated range in costs, the Commission estimated that in the aggregate SCI entities would

¹⁹²⁵ See Proposing Release, *supra* note 13, at 18171. As explained in the SCI proposal, the Commission preliminarily estimated a range of cost for complying with the policies and procedures required by proposed Rules 1000(b)(1) and (2) because some SCI entities are already in compliance with some of these requirements and thus would likely need to incur less costs to comply with the rules. For example, the Commission believed that many SCI SROs (e.g., certain national securities exchanges and registered clearing agencies) already have or have begun implementation of 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 two-hour resumption of clearance and settlement services following a wide-scale disruption. See *id.* at 18171, n. 633.

incur a total initial cost of between approximately \$17.6 million¹⁹²⁶ and \$132 million¹⁹²⁷ to comply with proposed Rules 1000(b)(1) and (2). In addition, the Commission estimated that, to comply with the policies and procedures required by proposed Rules 1000(b)(1) and (2), on average, each SCI entity would incur an ongoing annual cost of between approximately \$267,000¹⁹²⁸ and \$2 million.¹⁹²⁹ Based on this estimated range, the Commission estimated that in the aggregate SCI entities would incur a total annual ongoing cost of between approximately \$11.7 million¹⁹³⁰ and \$88 million.¹⁹³¹

One commenter noted that the Commission did not provide sufficient discussion of the basis for the cost estimates for complying with the policies and procedures required by proposed Rules 1000(b)(1) and (2).¹⁹³² However, this commenter was cautiously confident that its initial cost for full implementation of proposed Rules 1000(b)(1) and (2) would not exceed \$3 million plus four times the estimated burden under the Paperwork Reduction Act analysis, although the commenter believed that such cost would not be less than half of such \$3 million plus at least three times the Paperwork Reduction Act estimate.¹⁹³³ This commenter further noted that the

¹⁹²⁶ See id. at 18171, n. 634.

¹⁹²⁷ See id. at 18171, n. 635.

¹⁹²⁸ See id. at 18172, n. 637.

¹⁹²⁹ See id. at 18172, n. 638.

¹⁹³⁰ See id.

¹⁹³¹ See id. at 18172, n. 640.

¹⁹³² See MSRB Letter at 30.

¹⁹³³ See id. at 31. According to this commenter, if as a result of the restrictive listing of industry standards in Table A, it determines that it should adhere to one of the listed standards rather than the standards to which it currently adheres, its cost of compliance with proposed Rule 1000(b)(1) would be considerably increased and its total cost for compliance with proposed Rules 1000(b)(1) and (2) would likely be at or near \$3 million plus four times the estimated burden under the Paperwork Reduction Act analysis. See

approach taken by the Commission in the proposal with regard to federal securities law liabilities and the safe harbors likely will result in increased insurance costs for SCI entities and higher salaries for employees.¹⁹³⁴

Another commenter noted that, without further clarification, the broad scope of the policies and procedures requirement under Regulation SCI could be burdensome, in terms of the cost of developing and implementing new (or enhancing existing) policies and procedures, and in terms of complying and documenting compliance under such policies and procedures.¹⁹³⁵

According to this commenter, these requirements could significantly increase technology project costs (e.g., for testing, monitoring, and compliance staff) and would significantly prolong the systems development lifecycle and time to market.¹⁹³⁶ With respect to the Commission's cost estimate for proposed Rules 1000(b)(1) and (2), another commenter noted that the Commission's

id. As noted above in Section IV.B.1.b.iii, the Commission believes that staff guidance should be characterized as listing examples of publications describing processes, guidelines, frameworks, and/or standards for an SCI entity to consider looking to in developing reasonable policies and procedures, rather than strictly as listing examples of "standards." As such, nothing that the staff may include in its guidance precludes an SCI entity from adhering to standards such as ISO 27000, COBIT, or others referenced by commenters to the extent they result in policies and procedures that comply with the requirements of Rule 1001(a).

¹⁹³⁴ See id. The commenter did not provide an estimate of the anticipated increased insurance costs for SCI entities and higher salaries for employees. The Commission acknowledges that SCI entities may incur increased insurance and personnel costs because of the potential additional liability associated with Regulation SCI, although the Commission is unable to estimate these costs given it lacks specific information regarding current personnel and insurance costs and the amount of any potential increases associated with changes in liability. The Commission also notes that many entities that fall within the definition of SCI entity could already be subject to liability for systems issues and thus may already largely be incurring these insurance and personnel costs.

¹⁹³⁵ See FINRA Letter at 32. The estimated burden associated with the development and maintenance of policies and procedures is discussed in the Paperwork Reduction Act section above. See supra Section V.D.1.a.

¹⁹³⁶ See FINRA Letter at 32.

estimates do not adequately account for the opportunity costs of delays in systems innovation.¹⁹³⁷ This commenter stated that the Commission did not address the significant costs of complying with the requirements concerning the capacity, integrity, resiliency, availability, and security of systems.¹⁹³⁸

After considering the views of these commenters and in light of the changes to the proposed rules, the Commission now estimates that, to comply with all requirements underlying the policies and procedures required by Rules 1001(a) and (b),¹⁹³⁹ other than paperwork burdens, on average, each SCI entity will incur an initial cost of between approximately \$320,000 and \$2.4 million and an ongoing annual cost of between approximately \$213,600 and \$1.6 million.¹⁹⁴⁰ The Commission notes that it has reduced the cost for complying with the policies and procedures required by Rules 1001(a) and (b) in a variety of ways, including by, for example: refining the definition of SCI systems; more explicitly allowing SCI entities to tailor

¹⁹³⁷ See ITG Letter at 7. This commenter also noted that the estimates do not adequately account for the monitoring and notification costs that would be engendered by the proposal. See *id.*

¹⁹³⁸ See *id.*

¹⁹³⁹ These include, for example, establishing current and future capacity planning estimates, capacity stress testing, reviewing and keeping current systems development and testing methodology, regular reviews and testing to detect vulnerabilities, testing of all SCI systems and changes to SCI systems prior to implementation, implementing a system of internal controls, implementing a plan for assessments of the functionality of SCI systems, implementing a plan of coordination and communication between regulatory and other personnel of the SCI entity, including by responsible SCI personnel, designed to detect and prevent systems compliance issues, and hiring additional staff.

¹⁹⁴⁰ The Commission estimates an average range of cost for complying with the policies and procedures required by Rules 1001(a) and (b) because some SCI entities are already in compliance with some of these requirements. The Commission recognizes that, for SCI entities that do not currently comply with the policies and procedures required by Rules 1001(a) and (b), their cost of compliance may, depending on their nature, size, technology, business model, and other aspects of their business, be at the upper end of the estimated average cost range.

policies and procedures consistent with a risk-based approach; having separate staff guidance on current SCI industry standards rather than Commission guidance through proposed Table A, with staff guidance characterized as listing examples of publications describing processes, guidelines, frameworks, and/or standards for an SCI entity to consider looking to in developing reasonable policies and procedures, rather than strictly as listing examples of “standards;” and focusing compliance on the Exchange Act rather than federal securities laws generally.

At the same time, the Commission acknowledges that other aspects of the compliance costs could potentially be higher for the adopted rules than the proposed rules. For example, the requirement for a goal of two-hour resumption for all critical SCI systems (rather than only clearance and settlement systems) could increase compliance costs for SCI entities with critical SCI systems as compared to the proposal. However, as discussed above, the Commission has specified that the stated recovery timeframes in Regulation SCI are goals, rather than inflexible requirements.¹⁹⁴¹ In addition, for some SCI entities that would have chosen to not use the proposed SCI entity safe harbor, the Commission’s adoption of non-exhaustive, general minimum elements for systems compliance policies and procedures in Rule 1001(b)(2) could increase compliance costs as compared to the proposal. Based on the foregoing, the Commission believes that it is reasonable to revise the estimate to reflect the more targeted scope and increased flexibility of the adopted regulation, as compared to the proposal, in combination with potential increased costs associated with compliance with Rules 1001(a)(2)(v) and 1001(b)(2), and new costs associated with compliance with Rule 1001(a)(2)(vii).¹⁹⁴² Therefore, the Commission believes that on balance overall, the costs will be reduced, and in its best judgment,

¹⁹⁴¹ See supra note 504 and accompanying text.

¹⁹⁴² Rule 1001s(a)(2)(v), 1001(a)(2)(vii), and 1001(b)(2) are discussed further below.

each SCI entity is likely to incur an initial cost of between approximately \$320,000 and \$2.4 million and an ongoing annual cost of between approximately \$213,600 and \$1.6 million for complying with the policies and procedures required by Rules 1001(a) and (b). However, the Commission acknowledges that its cost estimates reflect a high degree of uncertainty. As noted above, the compliance costs of Rule 1001 may depend on the complexity of SCI entities' systems (e.g., the compliance costs will be higher for SCI entities with more complex systems). The initial compliance costs associated with Rule 1001 may also vary across SCI entities depending on the degree of current practices' compliance with the requirements of Rule 1001. Because it is difficult to gauge the precise degree of current compliance for each SCI entity in estimating potential costs with respect to Rule 1001 at this time, the Commission is estimating a range of compliance costs above.

The Commission estimates that, in the aggregate, SCI entities will incur a total initial cost of between approximately \$14 million¹⁹⁴³ and \$106 million¹⁹⁴⁴ to comply with the policies and procedures required by Rules 1001(a) and (b). In addition, the Commission estimates that, in the aggregate, SCI entities will incur total annual ongoing cost of between approximately \$9 million¹⁹⁴⁵ and \$70 million.¹⁹⁴⁶ These cost estimates are intended to cover the cost of complying with all substantive requirements under Rules 1001(a) and (b) other than paperwork related burdens.

¹⁹⁴³ \$320,000 × 44 SCI entities = \$14.1 million.

¹⁹⁴⁴ \$2.4 million × 44 SCI entities = \$105.6 million.

¹⁹⁴⁵ \$213,600 × 44 SCI entities = \$9.4 million.

¹⁹⁴⁶ \$1.6 million × 44 SCI entities = \$70.4 million.

The Commission acknowledges that, for SCI entities, the requirements of Rules 1001(a) and (b) could increase technology project costs, prolong the systems development lifecycle and time to market, and result in opportunity costs because of potential delays in systems innovation.¹⁹⁴⁷ On the other hand, as discussed throughout this release, the Commission believes that entities that are important to the functioning of the U.S. securities markets should be required to have policies and procedures reasonably designed to ensure systems capacity, integrity, resiliency, availability, security, and compliance. Further, as discussed above in Sections IV.B.1 and IV.B.2, the Commission has focused the scope of Rules 1001(a) and (b) as compared to the SCI Proposal. Moreover, in tandem with the adoption of a definition of critical SCI systems, the Commission is making more clear that Rule 1001(a) permits SCI entities to tailor policies and procedures consistent with a risk-based approach. With respect to Rule 1001(b), the Commission is adopting non-exhaustive, general minimum elements that an SCI entity must include in its systems compliance policies and procedures.¹⁹⁴⁸

Benefits and Qualitative Costs

Capacity, Integrity, Resiliency, Availability, and Security

Rule 1001(a)(1) requires that each SCI entity establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems and, for purposes of security standards, indirect SCI systems, have levels of capacity, integrity, resiliency, availability, and security, adequate to maintain the SCI entity's operational capability and

¹⁹⁴⁷ See supra note 1936 and accompanying text (discussing a commenter's view regarding the potential economic effects of the policies and procedures requirements).

¹⁹⁴⁸ See supra note 1935 and accompanying text (discussing a commenter's views that, without clarification, the policies and procedures requirement under Regulation SCI could be burdensome).

promote the maintenance of fair and orderly markets. Rule 1001(a)(2)(i)-(iv) provides that an SCI entity's policies and procedures under Rule 1001(a) must include, at a minimum: (i) the establishment of reasonable current and future technological infrastructure capacity planning estimates; (ii) periodic capacity stress tests of systems to determine their ability to process transactions in an accurate, timely, and efficient manner; (iii) a program to review and keep current systems development and testing methodology of such systems; and (iv) regular reviews and testing, as applicable, of systems, including backup systems, to identify vulnerabilities pertaining to internal and external threats, physical hazards, and natural or manmade disasters.¹⁹⁴⁹

Rules 1001(a)(1) and (2)(i)-(iv) codify and expand certain provisions of the ARP Policy Statements. They also expand on the requirements under Rule 301(b)(6) of Regulation ATS for ATSS that trade NMS stocks and non-NMS stocks. In particular, under the ARP Policy Statements and through the ARP Inspection Program, ARP participants, among other things, are expected to establish current and future capacity estimates; conduct capacity stress tests; and conduct annual reviews that cover significant elements of the operations of the automation process, including the capacity planning and testing process, contingency planning, systems development methodology, and vulnerability assessments. Further, Rule 301(b)(6) requires certain ATSS, with respect to those systems that support order entry, order routing, order execution, transaction reporting, and trade comparison, to establish certain capacity estimates, conduct periodic capacity stress tests of critical systems, develop and implement reasonable procedures to review and keep current systems development and testing methodology, review the vulnerability of their systems and data center computer operations to specified threats, establish

¹⁹⁴⁹ See Rule 1001(a)(2) and supra Section IV.B.1.

adequate contingency and disaster recovery plans, conduct an independent review of their systems controls annually for ensuring that Rule 301(b)(6)(ii)(A)-(E) are met and conduct a review by senior management of a report of the independent review, and promptly notify the Commission of certain systems outages and systems changes.¹⁹⁵⁰

As mentioned above, Rules 1001(a)(1) and (2)(i)-(iv) codify certain aspects of the ARP Policy Statements. For SCI entities that are current participants in the ARP Inspection Program, codifying these aspects into requirements to establish policies and procedures should help ensure more robust systems that help realize the benefits of Regulation SCI discussed in Section VI.C.1.¹⁹⁵¹

In addition to the effects of the codification of aspects of the ARP Inspection Program, the Commission believes that the rules would further reduce the risk and incidences of systems issues affecting the markets by imposing requirements on entities that are not currently participating in the ARP Inspection Program, and by covering systems and events not currently within the scope of the ARP Inspection Program. For example, Rules 1001(a)(2)(i)-(iv) will help maintain robust systems at SCI entities that currently do not have the policies and procedures in place required by the rule. In particular, the Commission believes that, taken together, Rules 1001(a)(2)(i)-(iv) will benefit the securities markets by leading to the establishment, maintenance, and enforcement of policies and procedures that will reduce the risks and

¹⁹⁵⁰ See 17 CFR 242.301(b)(6)(ii).

¹⁹⁵¹ Likewise, the relocation and modification of certain requirements in Rule 301(b)(6) of Regulation ATS applicable to significant-volume ATSs that trade NMS stocks and non-NMS stocks will help ensure that SCI ATSs create and maintain policies and procedures to support robust systems. See *supra* note 2 and accompanying text (noting that Regulation SCI, in addition to codifying the ARP Policy Statements, also supersedes and replaces aspects of those policy statements codified in Rule 301(b)(6) under the Exchange Act for significant-volume ATSs that trade NMS stocks and non-NMS stocks).

incidences of systems disruptions and systems intrusions. As noted above in Section VI.C.1, a reduction in the risk and incidences of systems issues could reduce interruptions in the price discovery process and liquidity flows.

Because current ARP participants will change their current practices to comply with Rules 1001(a)(2)(i)-(iv), the Commission recognizes that these entities will incur compliance costs that are incremental relative to the current compliance costs of the ARP Inspection Program.¹⁹⁵² Furthermore, SCI entities that are not currently participating in the ARP Inspection Program may incur higher initial compliance costs to meet the requirements of Rules 1001(a)(2)(i)-(iv), compared to SCI entities that are current participants of the ARP Inspection Program. The paperwork burdens are discussed in Section V, and other costs are included as part of the quantified costs estimated above related to all requirements associated with Rules 1001(a) and (b) other than paperwork burdens.¹⁹⁵³

A few commenters discussed in detail how setting forth policies and procedures with regard to systems development could yield benefits, such as efficient pricing of securities, to markets. One commenter noted that preventing defects from entering in software construction is the most cost effective approach to quality assurance.¹⁹⁵⁴ This commenter stated that it is ten times cheaper to find a defect in development than it is during systems testing, and it is one hundred times cheaper to fix a defect in development than in production (and this is not accounting for the impact on business).¹⁹⁵⁵ In addition, this commenter noted that software of

¹⁹⁵² See supra Section VI.B (discussing current practices of SCI entities).

¹⁹⁵³ See supra note 1940 and accompanying text.

¹⁹⁵⁴ See CAST Letter at 10.

¹⁹⁵⁵ See id.

higher quality is cheaper to maintain and easier to enhance, and that testing schedules for low quality, large software projects are two to three times longer and more than twice as costly as testing for high quality projects.¹⁹⁵⁶ According to information submitted by this commenter of large, mission critical systems across several industries, improving overall structural quality by 10 percent reduces “ticket volume” by over 30 percent.¹⁹⁵⁷ This commenter believed that this would be an inadvertent benefit of controlling integrity at the structural level that may even compensate for the cost of other aspects of Regulation SCI.¹⁹⁵⁸ Another commenter noted that the cost of a serious operational problem can rise to eight digits, and in extreme cases nine digits.¹⁹⁵⁹ This commenter noted that these costs are often shared with market participants beyond the owners of the disrupted systems.¹⁹⁶⁰ This commenter believed that the proposed Rule 1000(b)(1) requirements are reasonable and their cost can be balanced against the losses associated with the operational risks they address.¹⁹⁶¹

The Commission generally agrees with commenters that setting forth policies and procedures with regard to systems development could yield benefits to market participants and SCI entities, including a potential reduction in losses due to SCI events. Rule 1001(a)(2)(iii)

¹⁹⁵⁶ See id. (quoting Capers Jones and Olivier Bonsignour, The Economics of Software Quality (2012)).

¹⁹⁵⁷ See id. at 10-11.

¹⁹⁵⁸ See id. at 11.

¹⁹⁵⁹ See CISQ Letter at 2.

¹⁹⁶⁰ See id. at 2.

¹⁹⁶¹ See id. at 2. See also CISQ2 Letter at 6 (stating, “[t]he cost of recent outages in SCI systems easily justifies the additional effort in quality assurance. However, empirical evidence from software industry improvement programs demonstrates that the additional time added into quality assurance is more than compensated for by a reduction in rework to produce [return on investments] of 5:1 or greater”).

requires SCI entities to establish a program to review and keep current systems development and testing methodology for SCI systems and, for purposes of security standards, indirect SCI systems. The Commission believes that development and testing systems are important in ensuring the reliability and resiliency of SCI systems. More reliable and resilient systems should help reduce the occurrences of SCI events and improve systems uptime for SCI entities, and thus possibly result in a reduction in losses due to SCI events. Furthermore, the Commission recognizes that the use of inadequately tested software in production could result in substantial losses to market participants if it does not function as intended. For instance, if software malfunctions, it may not route orders as intended and also could result in mispricing of securities. Additionally, if a system's capacity thresholds are improperly estimated, it may become congested, resulting in higher indirect transaction costs due to lower execution quality (e.g., decrease in order fill rates). The Commission believes that costs associated with Rule 1001(a)(2)(iii) are appropriate in light of the reduction in losses due to SCI events and other benefits discussed throughout this Economic Analysis.

Business Continuity and Disaster Recovery Plans

Rule 1001(a)(2)(v) requires SCI entities' policies and procedures to set forth business continuity and disaster recovery plans that include maintaining backup and recovery capabilities sufficiently resilient and geographically diverse and that are reasonably designed to achieve next business day resumption of trading and two-hour resumption of critical SCI systems following a wide-scale disruption.¹⁹⁶² Therefore, as adopted, Rule 1001(a)(2)(v) puts an emphasis on trading

¹⁹⁶² FINRA Rule 4370 generally requires that a FINRA member maintain a written continuity plan identifying procedures relating to an emergency or significant business disruption, which is akin to adopted Rule 1001(a)(2)(v) requiring policies and procedures for business continuity and disaster recovery plans. However, the FINRA rule does not

and critical SCI systems with respect to resumption following a wide-scale disruption. As discussed above, the definition of critical SCI systems is intended to capture those systems that are critical to the operation of the securities markets, including systems that are potential single points of failure in the securities markets. The Commission understands that some SCI entities already have, to an extent, policies and procedures that are required by Rule 1001(a)(2)(v), while others would need to make more significant changes to their current practices.¹⁹⁶³

Rule 1001(a), among other things, is expected to help ensure prompt resumption of all critical SCI systems, which in turn is expected to help minimize interruptions in trading and liquidity after a wide-scale disruption. In addition, in the case of a wide-scale disruption, multiple SCI entities may be affected by the same incident at the same time. Given that U.S. securities market infrastructure is concentrated in relatively few areas, such as New York City, New Jersey, and Chicago, maintaining backup and recovery capabilities that are geographically diverse could facilitate resumption in trading and critical SCI systems following wide-scale market disruptions. As discussed in detail in Section VI.C.1, the Commission expects the reduction in the occurrence of trading interruptions and the duration of trading interruptions would promote pricing efficiency, price discovery, and liquidity flows in markets.

include the requirement that the business continuity and disaster recovery plans be reasonably designed to achieve next business day resumption of trading and two-hour resumption of critical SCI systems following a wide-scale disruption, nor does it require the functional and performance testing and coordination of industry or sector-testing of such plans. See supra note 115.

¹⁹⁶³ See infra note 1973 and accompanying text (discussing the estimated range of cost per SCI entity to comply with the policies and procedures required by Rules 1001(a) and (b)).

One commenter noted that the Commission's cost-benefit analysis in the SCI Proposal did not take into consideration the already existing industry excess capacity as backup.¹⁹⁶⁴ With respect to this commenter, the Commission understands, based on staff expertise, that systems are sized to adequately handle message traffic with excess capacity under normal conditions and in those situations that moderately exceed the norm. The Commission also understands, however, that exchanges periodically receive escalated levels of message traffic due to unanticipated events and must make real-time adjustments to manage the capacity of their systems, such as queuing and/or throttling. Therefore, the Commission is not persuaded that excess capacity is a reasonable alternative to backup systems because systems may reach their capacity periodically. Also, as noted above, in the case of a wide-scale disruption, multiple SCI entities may be affected by the same incident at the same time. Given that U.S. securities market infrastructure is concentrated in relatively few areas, maintaining backup and recovery capabilities that are geographically diverse could facilitate resumption in trading and critical SCI systems following wide-scale market disruptions.

The Commission also received comments regarding the costs of maintaining geographically diverse backup facilities under proposed Rule 1000(b)(1). One commenter stated that the Commission did not appropriately consider the costs and benefits of maintaining geographically diverse data centers to meet the next-day readiness requirement.¹⁹⁶⁵ This commenter believed that the cost of establishing and maintaining geographically diverse data centers alone will dwarf the estimated overall compliance cost of \$400,000 to \$3 million.¹⁹⁶⁶

¹⁹⁶⁴ See Angel Letter at 14.

¹⁹⁶⁵ See ISE Letter at 12. See also FIF Letter at 3.

¹⁹⁶⁶ See ISE Letter at 12.

This commenter estimated that the incremental all-in, five-year cost to it to relocate its backup site would be \$17 million.¹⁹⁶⁷ This commenter noted that the geographically diverse backup center requirement could also result in costs on members and users of the SCI entity.¹⁹⁶⁸

Another commenter noted that it maintains robust redundant and backup systems that exceed regulatory requirements and provide adequate capacity, security, and resiliency for its trading operations; however, the manpower and financial capital required to maintain and staff a geographically diverse backup site would easily push its annual and recurring compliance cost beyond the higher estimates provided by the Commission.¹⁹⁶⁹

The Commission notes that the potential cost for maintaining geographically diverse backup and recovery capabilities is likely less than those estimated by commenters given the scope of the adopted rule. Specifically, because Rule 1001(a)(2)(v) does not require an SCI entity to require its members or participants to use an SCI entity's backup facility in the same way they use the primary facility (i.e., does not require members or participants to co-locate their systems at backup sites to replicate the speed and efficiency of the primary site), the requirement for geographically diverse backup systems does not mean that the backup systems are required to be identical (e.g., same speed and efficiency) to the primary facility. Nevertheless, the Commission believes it is critical that SCI entities and their designated members or participants be able to operate with the SCI entities' backup systems in the event of a wide-scale disruption. In addition, the Commission notes that Rule 1001(a) does not specify any particular minimum distance or geographic location that would be necessary to achieve geographic diversity,

¹⁹⁶⁷ See id.

¹⁹⁶⁸ See id. The cost to members or participants of SCI entities in connection with business continuity and disaster recovery plan testing is discussed in Section VI.C.2.b.vii below.

¹⁹⁶⁹ See ITG Letter at 7-8.

although the Commission believes that backup sites should not rely on the same infrastructure components, such as for transportation, telecommunications, water supply, and electric power. Further, Regulation SCI does not require an SCI entity to have a geographically diverse backup facility so distant from the primary facility that the SCI entity may not rely primarily on the same labor pool to staff both facilities if it believed it to be appropriate.

With respect to commenters who expressed concern regarding the potential cost for maintaining geographically diverse backup and recovery capabilities, the Commission cannot estimate with confidence the precise costs for the creation of a new, geographically diverse backup facility, given the wide range of message traffic that various exchanges, ATSSs, and other entities receive and the reasonable flexibility in the design of the backup facility. Given that Rule 1001(a)(2)(v) does not require an SCI entity to require its members or participants to use an SCI entity's backup facility in the same way they use the primary facility, however, the Commission believes that the upper bound of building a new backup facility is equal to the cost of building a new primary facility. Given the Commission's response to commenters' concerns regarding the requirement to maintain geographically diverse backup and recovery capabilities, and the degree of flexibility within Regulation SCI to determine the precise nature and location of its backup site,¹⁹⁷⁰ the Commission believes that the commenter's estimate of \$17 million over five years (or \$3.4 million per year),¹⁹⁷¹ is high. Based on the Commission's best judgment, including taking into account Commission staff experience with SCI entities that have invested in geographically diverse backup facilities in recent years, the Commission believes that the average cost is more likely to be approximately \$1.5 million annually for an SCI entity (that does

¹⁹⁷⁰ See supra notes 541-544 and accompanying text.

¹⁹⁷¹ See supra note 1967 and accompanying text.

not already have geographically diverse backup facilities). Nevertheless, even were the costs to be at the upper amount suggested by the commenter, the Commission believes the costs are appropriate given that individual SCI entity resilience is fundamental to achieving the goal of improving U.S. securities market infrastructure resilience.¹⁹⁷²

The Commission recognizes that SCI entities may encounter significantly different costs in complying with the geographic diversity requirement underlying Rule 1001(a)(2)(v). As noted in Section VI.B.2, nearly all national securities exchanges already have backup facilities that do not rely on the same infrastructure components as those used by their primary facility. For those national securities exchanges that do not have such backup facilities, the cost to build such backup facilities will result in higher initial compliance costs than for national securities exchanges that do. For other SCI entities (e.g., some SCI ATs), the compliance costs to meet the geographic diversity requirement would depend on the nature, size, technology, business model, and other aspects of their business.¹⁹⁷³ Because SCI entities may encounter significantly different costs in complying with the geographic diversity requirement, the Commission believes that the initial compliance costs could have impact on competition among SCI entities.

The requirement to have policies and procedure to meet a goal of next day resumption in trading and two-hour resumption in critical SCI systems will impose compliance costs for SCI entities. The Interagency White Paper sets forth sound practices for core clearing and settlement

¹⁹⁷² See *supra* notes 499-544 and accompanying text.

¹⁹⁷³ The Commission notes that its average estimated range of initial cost of approximately \$320,000 to \$2.4 million per SCI entity to comply with Rules 1001(a) and (b), other than paperwork burdens, includes the cost to build and maintain a geographically diverse backup facility. The Commission estimates that the costs for SCI entities that do not currently have a geographically diverse backup facility would be at the higher end of this range.

organizations and firms that play significant roles in critical financial markets,¹⁹⁷⁴ and the 2003 BCP Policy Statement discusses the resumption of certain trading markets following a wide-scale disruption.¹⁹⁷⁵ As noted in Section VI.B.1, the Commission believes that SCI entities currently use an array of measures to restore systems when disruptions occur. However, the two-hour resumption goal for all critical SCI systems differs from the goals set forth in the Interagency White Paper insofar as the goal for Regulation SCI applies to critical SCI systems generally.¹⁹⁷⁶ To this extent, Rule 1001(a)(2)(v) would impose additional costs for SCI entities that currently have practices that are consistent with the Interagency White Paper for clearance and settlement systems but not all critical SCI systems. The next business day resumption goal for certain trading markets set forth in the 2003 BCP Policy Statement is consistent with the resumption goal for trading in Rule 1001(a)(2)(v). For some SCI entities that do not have policies and procedures with respect to critical SCI systems consistent with the Interagency White Paper and the 2003 BCP Policy Statement, the Commission believes that the initial compliance costs associated with establishing policies and procedures with respect to next day resumption in trading and two-hour resumption in all critical SCI systems would be larger than

¹⁹⁷⁴ According to the Interagency White Paper, core clearing and settlement organizations should develop the capacity to recover and resume clearing and settlement activities within the business day on which the disruption occurs with the overall goal of achieving recovery and resumption within two hours after an event. See Interagency White Paper, supra note 504, at 17812.

¹⁹⁷⁵ The 2003 BCP Policy Statement states that each SRO market and ECN should have a business continuity plan that anticipates the resumption of trading, in the securities traded by that market, no later than the next business day following a wide-scale disruption. See 2003 BCP Policy Statement, supra note 504, at 56658.

¹⁹⁷⁶ See supra Section IV.A.2.c (discussing the definition of critical SCI systems) and supra Section IV.B.1 (discussing the Commission's rationale for applying the two hour recovery goal to critical SCI systems generally instead of clearance and settlement services specifically).

those that do. The costs associated with designing and modifying policies and procedures with respect to systems resumption requirements are included in the costs related to paperwork burdens in Section V. Furthermore, as discussed in Section VI.C.1, the Commission believes that the systems resumption requirements of Rule 1001(a)(2)(v) will have an impact on competition among SCI entities in part because the associated initial compliance costs will be different among SCI entities.

Market data

Rule 1001(a)(2)(vi) provides that an SCI entity's policies and procedures must include standards that result in systems being designed, developed, tested, maintained, operated, and surveilled in a manner that facilitates the successful collection, processing, and dissemination of market data.¹⁹⁷⁷ Unlike the other provisions of Rule 1001(a)(2) discussed above, Rule 1001(a)(2)(vi) is not addressed in Regulation ATS or the ARP Policy Statements.

The Commission believes that Rule 1001(a)(2)(vi) should help ensure that timely and accurate market data is available to all market participants. Given that market participants rely on consolidated market data in a variety of ways, including making markets, formulating trading algorithms, and placing orders, the Commission believes that this is an important benefit of Regulation SCI, although the Commission recognizes that SCI entities currently already take measures to facilitate the successful collection, processing, and dissemination of market data. As discussed in Section VI.C.1, the Commission believes that the further improvements in timeliness and accuracy of market data would help further ensure pricing efficiencies and uninterrupted liquidity flows in markets. As Rule 1001(a)(2)(vi) will be a new requirement for SCI entities, it will impose incremental compliance costs on SCI entities in setting aside

¹⁹⁷⁷ See Rule 1001(a)(2) and supra Section IV.B.1.

additional resources to satisfy the requirements of the rule. These costs are included as part of the quantified costs estimated above related to all requirements underlying Rules 1001(a) and (b) other than paperwork burdens.¹⁹⁷⁸

Monitoring

Rule 1001(a)(2)(vii) provides that an SCI entity's policies and procedures must include monitoring of systems to identify potential SCI events. Rule 1001(a)(2)(vii) imposes a new requirement that is not addressed in Regulation ATS or the ARP Policy Statements.

The Commission believes that SCI entities, particularly those that participate in the ARP Inspection Program, already monitor their systems in order to identify potential systems issues. Nevertheless, by defining "SCI event" and requiring policies and procedures for monitoring systems to identify potential SCI events, the Commission believes that Rule 1001(a)(2)(vii) should further help ensure that SCI entities identify potential SCI events, which could allow them to prevent some SCI events from occurring or to take timely appropriate corrective action after the occurrence of SCI events. As discussed above, the Commission believes the reduction in the occurrence of SCI events or the reduction in the duration of SCI events that disrupt markets would reduce pricing inefficiencies and promote price discovery and liquidity. Although the Commission believes that SCI entities already monitor their systems in order to identify potential systems issues, the Commission believes that SCI entities will have to allocate additional resources to comply with the requirements of Rule 1001(a)(2)(vii), including potentially hiring additional staff, and thus will incur costs. These costs are included as part of the quantified costs estimated above related to all requirements underlying Rules 1001(a) and (b) other than paperwork burdens.

¹⁹⁷⁸ See supra note 1940 and accompanying text.

Current SCI Industry Standards

Rule 1001(a)(4) deems an SCI entity's policies and procedures under Rule 1001(a) to be reasonably designed if they are consistent with current SCI industry standards.¹⁹⁷⁹ However, Rule 1001(a)(4) specifically states that compliance with current SCI industry standards is not the exclusive means to comply with the requirements of Rule 1001(a). Therefore, as adopted, Rule 1001(a)(4) provides flexibility to allow each SCI entity to determine how to best meet the requirements in Rule 1001(a), taking into account, for example, its nature, size, technology, business model, and other aspects of its business. Thus, Rule 1001(a)(4) allows SCI entities to choose the technology standards that best fit with their business, promoting efficiency. Furthermore, as discussed in Section IV.B.1, staff guidance lists examples of publications describing processes, guidelines, frameworks, or standards for an SCI entity to consider looking to in developing reasonable policies and procedures under Rule 1001(a). The reference to the publications which the staff may include, and which the Commission believes should be general and flexible enough to be compatible with many widely-recognized technology standards, will help SCI entities to implement and comply with Regulation SCI.¹⁹⁸⁰

Some commenters expressed concern that SCI entities would closely adhere to the publications listed in Table A rather than take advantage of the flexibility built into the proposed rule out of concern that, if they did not, they would expose themselves to potential regulatory

¹⁹⁷⁹ Current SCI industry standards are required to be comprised of information technology practices that are widely available to information technology professionals in the financial sector and issued by an authoritative body that is a U.S. governmental entity or agency, association of U.S. governmental entities or agencies, or widely recognized organization. See Rule 1001(a)(4).

¹⁹⁸⁰ See supra Section IV.B.1.b (discussing the role of staff guidance on current SCI industry standards).

action for failure to comply with Regulation SCI.¹⁹⁸¹ As discussed above in Section IV.B.1, Rule 1001(a) allows for flexibility in choosing standards or guidelines when an SCI entity is designing policies and procedures required by that rule. Moreover, the staff guidance lists examples of publications describing processes, guidelines, frameworks, or standards for an SCI entity to consider looking to in developing reasonable policies and procedures under Rule 1001(a). As noted in Section IV.B.1, the Commission understands that many SCI entities are already following other technology standards, such as ISO 27000 and COBIT. The staff guidance would not preclude SCI entities from adhering to standards such as ISO 27000, COBIT, or others, to the extent they result in policies and procedures that comply with the requirements of Rule 1001(a).¹⁹⁸² Because there is no requirement for SCI entities to follow the publications listed as staff guidance, there is no separate compliance cost associated with the staff guidance in addition to the cost of complying with Rule 1001(a). As discussed throughout this section, the Commission recognizes that, in general, there will be costs associated with designing policies and procedures required by Rule 1001(a). Such costs to SCI entities that already set forth their policies and procedures based on industry standards, or that follow the publications listed in the staff guidance or comparable publications as a guide, would be minimal. On the other hand, other SCI entities that decide to modify their policies and procedures and those that do not have such policies and procedures in place may incur greater

¹⁹⁸¹ See, e.g., MSRB Letter at 11; Angel Letter at 8; BATS Letter at 6; and NYSE Letter at 20-21.

¹⁹⁸² Likewise, the staff guidance would not preclude an SCI entity from adopting a derivative of multiple standards, and/or customizing one or more standards for the particular system at issue. In assessing whether an SCI entity's use of such an approach in designing its policies and procedures would be "deemed" to be reasonably designed, the Commission's inquiry would be into whether its policies and procedures were consistent with standards meeting the criteria in adopted Rule 1001(a)(4).

costs in designing policies and procedures required by Rule 1001(a). The costs associated with modifying and designing policies and procedures are included in the costs related to paperwork burdens in Section V.

Systems Compliance

Rule 1001(b)(1) requires each SCI entity to establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems operate in a manner that complies with the Exchange Act and the rules and regulations thereunder, and the entity's rules and governing documents, as applicable. Rule 1001(b)(2)(i)-(iv) provides that an SCI entity's policies and procedures under Rule 1001(b)(1) must include, at a minimum: (i) testing of all SCI systems and any changes to SCI systems prior to implementation; (ii) a system of internal controls over changes to SCI systems; (iii) a plan for assessments of the functionality of SCI systems designed to detect systems compliance issues, including by responsible SCI personnel and by personnel familiar with applicable provisions of the Act and the rules and regulations thereunder and the SCI entity's rules and governing documents; and (iv) a plan of coordination and communication between regulatory and other personnel of the SCI entity, including by responsible SCI personnel, regarding SCI systems design, changes, testing, and controls designed to detect and prevent systems compliance issues. The Commission recognizes that SCI entities currently take varying measures to ensure that their systems operate in a manner that complies with relevant laws and rules. These practices at SCI entities may include escalating a compliance issue upon discovery, including legal and compliance personnel in the review of systems changes, and periodically reviewing rulebooks.

The Commission believes that Rule 1001(b) should help to ensure that SCI entities operate their SCI systems in compliance with the Exchange Act and relevant rules and should

help to reduce the occurrence of systems compliance issues. For example, the tests under Rule 1001(b)(2)(i) should help SCI entities to identify potential compliance issues before new systems or systems changes are implemented; the internal controls under Rule 1001(b)(2)(ii) should help to ensure that SCI entities remain vigilant against compliance issues when changing their systems and resolve potential compliance issues before the changes are implemented; and the systems assessment plans under Rule 1001(b)(2)(iii) and the coordination and communication plans under Rule 1001(b)(2)(iv) should help technology, regulatory, and other relevant personnel (including responsible SCI personnel) of SCI entities to work together to prevent compliance issues, and to promptly identify and address compliance issues if they occur. To the extent that compliance with Rule 1001(b) reduces the occurrence of systems compliance issues, Rule 1001(b) should help ensure investor protection. Because SCI entities will need to allocate their resources towards establishing, maintaining, and enforcing policies and procedures with regard to systems compliance, Rule 1001(b) will impose compliance costs on SCI entities. These costs are included as part of the quantified costs estimated above related to all requirements underlying Rules 1001(a) and (b) other than paperwork burdens.¹⁹⁸³

One commenter suggested that the Commission follow the Federal Aviation Administration's and NASA's approach, where, according to this commenter, individuals are encouraged to report safety issues and penalties are waived where there is self-reporting.¹⁹⁸⁴ As

¹⁹⁸³ See supra note 1940 and accompanying text. However, the costs associated with establishing and maintaining policies and procedures are included in the costs related to paperwork burdens in Section V.

¹⁹⁸⁴ See Angel Letter at 3-4. This commenter also stated that, in the SCI Proposal, the Commission did not analyze how other government regulatory agencies in the U.S. and elsewhere address technology risks (e.g., in the aviation, nuclear power, electricity, telecommunications, medical, and banking sectors). See Angel Letter at 3 and 15. The Commission notes that, in considering the adoption of Regulation SCI, it has considered

discussed above in Section IV.B.2.b, the Commission is not persuaded that it would be appropriate to provide a safe harbor for all problems that are self-reported by SCI entities and individuals because the Commission is not persuaded that the suggested self-report safe harbor will effectively further the intent of Regulation SCI.¹⁹⁸⁵ The extent to which regulators' reporting rules offer safe harbor protection is determined by particular circumstances and regulatory objectives. For purposes of Regulation SCI, a blanket safe harbor provision of the type proposed by the commenter would reduce incentives for SCI entities to take the proactive actions required to ensure the compliance of their SCI systems and, thus, could undermine the benefits of Regulation SCI discussed in Section IV.C.1.

Responsible SCI Personnel

Rule 1001(c) requires an SCI entity to establish, maintain, and enforce reasonably designed written policies and procedures that include the criteria for identifying responsible SCI personnel, the designation and documentation of responsible SCI personnel, and escalation procedures to quickly inform responsible SCI personnel of potential SCI events. Rule 1001(c) imposes a requirement that is not addressed in Regulation ATS or the ARP Policy Statements.

The Commission believes that requiring policies and procedures to identify and designate responsible SCI personnel and to establish escalation procedures to quickly inform responsible

some of the current practices in other industries, such as those discussed by panelists at the Technology Roundtable (e.g., aviation, nuclear power). See *supra* note 15 and Transcript of the Technology Roundtable, at 42-45.

¹⁹⁸⁵ The Commission notes that, in addition to dealing with a different problem in different industries, the "waiving of penalties" cited by the commenter has limitations (e.g., the ASRS system cited by the comment suspends safe harbor protection for repeat violators and does not offer safe harbor for certain types of violations). Safe harbor protection for self-reporters may be appropriate in some circumstances. However, the Commission believes that in the specific context of Regulation SCI, such safe harbor protections would not further the intent of the regulation.

SCI personnel of potential SCI events should help to effectively alert responsible SCI personnel of potential SCI events, in order for such personnel to determine whether an SCI event has occurred so that any appropriate actions can be taken in accordance with the requirements of Regulation SCI without unnecessary delay. As such, Rule 1001(c) should help reduce the duration of SCI events as SCI entities should become aware of potential SCI events and take appropriate corrective actions more quickly. The reduction in the duration of SCI events would benefit markets as it would promote pricing efficiency and price discovery as discussed in Section VI.C.1.

The Commission believes that the costs associated with Rule 1001(c) are attributed to paperwork burdens, which are discussed in Section V.D.1.a above.¹⁹⁸⁶ The Commission does not believe that Rule 1001(c) will impose significant other costs on SCI entities because these entities already identify and designate responsible SCI personnel and have escalation procedures.¹⁹⁸⁷

Periodic Review

Rules 1001(a)(3), (b)(3), and (c)(2) require each SCI entity to periodically review the effectiveness of the policies and procedures required under Rules 1001(a), (b), and (c), respectively, and to take prompt action to remedy deficiencies in such policies and procedures. Regulation ATS and the ARP Policy Statements do not explicitly address the periodic review of policies and procedures and remediation of deficient policies and procedures.

¹⁹⁸⁶ When monetized, the paperwork burden would result in approximately \$1.7 million initially and \$611,000 annually for all SCI entities in the aggregate.

¹⁹⁸⁷ As noted above, several commenters emphasized the importance of escalation procedures at SCI entities, pursuant to which technology staff or junior employees could assess a systems problem and escalate the issue up the chain of command to management as well as legal and/or compliance personnel. See supra note 740 and accompanying text.

The Commission believes that requiring periodic review of the policies and procedures and remedial actions to address any deficiencies in the policies and procedures will help to ensure that SCI entities maintain robust policies and procedures and update them when necessary so that the benefits of Rules 1001(a), (b), and (c) should continue to be realized. As such, the Commission believes that Rules 1001(a)(3), (b)(3), and (c)(2) will help realize the benefits of Regulation SCI, and would facilitate price discovery and liquidity flow, as discussed in Section VI.C.1. These requirements, however, will impose costs on SCI entities because they will have to use resources to review the policies and procedures required by Rules 1001(a), (b), and (c) beyond the resources currently expended for this purpose or will have to take more prompt remedial action to remedy any identified deficiencies. The Commission expects that these costs generally will arise following an SCI entity's periodic review of the effectiveness of its policies and procedures and as a result of SCI events. The Commission believes that the costs associated with the review and update requirements are attributed to paperwork burdens, which are discussed in Section V.D.1.a above.¹⁹⁸⁸ However, the Commission recognizes that, if an SCI entity takes prompt or unplanned remedial action following the discovery of deficiencies in its policies and procedures, this may result in indirect costs (i.e., opportunity costs) to SCI entities because they may need to delay or shift their resources away from profitable projects and reallocate their resources towards taking prompt or unplanned remedial actions required by the rules. However, it is difficult to assess such indirect costs imposed on SCI entities because the Commission lacks information necessary to provide a reasonable estimate. For example, the

¹⁹⁸⁸ As noted in Section V.D.1.a above, the paperwork burden related to the review of the policies and procedures is included in the estimated annual ongoing burden of Rules 1001(a), (b), and (c).

Commission does not have comprehensive and detailed information on the value of the potential forgone projects of SCI entities.

ii. Corrective Action – Rule 1002(a)

Rule 1002(a) requires an SCI entity to begin to take appropriate corrective action upon any responsible SCI personnel having a reasonable basis to conclude that an SCI event has occurred. Rule 1002(a) also requires corrective action to include, at a minimum, mitigating potential harm to investors and market integrity resulting from the SCI event and devoting adequate resources to remedy the SCI event as soon as reasonably practicable. Thus, it would not be appropriate for an SCI entity to unnecessarily delay the start of corrective action once its responsible SCI personnel have a reasonable basis to conclude that an SCI event has occurred, and the SCI entity would be required to focus on mitigating potential harm to investors and market integrity resulting from the SCI event and devoting adequate resources to remedy the SCI event as soon as reasonably practicable. The Commission believes that SCI entities already have a variety of procedures in place to take corrective actions when system issues occur. However, Rule 1002(a) will likely require modifications to those existing practices in part because the rule specifies the timing and enumerates certain goals for corrective action.¹⁹⁸⁹

The Commission believes that the corrective action requirement will reduce the length of systems disruptions, systems compliance issues, and systems intrusions, and thus, as noted in Section VI.C.1, reduce the negative effects of those interruptions on the SCI entity and market participants. Additionally, to the extent that corrective action could involve wide-scale systems

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For example, although the Commission believes that market participants already take corrective actions when system issues occur, currently, when taking corrective action, market participants may not always focus on mitigating potential harm to investors and market integrity or devoting adequate resources to remedy the issues as soon as reasonably practicable, as SCI entities are required to do under Rule 1002(a).

upgrades, some SCI entities may potentially seek to accelerate capital expenditures, for example, by updating their systems with newer technology earlier than they might have otherwise to comply with Regulation SCI. As such, Rule 1002(a) could further help ensure that SCI entities invest sufficient resources as soon as reasonably practicable to address systems issues.

The Commission recognizes that Rule 1002(a) may require SCI entities to undertake corrective action sooner and/or to increase investments in newer and more updated systems earlier than they might have otherwise. The Commission thus believes that Rule 1002(a) could impose modestly higher costs for SCI entities in responding to SCI events relative to their current practice.¹⁹⁹⁰ But, given the wide variety of current practices, the Commission is unable to estimate the incremental costs associated with the required changes. Furthermore, if Regulation SCI reduces the frequency and severity of SCI events in the future, the cost of corrective action could similarly decline over time. However, the Commission cannot estimate these costs because the degree to which Regulation SCI will reduce the frequency and severity of SCI events is unknown. The Commission also believes that, if an SCI entity takes corrective action sooner than they might have without the requirements of Regulation SCI, this may impose indirect costs (i.e., opportunity costs) to SCI entities because they may have to delay or reallocate their resources away from profitable projects and direct their resources toward taking corrective action required by the rule. However, the Commission acknowledges that it is difficult to assess such indirect costs imposed on SCI entities. For instance, the Commission does not have comprehensive and detailed information on the value of the potential foregone projects of SCI entities. Consequently, the Commission is, at this time, unable to estimate the costs of Rule

¹⁹⁹⁰ See also MSRB Letter at 32 (commenting that under most circumstances, any increased cost due to proposed Rule 1000(b)(3) would be modest since corrective action normally would already be taken).

1002(a) of Regulation SCI because the Commission lacks information necessary to provide a reasonable cost estimate.

Several commenters stated that the requirements of proposed Rule 1000(b)(3) put too great an emphasis on immediate corrective action at the expense of thoroughly analyzing the SCI event and its cause, considering potential remedies, and/or acting in accordance with internal policies and procedures before committing to a plan to take corrective action.¹⁹⁹¹ Partly in response to this concern, the Commission has modified the rule as adopted from the proposal. The Commission agrees that an SCI entity should be given appropriate time to perform an initial analysis and preliminary investigation into a potential systems issue before the corrective obligations are triggered. If a corrective action were to be applied without such analysis or investigation, then the impact of an SCI event could persist, exacerbating or prolonging its negative effects on markets and market participants. The Commission notes that Rule 1002(a) does not use the term “immediate.” Rather, Rule 1002(a) requires that corrective action be taken “as soon as reasonably practicable” once the triggering standard has been met. The Commission believes that, because the facts and circumstances of each specific SCI event will be different, this standard would help ensure that an SCI entity takes necessary corrective action soon after an SCI event, but not without sufficient time to first consider what is the appropriate action to remedy the SCI event in a particular situation and how such corrective action should be implemented.¹⁹⁹²

¹⁹⁹¹ See SIFMA Letter at 3; OCC Letter at 14; Joint SROs Letter at 11; LiquidPoint Letter at 4; DTCC Letter at 10; and Direct Edge Letter at 7.

¹⁹⁹² See also *supra* Section IV.B.3.a (discussing in more detail the triggering standard for corrective action, Commission notification, and information dissemination) and Section IV.B.3.b (discussing the corrective action requirement).

iii. Commission Notification – Rule 1002(b)

As discussed above in Section IV.B.3.c, Rule 1002(b) requires SCI entities to provide notifications to the Commission regarding SCI events. Specifically, upon any responsible SCI personnel having a reasonable basis to conclude that an SCI event has occurred, an SCI entity is required to notify the Commission of the SCI event immediately. Within 24 hours of any responsible SCI personnel having a reasonable basis to conclude that an SCI event has occurred, an SCI entity is required to submit a more detailed written notification, on a good faith, best efforts basis, pertaining to the SCI event. Until such time as the SCI event is resolved and the SCI entity's investigation of the SCI event is closed, the SCI entity is required to provide updates regularly, or at such frequency as requested by a representative of the Commission. The SCI entity is also required to submit a detailed final written notification after the SCI event is resolved and the SCI entity's investigation of the event is closed (and an additional interim written notification, if the SCI event is not resolved or the investigation is not closed within a specified period of time). Finally, SCI entities are required to notify the Commission of information regarding de minimis systems disruptions and de minimis systems intrusions on a quarterly basis.

The Commission believes that most, if not all, major systems incidents are reported by ARP entities to the Commission and that many "de minimis" systems issues are documented internally by SCI entities as part of their incident management systems. For those entities that do not participate in the ARP Inspection Program, the Commission also believes that some internal documentation of systems incidents exists. In addition, the Commission notes that some SCI entities currently notify the Commission of certain systems compliance issues.

Rule 1002(b) will apply to more entities (e.g., some SCI ATSS), more systems (e.g., market regulation and market surveillance systems, additional market data systems), and more types of systems issues (e.g., systems compliance issues) than the ARP Policy Statements, and also require more detailed reporting to the Commission.¹⁹⁹³ The Commission believes that Rule 1002(b) will enhance the effectiveness of Commission oversight of the operation of SCI entities. For example, one commenter suggested that SCI events notification results in greater transparency for the Commission, with multiple benefits, including ensuring that the Commission has a view into problems at particular SCI entities for regulatory purposes as well as perspective on the effect of a single problem to the market at-large.¹⁹⁹⁴ Further, the Commission believes that providing written notifications to the Commission could help prevent systems failures from being dismissed as momentary issues, because notification would help focus the SCI entity's attention on the issue and encourage allocation of SCI entity resources to resolve the issue as soon as reasonably practicable.

As noted in Section IV.B.3.c, the Commission received comment letters that discuss the resource and efficiency demands of the Commission notification requirement.¹⁹⁹⁵ Some commenters expressed concern that SCI entities may feel compelled to characterize and report a greater number of systems anomalies as disruptions to comply with Regulation SCI,¹⁹⁹⁶ and that the proposal would result in SCI entities having "shadow staff" on hand solely for reporting SCI

¹⁹⁹³ See supra Section IV.B.3.c (discussing in detail the requirements of Rule 1002(b)).

¹⁹⁹⁴ See Lauer Letter at 8.

¹⁹⁹⁵ See, e.g., UBS Letter at 3; Omgeo Letter at 16; MSRB Letter at 19; OCC Letter at 14; SunGard Letter at 5; Joint SROs Letter at 7; and NYSE Letter at 22.

¹⁹⁹⁶ See Joint SROs Letter at 9-10.

events so as to not divert staff away from working to resolve SCI events.¹⁹⁹⁷ While the Commission is adopting the definitions of systems disruptions, systems compliance issues, and systems intrusions, and providing discussions of these definitions in this release, the Commission acknowledges that some SCI entities could be overly cautious in seeking to be in compliance with Regulation SCI and therefore over-report systems issues to the Commission. Furthermore, the Commission notes that some SCI entities currently notify the Commission of systems related issues under the ARP Inspection Program or as part of their current business practice, but the Commission believes that SCI entities will have to allocate additional resources to meet the Commission notification requirement. Although the estimated cost to comply with the adopted notification provisions is greater than the estimate in the SCI Proposal, the Commission is not persuaded that the adopted rule, with its more targeted scope, will require SCI entities to have a “shadow staff” on hand solely for reporting SCI events. As discussed in Section IV.B.3.c, the Commission believes that concerns with respect to resource demands regarding the Commission notification requirements have been substantially mitigated by the numerous changes from the proposal, such as the adoption of a quarterly reporting framework for de minimis systems disruptions and de minimis systems intrusions; the adoption of an exception from the Commission notification requirements for de minimis systems compliance issues; the revised definitions of SCI systems, indirect SCI systems, systems disruption, and systems compliance issue; and the reduction in the obligations SCI entities have with respect to reporting requirements. In addition, the Commission is not persuaded that the burden of the Commission notification requirement will significantly reduce SCI entities’ ability to adequately respond to SCI events. It is the Commission’s experience that the staff engaging in corrective action to

¹⁹⁹⁷ See FINRA Letter at 19.

resolve an SCI event is generally distinct from the staff that has been charged with notifying the Commission of systems issues.

The compliance costs associated with Rule 1002(b) are attributed to the paperwork burden of Commission notifications of SCI events, including recordkeeping and submission of quarterly reports with respect to de minimis SCI events, as applicable.¹⁹⁹⁸ As discussed in the PRA, with respect to SCI events that are not de minimis, the Commission has estimated the total annual hourly burden to comply with Rules 1002(b)(1)-(4) to be 125,180 hours for all SCI entities (monetized to be approximately \$40 million), or 2,845 hours per SCI entity.¹⁹⁹⁹ This estimate is greater than that estimated in the SCI Proposal (which estimate was 58,080 hours for all SCI entities, or 1,320 hour per SCI entity to comply with proposed Rules 1000(b)(4)(i)-(iii)). As more fully explained in the PRA, the Commission has increased its estimate to comply with the Commission notification provisions in Rules 1002(b)(1)-(4), notwithstanding the more targeted scope of the adopted rule, as compared to the proposed rule. These increased estimates are in response to comment that the estimates in the SCI Proposal were too low, particularly with respect to the time necessary for an SCI entity to prepare, review, and submit the required notifications.²⁰⁰⁰ In addition, for Rule 1002(b)(5), which requires recordkeeping of all de minimis SCI events and quarterly reporting of de minimis systems disruptions and de minimis systems intrusions, the Commission has estimated a total of 7,040 hours for all SCI entities (monetized to be approximately \$2 million), or 160 hours per SCI entity, for Commission

¹⁹⁹⁸ When monetized, the paperwork burden would result in approximately \$42 million, in addition to approximately \$2 million in outsourcing cost, annually for all SCI entities in the aggregate.

¹⁹⁹⁹ See supra Section V.D.2.a (discussing the Commission's estimate of the hours required to comply with Rule 1002(b)).

²⁰⁰⁰ See id.

notification. The number of SCI events (de minimis and otherwise), and the burdens to comply with notification requirements will likely vary among individual SCI entities, based on the nature of their business, technology, and the relative criticality of each of their SCI systems.

In addition, the Commission believes that most, if not all, SCI entities already have some internal procedures for determining the severity of a systems issue. Nevertheless, to the extent that an SCI entity must determine whether an SCI event is a de minimis SCI event, Rule 1002(b) may impose one-time implementation costs on SCI entities associated with developing a process for ensuring that they are able to quickly and correctly make such determinations, as well as ongoing costs in reviewing the adopted process. The initial and ongoing burden associated with identifying certain systems and SCI events is discussed in Section V.D.3.b.²⁰⁰¹

Proposed Rule 1000(b)(4) did not distinguish de minimis SCI events from other SCI events in terms of the timing or type of Commission notifications. The Commission believes that the adopted quarterly Commission reporting requirement for de minimis systems disruptions and de minimis systems intrusions, and the exception from the Commission reporting requirement for de minimis systems compliance issues, will reduce costs related to Commission reporting (as compared to the costs of complying with the proposed Commission notification requirements) for SCI entities, and could facilitate more efficient allocation of SCI entities' resources toward more significant systems issues because de minimis SCI events would be subject to a recordkeeping requirement and de minimis systems disruptions and de minimis systems intrusions would be subject to a quarterly reporting requirement, rather than a

²⁰⁰¹ When monetized, the paperwork burden would result in approximately \$1.1 million initially and \$413,000 annually for all ARP entities in the aggregate, and approximately \$885,000 initially and \$292,000 annually for all non-ARP entities in the aggregate. These estimates include the identification of critical SCI systems, major SCI events, and de minimis SCI events.

requirement to report such events to the Commission more immediately. As de minimis SCI events are defined to have no or a de minimis impact on the SCI entity's operations or on market participants, the Commission believes that the recordkeeping requirement and quarterly reporting requirement, as applicable, will allow both the SCI entity and its personnel, as well as the Commission and its staff, to focus more of their attention and resources on other, more significant SCI events. Moreover, the quarterly Commission notification requirement for de minimis systems disruptions and de minimis systems intrusions will help SCI entities and the Commission to gather information on the nature, types, and frequency of de minimis SCI events and, thus, help identify potential weaknesses in systems across SCI entities and Commission's ability to monitor market events. The Commission believes that the quarterly reporting requirement for de minimis systems disruptions and de minimis systems intrusions balances the interest of SCI entities in having a limited reporting burden for de minimis systems disruptions and de minimis systems intrusions with the Commission's interest in oversight of the information technology programs of SCI entities.

Furthermore, proposed Rule 1000(b)(4)(iii) would have required an SCI entity to submit written updates pertaining to an SCI event until the SCI event is resolved. The Commission has revised the update requirement from the proposal in adopted Rule 1002(b)(3) so that the submission of updates may be provided either orally or in written form.²⁰⁰² This revision should reduce costs as compared to proposed Rule 1000(b)(4) by providing flexibility to SCI entities and because oral notifications will likely result in a lower burden than written notifications.

The Commission has also modified the 24-hour written notification requirement in adopted Rule 1002(b) to make clear that the written notification provided within 24 hours be

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See supra Section IV.B.3.c.

submitted on a good faith, best effort basis. Compared to the proposed rule, the Commission believes the adopted rules will help provide certainty to SCI entities that they will not be accountable for unintentional inaccuracies or omissions contained in these submissions. The “best efforts” standard will also help to ensure that SCI entities will make a diligent and timely attempt to provide all the information required by the written notification requirement, thus permitting the Commission to effectively monitor SCI events.

As discussed in Section IV.B.3.c, with respect to submitting final written notifications, proposed Rule 1000(b)(4)(ii) would have required the submission of the information required to be included in the final written notification within a shorter time frame. By requiring that the final written notification be submitted after resolution of an SCI event, the Commission believes that the adopted rule will encourage SCI entities to allocate their resources efficiently in resolving the SCI event.

One commenter expressed concern that, without a safe harbor and a guarantee of immunity, the disclosures to the Commission required under Regulation SCI would provide a roadmap for litigation against non-SRO entities.²⁰⁰³ As discussed in Section IV.B.2.b, the occurrence of a systems compliance issue does not necessarily mean that the SCI entity will be subject to an enforcement action. Rather, the Commission will exercise its discretion to initiate an enforcement action if the Commission determines that action is warranted, based on the particular facts and circumstances of an individual situation. Moreover, the Commission recognizes that compliance with Regulation SCI will increase the amount of information about

²⁰⁰³ See OTC Markets Letter at 15-16 (stating that “entities that do not have SRO immunity, such as ATSSs, may be subject to liability based on information reported under Reg. SCI’s Rule 1000(b)(4)(iv)...[w]ithout a safe harbor and a guarantee of immunity, this kind of disclosure provides a roadmap for litigation against non-SRO SCI entities”). See also FIF Letter at 5.

SCI events available to the Commission and SCI entities' members and participants, and that the greater availability of this information has some potential to increase litigation risks for SCI entities, including the risk of private civil litigation. Commenters did not provide estimates of potential litigation costs and Commission staff were unable to find readily-available public information from which to estimate specific costs of possible litigation associated with the increased information available about SCI events, but based on staff experience, depending on the complexity, scope, and length of the litigation, the costs to defend an individual case could be quite significant. The Commission notes, however, that it is not clear that the incremental increase in costs due to Regulation SCI will be significant in the aggregate. Regulation SCI does not alter the elements of any available private cause of action, and the elements of such actions are likely to limit the potential for recovery. Moreover, to the extent members and participants suffer damages when SCI events occur, SCI entities are already subject to litigation risk.

As an alternative to the adopted rule, some commenters suggested that non-material systems intrusions not be reported to the Commission at all, and only be recorded by the SCI entity to reduce the instances in which notice of systems intrusions would be required.²⁰⁰⁴ The Commission continues to believe that reporting intrusions in SCI systems and indirect SCI systems will help the Commission and its staff to detect patterns or understand trends over time and the nature of systems intrusions that may be occurring at multiple SCI entities and, thus, help ensure effective Commission oversight. As discussed in Section IV.B.3.c in detail, to reduce the burden associated with the Commission notification requirement, the Commission established separate reporting requirements (e.g., quarterly reporting) for de minimis systems disruptions and

²⁰⁰⁴ See Omgeo Letter at 12; and DTCC Letter at 8.

de minimis systems intrusions and provided an exception from the Commission reporting requirement for de minimis systems compliance issues.

iv. Information Dissemination – Rule 1002(c)

Rule 1002(c) requires an SCI entity to disseminate information regarding certain major SCI events to all of its members or participants and certain other SCI events to affected members or participants. Specifically, promptly after any responsible SCI personnel having a reasonable basis to conclude that an SCI event has occurred, an SCI entity is required to disseminate certain information regarding the SCI event. When certain additional information becomes known, the SCI entity is required to promptly disseminate such information. Until the SCI event is resolved, the SCI entity is required to provide regular updates on the required information.²⁰⁰⁵ As adopted, the information dissemination requirement does not apply to SCI events to the extent they relate to market regulation or market surveillance systems and de minimis SCI events. Rule 1002(c) imposes new requirements that are not currently part of the ARP Inspection Program. However, some entities currently provide their members or participants and, in some cases, market participants or the public more generally, with notices of systems issues.

As discussed in Section IV.B.3.d, a major SCI event is defined to mean an SCI event that has any impact on a critical SCI system or a significant impact on the SCI entity's operations or on market participants. The Commission believes that, in the context of a major SCI event, where the impact of the SCI event is most likely to be felt by many market participants, the goal

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Rule 1002(c)(2) provides an exception to the information dissemination requirement for systems intrusions when an SCI entity determines that dissemination of information would likely compromise the security of the SCI entity's systems, or an investigation of the systems intrusion, and documents the reasons for such determination.

of aiding market participants in evaluating the impact of the event would be efficiently served by dissemination of information to all members or participants of the SCI entity.²⁰⁰⁶

The Commission believes that Rule 1002(c) will help market participants—specifically the members or participants of SCI entities estimated to be affected by an SCI event and any additional members or participants subsequently estimated to be affected by an SCI event and, in some cases, all members or participants of an SCI entity—to better evaluate the operations of SCI entities by requiring certain information to be disclosed. Furthermore, increased awareness of SCI events through information disseminated to members or participants should provide SCI entities additional incentives to maintain robust systems and minimize the occurrence of SCI events. More robust SCI systems and the reduction in the occurrence of SCI events could reduce interruptions in price discovery process and liquidity flows as discussed above in Section VI.C.1.

One commenter provided information about the benefits of the proposed information dissemination requirements. Specifically, according to this commenter, one of the major benefits of Regulation SCI could be better sharing of information about technology problems.²⁰⁰⁷ According to this commenter, sharing information about hardware failures, systems intrusions, and software glitches will alert others in the industry about such problems and help reduce system-wide costs of diagnosing problems, as well as result in improved responses to technology

²⁰⁰⁶ At the same time, the Commission recognizes that some SCI events that meet the definition of “major SCI event” could also qualify as de minimis SCI events. Like other de minimis SCI events, they are excepted from the information dissemination requirement. In particular, because major SCI events are a subset of SCI events, the exception under Rule 1002(c)(4)(ii) applies to major SCI events that meet the requirements of that rule.

²⁰⁰⁷ See Angel Letter at 5.

problems.²⁰⁰⁸ This commenter also believed that the information will serve as warnings to other SCI entities to stay vigilant to prevent similar problems.²⁰⁰⁹ The Commission believes that benefits identified by the commenter could be benefits of Rule 1002(c).

As discussed above, while some entities currently provide their members or participants and, in some cases, market participants or the public more generally, with notices of certain systems issues (e.g., system outages), Rule 1002(c) imposes new requirements that are not currently part of the ARP Inspection Program. As such, the requirements of Rule 1002(c) will impose costs—which are attributed to paperwork burdens—on SCI entities with respect to preparing, drafting, reviewing, and making the information available to members or participants. These costs are discussed in more detail in Section V.D.2.b.²⁰¹⁰

In the SCI Proposal, the Commission recognized that SCI entities incur costs to determine whether an event needs to be disseminated. While the SCI events subject to the adopted information dissemination requirements are different from those that would have been subject to the proposed requirements, the Commission continues to recognize that the determination imposes costs. Specifically, identifying major SCI events may impose one-time implementation costs on SCI entities associated with developing a process for ensuring that they

²⁰⁰⁸ See id.

²⁰⁰⁹ See id. However, this commenter also disagreed with the Commission that SCI entities may be reluctant to admit publicly to their glitches. See id. at 14. According to this commenter, market participants interact repeatedly with each other on a real-time basis and are acutely aware of glitches when they occur. See id.

²⁰¹⁰ When monetized, the paperwork burden would result in approximately \$26 million, in addition to approximately \$1.6 million in outsourcing cost, annually for all SCI entities in the aggregate.

are able to quickly and correctly make such determinations, as well as periodic costs in reviewing the adopted process. These costs are discussed in more detail in Section V.D.3.b.²⁰¹¹

One commenter expressed concern that SCI entities may over-report issues out of an abundance of caution if SCI entities are not given clear guidelines as to what and to whom they are required to provide information.²⁰¹² This commenter believed that a flood of notifications, taken out of context, may create investor impression based on the quantity, not the quality, of the notifications disseminated, that certain counterparties pose serious risks to the market, when that is not the case.²⁰¹³ For the reasons discussed in Section IV.B.3.d, the Commission believes that information about SCI events (other than major SCI events and de minimis SCI events) should be disseminated to affected members or participants, and information about major SCI events (other than those that qualify as de minimis SCI events) should be disseminated to all members or participants of an SCI entity. At the same time, as compared to proposed Rule 1000(b)(5), the Commission is limiting the requirement for information dissemination to all members or participants of an SCI entity to major SCI events; limiting other information dissemination to members or participants affected by the SCI event; and excluding de minimis SCI events and SCI events related to market regulation or market surveillance systems from the information dissemination requirement. These changes would limit the compliance cost for Rule 1002(c), and are responsive to the commenter's concern that SCI entities may over-disclose systems issues.

²⁰¹¹ See also supra note 2001.

²⁰¹² See Fidelity Letter at 5.

²⁰¹³ See id.

As an alternative to the adopted rule, one commenter suggested broadening the proposed rule to require an SCI entity to disseminate information on SCI events to the public, and not just to its members or participants.²⁰¹⁴ This commenter believed that public dissemination of the facts of an SCI event would help enhance investor confidence by preventing speculation and misinformation, and would provide important learning opportunities for the industry and other SCI entities.²⁰¹⁵ The Commission acknowledges that there can be additional benefits from disseminating major SCI events to the public as noted by the commenter. Under the adopted rule, an SCI entity is required to disseminate information on major SCI events (other than those that qualify as de minimis SCI events) to all of its members and participants. The Commission believes that these market participants are the most likely to act on this information and, thus, induce additional competitive incentives for SCI entities to avoid systems issues. As such, the Commission believes that it can achieve the purposes of the rule without requiring public dissemination, and also believes any additional gain in benefits from public dissemination would be minimal.

v. Material Systems Changes – Rule 1003(a)

Rule 1003(a)(1) requires an SCI entity to provide quarterly reports to the Commission, describing completed, ongoing, and planned material systems changes to its SCI systems and the security of indirect SCI systems, during the prior, current, and subsequent calendar quarters. Rule 1003(a)(1) also requires an SCI entity to establish reasonable written criteria for identifying a change to its SCI systems and the security of its indirect SCI systems as material. Rule

²⁰¹⁴ See MFA Letter at 7.

²⁰¹⁵ See *id.*

1003(a)(2) requires an SCI entity to promptly submit a supplemental report to notify the Commission of a material error in or material omission from a previously submitted report.

Entities that participate in the ARP Inspection Program currently provide some material systems change notifications to the Commission and the Commission believes that all SCI entities have some internal processes for documenting systems changes as a matter of prudent business practice. For example, consistent with the ARP Policy Statements, certain entities provide annual reports on significant systems changes and notify the Commission on an as-needed basis regarding certain significant systems changes. In addition, ATSS are required to notify the Commission of certain systems changes pursuant to Rule 301(b)(2)(ii) and Rule 301(b)(6)(ii)(G) of Regulation ATS, as applicable. Rule 1003(a) changes some of the current practices and sets forth more detailed requirements for these notifications. For example, Rule 1003(a) covers material changes on a broader set of systems than the ARP Inspection Program or Regulation ATS. Rule 1003(a) also requires an SCI entity to submit quarterly reports on Form SCI regarding material systems changes, but does not require separate notification for each material systems change. Further, Rule 1003(a) requires an SCI entity to promptly notify the Commission (by submitting Form SCI) of a material error in or material omission from a previously submitted report. To the extent that Rule 1003(a) requires SCI entities to notify the Commission of material systems changes for more types of systems and to the extent that it requires notification at a higher frequency than current practice (quarterly reports vs. annual reports), the Commission believes that Rule 1003(a) should enhance the Commission's oversight of the operation of SCI entities.

The compliance costs of Rule 1003(a) primarily entail costs associated with preparing and submitting Form SCI in accordance with the instructions thereto. The initial and ongoing

cost estimates associated with preparing and submitting Form SCI with regard to material systems changes under Rules 1003(a)(1) and (2) are discussed in detail in Section V.D.2.c.²⁰¹⁶ The Commission does not expect Rule 1003(a) will impose significant costs on SCI entities other than those discussed in Section V.D.2.c.

According to one commenter, “[t]he larger market participants [that will be subject to Regulation SCI] are generally experienced and circumspect with regards to significant infrastructure changes, such as data center migrations and major platform upgrades.”²⁰¹⁷ This commenter expected that, for these larger entities, integrating Regulation SCI compliance into their existing programs can occur without crippling disruption or exorbitant cost, and expected that insight from the implementation of Regulation SCI would contribute to overall stability and resiliency of the markets over time.²⁰¹⁸ However, this commenter expressed concern that compliance with the Commission notification requirement will result in incremental costs that may in some cases delay or discourage innovation.²⁰¹⁹ Another commenter similarly expressed concern about the compliance burden and the resulting impact on competition and innovation associated with the 30-day advance Commission notification requirement for material systems changes.²⁰²⁰ In addition, one commenter noted that the Commission underestimated the cost of lost business opportunities and the inability to swiftly deploy corrective solutions that would

²⁰¹⁶ When monetized, the paperwork burden would result in approximately \$6.8 million annually for all SCI entities in the aggregate.

²⁰¹⁷ See SunGard Letter at 3.

²⁰¹⁸ See id.

²⁰¹⁹ See id.

²⁰²⁰ See BATS Letter at 15. See also, e.g., supra notes 999-1000 (discussing the views of commenters that the proposed 30-day advance notification requirement would stifle innovation and interfere with an SCI entity’s natural planning and development process).

result from the 30-day advance systems change notification requirements.²⁰²¹ This commenter noted that most ATS operators with advanced systems purposefully implement frequent agile modifications instead of major episodic changes in order to continuously improve their systems and minimize the impact of the changes.²⁰²² This commenter expressed concern that a built-in 30-day delay in implementing changes would encourage the deployment of larger, riskier changes more infrequently, thereby creating longer periods of time during which a systems issue and/or erroneous configuration would continue without correction.²⁰²³ This commenter also stated that the 30-day advance notification process has the potential to delay the deployment of corrective solutions that are necessary to ensure the provision of uninterrupted and efficient order matching services at the best available prices.²⁰²⁴

As noted above, as adopted, Regulation SCI does not include the proposed 30-day advance Commission notification requirement for material systems changes. Rather, Rule 1003(a)(1) requires quarterly reports of material systems changes. Elimination of the proposed 30-day advance Commission notification requirement addresses the concern of some commenters that the rule would impede agile development methodology and favor the waterfall development methodology, or delay the implementation of systems changes or innovations, particularly for smaller SCI entities. The quarterly reports will also provide the Commission and its staff with a more efficient framework to review material systems changes, because including all relevant material systems changes in a single report will allow the Commission to more easily

²⁰²¹ See ITG Letter at 8.

²⁰²² See id.

²⁰²³ See id.

²⁰²⁴ See id.

and clearly understand an SCI entity's framework for systems changes, including how certain material systems changes are related.²⁰²⁵

vi. SCI Review – Rule 1003(b)

Rule 1003(b) requires an SCI entity to conduct an SCI review of its compliance with Regulation SCI not less than once each year,²⁰²⁶ and submit a report of the SCI review to senior management of the SCI entity for review no more than 30 calendar days after completion of such SCI review. Rule 1003(b) also requires an SCI entity to submit a report of the SCI review to the Commission and to the board of directors of the SCI entity or the equivalent of such board, together with any response by senior management, within 60 calendar days after its submission to senior management of the SCI entity.

Systems reviews have been part of the ARP Inspection Program, and through this program, the Commission understands that many SCI entities currently undertake annual systems reviews and that senior management and/or the board of directors or a committee thereof reviews reports of such reviews. However, the Commission believes that the scope of the systems reviews, and the level of senior management and/or board involvement in such reviews, varies among ARP entities. The Commission expects that the SCI review requirement would produce

²⁰²⁵ As discussed above, Commission staff will not use material systems change reports to require any approval of planned systems changes in advance of their implementation pursuant to any provision of Regulation SCI, or to delay implementation of material systems changes pursuant to any provision of Regulation SCI. See supra Section IV.B.4.b.

²⁰²⁶ However, penetration test reviews of the network, firewalls, and production systems are required to be conducted not less than once every three years. See Rule 1003(b)(i). Assessments of SCI systems directly supporting market regulation or market surveillance are required to be conducted at a frequency based upon the risk assessment conducted as part of the SCI review, but also not less than once every three years. See Rule 1003(b)(1)(ii).

greater consistency in the approach that SCI entities take in systems reviews, which would help improve the efficiency of the Commission's oversight (e.g., inspection) of SCI entities' systems. In addition, the Commission believes that the SCI review requirement would result in SCI entities having an improved awareness of the relative strengths and weaknesses of their systems independent of the assessment of Commission staff, which should, in turn, improve systems and reduce the number of SCI events. As discussed in Section VI.C.1, the reduction in occurrence of SCI events could reduce interruptions in the price discovery process and liquidity flows.

The initial and ongoing paperwork burden associated with conducting an SCI review, submitting a report of the SCI review to senior management of the SCI entity for review, and submitting a report of the SCI review and any response by senior management to the Commission and to the board of directors of the SCI entity or the equivalent of such board is discussed in Section V.D.2.d.²⁰²⁷ SCI entities will also incur costs in addition to the paperwork burden to comply with the SCI review requirement. Although the Commission understands that most SCI entities currently undertake annual systems reviews, Rule 1003(b) sets forth specific requirements related to the SCI review. In particular, an SCI review is required to include a risk assessment with respect to SCI systems and indirect SCI systems of an SCI entity, an assessment of internal control design and effectiveness of SCI systems and indirect SCI systems, and penetration testing reviews. Moreover, Rule 1003(b) specifies that the SCI review is to determine the SCI entity's compliance with Regulation SCI. Rule 1003(b) also requires a report of the SCI review and any senior management response to be submitted to the board of directors of the SCI entity or the equivalent of such board and thus SCI entities may incur an additional

²⁰²⁷ When monetized, the paperwork burden would result in approximately \$9.7 million, in addition to approximately \$2.2 million in outsourcing cost, annually for all SCI entities in the aggregate.

cost as a result of additional time the board allocates to evaluate the review. The Commission cannot estimate costs other than paperwork burdens because the Commission does not have the information necessary to provide a reasonable estimate. In particular, the Commission lacks information on how SCI entities will structure their reviews.

As discussed above in Section IV.B.5, the Commission is not adopting a requirement that SCI reviews be conducted by an independent third party because the Commission believes that the goals of Regulation SCI can be achieved through reviews by either internal objective personnel or external objective personnel. The Commission acknowledges that, in some cases, there could be potential benefits from requiring third party reviews. However, as noted in Section IV.B.5, third parties can also have conflicts of interest that prevent a particular entity or personnel from meeting the objectivity standard required for an SCI review. In addition, during the Technology Roundtable in which participants discussed third party review, some panelists suggested that the use of an external third party is unnecessary because, for example, the training for a third party as well as the costs involved with third party evaluations would be large with little additional benefit.²⁰²⁸ The Commission agrees that SCI entities would likely need to provide significant guidance to third-party reviewers on the specific features of the entity's systems. The Commission recognizes that a third-party review requirement could impose additional costs on SCI entities, and believes that it is appropriate at this time to allow SCI entities to decide whether to incur such costs instead of mandating third-party review.

vii. Business Continuity and Disaster Recovery Plan Testing – Rule 1004

²⁰²⁸ See Transcript of the Technology Roundtable, at 86-91.

Rule 1004(b) requires the testing of an SCI entity's business continuity and disaster recovery plans at least once every 12 months. Rules 1004(a) and (b) require participation in such testing by those members or participants that an SCI entity reasonably determines are, taken as a whole, the minimum number necessary for the maintenance of fair and orderly markets in the event of the activation of its business continuity and disaster recovery plans. Rule 1004(c) requires an SCI entity to coordinate such testing on an industry- or sector-wide basis with other SCI entities.

The requirements under Rule 1004 are not a part of the ARP Inspection Program. As discussed above in Section VI.B.2, the securities industry generally has a voluntary system for testing business continuity and disaster recovery plans and market participants, including exchanges, members of exchanges, clearing agencies, clearing members, and ATSS, already coordinate certain business continuity and disaster recovery plan testing to some extent. For example, some SCI entities already require some of their members or participants to connect to their backup systems. Further, although participation is not always mandatory, some SCI entities already provide their members or participants with the opportunity to test the SCI entity's business continuity and disaster recovery plans. However, because not all SCI entities require member or participant participation in business continuity and disaster recovery plans testing, the Commission understands that not all market participants participate in such testing. Moreover, the Commission understands that, to the extent such participation occurs, it may in many cases be limited in nature (e.g., testing for connectivity to backup systems).²⁰²⁹

The Commission believes that, for SCI entities, voluntary testing is insufficient, and that business continuity and disaster recovery planning for market centers and certain members or

²⁰²⁹ See Proposing Release, supra note 13, at 18164.

participants must be an integral component of business continuity and disaster recovery preparedness. The Commission further believes that the requirements under Rule 1004 should help ensure that the securities markets will have improved backup infrastructure and fewer market-wide shutdowns. As discussed in detail in Section VI.C.1, fewer market-wide shutdowns should help facilitate continuous liquidity flows in markets, reduce pricing errors, and thus improve the quality of the price discovery process.

With respect to these benefits, one commenter suggested measuring benefits of reducing outages and technical issues by looking at, for example, loss of trading commissions due to outages.²⁰³⁰ This commenter estimated that the potential loss of equity commissions by broker-dealers over the two-day market closure from Superstorm Sandy may have been approximately \$374 million.²⁰³¹ The Commission believes that measuring potential benefits in terms of

²⁰³⁰ See Angel Letter at 15-16. The Commission also notes that this commenter and others expressed the view that enhanced BC/DR testing would have substantial benefits. See, e.g., *id.* at 9-10 (stating that the “ability of SROs to require their members to participate in testing is an important step forward in making sure that testing is as realistic as possible... [and] is one of the most valuable parts of Regulation SCI and will do the most to ensure improved market network reliability”); and UBS Letter at 5 (stating that the “critical task of BCP testing should not be undertaken in isolated silos by individual firms. Individual BCP testing that does not involve realistic scenarios with connected participants may mask gaps and/or be insufficient from a systems integrity standpoint” and that the benefits of a “new and more comprehensive BCP testing paradigm” would be “broad and considerable”).

²⁰³¹ This commenter based this estimate on FINRA member equity commissions in 2010 obtained from SIFMA. See Angel Letter at 16. In addition, this commenter referred to the losses and legal and administrative costs associated with the Facebook IPO, as well as the losses associated with the May 6, 2010 incident. See *id.* at 15-16. This commenter also more generally stated that the benefits of reducing outages and major technical issues are pretty straightforward – catastrophic failures in exchange systems are extremely costly, both in terms of direct losses to participants and in reduced investor confidence in the markets. See *id.* at 15. According to this commenter, even a modest reduction in the overall risk of a meltdown is quite cost effective to the economy as a whole. See *id.*

transaction costs (commission revenue) does not fully account for other benefits, such as uninterrupted liquidity flows and price discovery.²⁰³² Furthermore, the Commission believes that the estimated commission loss noted by the commenter likely overstates the actual losses in commissions because some of the “lost” trading may have only been delayed until the markets re-opened after Superstorm Sandy. Accordingly, the Commission is not persuaded that the estimate provided by the commenter represents the quantified benefit associated with this component of Regulation SCI. The Commission is unable to estimate the benefit of this component of Regulation SCI because the Commission does not have quantified information on the extent that a reduction in SCI events will help facilitate liquidity flows in markets, reduce pricing errors, and thus improve the quality of the price discovery process. Furthermore, the Commission is unable to quantify the impact of “delayed” trading because it lacks the information necessary to provide a reasonable estimate. In particular, data on the trading activity lost as opposed to “delayed” due to the two-day market closure would be extremely difficult to piece together in a meaningful way.

Costs to SCI Entities

The mandatory testing of SCI entity business continuity and disaster recovery plans, including backup systems, as required under Rule 1004, will result in additional costs to SCI entities. The Commission notes that some SCI entities already offer availability for their members or participants to test business continuity and disaster recovery plans. Furthermore, as mentioned above, market participants, including SCI entities, already coordinate certain business continuity plan testing to an extent. However, Rule 1004 mandates participation in testing for

²⁰³² As noted by this commenter, the \$374 million loss does not include lost trading profits to investors, or loss of utility from being able to hedge risk, monetize holdings, or otherwise trade. See *id.* at 16.

some entities that do not currently participate, requires more rigorous testing than currently required, and requires greater coordination than SCI entities and market participants currently engage in. In particular, Rule 1004 requires SCI entities to designate their members or participants to participate in business continuity and disaster recovery plan testing and to coordinate such testing with other SCI entities on an industry- or sector-wide basis. The requirement of member or participant designation in business continuity and disaster recovery plan testing under Rule 1004 imposes additional costs as an SCI would have to allocate resources towards initially establishing and later updating standards for the designation of its members and participants for testing. Furthermore, the requirement to coordinate industry- or sector-wide testing will impose additional administrative costs because an SCI entity would be required to notify its members or participants and also organize, schedule, and manage the coordinated testing.²⁰³³

Some commenters stated that the scope of the proposed testing requirement would impose costs on SCI entities that the Commission did not account for, including the cost to reconfigure their systems to engage in functional and performance testing, the cost of establishing effective coordinated test scripts for the testing, and time necessary to conduct the required testing.²⁰³⁴ Another commenter stated that testing will be costly to ATSS and their subscribers, and that the aggregate cost for all would be higher than the \$66 million estimated in

²⁰³³ Administrative costs associated with coordinating testing are included as part of the PRA burden of Rule 1004. See supra Section V.D.1.b. As discussed in Section V.D.1.b, the Commission continues to believe that plan processors will outsource the work related to compliance with Rule 1004.

²⁰³⁴ See supra Section IV.B.6.b (discussing comments on proposed Rule 1000(b)(9)).

the SCI Proposal.²⁰³⁵ This commenter noted that the cost includes the time, resources, and professional staff that would be devoted to the testing process, and the resulting lost business opportunities associated with the ability to focus on revenue generating projects.²⁰³⁶ In addition, this commenter stated that, while connectivity between an ATS and its subscribers may already be established, additional configurations and build out of systems may be required to create a testing environment that simulates live market conditions.²⁰³⁷

Another commenter stated that there are dozens of man-days of pre-test planning, preparation, pre-testing testing, testing, and post-mortem reviews for SCI entities associated with the industry test initiatives.²⁰³⁸ According to this commenter, there are anywhere from tens to hundreds of business and technology staff engaged in this initiative.²⁰³⁹ This commenter estimated the following staff levels required to support testing: exchanges – 175-200+ man-days; member firms – 80-85 man-days; and ATSS – 12-25 man-days.²⁰⁴⁰ Based on the commenter's upper estimates measured in man-days, the Commission estimated monetary values by allocating hours among the traders, technologists, programmers/system administrators, exchange personnel, and analysts necessary for implementation of disaster recovery testing. This estimation yields implied annual average total cost estimates of \$500,000 and \$60,000 for

²⁰³⁵ See ITG Letter at 15-16.

²⁰³⁶ See *id.*

²⁰³⁷ See *id.*

²⁰³⁸ See Tellefsen Letter at 11.

²⁰³⁹ See *id.*

²⁰⁴⁰ See *id.*

exchanges and ATSS, respectively.²⁰⁴¹ For the reasons discussed below, the Commission believes that this commenter's cost estimate does not accurately reflect the costs to SCI entities.

The Commission recognizes that the factors described by commenters will contribute to costs for SCI entities associated with business continuity and disaster recovery plans testing. For example, as discussed in Section IV.B.6.b, the Commission acknowledges that systems reconfiguration for functional and performance testing and establishing an effective coordinated test script could be a complex process and result in costs. At the same time, the Commission believes that systems reconfiguration and the establishment of an effective coordinated test script is an important first step in establishing robust and effective business continuity and disaster continuity plans testing. The Commission also notes that costs of Rule 1004 are likely to be lower than those estimated by commenters because of changes made to the proposed rule. For example, although Rule 1004 would require testing of BC/DR plans that is more rigorous than some types of testing urged by some commenters, the adopted rule includes a more targeted member and participant designation provision than the proposed rule. As discussed above in

²⁰⁴¹ The allocations are based on Commission staff experience that exchanges would divide their personnel as 85% technologists, 5% exchange rule enforcement personnel, and 10% business analysts, and ATSS are assumed to divide their personnel as 90% technologists and 10% business analysts based on staff experience. The hourly rates are from SIFMA's *Management & Professional Earnings in the Securities Industry 2012*, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. The calculation for ATSS was as follows: 25 days × (10% time required by analysts × \$245/hour + 90% time required by technologists × \$282/hour) = \$55,660 per ATS. For each exchange: 200 days × (85% time required by technologists × \$282/hour + 10% time required by analysts × \$245/hour + 5% time required by supervisors × \$446/hour) = \$458,400 per exchange. The Commission has rounded up because the breakdown between analysts, supervisors, and technologists may vary between ATSS and Exchanges.

In the absence of a specific estimate provided by the commenter for plan processors or clearing agencies, the estimate for exchanges is assumed to apply to these types of SCI entities. Estimates for members and participants are discussed separately below.

Section IV.B.6.b, compared to proposed Rule 1000(b)(9), the Commission believes that the adoption of a more targeted designation requirement is likely to result in a smaller number of SCI entity members or participants being designated to participate in business continuity and disaster recovery plans testing and thus should result in lower costs for SCI entities to coordinate testing.²⁰⁴²

The Commission is unable to provide a quantified estimate of the specific costs for SCI entities associated with the mandatory testing of SCI entity business continuity and disaster recovery plans, including backup systems. Although several commenters provided general estimates as to the costs of compliance with Rule 1004, these commenters did not provide their assumptions or a description of the quantified costs associated with each potential source of costs. Given the lack of information provided by commenters and that these costs could vary significantly based on the specific systems of each SCI entity, the Commission is unable to determine whether the costs provided by commenters are representative. Additionally, the Commission notes that commenters appeared to focus on costs as if assuming there is no testing today. Because SCI entities currently engage in some coordinated BC/DR testing, the Commission believes that the average incremental cost to SCI entities, in addition to the burden estimated in the PRA, would be lower than these commenters' cost estimates. The Commission also believes that costs would be significantly lower in the year following the initial year of testing. Because the Commission does not have detailed information regarding the current level of BC/DR testing and coordination of such testing by each SCI entity, and the cost associated

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See *supra* Section IV.B.6.b (discussing the designation requirement in adopted Rule 1004).

with such testing and coordination, however, the Commission cannot at this time provide a quantified estimate of the cost for SCI entities to comply with Rule 1004.

Costs to SCI Entity Members and Participants

The Commission believes that Rule 1004 will also impose costs on SCI entity designated members and participants. In the SCI Proposal, based on discussions with market participants, the Commission estimated that the cost of business continuity and disaster recovery plan testing would range from immaterial administrative costs (for SCI entity members and participants that currently maintain connections to SCI entity backup systems) to a range of \$24,000 to \$60,000 per year per member or participant in connection with each SCI entity.²⁰⁴³ As noted in the SCI Proposal and also above, the Commission understood that most of the larger members or participants of SCI entities already maintain connectivity with the backup systems of SCI entities and, thus, the additional connectivity costs imposed by proposed Rule 1000(b)(9) to these larger members or participants may be minimal.²⁰⁴⁴ However, among smaller members or participants of SCI entities, the number of members or participants who maintain such connectivity is lower.²⁰⁴⁵ Therefore, costs at the higher end of the estimated range would accrue for members or participants who would need to invest in additional infrastructure and to maintain connectivity with an SCI entity's backup systems in order to participate in testing.

Furthermore, in the SCI Proposal, the Commission acknowledged that it is difficult to provide an estimate for the total aggregate cost to SCI entity members or participants under

²⁰⁴³ See Proposing Release, *supra* note 13, at 18172.

²⁰⁴⁴ See *id.* at 18172 and n. 642.

²⁰⁴⁵ See *id.* at 18172.

proposed Rule 1000(b)(9).²⁰⁴⁶ Because each SCI entity had discretion in determining its standards for designating members or participants for the testing required by proposed Rule 1000(b)(9)(i), the Commission did not have enough information to estimate the number of members or participants at each SCI entity that would be designated as required to participate in testing and to determine whether such designated members or participants are those that already maintain connections to SCI entity backup systems. With limited information, the Commission provided a total aggregate annual cost estimate in the SCI Proposal of approximately \$66 million for designated members and participants to participate in business continuity and disaster recovery plans testing.²⁰⁴⁷

Several commenters stated that the Commission underestimated the cost of business continuity and disaster recovery plan testing under proposed Rule 1000(b)(9). One commenter noted that the Commission failed to take into account those SCI entities that engage in systems-specific testing upon implementation or initial connection by a market participant, but do not engage in business continuity and disaster recovery testing with the participation of market participants.²⁰⁴⁸ One commenter noted that the average cost for a broker-dealer to maintain fully redundant systems at all relevant exchange backup facilities would be approximately \$3 million annually, according to one of its informal surveys.²⁰⁴⁹ Further, this cost would not include the

²⁰⁴⁶ See id.

²⁰⁴⁷ See id. at 18172 and n.643.

²⁰⁴⁸ See MSRB Letter at 38.

²⁰⁴⁹ See FIA PTG Letter at 3. See also BIDS Letter at 8 (commenting that testing and backup connections are expensive, and the expense of the connections could outweigh the value or the utilization of the value that certain venues provide).

initial capital costs related to the infrastructure or the labor/employment necessary for the maintenance and monitoring of backup connection and facilities.²⁰⁵⁰

Other commenters stated that the Commission underestimated other aspects of the cost of business continuity and disaster recovery plan testing under proposed Rule 1000(b)(9). One commenter believed that the requirement for members to connect to an SCI entity's backup site could pose significant economic burden and provide little benefit to the market.²⁰⁵¹ This commenter believed that the cost of such connections would be well over the \$10,000 per connection that the Commission estimated.²⁰⁵² According to this commenter, establishing and maintaining a connection with comparable trading capability and latency could cost a broker-dealer that co-locates at an SCI entity's data center between \$15,000 and \$20,000 monthly simply for the necessary communication lines.²⁰⁵³ In addition, this commenter noted that such members would need additional hardware (estimated to be up to \$500,000) to establish an appropriate presence at the backup site to ensure that they could trade in an efficient manner with low latency.²⁰⁵⁴ This commenter believed that compliance with the Rule 1000(b)(9) requirements could cause broker-dealers to reduce the number of SCI entities through which they

²⁰⁵⁰ See FIA PTG Letter at 3. This commenter noted that the costs vary widely among members and exchanges but are not insubstantial. See id.

²⁰⁵¹ See ISE Letter at 9.

²⁰⁵² See id.

²⁰⁵³ See id.

²⁰⁵⁴ See id.

trade.²⁰⁵⁵ This commenter suggested that the standard for designating members should be those members “critical to the operation of the SCI entity.”²⁰⁵⁶

Another commenter estimated that the costs to a market making firm to support fully redundant exchange and ATS backup facilities would be approximately \$7 million to \$10 million in initial capital, with annual costs of between \$5 million and \$9 million.²⁰⁵⁷ According to this commenter, this cost is not justified by the benefits because backup facilities would not be used in the event of an outage at the primary site,²⁰⁵⁸ and would lead firms to reconsider their ability to make markets on as many trading platforms and potentially reduce price competition.²⁰⁵⁹

The same commenter who provided an estimate of burdens for SCI entities expressed the view that there are also dozens of man-days of pre-test planning, preparation, pre-testing testing, testing, and post-mortem reviews for members and participants that would be associated with industry test initiatives.²⁰⁶⁰ Based on the commenter’s upper estimates for member firms, measured in man-days, the Commission assigned monetary values using appropriate hours allocation among the traders, technologists, programmers/system administrators, exchange

²⁰⁵⁵ See id.

²⁰⁵⁶ See id. According to this commenter, under the suggested standard, its focus would be on its seven Primary Market Makers who provide continuous liquidity, and these members would provide a baseline of liquidity for trading. See id. However, this commenter believed that, in order to satisfy the standard to provide “fair and orderly trading,” it may need to require some or all of its 145 Electronic Access Members who access liquidity. See id.

²⁰⁵⁷ See KCG Letter at 4, 12. This commenter stated that the cost of supporting a backup facility of an SCI entity would be reduced, if the backup facility of an SCI entity were at the primary site of another SCI entity where the market maker traded. See id. at 12.

²⁰⁵⁸ See id. at 4.

²⁰⁵⁹ See id. at 12.

²⁰⁶⁰ See also supra note 2038 and accompanying text (discussing this commenter’s cost estimate for SCI entities).

personnel, and analysts necessary for implementation of disaster recovery testing. This procedure yields an annual average total cost estimate of about \$200,000 for each member firm.²⁰⁶¹ For the reasons discussed below, the Commission believes that this commenter's cost estimate does not accurately reflect the costs to members or participants.

The Commission acknowledges that members or participants will incur costs as a result of Rule 1004. However, the Commission believes that the members or participants likely to be designated to participate in such testing are those that conduct a high level of activity with the SCI entity, or that play an important role for the SCI entity (such as market makers), and who are more likely to have already established connections to the SCI entity's backup site. The Commission believes that many of these members or participants already have established connectivity with the SCI entity's backup site and already monitor and maintain such connectivity, and thus the additional connectivity costs imposed by Rule 1004 would be modest to these members or participants.

For members or participants that currently do not have connectivity, the Commission recognizes the requirements of Rule 1004 will impose costs on members or participants in establishing, maintaining, and monitoring backup connection and facilities. The Commission believes that a few commenters who stated that the Commission underestimated these costs may have based their cost estimates for proposed Rule 1000(b)(9) on the assumption that member

²⁰⁶¹ The allocations are based on the staff experience that member firms divide their personnel as 45% traders, 45% technologists, and 10% business analysts. The hourly rates are from SIFMA's *Management & Professional Earnings in the Securities Industry 2012*, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. The calculation for member firms was as follows: 85 days × (10% time required by analysts × \$245/hour + 45% time required by technologists × \$282/hour + 45% time required by traders × \$312/hour) = \$198,424 per member firm.

connections to SCI entities' backup systems need to be the same as those at the primary site.²⁰⁶² However, as discussed above in Section IV.B.6, Rule 1004 does not require SCI entity members or participants to maintain the same level of connectivity with the backup sites of an SCI entity as they do with the primary sites. In the event of a wide-scale disruption in the securities markets, the Commission acknowledges that an SCI entity and its members or participants may not be able to provide the same level of liquidity as on a normal trading day. In addition, the Commission recognizes that the concept of "fair and orderly markets" does not require that trading on a day when business continuity and disaster recovery plans are in effect reflect the same level of liquidity, depth, volatility, and other characteristics of trading on a normal trading day.

The Commission, however, is unable to provide a quantified estimate of the specific costs for SCI entity members or participants associated with the mandatory testing required by Rule 1004. Although several commenters provided general estimates as to the costs of compliance with Rule 1004, these commenters did not provide their assumptions or a description of the quantified costs associated with each potential source of costs. Given the lack of information provided by commenters and that these costs could vary significantly based on the specific systems of each SCI entity and member or participant, the Commission is unable to determine whether the costs provided by commenters are representative. Additionally, the Commission notes that some commenters appeared to focus on costs as if assuming there is no testing today. Because some members and participants of SCI entities currently participate in SCI entities' BC/DR testing, these members and participants would not incur the full costs estimated by the

²⁰⁶² See *supra* notes 2049, 2050, 2052-2054, and 2057 and accompanying text (discussing commenters' estimates of the cost to maintain fully redundant systems at relevant SCI entity backup facilities).

commenters. Thus the Commission believes that the average incremental cost to members or participants would be lower than these commenter's estimates because the estimates do not account for current practices. The Commission also believes that costs will be highly variable among member firms, and will be significantly lower in the year following the initial year of testing. Because the Commission does not have detailed information regarding the current level of engagement by members or participants in BC/DR testing and the associated costs, or the details of the BC/DR testing that SCI entities will implement pursuant to Rule 1004, the Commission cannot at this time provide a precise quantified estimate of the cost for SCI entities' designated members or participants to comply with Rule 1004.²⁰⁶³ The Commission also notes that it is critical that SCI entities and their designated members or participants be able to operate with the SCI entities' backup systems in the event of a wide-scale disruption, and believes that the costs that would be incurred by essential market participants are appropriate in light of the benefits discussed above.²⁰⁶⁴

²⁰⁶³ Although the Commission cannot at this time precisely estimate the total cost of compliance with Rule 1004, the Commission believes that \$10,000 on average per SCI entity is a reasonable estimate solely for the incremental cost of connectivity associated with the requirements of Rule 1004. As noted above, the Commission continues to believe that it is reasonable to estimate that the members or participants of SCI entities that are most likely to be designated as required to participate in testing are those that conduct a high level of activity with the SCI entity, or that play an important role for the SCI entity (such as market makers), and that such members or participants are likely to already maintain connectivity with an SCI entity's backup systems. Therefore, the Commission is not persuaded that its estimate of the average connectivity cost for each member or participant of an SCI entity should be modified from \$10,000.

²⁰⁶⁴ Further, in response to comment that the added benefit of requiring fully redundant backup systems is almost impossible to measure while the cost of implementation is significant, the Commission acknowledges that testing of a BC/DR plan does not guarantee flawless execution of that plan, but still believes testing is warranted because a tested plan is likely to be more reliable and effective than an inadequately tested plan.

Although the Commission generally believes that the aggregate cost to SCI entity members or participants under Rule 1004 will be lower than the cost estimated for proposed Rule 1000(b)(9), the Commission continues to believe it is difficult to provide an estimate for the aggregate cost to SCI entity members or participants because under Rule 1004, each SCI entity has reasonable discretion in designating its members or participants for the required testing, and, as noted above, the Commission does not possess necessary information to estimate the number of designated members or participants and to determine whether such designated members or participants are those that already have established and maintained connectivity to the SCI entity's backup systems. Accordingly, the Commission cannot at this time provide a quantified estimate of the total aggregate cost to SCI entity members or participants under Rule 1004.²⁰⁶⁵

Moreover, as noted above in Section IV.B.6.b, the Commission believes that adoption of a designation requirement that requires SCI entities to exercise reasonable discretion to identify those members or participants that, taken as a whole, are the "minimum necessary" for the

²⁰⁶⁵ The Commission believes that it can reasonably estimate connectivity costs but not all costs associated with BC/DR testing. With respect to connectivity, the Commission now estimates that Rule 1004 will impose a total aggregate annual cost of approximately \$18 million for designated members and participants. This estimate assumes that each of the 44 SCI entities will designate between 10 and 20 percent of its members or participants to participate in the necessary testing. This 10-20 percent estimate is based on staff experience and takes into consideration comment that typically 20 percent of an SCI entity's members might provide 80 percent of the order flow or liquidity (see Tellefsen Letter at 9), and balances it against another commenter's view that if the standard for designation was to identify those firms "critical to the operation of the SCI entity" (which is more targeted than the adopted standard), this commenter would designate approximately five percent of its members to participate in testing (see ISE Letter at 9). The Commission understands that many SCI entities have between 200 and 400 members or participants, although some have more and some have fewer. Therefore, the Commission estimates that on average, each SCI entity will designate approximately 40 members or participants in such testing. Based on these assumptions, the Commission estimates the total aggregate cost for connectivity to all designated members or participants of all SCI entities to be approximately \$17.6 million (44 SCI entities × 40 members or participants × \$10,000 = \$17.6 million).

maintenance of fair and orderly markets in the event of the activation of such plans is likely to result in a smaller number of SCI entity members or participants being designated for participation in testing as compared to the SCI Proposal, thus reducing total costs to all members or participants combined. Because the Commission believes that SCI entities have an incentive to limit the imposition of the cost and burden associated with testing to the minimum necessary to comply with the rule, it also believes that, given the option, most SCI entities would, in the exercise of reasonable discretion, prefer to designate fewer members or participants to participate in testing, than to designate more. On balance, the Commission believes that the adopted rule will incentivize SCI entities to designate those members and participants that are in fact the minimum necessary for the maintenance of fair and orderly markets in the event of the activation of their BC/DR plans, and that this should reduce the number of designations to which any particular member or participant would be subject, compared to the SCI Proposal.

It remains possible, as some commenters noted, that firms that are members of multiple SCI entities will be the subject of multiple designations, and that multiple designations could require certain firms to maintain connections to backup sites and participate in testing of the BC/DR plans of multiple SCI entities. As discussed in Section IV.B.6.b, the Commission believes this possibility, though real, may be mitigated by the fact that designations are likely to be made to firms that are already connected to one or more SCI entity backup facilities, because they are more likely to be significant members or participants of the applicable SCI entities; and that, because some SCI entity backup facilities are located in close proximity to each other, multiple connections to such backup facilities may be less costly than if SCI entity backup facilities were not so located. The Commission recognizes that there would be greater costs to a firm being designated by multiple SCI entities to participate in the testing of their business

continuity and disaster recovery plans, but believes that these greater costs are warranted for such firms, as they represent significant participants in each of the SCI entities for which they are designated, and their participation in the testing of each such SCI entity's business continuity and disaster recovery plans is necessary to evaluate whether such plans are reliable and effective. The Commission recognizes that a firm that is designated to participate in testing with multiple SCI entities may assess the costs and burdens of participating in every test to be too great, and make business decisions to withdraw its membership or participation from one or more such SCI entities so as to avoid the costs and burdens of such testing. The Commission believes such a scenario is unlikely because such firm is likely to be a larger firm with a significant level of participation in such SCI entity and is likely to already have connections to backup facilities of the SCI entity.

The Commission believes that the cost associated with Rule 1004 is unlikely to induce the designated members or participants to reduce the number of SCI entities through which they trade and adversely affect price competitiveness in markets.²⁰⁶⁶ As noted above, the Commission also recognizes that costs to some SCI entity members or participants associated with Rule 1004 could be significant, and also highly variable depending on the business continuity and disaster recovery plans being tested. Based on industry sources, the Commission understands that most of the larger members or participants of SCI entities already maintain connectivity with the backup systems of SCI entities. However, the Commission understands that there is a lower incidence of smaller members or participants maintaining connectivity with the backup sites of SCI entities.²⁰⁶⁷ As such, the Commission believes that the compliance costs

²⁰⁶⁶ See supra notes 2055 and 2059 and accompanying text.

²⁰⁶⁷ See Proposing Release, supra note 13, at 18172, n. 642.

associated with Rule 1004 would be higher for those members or participants that are designated for testing by SCI entities who would need to invest in additional infrastructure to maintain connectivity with an SCI entity's backup systems to participate in testing, which the Commission believes is more likely to be the case for smaller members or participants designated for testing.

The Commission acknowledges that the compliance costs associated with Rule 1004 could raise barriers to entry and affect competition among members or participants of SCI entities. Specifically, to the extent that members or participants could be subject to designation in business continuity and disaster recovery plan testing and could incur additional compliance costs, the member or participant designation requirement of Rule 1004 could raise barriers to entry. Also, as discussed above, the compliance costs of the rule will likely be higher for smaller members or participants of SCI entities compared to larger members or participants of SCI entities. However, the Commission believes the adverse effect on competition may be mitigated to some extent as the most likely members or participants to be designated for testing are larger members or participants who already maintain connectivity with an SCI entity's backup systems. Further, the adverse effect on competition could be partially mitigated to the extent that larger firms, which are members of multiple SCI entities, could incur additional compliance costs as these larger member firms could be subject to multiple designations for business continuity and disaster recovery plan testing.

One commenter noted that mere network connectivity to an exchange or ATS would be insufficient for a market maker to provide meaningful liquidity on an SCI entity.²⁰⁶⁸ This commenter noted that, if the Commission does not intend for SCI entities to be able to trade in the same way from a backup facility as it trades from the primary site, then market makers could

²⁰⁶⁸ See KCG Letter at 12.

maintain a more limited remote connectivity to the backup site and incur less cost, although this commenter believed that such an approach would not facilitate the posting of competitive quotes.²⁰⁶⁹ This commenter believed that this alternative approach would result in unusually wide markets, and would not result in any benefits.²⁰⁷⁰

As discussed in Section IV.B.6, Rule 1001(a) does not require that backup facilities of SCI entities fully duplicate the features of primary facilities. Further as discussed in Section IV.B.6, SCI entity members or participants are not required by Regulation SCI to maintain the same level of connectivity with the backup sites of an SCI entity as they do with the primary sites. In the event of a wide-scale disruption in the securities markets, the Commission acknowledges that SCI entities and their members or participants may not be able to provide the same level of liquidity as on a normal trading day. However, the Commission expects that, on a day when business continuity and disaster recovery plans are in effect due to a wide-scale disruption in the securities markets, the requirements of Rule 1004 will help ensure adequate levels of liquidity and pricing efficiency to facilitate trading and maintain fair and orderly markets without imposing excessive costs on SCI entities and market participants by requiring them to maintain the same connectivity with the backup systems as with the primary sites.

Alternatives

Several commenters suggested alternatives to the proposed BC/DR testing requirements.²⁰⁷¹ Two commenters suggested that few ATSS are critical enough to warrant

²⁰⁶⁹ See id. at 13.

²⁰⁷⁰ See id. at 13.

²⁰⁷¹ See SIFMA Letter at 17; BIDS Letter at 8; and ITG Letter at 15.

inclusion in the BC/DR testing requirement.²⁰⁷² One commenter suggested that only SCI entities that provide market functions on which other market participants depend be subject to the requirements for separate backup and recovery capabilities.²⁰⁷³ Furthermore, one commenter urged that BC/DR testing coordination only be required among providers of singular services in the market (i.e., exchange that lists securities, exclusive processors under NMS plans, and clearing and settlement agencies).²⁰⁷⁴

The Commission is not persuaded that SCI ATSS should be excluded from the requirements of BC/DR testing plans. In today's market, as discussed in Section IV.A.1.b, ATSS collectively represent a significant source of liquidity for stock trading. Although the concept of "fair and orderly markets" when BC/DR plans are in effect does not require the same level of liquidity, depth, volatility, and other characteristics of trading on a normal trading day, the Commission believes that excluding significant ATSS from BC/DR testing could harm liquidity, depth, and volatility when BC/DR plans are in effect and, thus, could significantly reduce the benefits of Rule 1004. Furthermore, with respect to the commenter that urged the Commission only to include providers of singular services in BC/DR testing coordination, as mentioned in Section IV.A.1.b, because trading in the U.S. securities markets today is dispersed among exchanges, ATSS, and other trading venues, and often involves trading strategies that require access to multiple trading venues, including ATSS, simultaneously, including all SCI entities, the Commission believes that requiring SCI entities to coordinate testing would result in testing under more realistic market conditions and help ensure that securities markets have improved

²⁰⁷² See BIDS Letter at 8; and ITG Letter at 15.

²⁰⁷³ See KCG Letter at 8.

²⁰⁷⁴ See Direct Edge Letter at 9.

backup infrastructure, fewer market shutdowns, and fair and orderly markets in the event of the activation of BC/DR plans.

Furthermore, one commenter stated that coordinated BC/DR testing is a good aspirational goal, but expressed concern that too much is outside of the control of an individual SCI entity, and therefore the rule should, at most, require SCI entities to attempt to coordinate such testing.²⁰⁷⁵ With respect to the comment suggesting that BC/DR testing coordination should be an aspirational goal rather than a requirement, the Commission believes that voluntary BC/DR testing is insufficient and will not further the goal of Regulation SCI as evidenced by Superstorm Sandy discussed in Section IV.B.6. As discussed above, the Commission acknowledges that there could be potential difficulties, including communicating with other SCI entities, in coordinating BC/DR testing on an industry- or sector-wide basis.

c. Recordkeeping and Electronic Filing – Rules 1005-1007

Entities that participate in the ARP Inspection Program currently keep records related to the ARP Inspection Program. However, the recordkeeping requirements of Rules 1005-1007 would apply to more entities, systems, and types of systems issues than the ARP Inspection Program. In addition, SCI entities are already subject to certain Commission recordkeeping requirements.²⁰⁷⁶ However, records relating to Regulation SCI may not be specifically addressed

²⁰⁷⁵ See CME Letter at 13.

²⁰⁷⁶ See, e.g., 17 CFR 240.17a-1, applicable to SCI SROs; 17 CFR 240.17a-3 and 17a-4, applicable to broker-dealers; and 17 CFR 242.301-303, applicable to ATSS.

It has been the experience of the Commission that SCI entities presently subject to the ARP Inspection Program (nearly all of whom are SCI SROs that are also subject to the recordkeeping requirements of Rule 17a-1(a)) do generally keep and preserve the types of records that would be subject to the requirements of Rule 1005. Nevertheless, the Commission continues to believe that Regulation SCI's codification of these preservation

in the recordkeeping requirements of certain rules.²⁰⁷⁷ The Commission believes that the recordkeeping requirements specifically related to Regulation SCI would enhance the ability of the Commission to evaluate SCI entities' compliance with Regulation SCI.

With respect to SCI SROs in particular, the Commission notes that they are subject to the recordkeeping requirements of Rule 17a-1 under the Exchange Act, and the breadth of Rule 17a-1 is such that it would require SCI SROs to make, keep, and preserve records relating to their compliance with Regulation SCI. Therefore, Rule 1005(a) requires each SCI SRO to make, keep, and preserve all documents relating to its compliance with Regulation SCI as prescribed in Rule 17a-1 under the Exchange Act.²⁰⁷⁸

Rule 1005(b) requires each SCI entity that is not an SCI SRO to make, keep, and preserve at least one copy of all documents relating to its compliance with Regulation SCI. Each such SCI entity is required to keep all such documents for a period of not less than five years, the first two years in a place that is readily accessible to the Commission or its representatives for inspection and examination. Each such SCI entity is also required to promptly furnish copies of such documents to Commission representatives upon request. Rule 1005(c) requires each such SCI entity, upon or immediately prior to ceasing to do business or ceasing to be registered under the Exchange Act, to take all necessary action to ensure that the records required to be made, kept, and preserved by Rule 1005 shall be accessible to the Commission and its representatives in the manner required by Rule 1005 and for the remainder of the period required by Rule 1005.

practices will support an accurate, timely, and efficient inspection and examination process and help ensure that all types of SCI entities keep and preserve such records.

²⁰⁷⁷ See Proposing Release, supra note 13, at 18128.

²⁰⁷⁸ See supra Section IV.C.1.a (discussing recordkeeping requirements for SROs under Rule 17a-1).

According to Rule 1007, if the records required to be filed or kept by an SCI entity under Regulation SCI are prepared or maintained by a service bureau or other recordkeeping service on behalf of the SCI entity, the SCI entity is required to ensure that such records are available for review by the Commission and its representatives by submitting a written undertaking, in a form acceptable to the Commission, by such service bureau or other recordkeeping service to that effect.

For SCI entities other than SCI SROs, Rule 1005 specifically addresses recordkeeping requirements with respect to records relating to Regulation SCI compliance. The Commission believes that Rules 1005 and 1007 would allow Commission staff to perform efficient inspections and examinations of SCI entities for their compliance with Regulation SCI, and would increase the likelihood that Commission staff can identify conduct inconsistent with Regulation SCI at earlier stages in the inspection and examination process. Furthermore, as discussed in Section IV.C.1.a, although many SCI events may be resolved in a short time frame, there may be other SCI events that may not be discovered for an extended period of time after their occurrences, or may take significant periods of time to fully resolve. In such cases, having an SCI entity's records available for a longer period of time or even after it has ceased to do business or be registered under the Exchange Act would be beneficial. Preserved information should provide the Commission with an additional source to help determine the causes and consequences of one or more SCI events and better understand how such events may have impacted trade execution, price discovery, liquidity, and investor participation. Consequently, the Commission believes that the requirements of Rules 1005 and 1007 would help ensure compliance with Regulation SCI and help realize the potential benefits (e.g., better pricing efficiency, price discovery, and liquidity flows) of the regulation.

As noted above, the breadth of Rule 17a-1 under the Exchange Act is such that it would require SCI SROs to make, keep, and preserve records relating to their compliance with Regulation SCI. Therefore, for SCI SROs, the incremental compliance costs associated with Rules 1005 and 1007 will be modest.²⁰⁷⁹ On the other hand, for SCI entities that are not SCI SROs, the recordkeeping requirements of Rules 1005 and 1007 will impose additional costs, including one-time cost to set up or modify an existing recordkeeping system to comply with Rules 1005 and 1007. The initial and ongoing compliance costs associated with the recordkeeping requirements are attributed to paperwork burdens, which are discussed in Section V.D.4 above.²⁰⁸⁰

Rule 1006 requires SCI entities to electronically file all written information to the Commission on Form SCI (except for notifications submitted pursuant to Rules 1002(b)(1) and (b)(3)). Rule 1006 should provide a uniform manner in which the Commission would receive—and SCI entities would provide—written notifications, reviews, descriptions, analyses, or reports required by Regulation SCI.²⁰⁸¹ Rule 1006 should add efficiency for SCI entities in drafting and submitting the required reports, and for the Commission in reviewing, analyzing, and responding

²⁰⁷⁹ As noted above, it has been the experience of the Commission that SCI entities presently subject to the ARP Inspection Program generally keep and preserve the types of records that would be subject to the requirements of Rule 1005. Nearly all of these ARP participants are SCI SROs that are also subject to the recordkeeping requirements of Rule 17a-1.

²⁰⁸⁰ When monetized, the paperwork burden associated with all recordkeeping requirements would result in approximately \$857,000 initially for all non-SRO SCI entities in the aggregate, and \$27,000 annually for all non-SRO SCI entities in the aggregate.

²⁰⁸¹ See Proposing Release, supra note 13, at 18129-30.

to the information provided.²⁰⁸² All costs associated with Form SCI are attributed to paperwork burdens discussed in Section V.

Every SCI entity will be required to have the ability to electronically submit Form SCI through the EFFS system, and every person designated to sign Form SCI will be required to have an electronic signature and a digital ID. Each SCI entity will also be required to submit documents attached as exhibits through the EFFS system in a text-searchable format, subject to a limited exception.²⁰⁸³ The Commission believes that requiring documents to be submitted in a text-searchable format, subject to a limited exception, is necessary to allow Commission staff to efficiently review and analyze information provided by SCI entities. Additionally, the Commission believes that this requirement will not impose an additional burden on SCI entities, as SCI entities likely already prepare documents in an electronic format that is text searchable or can readily be converted into a format that is text searchable. The Commission also believes that many SCI entities currently have the ability to access the EFFS system and electronically submit Form SCI such that the requirement to submit Form SCI electronically will not impose significant new implementation or ongoing costs.²⁰⁸⁴ The Commission also believes that some of the persons who will be designated to sign Form SCI already have digital IDs and the ability

²⁰⁸² See *id.* at 18130.

²⁰⁸³ As noted in Section IV.C.2, the General Instructions to Form SCI, Item A. specify that documents filed through the EFFS system must be in a text-searchable format without the use of optical character recognition, with a limited exception to allow for a portion of a Form SCI submission (e.g., an image or diagram) that cannot be made available in a text-searchable format to be submitted in a non-text-searchable format.

²⁰⁸⁴ The initial and ongoing costs associated with various electronic submissions of Form SCI are discussed in the Paperwork Reduction Act section above. See *supra* Section V.

to provide an electronic signature. To the extent that some persons do not have digital IDs, the additional cost to obtain and maintain digital IDs is accounted for in the paperwork burden.²⁰⁸⁵

As an alternative to the adopted electronic submission requirement, the Commission considered requiring data to be submitted in a tagged data format such as XBRL. Requiring reports to be filed in a tagged data format such as XBRL would likely permit faster and more efficient analysis of information disclosed in reports but would also likely impose additional compliance costs associated with tagging information in the narrative responses.

Rather than requiring the use of XBRL formatting for Form SCI, the Commission notes that certain fields in Sections I-III of Form SCI will require information provided by SCI entities to be in a format that will allow the Commission to gather information in a structured manner (e.g., the submission type and SCI event type in Section I). By collecting information on Form SCI in a way that allows the Commission to gather key information in a structured manner, the Commission believes it will be able to more efficiently review and process filings made on Form SCI. Moreover, gathering certain information in Sections I-III of Form SCI in a structured format should not result in an additional cost to SCI entities.

VII. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act (“RFA”)²⁰⁸⁶ requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. The Commission certified in the SCI Proposal, pursuant to Section 605(b) of the Regulatory Flexibility Act of 1980 (“RFA”),²⁰⁸⁷

²⁰⁸⁵ See *supra* Section V.D.2.e.

²⁰⁸⁶ 5 U.S.C. 601 *et seq.*

²⁰⁸⁷ 5 U.S.C. 605(b).

that proposed Regulation SCI would not, if adopted, have a significant impact on a substantial number of small entities. The Commission received no comments on this certification.

A. SCI Entities

Paragraph (a) of Rule 0-10 provides that for purposes of the RFA, a small entity when used with reference to a "person" other than an investment company means a person that, on the last day of its most recent fiscal year, had total assets of \$5 million or less.²⁰⁸⁸ With regard to broker-dealers, small entity means a broker or dealer that had total capital of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to Rule 17a-5(d) under the Exchange Act, or, if not required to file such statements, had total capital of less than \$500,000 on the last business day of the preceding fiscal year (or in the time that it has been in business, if shorter), and that is not affiliated with any person (other than a natural person) that is not a small business or small organization.²⁰⁸⁹ With regard to clearing agencies, small entity means a clearing agency that compared, cleared, and settled less than \$500 million in securities transactions during the preceding fiscal year (or in the time that it has been in business, if shorter), had less than \$200 million of funds and securities in its custody or control at all times during the preceding fiscal year (or in the time that it has been in business, if shorter), and is not affiliated with any person (other than a natural person) that is not a small business or small organization.²⁰⁹⁰ With regard to exchanges, small entity means an exchange that has been exempt from the reporting requirements of Rule 601 under Regulation NMS, and is not affiliated with any person (other than a natural person) that is not a small business or small

²⁰⁸⁸ See 17 CFR 240.0-10(a).

²⁰⁸⁹ See 17 CFR 240.0-10(c).

²⁰⁹⁰ See 17 CFR 240.0-10(d).

organization.²⁰⁹¹ With regard to securities information processors, small entity means a securities information processor that had gross revenue of less than \$10 million during the preceding fiscal year (or in the time it has been in business, if shorter), provided service to fewer than 100 interrogation devices or moving tickers at all times during the preceding fiscal year (or in the time it has been in business, if shorter), and is not affiliated with any person (that is not a natural person) that is not a small business or small organization.²⁰⁹² Under the standards adopted by the Small Business Administration (“SBA”), entities engaged in financial investments and related activities are considered small entities if they have \$35.5 million or less in average annual receipts.²⁰⁹³

Based on the Commission’s existing information about the entities that will be subject to Regulation SCI, the Commission believes that SCI entities that are self-regulatory organizations (national securities exchanges, national securities associations, registered clearing agencies, and the MSRB) or exempt clearing agencies subject to ARP would not fall within the Commission’s definition of small entity as described above. With regard to plan processors, which are defined under Rule 600(b)(55) of Regulation NMS to mean a self-regulatory organization or securities information processor acting as an exclusive processor in connection with the development, implementation and/or operation of any facility contemplated by an effective NMS plan,²⁰⁹⁴ the

²⁰⁹¹ See 17 CFR 240.0-10(e).

²⁰⁹² See 17 CFR 240.0-10(g).

²⁰⁹³ See SBA’s Table of Small Business Size Standards, Subsector 523 and 13 CFR 121.201. Such entities include firms engaged in investment banking and securities dealing, securities brokerage, commodity contracts dealing, commodity contracts brokerage, securities and commodity exchanges, miscellaneous intermediation, portfolio management, investment advice, trust, fiduciary and custody activities, and miscellaneous financial investment activities.

²⁰⁹⁴ See 17 CFR 242.600(b)(55).

Commission's definition of small entity as it relates to self-regulatory organizations and securities information processors would apply. The Commission does not believe that any plan processor would be a small entity as defined above. With regard to SCI ATSS, because they are registered as broker-dealers, the Commission's definition of small entity as it relates to broker-dealers would apply. The Commission does not believe that any of the SCI ATSS would be a small entity as defined above.

B. Certification

For the foregoing reasons, the Commission again certifies that Regulation SCI will not have a significant economic impact on a substantial number of small entities.

VIII. Statutory Authority and Text of Amendments

Pursuant to the Exchange Act, 15 U.S.C. 78a et seq., and particularly, Sections 2, 3, 5, 6, 11A, 15, 15A, 17, 17A, 23(a), and 24 thereof, 15 U.S.C. 78b, 78c, 78e, 78f, 78k-1, 78o, 78o-3, 78q, 78q-1, 78x, and 78w(a), the Commission adopts Regulation SCI under the Exchange Act and Form SCI under the Exchange Act, and amends Regulation ATS and Rule 24b-2 under the Exchange Act.

List of Subjects in 17 CFR Parts 240, 242, and 249

Brokers; Confidential business information; Reporting and recordkeeping requirements; and Securities.

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78o-10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, 7201 et seq., and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350, unless otherwise noted.

* * * * *

§ 240.24b-2. Nondisclosure of information filed with the Commission and with any exchange.

2. Amend § 240.24b-2 by:

a. After the words PRELIMINARY NOTE: adding the words “Except as otherwise provided in this rule,” and changing the word “Confidential” to “confidential”.

b. Adding at the beginning of paragraph (b) the words “Except as otherwise provided in paragraph (g) of this section,” and changing the word “The” to “the”.

c. Adding paragraph (g) to read as follows:

(g) An SCI entity (as defined in § 242.1000 of this chapter) shall not omit the confidential portion from the material filed in electronic format on Form SCI pursuant to Regulation SCI, § 242.1000 et. seq., and, in lieu of the procedures described in paragraph (b) of this section, may request confidential treatment of all information provided on Form SCI by completing Section IV of Form SCI.

PART 242—REGULATIONS M, SHO, ATS, AC, NMS AND SCI AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

3. The authority citation for part 242 continues to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k-1(c), 78l, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 78mm, 80a23, 80a-29, and 80a-37.

* * * * *

4. The heading of part 242 is revised to read as set forth above.
5. Add §§ 242.1000 through 242.1007 to read as follows:

* * * * *

Regulation SCI – Systems Compliance and Integrity.

Sec.

- 242.1000 Definitions.
- 242.1001 Obligations related to policies and procedures of SCI entities.
- 242.1002 Obligations related to SCI events.
- 242.1003 Obligations related to systems changes; SCI review.
- 242.1004 SCI entity business continuity and disaster recovery plans testing requirements for members or participants.
- 242.1005 Recordkeeping requirements related to compliance with Regulation SCI.
- 242.1006 Electronic filing and submission.
- 242.1007 Requirements for service bureaus.

§ 242.1000 Definitions.

For purposes of Regulation SCI (§§ 242.1000 through 242.1007), the following definitions shall apply:

The term critical SCI systems means any SCI systems of, or operated by or on behalf of, an SCI entity that:

(a) Directly support functionality relating to:

- (1) Clearance and settlement systems of clearing agencies;
- (2) Openings, reopenings, and closings on the primary listing market;
- (3) Trading halts;
- (4) Initial public offerings;
- (5) The provision of consolidated market data; or
- (6) Exclusively-listed securities; or

(b) Provide functionality to the securities markets for which the availability of alternatives is significantly limited or nonexistent and without which there would be a material impact on fair and orderly markets.

The term electronic signature has the meaning set forth in §240.19b-4(j) of this chapter.

The term exempt clearing agency subject to ARP means an entity that has received from the Commission an exemption from registration as a clearing agency under Section 17A of the Act, and whose exemption contains conditions that relate to the Commission's Automation Review Policies (ARP), or any Commission regulation that supersedes or replaces such policies.

The term indirect SCI systems means any systems of, or operated by or on behalf of, an SCI entity that, if breached, would be reasonably likely to pose a security threat to SCI systems.

The term major SCI event means an SCI event that has had, or the SCI entity reasonably estimates would have:

- (a) Any impact on a critical SCI system; or
- (b) A significant impact on the SCI entity's operations or on market participants.

The term plan processor has the meaning set forth in §242.600(b)(55).

The term responsible SCI personnel means, for a particular SCI system or indirect SCI

system impacted by an SCI event, such senior manager(s) of the SCI entity having responsibility for such system, and their designee(s).

The term SCI alternative trading system or SCI ATS means an alternative trading system, as defined in §242.300(a), which during at least four of the preceding six calendar months:

(a) Had with respect to NMS stocks:

(1) Five percent (5%) or more in any single NMS stock, and one-quarter percent (0.25%) or more in all NMS stocks, of the average daily dollar volume reported by applicable transaction reporting plans; or

(2) One percent (1%) or more in all NMS stocks of the average daily dollar volume reported by applicable transaction reporting plans; or

(b) Had with respect to equity securities that are not NMS stocks and for which transactions are reported to a self-regulatory organization, five percent (5%) or more of the average daily dollar volume as calculated by the self-regulatory organization to which such transactions are reported;

(c) Provided, however, that such SCI ATS shall not be required to comply with the requirements of Regulation SCI until six months after satisfying any of paragraphs (a) or (b) of this section, as applicable, for the first time.

The term SCI entity means an SCI self-regulatory organization, SCI alternative trading system, plan processor, or exempt clearing agency subject to ARP.

The term SCI event means an event at an SCI entity that constitutes:

(a) A systems disruption;

(b) A systems compliance issue; or

(c) A systems intrusion.

The term SCI review means a review, following established procedures and standards, that is performed by objective personnel having appropriate experience to conduct reviews of SCI systems and indirect SCI systems, and which review contains:

(a) A risk assessment with respect to such systems of an SCI entity; and

(b) An assessment of internal control design and effectiveness of its SCI systems and indirect SCI systems to include logical and physical security controls, development processes, and information technology governance, consistent with industry standards.

The term SCI self-regulatory organization or SCI SRO means any national securities exchange, registered securities association, or registered clearing agency, or the Municipal Securities Rulemaking Board; provided however, that for purposes of this section, the term SCI self-regulatory organization shall not include an exchange that is notice registered with the Commission pursuant to 15 U.S.C. 78f(g) or a limited purpose national securities association registered with the Commission pursuant to 15 U.S.C. 78o-3(k).

The term SCI systems means all computer, network, electronic, technical, automated, or similar systems of, or operated by or on behalf of, an SCI entity that, with respect to securities, directly support trading, clearance and settlement, order routing, market data, market regulation, or market surveillance.

The term senior management means, for purposes of Rule 1003(b), an SCI entity's Chief Executive Officer, Chief Technology Officer, Chief Information Officer, General Counsel, and Chief Compliance Officer, or the equivalent of such employees or officers of an SCI entity.

The term systems compliance issue means an event at an SCI entity that has caused any SCI system of such entity to operate in a manner that does not comply with the Act and the rules and regulations thereunder or the entity's rules or governing documents, as applicable.

The term systems disruption means an event in an SCI entity's SCI systems that disrupts, or significantly degrades, the normal operation of an SCI system.

The term systems intrusion means any unauthorized entry into the SCI systems or indirect SCI systems of an SCI entity.

§ 242.1001 Obligations related to policies and procedures of SCI entities.

(a) Capacity, integrity, resiliency, availability, and security. (1) Each SCI entity shall establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems and, for purposes of security standards, indirect SCI systems, have levels of capacity, integrity, resiliency, availability, and security, adequate to maintain the SCI entity's operational capability and promote the maintenance of fair and orderly markets.

(2) Policies and procedures required by paragraph (a)(1) of this section shall include, at a minimum:

(i) The establishment of reasonable current and future technological infrastructure capacity planning estimates;

(ii) Periodic capacity stress tests of such systems to determine their ability to process transactions in an accurate, timely, and efficient manner;

(iii) A program to review and keep current systems development and testing methodology for such systems;

(iv) Regular reviews and testing, as applicable, of such systems, including backup systems, to identify vulnerabilities pertaining to internal and external threats, physical hazards, and natural or manmade disasters;

(v) Business continuity and disaster recovery plans that include maintaining backup and recovery capabilities sufficiently resilient and geographically diverse and that are reasonably

designed to achieve next business day resumption of trading and two-hour resumption of critical SCI systems following a wide-scale disruption;

(vi) Standards that result in such systems being designed, developed, tested, maintained, operated, and surveilled in a manner that facilitates the successful collection, processing, and dissemination of market data; and

(vii) Monitoring of such systems to identify potential SCI events.

(3) Each SCI entity shall periodically review the effectiveness of the policies and procedures required by paragraph (a) of this section, and take prompt action to remedy deficiencies in such policies and procedures.

(4) For purposes of paragraph (a) of this section, such policies and procedures shall be deemed to be reasonably designed if they are consistent with current SCI industry standards, which shall be comprised of information technology practices that are widely available to information technology professionals in the financial sector and issued by an authoritative body that is a U.S. governmental entity or agency, association of U.S. governmental entities or agencies, or widely recognized organization. Compliance with such current SCI industry standards, however, shall not be the exclusive means to comply with the requirements of paragraph (a) of this section.

(b) Systems compliance. (1) Each SCI entity shall establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems operate in a manner that complies with the Act and the rules and regulations thereunder and the entity's rules and governing documents, as applicable.

(2) Policies and procedures required by paragraph (b)(1) of this section shall include, at a minimum:

(i) Testing of all SCI systems and any changes to SCI systems prior to implementation;

(ii) A system of internal controls over changes to SCI systems;

(iii) A plan for assessments of the functionality of SCI systems designed to detect systems compliance issues, including by responsible SCI personnel and by personnel familiar with applicable provisions of the Act and the rules and regulations thereunder and the SCI entity's rules and governing documents; and

(iv) A plan of coordination and communication between regulatory and other personnel of the SCI entity, including by responsible SCI personnel, regarding SCI systems design, changes, testing, and controls designed to detect and prevent systems compliance issues.

(3) Each SCI entity shall periodically review the effectiveness of the policies and procedures required by paragraph (b) of this section, and take prompt action to remedy deficiencies in such policies and procedures.

(4) Safe harbor from liability for individuals. Personnel of an SCI entity shall be deemed not to have aided, abetted, counseled, commanded, caused, induced, or procured the violation by an SCI entity of paragraph (b) of this section if the person:

(i) Has reasonably discharged the duties and obligations incumbent upon such person by the SCI entity's policies and procedures; and

(ii) Was without reasonable cause to believe that the policies and procedures relating to an SCI system for which such person was responsible, or had supervisory responsibility, were not established, maintained, or enforced in accordance with paragraph (b) of this section in any material respect.

(c) Responsible SCI personnel. (1) Each SCI entity shall establish, maintain, and enforce reasonably designed written policies and procedures that include the criteria for identifying

responsible SCI personnel, the designation and documentation of responsible SCI personnel, and escalation procedures to quickly inform responsible SCI personnel of potential SCI events.

(2) Each SCI entity shall periodically review the effectiveness of the policies and procedures required by paragraph (c)(1) of this section, and take prompt action to remedy deficiencies in such policies and procedures.

§ 242.1002 Obligations related to SCI events.

(a) Corrective action. Upon any responsible SCI personnel having a reasonable basis to conclude that an SCI event has occurred, each SCI entity shall begin to take appropriate corrective action which shall include, at a minimum, mitigating potential harm to investors and market integrity resulting from the SCI event and devoting adequate resources to remedy the SCI event as soon as reasonably practicable.

(b) Commission notification and recordkeeping of SCI events. Each SCI entity shall:

(1) Upon any responsible SCI personnel having a reasonable basis to conclude that an SCI event has occurred, notify the Commission of such SCI event immediately;

(2) Within 24 hours of any responsible SCI personnel having a reasonable basis to conclude that the SCI event has occurred, submit a written notification pertaining to such SCI event to the Commission, which shall be made on a good faith, best efforts basis and include:

(i) A description of the SCI event, including the system(s) affected; and

(ii) To the extent available as of the time of the notification: the SCI entity's current assessment of the types and number of market participants potentially affected by the SCI event; the potential impact of the SCI event on the market; a description of the steps the SCI entity has taken, is taking, or plans to take, with respect to the SCI event; the time the SCI event was

resolved or timeframe within which the SCI event is expected to be resolved; and any other pertinent information known by the SCI entity about the SCI event;

(3) Until such time as the SCI event is resolved and the SCI entity's investigation of the SCI event is closed, provide updates pertaining to such SCI event to the Commission on a regular basis, or at such frequency as reasonably requested by a representative of the Commission, to correct any materially incorrect information previously provided, or when new material information is discovered, including but not limited to, any of the information listed in paragraph (b)(2)(ii) of this section;

(4)(i)(A) If an SCI event is resolved and the SCI entity's investigation of the SCI event is closed within 30 calendar days of the occurrence of the SCI event, then within five business days after the resolution of the SCI event and closure of the investigation regarding the SCI event, submit a final written notification pertaining to such SCI event to the Commission containing the information required in paragraph (b)(4)(ii) of this section.

(B)(1) If an SCI event is not resolved or the SCI entity's investigation of the SCI event is not closed within 30 calendar days of the occurrence of the SCI event, then submit an interim written notification pertaining to such SCI event to the Commission within 30 calendar days after the occurrence of the SCI event containing the information required in paragraph (b)(4)(ii) of this section, to the extent known at the time.

(2) Within five business days after the resolution of such SCI event and closure of the investigation regarding such SCI event, submit a final written notification pertaining to such SCI event to the Commission containing the information required in paragraph (b)(4)(ii) of this section.

(ii) Written notifications required by paragraph (b)(4)(i) of this section shall include:

(A) A detailed description of: the SCI entity's assessment of the types and number of market participants affected by the SCI event; the SCI entity's assessment of the impact of the SCI event on the market; the steps the SCI entity has taken, is taking, or plans to take, with respect to the SCI event; the time the SCI event was resolved; the SCI entity's rule(s) and/or governing document(s), as applicable, that relate to the SCI event; and any other pertinent information known by the SCI entity about the SCI event;

(B) A copy of any information disseminated pursuant to paragraph (c) of this section by the SCI entity to date regarding the SCI event to any of its members or participants; and

(C) An analysis of parties that may have experienced a loss, whether monetary or otherwise, due to the SCI event, the number of such parties, and an estimate of the aggregate amount of such loss.

(5) The requirements of paragraphs (b)(1) through (4) of this section shall not apply to any SCI event that has had, or the SCI entity reasonably estimates would have, no or a de minimis impact on the SCI entity's operations or on market participants. For such events, each SCI entity shall:

(i) Make, keep, and preserve records relating to all such SCI events; and

(ii) Submit to the Commission a report, within 30 calendar days after the end of each calendar quarter, containing a summary description of such systems disruptions and systems intrusions, including the SCI systems and, for systems intrusions, indirect SCI systems, affected by such systems disruptions and systems intrusions during the applicable calendar quarter.

(c) Dissemination of SCI events.

(1) Each SCI entity shall:

(i) Promptly after any responsible SCI personnel has a reasonable basis to conclude that an SCI event that is a systems disruption or systems compliance issue has occurred, disseminate the following information about such SCI event:

(A) The system(s) affected by the SCI event; and

(B) A summary description of the SCI event; and

(ii) When known, promptly further disseminate the following information about such SCI event:

(A) A detailed description of the SCI event;

(B) The SCI entity's current assessment of the types and number of market participants potentially affected by the SCI event; and

(C) A description of the progress of its corrective action for the SCI event and when the SCI event has been or is expected to be resolved; and

(iii) Until resolved, provide regular updates of any information required to be disseminated under paragraphs (c)(1)(i) and (ii) of this section.

(2) Each SCI entity shall, promptly after any responsible SCI personnel has a reasonable basis to conclude that a SCI event that is a systems intrusion has occurred, disseminate a summary description of the systems intrusion, including a description of the corrective action taken by the SCI entity and when the systems intrusion has been or is expected to be resolved, unless the SCI entity determines that dissemination of such information would likely compromise the security of the SCI entity's SCI systems or indirect SCI systems, or an investigation of the systems intrusion, and documents the reasons for such determination.

(3) The information required to be disseminated under paragraphs (c)(1) and (2) of this section promptly after any responsible SCI personnel has a reasonable basis to conclude that an

SCI event has occurred, shall be promptly disseminated by the SCI entity to those members or participants of the SCI entity that any responsible SCI personnel has reasonably estimated may have been affected by the SCI event, and promptly disseminated to any additional members or participants that any responsible SCI personnel subsequently reasonably estimates may have been affected by the SCI event; provided, however, that for major SCI events, the information required to be disseminated under paragraphs (c)(1) and (2) of this section shall be promptly disseminated by the SCI entity to all of its members or participants.

(4) The requirements of paragraphs (c)(1) through (3) of this section shall not apply to:

(i) SCI events to the extent they relate to market regulation or market surveillance systems; or

(ii) Any SCI event that has had, or the SCI entity reasonably estimates would have, no or a de minimis impact on the SCI entity's operations or on market participants.

§ 242.1003 Obligations related to systems changes; SCI review.

(a) Systems changes. Each SCI entity shall:

(1) Within 30 calendar days after the end of each calendar quarter, submit to the Commission a report describing completed, ongoing, and planned material changes to its SCI systems and the security of indirect SCI systems, during the prior, current, and subsequent calendar quarters, including the dates or expected dates of commencement and completion. An SCI entity shall establish reasonable written criteria for identifying a change to its SCI systems and the security of indirect SCI systems as material and report such changes in accordance with such criteria.

(2) Promptly submit a supplemental report notifying the Commission of a material error in or material omission from a report previously submitted under paragraph (a) of this section.

(b) SCI review. Each SCI entity shall:

(1) Conduct an SCI review of the SCI entity's compliance with Regulation SCI not less than once each calendar year; provided, however, that:

(i) Penetration test reviews of the network, firewalls, and production systems shall be conducted at a frequency of not less than once every three years; and

(ii) Assessments of SCI systems directly supporting market regulation or market surveillance shall be conducted at a frequency based upon the risk assessment conducted as part of the SCI review, but in no case less than once every three years; and

(2) Submit a report of the SCI review required by paragraph (b)(1) of this section to senior management of the SCI entity for review no more than 30 calendar days after completion of such SCI review; and

(3) Submit to the Commission, and to the board of directors of the SCI entity or the equivalent of such board, a report of the SCI review required by paragraph (b)(1) of this section, together with any response by senior management, within 60 calendar days after its submission to senior management of the SCI entity.

§ 242.1004 SCI entity business continuity and disaster recovery plans testing requirements for members or participants.

With respect to an SCI entity's business continuity and disaster recovery plans, including its backup systems, each SCI entity shall:

(a) Establish standards for the designation of those members or participants that the SCI entity reasonably determines are, taken as a whole, the minimum necessary for the maintenance of fair and orderly markets in the event of the activation of such plans;

(b) Designate members or participants pursuant to the standards established in paragraph (a) of this section and require participation by such designated members or participants in scheduled functional and performance testing of the operation of such plans, in the manner and frequency specified by the SCI entity, provided that such frequency shall not be less than once every 12 months; and

(c) Coordinate the testing of such plans on an industry- or sector-wide basis with other SCI entities.

§ 242.1005 Recordkeeping requirements related to compliance with Regulation SCI.

(a) An SCI SRO shall make, keep, and preserve all documents relating to its compliance with Regulation SCI as prescribed in §240.17a-1 of this chapter.

(b) An SCI entity that is not an SCI SRO shall:

(1) Make, keep, and preserve at least one copy of all documents, including correspondence, memoranda, papers, books, notices, accounts, and other such records, relating to its compliance with Regulation SCI, including, but not limited to, records relating to any changes to its SCI systems and indirect SCI systems;

(2) Keep all such documents for a period of not less than five years, the first two years in a place that is readily accessible to the Commission or its representatives for inspection and examination; and

(3) Upon request of any representative of the Commission, promptly furnish to the possession of such representative copies of any documents required to be kept and preserved by it pursuant to paragraphs (b)(1) and (2) of this section.

(c) Upon or immediately prior to ceasing to do business or ceasing to be registered under the Securities Exchange Act of 1934, an SCI entity shall take all necessary action to ensure that

the records required to be made, kept, and preserved by this section shall be accessible to the Commission and its representatives in the manner required by this section and for the remainder of the period required by this section.

§ 242.1006 Electronic filing and submission.

(a) Except with respect to notifications to the Commission made pursuant to § 242.1002(b)(1) or updates to the Commission made pursuant to paragraph § 242.1002(b)(3), any notification, review, description, analysis, or report to the Commission required to be submitted under Regulation SCI shall be filed electronically on Form SCI (§249.1900 of this chapter), include all information as prescribed in Form SCI and the instructions thereto, and contain an electronic signature; and

(b) The signatory to an electronically filed Form SCI shall manually sign a signature page or document, in the manner prescribed by Form SCI, authenticating, acknowledging, or otherwise adopting his or her signature that appears in typed form within the electronic filing. Such document shall be executed before or at the time Form SCI is electronically filed and shall be retained by the SCI entity in accordance with § 242.1005.

§ 242.1007 Requirements for service bureaus.

If records required to be filed or kept by an SCI entity under Regulation SCI are prepared or maintained by a service bureau or other recordkeeping service on behalf of the SCI entity, the SCI entity shall ensure that the records are available for review by the Commission and its representatives by submitting a written undertaking, in a form acceptable to the Commission, by such service bureau or other recordkeeping service, signed by a duly authorized person at such service bureau or other recordkeeping service. Such a written undertaking shall include an agreement by the service bureau to permit the Commission and its representatives to

examine such records at any time or from time to time during business hours, and to promptly furnish to the Commission and its representatives true, correct, and current electronic files in a form acceptable to the Commission or its representatives or hard copies of any or all or any part of such records, upon request, periodically, or continuously and, in any case, within the same time periods as would apply to the SCI entity for such records. The preparation or maintenance of records by a service bureau or other recordkeeping service shall not relieve an SCI entity from its obligation to prepare, maintain, and provide the Commission and its representatives access to such records.

Amendments to Regulation ATS – Alternative Trading Systems, 17 CFR § 242.301

6. § 242.301 to Part 242 is amended by:
 - a. Removing paragraphs (b)(6)(i)(A) and (b)(6)(i)(B);
 - b. Redesignating paragraph (b)(6)(i)(C) as (b)(6)(i)(A); and
 - c. Redesignating paragraph (b)(6)(i)(D) as (b)(6)(i)(B).

PART 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934

7. The general authority citation for Part 249 continues to read in part as follows:

Authority: 15 U.S.C. 78a et seq. and 7201; and 18 U.S.C. 1350 unless otherwise noted.

* * * * *

8. Add subpart T, consisting of § 249.1900 to read as follows:

Subpart T—Form SCI, for filing notices and reports as required by Regulation SCI.

§ 249.1900. Form SCI, for filing notices and reports as required by Regulation SCI.

Form SCI shall be used to file notices and reports as required by Regulation SCI (§§ 242.1000 through 242.1007).

[Note: The text of Form SCI does not, and the amendments will not, appear in the Code of Federal Regulations.]

**Securities and Exchange Commission
Washington, DC 20549
Form SCI**

OMB Number:
Expiration Date:
Estimated Average burden
hours per response.....

Page 1 of _____

File No. SCI-{name}-YYYY-###

SCI Notification and Reporting by: {SCI entity name}

Pursuant to Rules 1002 and 1003 of Regulation SCI under the Securities Exchange Act of 1934

- Initial
- Withdrawal

SECTION I: Rule 1002 - Commission Notification of SCI Event

A. Submission Type (select one only)

- Rule 1002(b)(1) Initial Notification of SCI event
- Rule 1002(b)(2) Notification of SCI event
- Rule 1002(b)(3) Update of SCI event: ####
- Rule 1002(b)(4) Final Report of SCI Event
- Rule 1002(b)(4) Interim Status Report of SCI event

If filing a Rule 1002(b)(1) or Rule 1002(b)(3) submission, please provide a brief description:

B. SCI Event Type(s) (select all that apply)

- Systems compliance issue
- Systems disruption
- Systems intrusion

C. General Information Required for (b)(2) filings.

- 1) Has the Commission previously been notified of the SCI event pursuant to 1002(b)(1)? *yes/no*
- 2) Date/time SCI event occurred: *mm/dd/yyyy hh:mm am/pm*
- 3) Duration of SCI event: *hh:mm, or days*
- 4) Please provide the date and time when a responsible SCI personnel had reasonable basis to conclude the SCI event occurred:
mm/dd/yyyy hh:mm am/pm
- 5) Has the SCI event been resolved? *yes/no*
 - a) If yes, provide date and time of resolution: *mm/dd/yyyy hh:mm am/pm*
- 6) Is the investigation of the SCI event closed? *yes/no*
 - a) If yes, provide date of closure: *mm/dd/yyyy*
- 7) Estimated number of market participants potentially affected by the SCI event: ####
- 8) Is the SCI event a major SCI event (as defined in Rule 1000)? *yes/no*

D. Information about impacted systems:

Name(s) of system(s):

Type(s) of system(s) impacted by the SCI event (check all that apply):

- Trading Clearance and settlement Order routing
 Market data Market regulation Market surveillance
 Indirect SCI systems (please describe):

Are any critical SCI systems impacted by the SCI event (check all that apply)? Yes/No

- 1) Systems that directly support functionality relating to:
- Clearance and settlement systems of clearing agencies
 - Openings, reopenings, and closings on the primary listing market
 - Trading halts Initial public offerings
 - The provision of consolidated market data Exclusively-listed securities
- 2) Systems that provide functionality to the securities markets for which the availability of alternatives is significantly limited or nonexistent and without which there would be a material impact on fair and orderly markets (please describe):

SECTION II: Periodic Reporting (select one only)

A. Quarterly Reports: For the quarter ended: mm/dd/yyyy

- Rule 1002(b)(5)(ii): Quarterly report of systems disruptions and systems intrusions with no or a de minimis impact.
 Rule 1003(a)(1): Quarterly report of material systems changes
 Rule 1003(a)(2): Supplemental report of material systems changes

B. SCI Review Reports

- Rule 1003(b)(3): Report of SCI review, together with any response by senior management

Date of completion of SCI review: mm/dd/yyyy

Date of submission of SCI review to senior management: mm/dd/yyyy

SECTION III: Contact Information

Provide the following information of the person at the {SCI entity name} prepared to respond to questions for this submission:

First Name: Last Name:

Title:

E-Mail:

Telephone: Fax:

Additional Contacts (Optional)

First Name: Last Name:

Title:

E-Mail:

Telephone: Fax:

First Name: Last Name:

Title:

E-Mail:

Telephone: Fax:

SECTION IV: Signature

Confidential treatment is requested pursuant to Rule 24b-2(g). Additionally, pursuant to the requirements of the Securities Exchange Act of 1934, {SCI Entity name} has duly caused this {notification}{report} to be signed on its behalf by the undersigned duly authorized officer:

Date:

By (Name) Title (_____)

“Digitally Sign and Lock Form”

<p>Exhibit 1: Rule 1002(b)(2) Notification of SCI Event Add/Remove/View</p>	<p>Within 24 hours of any responsible SCI personnel having a reasonable basis to conclude that the SCI event has occurred, the SCI entity shall submit a written notification pertaining to such SCI event to the Commission, which shall be made on a good faith, best efforts basis and include:</p> <ul style="list-style-type: none"> (a) a description of the SCI event, including the system(s) affected; and (b) to the extent available as of the time of the notification: the SCI entity's current assessment of the types and number of market participants potentially affected by the SCI event; the potential impact of the SCI event on the market; a description of the steps the SCI entity has taken, is taking, or plans to take, with respect to the SCI event; the time the SCI event was resolved or timeframe within which the SCI event is expected to be resolved; and any other pertinent information known by the SCI entity about the SCI event.
<p>Exhibit 2: Rule 1002(b)(4) Final or Interim Report of SCI Event Add/Remove/View</p>	<p>When submitting a final report pursuant to either Rule 1002(b)(4)(i)(A) or Rule 1002(b)(4)(i)(B)(2), the SCI entity shall include:</p> <ul style="list-style-type: none"> (a) a detailed description of: the SCI entity's assessment of the types and number of market participants affected by the SCI event; the SCI entity's assessment of the impact of the SCI event on the market; the steps the SCI entity has taken, is taking, or plans to take, with respect to the SCI event; the time the SCI event was resolved; the SCI entity's rule(s) and/or governing document(s), as applicable, that relate to the SCI event; and any other pertinent information known by the SCI entity about the SCI event; (b) a copy of any information disseminated pursuant to Rule 1002(c) by the SCI entity to date regarding the SCI event to any of its members or participants; and (c) an analysis of parties that may have experienced a loss, whether monetary or otherwise, due to the SCI event, the number of such parties, and an estimate of the aggregate amount of such loss. <p>When submitting an interim report pursuant to Rule 1002(b)(4)(i)(B)(1), the SCI entity shall include such information to the extent known at the time.</p>
<p>Exhibit 3: Rule 1002(b)(5)(ii) Quarterly Report of De Minimis SCI Events Add/Remove/View</p>	<p>The SCI entity shall submit a report, within 30 calendar days after the end of each calendar quarter, containing a summary description of systems disruptions and systems intrusions that have had, or the SCI entity reasonably estimates would have, no or a de minimis impact on the SCI entity's operations or on market participants, including the SCI systems and, for systems intrusions, indirect SCI systems, affected by such SCI events during the applicable calendar quarter.</p>
<p>Exhibit 4: Rule 1003 (a) Quarterly Report of Systems Changes Add/Remove/View</p>	<p>When submitting a report pursuant to Rule 1003(a)(1), the SCI entity shall provide a report, within 30 calendar days after the end of each calendar quarter, describing completed, ongoing, and planned material changes to its SCI systems and the security of indirect SCI systems, during the prior, current, and subsequent calendar quarters, including the dates or expected dates of commencement and completion. An SCI entity shall establish reasonable written criteria for identifying a change to its SCI systems and the security of indirect SCI systems as material and report such changes in accordance with such criteria.</p> <p>When submitting a report pursuant to Rule 1003(a)(2), the SCI entity shall provide a supplemental report of a material error in or material omission from a report previously submitted under Rule 1003(a)(1).</p>
<p>Exhibit 5: Rule 1003(b)(3) Report of SCI review Add/Remove/View</p>	<p>The SCI entity shall provide a report of the SCI review, together with any response by senior management, within 60 calendar days after its submission to senior management of the SCI entity.</p>
<p>Exhibit 6: Optional Attachments Add/Remove/View</p>	<p>This exhibit may be used in order to attach other documents that the SCI entity may wish to submit as part of a Rule 1002(b)(1) initial notification submission or Rule 1002(b)(3) update submission.</p>

GENERAL INSTRUCTIONS FOR FORM SCI

A. Use of the Form

Except with respect to notifications to the Commission made pursuant to Rule 1002(b)(1) or updates to the Commission made pursuant to Rule 1002(b)(3), any notification, review, description, analysis, or report required to be submitted pursuant to Regulation SCI under the Securities Exchange Act of 1934 (“Act”) shall be filed in an electronic format through an electronic form filing system (“EFFS”), a secure website operated by the Securities and Exchange Commission (“Commission”). Documents attached as exhibits filed through the EFFS system must be in a text-searchable format without the use of optical character recognition. If, however, a portion of a Form SCI submission (e.g., an image or diagram) cannot be made available in a text-searchable format, such portion may be submitted in a non-text searchable format.

B. Need for Careful Preparation of the Completed Form, Including Exhibits

This form, including the exhibits, is intended to elicit information necessary for Commission staff to work with SCI self-regulatory organizations, SCI alternative trading systems, plan processors, and exempt clearing agencies subject to ARP (collectively, “SCI entities”) to ensure the capacity, integrity, resiliency, availability, security, and compliance of their automated systems. An SCI entity must provide all the information required by the form, including the exhibits, and must present the information in a clear and comprehensible manner. A filing that is incomplete or similarly deficient may be returned to the SCI entity. Any filing so returned shall for all purposes be deemed not to have been filed with the Commission. See also Rule 0-3 under the Act (17 CFR 240.0-3).

C. When to Use the Form

Form SCI is comprised of six types of required submissions to the Commission pursuant to Rules 1002 and 1003. In addition, Form SCI permits SCI entities to submit to the Commission two additional types of submissions pursuant to Rules 1002(b)(1) and 1002(b)(3); however, SCI entities are not required to use Form SCI for these two types of submissions to the Commission. In filling out Form SCI, an SCI entity shall select the type of filing and provide all information required by Regulation SCI specific to that type of filing.

The first two types of required submissions relate to Commission notification of certain SCI events:

(1) "Rule 1002(b)(2) Notification of SCI Event" submissions for notifications regarding systems disruptions, systems compliance issues, or systems intrusions (collectively, "SCI events"), other than any systems disruption or systems intrusion that has had, or the SCI entity reasonably estimates would have, no or a de minimis impact on the SCI entity's operations or on market participants; and

(2) "Rule 1002(b)(4) Final or Interim Report of SCI Event" submissions, of which there are two kinds (a final report under Rule 1002(b)(4)(i)(A) or Rule 1002(b)(4)(i)(B)(2); or an interim status report under Rule 1002(b)(4)(i)(B)(1)).

The other four types of required submissions are periodic reports, and include:

(1) "Rule 1002(b)(5)(ii)" submissions for quarterly reports of systems disruptions and systems intrusions which have had, or the SCI entity reasonably estimates would have, no or a de minimis impact on the SCI entity's operations or on market participants ("de minimis SCI events");

(2) "Rule 1003(a)(1)" submissions for quarterly reports of material systems changes;

(3) "Rule 1003(a)(2)" submissions for supplemental reports of material systems changes;
and

(4) "Rule 1003(b)(3)" submissions for reports of SCI reviews.

Required Submissions for SCI Events

For 1002(b)(2) submissions, an SCI entity must notify the Commission using Form SCI by selecting the appropriate box in Section I and filling out all information required by the form, including Exhibit 1. 1002(b)(2) submissions must be submitted within 24 hours of any responsible SCI personnel having a reasonable basis to conclude that an SCI event has occurred.

For 1002(b)(4) submissions, if an SCI event is resolved and the SCI entity's investigation of the SCI event is closed within 30 calendar days of the occurrence of the SCI event, an SCI entity must file a final report under Rule 1002(b)(4)(i)(A) within five business days after the resolution of the SCI event and closure of the investigation regarding the SCI event. However, if an SCI event is not resolved or the SCI entity's investigation of the SCI event is not closed within 30 calendar days of the occurrence of the SCI event, an SCI entity must file an interim status report under Rule 1002(b)(4)(i)(B)(1) within 30 calendar days after the occurrence of the SCI event. For SCI events in which an interim status report is required to be filed, an SCI entity must file a final report under Rule 1002(b)(4)(i)(B)(2) within five business days after the resolution of the SCI event and closure of the investigation regarding the SCI event. For 1002(b)(4) submissions, an SCI entity must notify the Commission using Form SCI by selecting the appropriate box in Section I and filling out all information required by the form, including Exhibit 2.

Required Submissions for Periodic Reporting

For 1002(b)(5)(ii) submissions, an SCI entity must submit quarterly reports of systems disruptions and systems intrusions which have had, or the SCI entity reasonably estimates would have, no or a de minimis impact on the SCI entity's operations or on market participants. The SCI entity must select the appropriate box in Section II and fill out all information required by the form, including Exhibit 3.

For 1003(a)(1) submissions, an SCI entity must submit its quarterly report of material systems changes to the Commission using Form SCI. The SCI entity must select the appropriate box in Section II and fill out all information required by the form, including Exhibit 4.

Filings made pursuant to Rule 1002(b)(5)(ii) and Rule 1003(a)(1) must be submitted to the Commission within 30 calendar days after the end of each calendar quarter (i.e., March 31st, June 30th, September 30th and December 31st) of each year.

For 1003(a)(2) submissions, an SCI entity must submit a supplemental report notifying the Commission of a material error in or material omission from a report previously submitted under Rule 1003(a). The SCI entity must select the appropriate box in Section II and fill out all information required by the form, including Exhibit 4.

For 1003(b)(3) submissions, an SCI entity must submit its report of its SCI review, together with any response by senior management, to the Commission using Form SCI. A 1003(b)(3) submission is required within 60 calendar days after the report of the SCI review has been submitted to senior management of the SCI entity. The SCI entity must select the appropriate box in Section II and fill out all information required by the form, including Exhibit 5.

Optional Submissions

An SCI entity may, but is not required to, use Form SCI to submit a notification pursuant to Rule 1002(b)(1). If the SCI entity uses Form SCI to submit a notification pursuant to Rule 1002(b)(1), it must select the appropriate box in Section I and provide a short description of the SCI event. Documents may also be attached as Exhibit 6 if the SCI entity chooses to do so. An SCI entity may, but is not required to, use Form SCI to submit an update pursuant to Rule 1002(b)(3). Rule 1002(b)(3) requires an SCI entity to, until such time as the SCI event is resolved and the SCI entity's investigation of the SCI event is closed, provide updates pertaining to such SCI event to the Commission on a regular basis, or at such frequency as reasonably requested by a representative of the Commission, to correct any materially incorrect information previously provided, or when new material information is discovered, including but not limited to, any of the information listed in Rule 1002(b)(2)(ii). If the SCI entity uses Form SCI to submit an update pursuant to Rule 1002(b)(3), it must select the appropriate box in Section I and provide a short description of the SCI event. Documents may also be attached as Exhibit 6 if the SCI entity chooses to do so.

D. Documents Comprising the Completed Form

The completed form filed with the Commission shall consist of Form SCI, responses to all applicable items, and any exhibits required in connection with the filing. Each filing shall be marked on Form SCI with the initials of the SCI entity, the four-digit year, and the number of the filing for the year (e.g., SCI Name-YYYY-XXX).

E. Contact Information; Signature; and Filing of the Completed Form

Each time an SCI entity submits a filing to the Commission on Form SCI, the SCI entity must provide the contact information required by Section III of Form SCI. Space for additional contact information, if appropriate, is also provided.

All notifications and reports required to be submitted through Form SCI shall be filed through the EDFS. In order to file Form SCI through the EDFS, SCI entities must request access to the Commission's External Application Server by completing a request for an external account user ID and password. Initial requests will be received by contacting (202) 551-5777. An e-mail will be sent to the requestor that will provide a link to a secure website where basic profile information will be requested. A duly authorized individual of the SCI entity shall electronically sign the completed Form SCI as indicated in Section IV of the form. In addition, a duly authorized individual of the SCI entity shall manually sign one copy of the completed Form SCI, and the manually signed signature page shall be preserved pursuant to the requirements of Rule 1005.

F. Withdrawals of Commission Notifications and Periodic Reports

If an SCI entity determines to withdraw a Form SCI, it must complete Page 1 of the Form SCI and indicate by selecting the appropriate check box to withdraw the submission.

G. Paperwork Reduction Act Disclosure

This collection of information will be reviewed by the Office of Management and Budget in accordance with the clearance requirements of 44 U.S.C. 3507. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The Commission estimates that the average burden to respond to Form SCI will be between one and 125 hours, depending upon the purpose for which the form is being filed. Any member of the public may direct to the Commission any comments concerning the accuracy of this burden estimate and any suggestions for reducing this burden.

Except with respect to notifications to the Commission made pursuant to Rule 1002(b)(1) or updates to the Commission made pursuant to Rule 1002(b)(3), it is mandatory that an SCI entity file all notifications, reviews, descriptions, analyses, and reports required by Regulation SCI using Form SCI. The Commission will keep the information collected pursuant to Form SCI confidential to the extent permitted by law. Subject to the provisions of the Freedom of Information Act, 5 U.S.C. 522 ("FOIA"), and the Commission's rules thereunder (17 CFR 200.80(b)(4)(iii)), the Commission does not generally publish or make available information contained in any reports, summaries, analyses, letters, or memoranda arising out of, in anticipation of, or in connection with an examination or inspection of the books and records of any person or any other investigation.

H. Exhibits

List of exhibits to be filed, as applicable:

Exhibit 1: Rule 1002(b)(2) – Notification of SCI Event. Within 24 hours of any responsible SCI personnel having a reasonable basis to conclude that the SCI event has occurred, the SCI entity shall submit a written notification pertaining to such SCI event to the Commission, which shall be made on a good faith, best efforts basis and include: (a) a description of the SCI event, including the system(s) affected; and (b) to the extent available as of the time of the notification: the SCI entity's current assessment of the types and number of market participants potentially affected by the SCI event; the potential impact of the SCI event on the market; a description of the steps the SCI entity has taken, is taking, or plans to take, with respect to the SCI event; the time the SCI event was resolved or timeframe within which the SCI event is expected to be resolved; and any other pertinent information known by the SCI entity about the SCI event.

Exhibit 2: Rule 1002(b)(4) – Final or Interim Report of SCI Event. When submitting a final report pursuant to either Rule 1002(b)(4)(i)(A) or Rule 1002(b)(4)(i)(B)(2), the SCI entity shall include: (a) a detailed description of: the SCI entity's assessment of the types and number of market participants affected by the SCI event; the SCI entity's assessment of the impact of the SCI event on the market; the steps the SCI entity has taken, is taking, or plans to take, with respect to the SCI event; the time the SCI event was resolved; the SCI entity's rule(s) and/or governing document(s), as applicable, that relate to the SCI event; and any other pertinent information known by the SCI entity about the SCI event; (b) a copy of any information disseminated pursuant to Rule 1002(c) by the SCI entity to date regarding the SCI event to any of its members or participants; and (c) an analysis of parties that may have experienced a loss, whether monetary or otherwise, due to the SCI event, the number of such parties, and an estimate of the aggregate amount of such loss. When submitting an interim report pursuant to Rule 1002(b)(4)(i)(B)(1), the SCI entity shall include such information to the extent known at the time.

Exhibit 3: Rule 1002(b)(5)(ii) – Quarterly Report of De Minimis SCI Events. The SCI entity shall submit a report, within 30 calendar days after the end of each calendar quarter, containing a summary description of systems disruptions and systems intrusions that have had, or the SCI entity reasonably estimates would have, no or a de minimis impact on the SCI entity's operations or on market participants, including the SCI systems and, for systems intrusions, indirect SCI systems, affected by such SCI events during the applicable calendar quarter.

Exhibit 4: Rule 1003(a) – Quarterly Report of Systems Changes. When submitting a report pursuant to Rule 1003(a)(1), the SCI entity shall provide a report, within 30 calendar days after the end of each calendar quarter, describing completed, ongoing, and planned material changes

to its SCI systems and the security of indirect SCI systems, during the prior, current, and subsequent calendar quarters, including the dates or expected dates of commencement and completion. An SCI entity shall establish reasonable written criteria for identifying a change to its SCI systems and the security of indirect SCI systems as material and report such changes in accordance with such criteria. When submitting a report pursuant to Rule 1003(a)(2), the SCI entity shall provide a supplemental report of a material error in or material omission from a report previously submitted under Rule 1003(a); provided, however, that a supplemental report is not required if information regarding a material systems change is or will be provided as part of a notification made pursuant to Rule 1002(b).

Exhibit 5: Rule 1003(b)(3) – Report of SCI Review. The SCI entity shall provide a report of the SCI review, together with any response by senior management, within 60 calendar days after its submission to senior management of the SCI entity.

Exhibit 6: Optional Attachments. This exhibit may be used in order to attach other documents that the SCI entity may wish to submit as part of a Rule 1002(b)(1) initial notification submission or Rule 1002(b)(3) update submission.

I. Explanation of Terms

Critical SCI systems means any SCI systems of, or operated by or on behalf of, an SCI entity that: (a) directly support functionality relating to: (1) clearance and settlement systems of clearing agencies; (2) openings, reopenings, and closings on the primary listing market; (3) trading halts; (4) initial public offerings; (5) the provision of consolidated market data; or (6) exclusively-listed securities; or (b) provide functionality to the securities markets for which the

availability of alternatives is significantly limited or nonexistent and without which there would be a material impact on fair and orderly markets.

Indirect SCI systems means any systems of, or operated by or on behalf of, an SCI entity that, if breached, would be reasonably likely to pose a security threat to SCI systems.

Major SCI event means an SCI event that has had, or the SCI entity reasonably estimates would have: (a) any impact on a critical SCI system; or (b) a significant impact on the SCI entity's operations or on market participants.

Responsible SCI personnel means, for a particular SCI system or indirect SCI system impacted by an SCI event, such senior manager(s) of the SCI entity having responsibility for such system, and their designee(s).

SCI entity means an SCI self-regulatory organization, SCI alternative trading system, plan processor, or exempt clearing agency subject to ARP.

SCI event means an event at an SCI entity that constitutes: (a) a systems disruption; (b) a systems compliance issue; or (c) a systems intrusion.

SCI review means a review, following established procedures and standards, that is performed by objective personnel having appropriate experience to conduct reviews of SCI systems and indirect SCI systems, and which review contains: (a) a risk assessment with respect to such systems of an SCI entity; and (b) an assessment of internal control design and effectiveness of its SCI systems and indirect SCI systems to include logical and physical security controls, development processes, and information technology governance, consistent with industry standards.

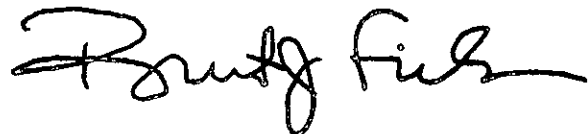
SCI systems means all computer, network, electronic, technical, automated, or similar systems of, or operated by or on behalf of, an SCI entity that, with respect to securities, directly support trading, clearance and settlement, order routing, market data, market regulation, or market surveillance.

Systems Compliance Issue means an event at an SCI entity that has caused any SCI system of such entity to operate in a manner that does not comply with the Act and the rules and regulations thereunder or the entity's rules or governing documents, as applicable.

Systems Disruption means an event in an SCI entity's SCI systems that disrupts, or significantly degrades, the normal operation of an SCI system.

Systems Intrusion means any unauthorized entry into the SCI systems or indirect SCI systems of an SCI entity.

By the Commission.



Brent J. Fields
Secretary

Date: November 19, 2014

Exhibit A

**Key to Comment Letters Cited in Regulation SCI Adopting Release
(File No. S7-01-13)**

Letter from Charles V. Rossi, President, The Securities Transfer Association, Inc. to Elizabeth Murphy, Secretary, Commission, dated April 3, 2013 ("STA Letter")

Letter from John J. Rapa, President/Chief Executive Officer, Tellefsen and Company, L.L.C., Northborough, Massachusetts to Elizabeth Murphy, Commission, dated April 19, 2013 ("Tellefsen Letter")

Letter from Cynthia Fuller, Executive Director, on behalf of Accredited Standards Committee X9, Inc. Financial Industry Standards to the Commission, dated May 23, 2013 ("X9 Letter")

Letter from Scott Cooper, Vice President, Government Relations and Public Policy, American National Standards Institute to the Commission, dated May 23, 2013 ("ANSI Letter")

Letter from James J. Angel, Ph.D., CFA, Visiting Associate Professor, The Wharton School, University of Pennsylvania to the Commission, dated June 3, 2013 ("Angel Letter")

Letter from Raymond M. Tierney III, President and Chief Executive Officer, Bloomberg Tradebook LLC to Elizabeth Murphy, Secretary, Commission, dated June 19, 2013 ("Tradebook Letter")

Letter from Jay M. Goldstone, Chairman, Municipal Securities Rulemaking Board, Alexandria, Virginia to Elizabeth Murphy, Secretary, Commission, dated June 28, 2013 ("MSRB Letter")

Letter from Thomas V. D'Ambrosio, Chairman, Committee on Futures and Derivatives, New York City Bar Association to Elizabeth Murphy, Secretary, Commission, dated July 1, 2013 ("NYC Bar Letter")

Letter from Richard M. Whiting, Executive Director and General Counsel, The Financial Services Roundtable to Elizabeth Murphy, Secretary, Commission, dated July 5, 2013 ("FSR Letter")

Letter from Rob Flatley, Chief Executive Officer and President, CoreOne Technologies to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 ("CoreOne Letter")

Letter from Manisha Kimmel, Executive Director, Financial Information Forum to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 ("FIF Letter")

Letter from Larry E. Thompson, Managing Director and General Counsel, The Depository Trust Clearing Corporation to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 ("DTCC Letter")

Letter from Raymond Tamayo, Chief Information Officer, Options Clearing Corporation to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 (“OCC Letter”)

Letter from Timothy J. Mahoney, CEO, BIDS Trading, L.P., New York, New York to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 (“BIDS Letter”)

Letter from Michael Simon, Secretary, International Securities Exchange, LLC to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 (“ISE Letter”)

Letter from Courtney D. McGuinn, Operations Director, FIX Protocol Ltd., New York, New York to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 (“FIX Letter”)

Letter from R.T. Leuchtkafer to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 (“Leuchtkafer Letter ”)

Letter from Dennis M. Kelleher, President & CEO; Stephen W.Hall, Securities Specialist; Katelynn O. Bradley, Attorney; and David Frenk, Director of Research; Better Markets, Inc. to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 (“Better Markets Letter”)

Letter from Lev Lesokhin, Executive Vice President, Strategy and Markets, CAST, Inc., New York, New York to the Commission, dated July 8, 2013 (“CAST Letter”)

Letter from Robert J. McCarthy, Director of Regulatory Policy, Wells Fargo Advisors to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 (“Wells Fargo Letter”)

Letter from Marcia E. Asquith, Senior Vice President and Corporate Secretary, FINRA to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 (“FINRA Letter”)

Letter from Dr. Bill Curtis, Director, Consortium for IT Software Quality to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 (“CISQ Letter”)

Letter from Howard Meyerson, General Counsel, Liquidnet, Inc., New York, New York to the Commission, dated July 8, 2013 (“Liquidnet Letter”)

Letter from David T. Bellaire, Esq., Executive Vice President and General Counsel, Financial Services Institute, Washington, District of Columbia to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 (“FSI Letter”)

Letter from Scott C. Goebel, General Counsel, Fidelity Management and Research Co., Boston, Massachusetts to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 (“Fidelity Letter”)

Letter from Joseph Adamczyk, Executive Director, Associate General Counsel, CME Group Inc. to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 (“CME Letter”)

Letter from Norman M. Reed, Omgeo LLC, New York, New York to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 ("Omgeo Letter")

Letter from David Lauer, Market Structure and Technology Architecture Consultant, Step Ahead Technologies, LLC to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 ("Lauer Letter")

Letter from Theodore R. Lazo, Managing Director and Associate General Counsel, SIFMA to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 ("SIFMA Letter")

Letter from Jeffrey Wallis, Managing Partner, SunGard Consulting Services, New York, New York to Elizabeth Murphy, Secretary, Commission, dated July 8, 2013 ("SunGard Letter")

Letter from Janet McGinness, EVP & Corporate Secretary, NYSE Euronext to Elizabeth Murphy, Secretary, Commission, dated July 9, 2013 ("NYSE Letter")

Letter from Eric J. Swanson, Secretary, BATS Global Markets to Elizabeth Murphy, Secretary, Commission, dated July 10, 2013 ("BATS Letter")

Letter from Mary Ann Burns, Futures Industry Association Principal Traders Group, Washington, District of Columbia to Elizabeth Murphy, Secretary, Commission, dated July 11, 2013 ("FIA PTG Letter")

Letter from James P. Selway, III, P. Mats Goebels and Sudhanshu Arya, ITG Inc. to Elizabeth Murphy, Secretary, Commission, dated July 11, 2013 ("ITG Letter")

Letter from Karrie McMillan, General Counsel, Investment Company Institute to Elizabeth Murphy, Secretary, Commission, dated July 12, 2013 ("ICI Letter")

Letter from Stuart J. Kaswell, Executive Vice President & Managing Director, Managed Funds Association, and Jiri Król, Deputy CEO, Head of Government and Regulatory Affairs, Alternative Investment Management Association to Elizabeth Murphy, Secretary, Commission, dated July 17, 2013 ("MFA Letter")

Letter from Anthony J. Saliba, Chief Executive Officer, LiquidPoint, LLC to Elizabeth Murphy, Secretary, Commission, dated July 22, 2013 ("LiquidPoint Letter")

Letter from Elizabeth K. King, Global Head of Regulatory Affairs, KCG Holdings, Inc., Jersey City, New Jersey to Elizabeth Murphy, Secretary, Commission, dated July 25, 2013 ("KCG Letter")

Letter from Roger Anerella, Managing Director, Global Head of Securities Execution Services, UBS Investment Bank to Elizabeth Murphy, Secretary, Commission, dated July 26, 2013 ("UBS Letter")

Letter from Eric Swanson, SVP, General Counsel and Secretary, BATS Global Markets, Inc., et al. to Elizabeth Murphy, Secretary, Commission, dated July 30, 2013 ("Joint SROs Letter")

Letter from Thomas S. Vales, Chief Executive Officer, TMC Bonds LLC to Elizabeth Murphy, Secretary, Commission, dated August 6, 2013 ("TMC Bonds Letter")

Letter from James J. Angel, Ph.D., CFA, Visiting Associate Professor, The Wharton School, University of Pennsylvania to the Commission, dated September 3, 2013 ("Angel2 Letter")

Letter from Benjamin R. Londergan, Chief Executive Officer, Group One Trading L.P. to Elizabeth Murphy, Secretary, Commission, dated September 3, 2013 ("Group One Letter")

Letter from Ari Gabinet, Executive Vice President and General Counsel, OFI Global Asset Management to Elizabeth Murphy, Secretary, Commission, dated September 9, 2013 ("Oppenheimer Letter")

Letter from Daniel Zinn, General Counsel, OTC Markets Group Inc. to Elizabeth Murphy, Secretary, Commission, dated September 12, 2013 ("OTC Markets Letter")

Letter from Dr. Bill Curtis, Director, Consortium for IT Software Quality to Elizabeth Murphy, Secretary, Commission, dated September 17, 2013 ("CISQ2 Letter")

Letter from William O'Brien, Chief Executive Officer, Direct Edge Holdings to Elizabeth M. Murphy, Secretary, Commission, dated September 25, 2013 ("Direct Edge Letter")

Letter from Richie Prager, Managing Director, Head of Trading & Liquidity Strategies, Hubert De Jesus, Managing Director, Co-Head of Market Structure & Electronic Trading, Supurna Vedbrat, Managing Director, Co-Head of Market Structure & Electronic Trading, and Joanne Medero, Managing Director, Government Relations & Public Policy, BlackRock, Inc. to Mary Jo White, Chair, Commission, dated September 12, 2014 ("BlackRock Letter").

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-73649; File No. S7-04-09)

November 19, 2014

**ORDER EXTENDING TEMPORARY CONDITIONAL EXEMPTION FOR
NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS FROM
REQUIREMENTS OF RULE 17g-5 UNDER THE SECURITIES EXCHANGE ACT OF
1934 AND REQUEST FOR COMMENT**

I. Introduction

On May 19, 2010, the Securities and Exchange Commission ("Commission") conditionally exempted, with respect to certain credit ratings and until December 2, 2010, nationally recognized statistical rating organizations ("NRSROs") from certain requirements in Rule 17g-5(a)(3)¹ under the Securities Exchange Act of 1934 ("Exchange Act"), which had a compliance date of June 2, 2010.² Pursuant to the Order, an NRSRO is not required to comply with Rule 17g-5(a)(3) until December 2, 2010 with respect to credit ratings where: (1) the issuer of the structured finance product is a non-U.S. person; and (2) the NRSRO has a reasonable basis to conclude that the structured finance product will be offered and sold upon issuance, and that any arranger linked to the structured finance product will effect transactions of the structured finance product after issuance, only in transactions that occur outside the U.S. ("covered transactions").³ On November 23, 2010, the Commission extended the conditional temporary exemption until December 2, 2011.⁴ On November 16, 2011, the Commission extended the conditional temporary exemption until December 2, 2012.⁵ On November 26, 2012, the

¹ See 17 CFR 240.17g-5(a)(3).

² See Exchange Act Release No. 62120 (May 19, 2010), 75 FR 28825 (May 24, 2010) ("Order").

³ See *id.* at 28827-28 (setting forth conditions of relief).

⁴ See Exchange Act Release No. 63363 (Nov. 23, 2010), 75 FR 73137 (Nov. 29, 2010) ("First Extension Order").

⁵ See Exchange Act Release No. 65765 (Nov. 16, 2011), 76 FR 72227 (Nov. 22, 2011) ("Second Extension Order").

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Commission extended the conditional temporary exemption until December 2, 2013.⁶ On November 22, 2013, the Commission extended the conditional temporary exemption until December 2, 2014.⁷ The Commission is extending the temporary conditional exemption exempting NRSROs from complying with Rule 17g-5(a)(3) with respect to rating covered transactions until December 2, 2015.

II. Background

Rule 17g-5 identifies, in paragraphs (b) and (c) of the rule, a series of conflicts of interest arising from the business of determining credit ratings.⁸ Paragraph (a) of Rule 17g-5⁹ prohibits an NRSRO from issuing or maintaining a credit rating if it is subject to the conflicts of interest identified in paragraph (b) of Rule 17g-5 unless the NRSRO has taken the steps prescribed in paragraph (a)(1) (*i.e.*, disclosed the type of conflict of interest in Exhibit 6 to Form NRSRO in accordance with Section 15E(a)(1)(B)(vi) of the Exchange Act¹⁰ and Rule 17g-1)¹¹ and paragraph (a)(2) (*i.e.*, established and is maintaining and enforcing written policies and procedures to address and manage conflicts of interest in accordance with Section 15E(h) of the Exchange Act).¹² Paragraph (c) of Rule 17g-5 specifically prohibits seven types of conflicts of interest. Consequently, an NRSRO is prohibited from issuing or maintaining a credit rating when it is subject to these conflicts regardless of whether it had disclosed them and established procedures reasonably designed to address them.

⁶ See Exchange Act Release No. 34-68286 (Nov. 26, 2012), 77 FR 71201 (Nov. 29, 2012) (“Third Extension Order”).

⁷ See Exchange Act Release No. 34-70919 (Nov. 22, 2013), 78 FR 70984 (Nov. 27, 2013) (“Fourth Extension Order”).

⁸ 17 CFR 240.17g-5(b) and (c).

⁹ 17 CFR 240.17g-5(a).

¹⁰ 15 U.S.C. 78o-7(a)(1)(B)(vi).

¹¹ 17 CFR 240.17g-1.

¹² 15 U.S.C. 78o-7(h).

In December 2009, the Commission adopted subparagraph (a)(3) to Rule 17g-5. This provision requires an NRSRO that is hired by an arranger to determine an initial credit rating for a structured finance product to take certain steps designed to allow an NRSRO that is not hired by the arranger to nonetheless determine an initial credit rating – and subsequently monitor that credit rating – for the structured finance product.¹³ In particular, under Rule 17g-5(a)(3), an NRSRO is prohibited from issuing or maintaining a credit rating when it is subject to the conflict of interest identified in paragraph (b)(9) of Rule 17g-5 (*i.e.*, being hired by an arranger to determine a credit rating for a structured finance product)¹⁴ unless it has taken the steps prescribed in paragraphs (a)(1) and (2) of Rule 17g-5 (discussed above) and the steps prescribed in new paragraph (a)(3) of Rule 17g-5.¹⁵ Rule 17g-5(a)(3), among other things, requires that the NRSRO must:

- Maintain on a password-protected Internet Web site a list of each structured finance product for which it currently is in the process of determining an initial credit rating in chronological order and identifying the type of structured finance product, the name of the issuer, the date the rating process was initiated, and the Internet Web site address where the arranger represents the information provided to the hired NRSRO can be accessed by other NRSROs;
- Provide free and unlimited access to such password-protected Internet Web site during the applicable calendar year to any NRSRO that provides it with a copy of the

¹³ See 17 CFR 240.17g-5(a)(3); see also Exchange Act Release No. 61050 (Nov. 23, 2009), 74 FR 63832 (Dec. 4, 2009) (“Adopting Release”) at 63844-45.

¹⁴ Paragraph (b)(9) of Rule 17g-5 identifies the following conflict of interest: issuing or maintaining a credit rating for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction that was paid for by the issuer, sponsor, or underwriter of the security or money market instrument. 17 CFR 240.17g-5(b)(9).

¹⁵ 17 CFR 240.17g-5(a)(3).

certification described in paragraph (e) of Rule 17g-5 that covers that calendar year;¹⁶
and

- Obtain from the arranger a written representation that can reasonably be relied upon that the arranger will, among other things, disclose on a password-protected Internet Web site the information it provides to the hired NRSRO to determine the initial credit rating (and monitor that credit rating) and provide access to the Web site to an NRSRO that provides it with a copy of the certification described in paragraph (e) of Rule 17g-5.¹⁷

¹⁶ Paragraph (e) of Rule 17g-5 requires that an NRSRO seeking to access the hired NRSRO's Internet Web site during the applicable calendar year must furnish the Commission with the following certification:

The undersigned hereby certifies that it will access the Internet Web sites described in 17 CFR §240.17g-5(a)(3) solely for the purpose of determining or monitoring credit ratings. Further, the undersigned certifies that it will keep the information it accesses pursuant to 17 CFR §240.17g-5(a)(3) confidential and treat it as material nonpublic information subject to its written policies and procedures established, maintained, and enforced pursuant to section 15E(g)(1) of the Act (15 U.S.C. 78o-7(g)(1)) and 17 CFR §240.17g-4. Further, the undersigned certifies that it will determine and maintain credit ratings for at least 10% of the issued securities and money market instruments for which it accesses information pursuant to 17 CFR §240.17g-5(a)(3)(iii), if it accesses such information for 10 or more issued securities or money market instruments in the calendar year covered by the certification. Further, the undersigned certifies one of the following as applicable: (1) In the most recent calendar year during which it accessed information pursuant to §17 CFR 240.17g-5(a)(3), the undersigned accessed information for [Insert Number] issued securities and money market instruments through Internet Web sites described in 17 CFR §240.17g-5(a)(3) and determined and maintained credit ratings for [Insert Number] of such securities and money market instruments; or (2) The undersigned previously has not accessed information pursuant to 17 CFR §240.17g-5(a)(3) 10 or more times during the most recently ended calendar year.

¹⁷ In particular, under paragraph (a)(3)(iii) of Rule 17g-5, the arranger must represent to the hired NRSRO that it will: (1) Maintain the information described in paragraphs (a)(3)(iii)(C) and (a)(3)(iii)(D) of Rule 17g-5 available at an identified password-protected Internet Web site that presents the information in a manner indicating which information currently should be relied on to determine or monitor the credit rating; (2) Provide access to such password-protected Internet Web site during the applicable calendar year to any NRSRO that provides it with a copy of the certification described in paragraph (e) of Rule 17g-5 that covers that calendar year, provided that such certification indicates that the nationally recognized statistical rating organization providing the certification either: (i) determined and maintained credit ratings for at least 10% of the issued securities and money market instruments for which it accessed information pursuant to paragraph (a)(3)(iii) of Rule 17g-5 in the calendar year prior to the year covered by the certification, if it accessed such information for 10 or more issued securities or money market instruments; or (ii) has not accessed information pursuant to paragraph (a)(3) of Rule 17g-5 10 or more times during the most recently ended calendar year; (3) Post on such password-protected Internet Web site all information the arranger provides to the NRSRO, or contracts with a third party to provide to the NRSRO, for the purpose of determining the initial credit rating for the security or money market instrument, including information about the characteristics of the assets underlying or referenced by the security or money market instrument, and the legal structure of the security or money market instrument, at the same time such information is

The Commission stated in the Adopting Release that subparagraph Rule 17g-5(a)(3) is designed to address conflicts of interest and improve the quality of credit ratings for structured finance products by making it possible for more NRSROs to rate structured finance products.¹⁸ For example, the Commission noted that when an NRSRO is hired to rate a structured finance product, some of the information it relies on to determine the rating is generally not made public.¹⁹ As a result, structured finance products frequently are issued with ratings from only the one or two NRSROs that have been hired by the arranger, with the attendant conflict of interest that creates.²⁰ The Commission stated that subparagraph Rule 17g-5(a)(3) was designed to increase the number of credit ratings extant for a given structured finance product and, in particular, to promote the issuance of credit ratings by NRSROs that are not hired by arrangers.²¹ The Commission's goal in adopting the rule was to provide users of credit ratings with more views on the creditworthiness of structured finance products.²² In addition, the Commission stated that Rule 17g-5(a)(3) was designed to reduce the ability of arrangers to obtain better than warranted ratings by exerting influence over NRSROs hired to determine credit ratings for structured finance products.²³ Specifically, by opening up the rating process to more NRSROs, the Commission intended to make it easier for the hired NRSRO to resist such pressure by

provided to the NRSRO; and (4) Post on such password-protected Internet Web site all information the arranger provides to the NRSRO, or contracts with a third party to provide to the NRSRO, for the purpose of undertaking credit rating surveillance on the security or money market instrument, including information about the characteristics and performance of the assets underlying or referenced by the security or money market instrument at the same time such information is provided to the NRSRO.

¹⁸ Adopting Release at 63844.

¹⁹ Id.

²⁰ Id.

²¹ Id.

²² Id.

²³ Id.

increasing the likelihood that any steps taken to inappropriately favor the arranger could be exposed to the market through the credit ratings issued by other NRSROs.²⁴

Rule 17g-5(a)(3) became effective on February 2, 2010, and the compliance date for Rule 17g-5(a)(3) was June 2, 2010.

III. Extension of Conditional Temporary Extension

In the Order, the Commission requested comment generally, but also on a number of specific issues.²⁵ The Commission received six comment letters in response to this solicitation of comment.²⁶ The commenters expressed concern that the extraterritorial application of Rule 17g-5(a)(3) could, in the commenter's view, among other things, disrupt local securitization markets,²⁷ inhibit the ability of local firms to raise capital,²⁸ and conflict with local laws.²⁹

Several commenters also requested that the conditional temporary exemption be extended or made permanent.³⁰ The First Extension Order again solicited public comment on issues raised in

²⁴ Id.

²⁵ See Order at 28828.

²⁶ Letter from Masamichi Kono, Vice Commissioner for International Affairs, Financial Services Agency, Japan, dated Nov. 12, 2010 ("Japan FSA Letter"); Letter from Masaru Ono, Executive Director, Securitization Forum of Japan, dated Nov. 12, 2010 ("SFJ Letter"); Letter from Rick Watson, Managing Director, Association for Financial Markets in Europe / European Securitisation Forum, dated Nov. 11, 2010 ("AFME Letter"); Letter from Jack Rando, Director, Capital Markets, Investment Industry Association of Canada, dated Sep. 22, 2010 ("IIAC Letter"); Letter from Christopher Dalton, Chief Executive Officer, Australian Securitisation Forum, dated Jun. 27, 2010 ("AuSF Letter"); Letter from Takefumi Emori, Managing Director, Japan Credit Rating Agency, Ltd. ("JCR"), dated Jun. 25, 2010 ("JCR Letter").

²⁷ See Japan FSA Letter; SFJ Letter; AFME Letter; JCR Letter; AuSF Letter.

²⁸ See AFME Letter; JCR Letter; AuSF Letter.

²⁹ See Japan FSA Letter; AFME Letter; JCR Letter; AuSF Letter; IIAC Letter. With respect to local laws, we note that the European Commission in recent months has issued a relevant proposal for amendments to the European Union Regulation on Credit Ratings. See "Regulation of the European Parliament and of the Council on amending Regulation (EC) No 1060/2009 on credit rating agencies" (available at http://ec.europa.eu/internal_market/securities/docs/agencies/100602_proposal_en.pdf).

³⁰ See Japan FSA Letter; SFJ Letter; AFME Letter; JCR Letter.

connection with the extra-territorial application of Rule 17g-5(a)(3).³¹ One commenter requested that the Order be made permanent, citing many of the same reasons set forth in prior comment letters.³² The Second Extension Order again solicited public comment on issues raised in connection with the extra-territorial application of Rule 17g-5(a)(3).³³ Commenters supported the exemption regarding the extra-territorial application of the Rule,³⁴ with one of those commenters again requesting that the Order be made permanent.³⁵ The Third Extension Order again solicited public comment on issues raised in connection with the extra-territorial application of Rule 17g-5(a)(3). No comments were received. The Fourth Extension Order again solicited public comment on issues raised in connection with the extra-territorial application of Rule 17g-5(a)(3). One comment was received and the commenter supported the exemption regarding the extra-territorial application of the Rule.³⁶

Given the continued concerns about potential disruptions of local securitization markets, and because the Commission's consideration of the issues raised will benefit from additional time to engage in further dialogue with interested parties and to monitor market and regulatory developments, the Commission believes extending the conditional temporary exemption until December 2, 2015 is necessary or appropriate in the public interest, and is consistent with the protection of investors.

³¹ See Letter from Tom Deutsch, Executive Director, American Securitization Forum, and Chris Dalton, Chief Executive Officer, Australian Securitization Forum, dated Aug. 9, 2011 ("ASF/AuSF Letter 1"); Letter from Jack Rando, Director, Capital Markets, Investment Industry Association of Canada, dated Nov. 2, 2011 ("IIAC Letter 2").

³² See ASF/AuSF Letter 1.

³³ Letter from Chris Barnard to the Commission, dated Nov. 23, 2011 ("Barnard Letter"); Letter from Tom Deutsch, Executive Director, American Securitization Forum and Chris Dalton, Chief Executive Officer, Australian Securitisation Forum, dated Aug. 28, 2012 ("ASF/AuSF Letter 2").

³⁴ See Barnard Letter; ASF/AuSF Letter 2.

³⁵ See ASF/AuSF Letter 2.

³⁶ See Letter from Chris Barnard to the Commission, dated Nov. 26, 2013.

IV. Request for Comment

The Commission believes that it would be useful to continue to provide interested parties opportunity to comment. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/exorders.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-04-09 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-04-09. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/exorders.shtml>). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F St. NE, Washington, DC 20549 on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

V. Conclusion

For the foregoing reasons, the Commission believes it would be necessary or appropriate in the public interest and consistent with the protection of investors to extend the conditional temporary exemption exempting NRSROs from complying with Rule 17g-5(a)(3) with respect to rating covered transactions until December 2, 2015.

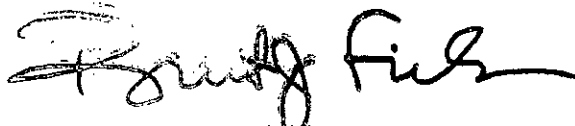
ACCORDINGLY,

IT IS HEREBY ORDERED, pursuant to Section 36 of the Exchange Act, that a nationally recognized statistical rating organization is exempt until December 2, 2015 from the requirements in Rule 17g-5(a)(3) (17 CFR 240.17g-5(a)(3)) for credit ratings where:

(1) The issuer of the security or money market instrument is not a U.S. person (as defined under Securities Act Rule 902(k)); and

(2) The nationally recognized statistical rating organization has a reasonable basis to conclude that the structured finance product will be offered and sold upon issuance, and that any arranger linked to the structured finance product will effect transactions of the structured finance product after issuance, only in transactions that occur outside the U.S.

By the Commission.



Brent J. Fields
Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73656 / November 20, 2014

ADMINISTRATIVE PROCEEDING
File Nos. 3-12749, 3-12750, and 3-12751

In the Matter of

**COMMONWEALTH EQUITY
SERVICES, LLP d/b/a
COMMONWEALTH FINANCIAL
NETWORK,**

Respondent.

**ORDER AUTHORIZING THE TRANSFER
OF REMAINING FUNDS AND ANY
FUTURE FUNDS RETURNED TO THE
FAIR FUND TO THE U.S. TREASURY,
DISCHARGING THE FUND
ADMINISTRATOR AND TERMINATING
THE FAIR FUND**

In the Matter of

**DETWILER, MITCHELL,
FENTON & GRAVES, INC.,**

Respondent.

In the Matter of

JAMES X. MCCARTY,

Respondent.

On September 6, 2007, the Securities and Exchange Commission ("Commission") issued settled orders instituting administrative proceedings, making findings, and imposing remedial sanctions pursuant to Section 15(b) of the Securities Exchange Act of 1934 against Commonwealth Equity Services, LLP d/b/a Commonwealth Financial Network ("Commonwealth") and Detwiler, Mitchell, Fenton & Graves, Inc. ("DMFG") (Exchange Act Rel. Nos. 56362 and 56363 (September 6, 2007)). In addition, the Commission issued a settled

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order instituting administrative proceedings, making findings, and imposing remedial sanctions pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 203(f) of the Investment Advisers Act of 1940 against James X. McCarty ("McCarty") (Exchange Act Rel. No. 56364 (September 6, 2007)) (collectively, "Orders"). The Commission found that Commonwealth, DMFG and McCarty (collectively, "Respondents") failed reasonably to supervise Bradford C. Bleidt with a view to preventing and detecting his violations of the federal securities laws. The Orders established a Fair Fund, comprised of \$550,003 in disgorgement and penalties paid by Respondents, and provided that the Fair Fund was to be distributed to injured investors. On February 12, 2008, the Commission issued an Order Approving Distribution Plan (Exchange Act Rel. No. 57310 (February 12, 2008)).

The distribution plan ("Plan") provides that the Fair Fund be distributed to investors defrauded by Bleidt from 1991 through November 2004. On May 21, 2008, the Commission entered an Order Directing Disbursement of Fair Fund in the amount of \$537,000 (Exchange Act Rel. No. 57843 (May 21, 2008)), and on June 2, 2008 this amount was distributed to 125 Eligible Investors. On August 12, 2010, the Commission issued a second Order Directing Disbursement of a Fair Fund in the amount of \$10,880.98 (Exchange Act Rel. No. 62705 (August 12, 2010)), and on August 23, 2010, this amount was distributed to the same 125 Eligible Investors. One check totaling \$44.14 from the second distribution was not negotiated and this amount remains in the Fair Fund.

The Fair Fund earned \$7,649.01 in interest. In addition, it paid \$775.00 in federal taxes, \$400 in District of Columbia taxes, \$7.66 in investment expenses to the Bureau of Public Debt, and \$8,774.37 was paid to the Tax Administrator for its fees and expenses. The amount remaining in the Fair Fund is \$2,478.57 and reflects the amount held in reserve to pay tax liabilities, fees and expenses, and one check for \$44.14 that was not negotiated.

The Plan provides that the Fair Fund shall be eligible for termination after all of the following have occurred: (1) a final accounting has been submitted by the Fund Administrator and approved by the Commission; (2) all taxes, fees and expenses have been paid; and (3) all remaining funds or any residual have been transferred to the United States Treasury. A final accounting, which was submitted to the Commission for approval as required by Rule 1105(f) of the Commission's Rules on Fair Fund and Disgorgement Plans and as set forth in the Plan, is now approved. Staff has verified that all taxes, fees, and expenses have been paid, and the Commission is in possession of the remaining Fair Fund monies.

Accordingly, IT IS ORDERED that:

- A. The remaining Fair Fund balance of \$2,478.57, and any future funds that are returned to the Fair Fund, shall be transferred to the U.S. Treasury;
- B. The Fund Administrator, Philip C. Koski, is discharged, and
- C. The Fair Fund is terminated.

By the Commission.

Brent J. Fields
Secretary



By: Lynn M. Powalski
Deputy Secretary

*Commissioner Aguilar
Commissioner Gallagher
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73654 / November 20, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-15913

In the Matter of

Wedbush Securities Inc.,
Jeffrey Bell, and Christina
Fillhart,

Respondents.

ORDER MAKING FINDINGS AND
IMPOSING REMEDIAL SANCTIONS
AND A CEASE-AND-DESIST ORDER
PURSUANT TO SECTION 21C OF THE
SECURITIES EXCHANGE ACT OF 1934
AS TO CHRISTINA FILLHART

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest to enter this Order Making Findings and Imposing Remedial Sanctions and a Cease-And-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") as to Christina Fillhart ("Respondent").¹

II.

Respondent has submitted an Offer of Settlement (the "Offer") that the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over her and over the subject matter of these proceedings, which are admitted, and except as provided herein in Section V, Respondent consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-And-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 as to Christina Fillhart ("Order"), as set forth below.

¹ On June 6, 2014, the Commission instituted public administrative and cease-and-desist proceedings pursuant to Sections 15(b) and 21C of the Exchange Act and Section 203(e) of the Advisers Act against Respondent Fillhart and co-respondents Wedbush Securities Inc. and Jeffrey Bell.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds² that:

Summary

1. These proceedings involve the market access business of Wedbush, one of the largest volume market access providers in the United States. From July 2011 until at least January 2013 (the "relevant period"), Wedbush served as the gateway to U.S. markets for dozens of trading firms, including foreign, domestic, registered, and unregistered firms, as well as thousands of their traders. Most of these firms and their traders engaged in trading activity that did not flow through any Wedbush systems before reaching exchanges and other trading venues in the U.S.

2. During the relevant period, Wedbush failed to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the risks associated with its market access business, as required by Exchange Act Rule 15c3-5 (the "Market Access Rule" or "Rule").³ Violations of the Market Access Rule pose significant risks to the orderly functioning of the U.S. securities markets. Wedbush allowed thousands of essentially anonymous foreign traders to send orders directly to U.S. trading venues to trade billions of shares every month. Wedbush enjoyed increased trading commissions and fees generated by its high-volume market access customers from its risky market access business.

3. Wedbush failed to adopt and implement risk management controls that were reasonably designed to ensure compliance with applicable regulatory requirements—such as those for preventing naked short sales, wash trades, manipulative layering and money laundering. Wedbush's failure to adopt and implement such controls came after communications by the Commission's staff through an examination deficiency letter and in face-to-face meetings regarding Wedbush's compliance procedures whereby the staff informed Wedbush of compliance shortcomings and significant compliance concerns, particularly the access provided to unknown overseas traders. By nonetheless failing to adopt and implement the necessary risk management controls, Wedbush willfully violated the Market Access Rule, while Fillhart caused Wedbush's violation of the Rule by virtue of her responsibilities at the firm and her participation in communications with the Commission's staff.

4. Wedbush's lack of reasonably-designed market access controls and procedures resulted in Wedbush violating other regulatory requirements, including Regulations SHO and NMS. Wedbush also failed to preserve certain written communications with customers pertaining to its business as required by Exchange Act Rule 17a-4, including communications containing trading instructions relating to brokerage orders submitted directly by Wedbush's market access customers. In connection with its market access business, Wedbush also failed to file suspicious activity reports pursuant to anti-money laundering ("AML") requirements in violation of Exchange Act Rule 17a-8.

² The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

³ 17 C.F.R. § 240.15c3-5.

Respondents

5. Wedbush Securities Inc. is a California corporation with its headquarters in Los Angeles, California. The firm was founded in 1955 and registered with the NASD as a broker-dealer in 1955, with the Commission as a broker-dealer in 1966 and as an investment adviser in 1970. Wedbush is a wholly-owned subsidiary of Wedbush, Inc., a privately-held company. As of December 31, 2012, Wedbush had 79 branch offices and 844 employees. During the relevant period, Wedbush was consistently ranked as one of the five largest firms by trading volume on NASDAQ.

6. During the relevant period, Jeffrey Bell was Executive Vice President of the Correspondent Services Division of Wedbush, reporting to the firm's President, and was an associated person of Wedbush. Bell also was President of Lime Brokerage LLC ("Lime"), another wholly-owned subsidiary of Wedbush, Inc. Bell, age 40, is a resident of Austin, Texas, and holds Series 7 and 24 licenses.

7. Christina Fillhart is a Senior Vice President in the Correspondent Services Division of Wedbush and is an associated person of Wedbush. Fillhart reported to Bell until late 2012, when she began reporting to one of Wedbush's Co-Chief Compliance Officers. Fillhart, age 56, is a resident of Covina, California, and holds Series 7, 24, 27, 53, and 63 licenses.

The Market Access Rule

8. The Commission adopted the Market Access Rule in November 2010 to require that broker-dealers with market access "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." *Risk Management Controls for Brokers or Dealers with Market Access*, 75 Fed. Reg. 69792, 69792 (Nov. 15, 2010) (Final Rule Release).

9. Section (b) of the Market Access Rule requires a broker-dealer with market access, or that provides a customer or any other person with access to an exchange through the use of its market participant identifier ("MPID") or otherwise, to "establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks" of its market access business.

10. Section (c) of the Market Access Rule identifies specific required elements of a broker-dealer's system of risk management controls and supervisory procedures relating to market access. Subsection (c)(1) addresses financial controls and procedures and subsection (c)(2) addresses regulatory controls and procedures. Under subsection (c)(2), a broker-dealer must have controls and procedures that are reasonably designed to ensure compliance with all regulatory requirements, including controls to prevent the entry of orders that do not comply with all regulatory requirements that must be satisfied on a pre-order entry basis and controls to restrict access to trading systems and technology that provide market access to persons and accounts pre-approved and authorized by the broker-dealer with market access.

11. Section (d) of the Market Access Rule requires the risk management controls and supervisory procedures to be under the "direct and exclusive control" of the broker-dealer with market access. Subsection (d)(1) contains an exception to the direct and exclusive control requirement that applies when a broker-dealer with market access reasonably allocates, by written contract, after a thorough due diligence review, control over specific regulatory risk management controls and supervisory procedures to a broker-dealer customer who is registered with an exchange in the United States where the broker or dealer with market access has a reasonable basis for determining that such broker-dealer customer, based on its position in the transaction and relationship with an ultimate customer, has better access to the ultimate customer and its trading information such that it can more effectively implement the specified controls or procedures.

12. Section (e) of the Market Access Rule requires a broker-dealer with market access to establish, document, and maintain a system for regularly reviewing the effectiveness of its risk management controls and supervisory procedures relating to market access. Subsection (e)(1) requires the broker-dealer to conduct and document a review of its market access business at least annually in accordance with written procedures, and subsection (e)(2) requires the CEO to certify annually that the broker-dealer conducted the review and is in compliance with the Rule.

Wedbush's Market Access Business

13. Wedbush's primary market access business is part of the Correspondent Services Division, which originally handled only traditional clearing operations for introducing broker-dealers, otherwise known as "correspondent" firms. Wedbush began providing "sponsored" market access to customer firms in 2004, which allowed customer firms and their traders to send orders that bypassed Wedbush's trading systems and were routed directly to exchanges and other trading venues under a Wedbush MPID. Sponsored access customers were able to send orders that bypassed Wedbush's systems by using online trading platforms or software programs that the customer either owned directly or leased from a third-party platform provider, referred to as a service bureau.

14. During the relevant period, Wedbush had about 50 sponsored access customers that generated average monthly trading volume of 10 billion shares. Several of Wedbush's sponsored access customer firms had hundreds or thousands of authorized traders each. Wedbush's correspondent services business was the most profitable operation of Wedbush, Inc. Bell and Fillhart each received bonus compensation based in part on the profitability of the Correspondent Services Division, which depended largely on the trading volumes of Wedbush's market access customers. During the relevant period, Bell received salary of \$344,000 and bonus compensation of \$310,000 and Fillhart received salary of \$150,000 and bonus compensation of \$105,000.

15. In June 2011, Wedbush acquired Lime Brokerage LLC, a provider of trading technology platforms. After Wedbush acquired Lime, about 20% of Wedbush's sponsored access customers began using the Lime platform. The other 80% continued to use sponsored access either through their own proprietary trading platform or through a third-party platform that the customer leased from a service bureau. As a result, during the relevant period, the vast majority of orders from Wedbush's sponsored access customers did not flow through Wedbush's own risk management systems.

16. Wedbush's primary risk management controls and supervisory procedures relating to market access were described in Chapter 31 of the firm's written supervisory procedures ("WSPs"), titled "Sponsored Access." On July 14, 2011, the day most provisions of the Market Access Rule took effect, Wedbush updated Chapter 31 to cite certain provisions of the Rule.

17. Bell and Fillhart, along with one other senior Wedbush employee in the Correspondent Services Division, had the primary responsibility for preparing and adopting Wedbush's controls and procedures relating to market access. Bell and Fillhart had authority to adopt and revise the firm's controls and procedures relating to market access, including the WSPs, without approval of Wedbush's President or Co-Chief Compliance Officers.

Wedbush Knew Of Compliance Issues For Its Sponsored Access Trading

18. Prior to the effective date of Rule 15c3-5, Wedbush received a number of indications that its sponsored access trading business posed particular regulatory and compliance risks. In 2009 and 2010, just before the relevant period, two of Wedbush's sponsored access customer firms extended their market access to a Latvian trader who used that access to conduct profitable trading as part of a widespread account intrusion and market manipulation scheme. The Commission obtained a judgment by default against the Latvian trader in connection with the scheme after learning the trader's identity from Fillhart in 2011. See *SEC v. Nagaicevs*, N.D. Cal. Case No. 12-CV-00413-JST (Order Granting Motion for Default Judgment, dated July 12, 2013; Order of Judgment and Equitable and Other Relief Against Defendant Igors Nagaicevs, dated July 18, 2013).

19. The Commission also imposed cease-and-desist orders, civil monetary penalties, and other relief against one of the Wedbush customer firms for acting as an unregistered broker in extending market access to the Latvian trader, and also obtained relief against the firm's principals. See *In the Matter of KM Capital Management, LLC, et al.*, Admin. Proc. File No. 3-14720 (Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 as to Yisroel M. Wachs, dated Sept. 19, 2012; Initial Decision as to KM Capital Management, LLC and Joshua A. Klein, dated Nov. 28, 2012; Notice that Initial Decision Has Become Final, dated Oct. 17, 2013).

20. Wedbush was well aware of the requirements, objectives, and importance of Rule 15c3-5. During the public comment period for the then-proposed Rule 15c3-5, Bell submitted a comment letter to the Commission on behalf of Wedbush on March 31, 2010. Bell also submitted a comment letter to the Commission on behalf of Wedbush on February 23, 2009 addressing a Nasdaq proposed rule change relating to sponsored market access, which was later approved by the Commission. Although proposing certain changes to the Nasdaq proposed rule, Bell and Wedbush stated in the 2009 comment letter that sponsoring non-broker-dealer customers "requires the highest level of due diligence, oversight and controls. In this case, the sponsoring member is also the broker-dealer of record and would be accountable for all the responsibilities as such." Despite this acknowledgement, one of Wedbush's largest sponsored access customers was not a broker-dealer registered in the United States, and Wedbush failed to engage in the "highest level of due diligence, oversight and controls."

21. On May 17, 2011, Commission staff from the Office of Compliance Inspections and Examinations ("OCIE") sent an Examination Deficiency Letter to Wedbush, which was addressed to Bell. That letter advised Wedbush that the staff had identified deficient Wedbush controls relating to short sales, in violation of Regulation SHO, due in part to an excessive reliance upon a non-broker-dealer sponsored access client to locate shares before placing a short sale order. The Deficiency Letter also identified problems with internal controls over a third-party order management system. The Letter also stated that Wedbush had failed to respond promptly to compliance issues when they arose and there were weaknesses in its anti-money-laundering controls. This letter put Wedbush on notice that it was relying on inadequate regulatory controls that were outside of its direct and exclusive control.

22. On July 5, 2011, Wedbush representatives, including Bell and Fillhart, met with representatives of OCIE to discuss the impending effectiveness of the final Rule 15c3-5. During that meeting, the Commission's staff expressed concerns about Wedbush's largest sponsored non-broker-dealer client and the need to identify the ultimate traders. Wedbush's presentation to the staff cited the Market Access Rule requirements relating to allocating compliance responsibilities to sponsored access broker-dealer clients and maintaining "direct and exclusive control" of risk settings in trading platforms.

Market Access Through Third-Party Trading Platforms

23. Section (d) of the Market Access Rule requires Wedbush to maintain exclusive control over the risk settings in the trading platforms that its customers use to access the markets, including both Wedbush's own Lime platform and the non-Wedbush trading platforms that 80% of Wedbush's customers used. As described below, for many customers that used non-Wedbush trading platforms, Wedbush's control was not exclusive because it allowed customers to have access to determine and make changes to risk settings in the trading platforms.

24. Wedbush did not directly set or monitor regulatory risk settings in the third-party or client-proprietary trading platforms that 80% of Wedbush's customers used. Customers had access to set and revise the risk settings, and could disable risk settings intended to prevent violations of specific regulatory requirements, such as illegal short sales, wash trades, and violations of Regulation NMS. In addition to Wedbush not having exclusive control over the settings, Wedbush's customers, rather than Wedbush, leased the trading platforms from third parties and Wedbush had no contractual relationship with the platform providers.

25. Wedbush employees in the Correspondent Services Division received access from platform providers to view risk settings and trading activity in the platforms, but Bell and Fillhart knew that Wedbush did not have exclusive control over the settings.

26. Shortly before most provisions of the Market Access Rule took effect, Wedbush obtained email statements from many of the trading platform providers that the risk management settings in the platforms were under the direct and exclusive control of Wedbush. In reality, Wedbush did not have exclusive control of the risk management settings because Wedbush continued allowing sponsored access customers to determine and make changes to the risk settings in the platforms, and Wedbush had no contractual relationship with the platform providers. These

statements also were not part of any legally enforceable contract; Wedbush had no contractual relationship with the platform providers.

27. Wedbush's WSPs stated that each new sponsored access customer would perform an initial "risk demonstration" to show Wedbush the customer's trading platform settings for certain financial and regulatory risk controls. Wedbush had a checklist for the risk demonstration that included settings to prevent clearly erroneous trades, wash trades, illegal short sales,⁴ and, unless authorized by Wedbush, intermarket sweep orders ("ISOs").⁵ That Wedbush needed the customer to show the settings to Wedbush demonstrates that Wedbush did not have "direct and exclusive control" over the risk settings in the platforms, as required by Rule 15c3-5(d).

28. In June 2012, platform providers, rather than sponsored access customers, provided Wedbush demonstrations of risk settings in their trading platforms. During a demonstration, the provider would submit test orders and confirm that certain risk settings were in place at the time of the demonstration.

29. Wedbush did not receive demonstrations of the actual risk settings in effect for particular sponsored access customers, and Wedbush did not have any physical ability to prevent customers from subsequently changing the settings shown during the platform provider's demonstration. Wedbush also did not maintain records of the risk settings in the platforms so that it could determine whether any settings had been changed without its consent.

30. Customers could, and sometimes did, change the risk settings without Wedbush's knowledge or consent. For example, as discussed below, Fillhart learned that on numerous occasions a risk setting to prevent illegal short sales failed to prevent violations of Regulation SHO because the wrong list of securities that were easy to borrow was loaded into the customer's third-party trading platform. Fillhart also learned that a customer repeatedly circumvented a risk setting that was designed to prevent the use of ISOs. For other risk settings, such as controls to prevent wash trades, Wedbush often did not require customers or platform providers to activate the settings.

Attempts to Allocate Responsibility for Regulatory Controls and Procedures

31. The Final Rule Release for the Market Access Rule stated that Section 15c3-5(d) "is designed to eliminate the practice . . . whereby the broker-dealer providing market access relies on

⁴ Rule 203(b)(1) of Regulation SHO prohibits broker-dealers from accepting or effecting a short sale order unless the broker-dealer has borrowed the security or entered into an arrangement to borrow the security, or has reasonable grounds to believe that the security can be timely borrowed, and has documented its compliance with Rule 203(b)(1).

⁵ Rule 611(c) of Regulation NMS requires the broker-dealer responsible for routing an ISO to take reasonable steps to establish that the order meets the requirements of Rule 600(b)(30) of Regulation NMS, which requires the broker-dealer routing the ISO to route simultaneously additional orders, as necessary, to execute against the full size of all better-priced protected quotations.

its customer, a third party service provider, or others, to establish and maintain the applicable risk controls." *See* 75 Fed. Reg. at 69804. The Final Rule Release further cautioned that "the Commission continues to be concerned about circumstances where broker-dealers providing market access simply rely on assurances from their customers that appropriate risk controls are in place. . . . Accordingly, the Commission emphasizes that in any permitted allocation arrangement, the broker-dealer providing market access may not merely rely on another broker-dealer's attestation that it has implemented appropriate controls or procedures." *Id.* at 69808.

32. After the Market Access Rule took effect, Wedbush simply relied on attestations in the exact manner that the Final Rule Release said was improper. Wedbush attempted to assign to other broker-dealers the responsibility for regulatory risk management controls and supervisory procedures for many of its sponsored access customers. Wedbush employees documented purported agreements to assign responsibilities to other broker-dealers, but as described below, despite the plain language of Rule 15c3-5(d) and the staff's statements on July 5, 2011, Wedbush failed to conduct the required "thorough due diligence review" when purporting to allocate responsibility to another broker-dealer and continued to simply rely on the other broker-dealer's attestation that it had implemented appropriate controls and procedures.

33. For some customers, Wedbush entered into an allocation agreement with a registered introducing broker-dealer. For other customers, Wedbush entered into an allocation agreement directly with the sponsored access customer itself, if it was a registered broker-dealer trading its own capital on a proprietary basis. Some of these sponsored access customers used trading platforms that they themselves owned, either directly or through a corporate affiliate that they controlled. As a result, Wedbush often relied on a broker-dealer customer to monitor its own trading.

34. All of Wedbush's purported allocation agreements were based on the same form, which Bell approved. The agreements did not specify any particular controls or procedures that Wedbush purported to be allocating. Even though Wedbush, as the party with market access, purportedly was attempting to allocate responsibility for controls or procedures to another broker-dealer, the agreements mistakenly stated that the other broker-dealer, rather than Wedbush, had "allocatable regulatory responsibilities as defined within SEC Rule 15c3-5." As a result, it was not even clear from the documents themselves from and to which broker-dealer the controls or procedures purportedly were being allocated.

35. Bell knew or should have known that Wedbush did not conduct the required due diligence reviews of the other broker-dealers in connection with its attempts to allocate responsibilities for market access controls and procedures, and that Wedbush also did not conduct later reviews to determine whether the other broker-dealers were adequately carrying out the responsibilities purportedly allocated. The agreements simply contained a statement by the introducing broker-dealer or registered customer firm that its regulatory risk management controls and supervisory procedures were reasonably designed to ensure compliance with all regulatory requirements.

36. Better access to the ultimate customer was discussed in the Final Rule Release as the reason why control over certain regulatory controls could be allocated after due diligence. Yet

Wedbush did not have any policies or procedures for determining whether a broker-dealer to which it claimed to have assigned responsibilities had better access than Wedbush to ultimate customers such that the other broker-dealer could more effectively implement the risk management controls and supervisory procedures relating to market access.

Regulatory Requirements That Must Be Satisfied On a Pre-Order Entry Basis

37. Subsection (c)(2)(i) of the Market Access Rule required Wedbush to have risk management controls and supervisory procedures that were reasonably designed to prevent the entry of orders that do not comply with all regulatory requirements that must be satisfied on a pre-order entry basis. The Final Rule Release for the Market Access Rule specifically identified Regulations SHO and NMS as examples of regulatory requirements that must be satisfied on a pre-order entry basis, and with which a broker-dealer's controls and procedures must ensure compliance. *See* 75 Fed. Reg. at 69803. As described below, Wedbush's risk management controls and supervisory procedures were not reasonably designed to satisfy these pre-trade regulatory requirements and, in fact, did not prevent Wedbush customers from entering numerous orders that violated Regulations SHO and NMS.

38. Wedbush was responsible for ensuring that all short-sale orders submitted by its sponsored access customers complied with Regulation SHO. Among other things, Regulation SHO required Wedbush, prior to accepting or effecting a short sale order, to borrow the security or enter into an agreement to borrow the security, or have reasonable grounds to believe that the security could be timely borrowed (generally known as the "locate" requirement). Absent countervailing factors, "easy-to-borrow" lists may provide "reasonable grounds" for a broker-dealer to believe that the security sold short is available for borrowing without directly contacting the source of the borrowed securities (known as "easy-to-borrow securities"). Thus, for instance, if a broker-dealer seeking to rely on the list knows or should know that there are concerns regarding the list, it would not be reasonable for the broker-dealer to rely on the list. As an example, the Commission has stated that repeated failures to deliver in securities included on an "easy-to-borrow" list would indicate that the broker-dealer's reliance on such a list did not satisfy the "reasonable grounds" standard of Rule 203. *See Short Sales*, 69 Fed. Reg. 48008, 48014 (Aug. 6, 2004).

39. Wedbush's WSPs stated that the firm sometimes relied on sponsored access customers to meet the short-sale requirements of Regulation SHO. Wedbush maintained a list of easy-to-borrow securities, but Wedbush relied on sponsored access customers or their platform providers to load that list into third-party trading platforms rather than taking direct steps to make sure that customers were using the correct list. Maintaining up-to-date lists in the trading platforms was a key step in the control process because the platforms relied on the lists to determine whether Regulation SHO had been satisfied before routing a short-sale order for execution.

40. Wedbush's procedures asserted that Wedbush allowed customers to submit short-sale orders for securities on the easy-to-borrow list and that it required customers to otherwise locate shares to borrow before submitting short-sale orders for securities not on the easy-to-borrow list. However, if a customer or platform provider failed to load the correct easy-to-borrow list, Wedbush had no controls or procedures to prevent the customer from submitting a short-sale order for a security that was not easy-to-borrow without first obtaining a locate.

41. On three occasions between July 2011 and November 2012, Fillhart learned that a customer or platform provider loaded the wrong easy-to-borrow list, which resulted in Wedbush customers submitting short-sale orders for securities that were not easy to borrow without first having located shares that it had reasonable grounds to believe could be timely borrowed as required by Regulation SHO. Bell and Fillhart knew that similar incidents had occurred numerous times before July 2011, based on the May 2011 OCIE Deficiency Letter and face-to-face meetings that Bell and Fillhart attended with Commission staff. The incidents demonstrated that Wedbush did not have "direct and exclusive control" over these risk settings in the trading platforms as required by Rule 15c3-5(d) and did not have controls reasonably designed to ensure compliance with all regulatory requirements that must be satisfied on a pre-order entry basis.

42. Wedbush was responsible for ensuring that all orders marked as ISOs by its sponsored access customers complied with Regulation NMS, which requires the broker-dealer responsible for routing an ISO to route simultaneously additional orders, as necessary, to execute against the full size of all better-priced protected quotations. Sending the simultaneous orders to sweep the market of better-priced protected quotations is essential to ensuring that the ISO order type is not misused and that other market participants willing to trade at more favorable prices do not have their orders bypassed.

43. Wedbush's WSPs asserted that in order to comply with Regulation NMS, Wedbush did not permit a customer to use ISOs unless the customer swept the market of all better-priced protected quotations. However, Wedbush did not have any controls or procedures reasonably designed to ensure that its customers complied with this regulatory requirement.

44. As a result of Wedbush's lack of "direct and exclusive control" over risk settings designed to ensure ISO compliance, and its failure to have controls and procedures reasonably designed to ensure compliance with the ISO requirements of Regulation NMS, at least one Wedbush customer submitted ISOs without Wedbush's prior knowledge and without a broker-dealer acting to ensure compliance with the relevant regulatory requirements. In April 2011, Fillhart learned from an exchange that one of Wedbush's largest sponsored access customers was submitting ISOs even though Wedbush did not authorize the customer to submit ISOs and even though Wedbush had not allocated responsibility to another registered broker-dealer to ensure that ISOs submitted by the customer complied with Regulation NMS. Without Wedbush's knowledge, the customer and its third-party platform provider had enabled an order route that was configured to allow ISOs, even though the platform provider had previously informed Wedbush that the customer was not able to submit ISOs. This also demonstrated that it was unreasonable for Wedbush to rely on the written attestations that it received from the platform providers, as described above.

45. Because Wedbush had not authorized the customer to submit ISOs, Wedbush had not taken any steps to ensure that the ISOs complied with Regulation NMS. Fillhart instructed the platform provider to close the ISO route, but she did not directly close or disable the route and she knew that Wedbush did not have any controls or procedures to prevent a similar route from being enabled again in the future.

46. In November 2011, Fillhart learned that the same customer had again enabled an ISO route in its trading platform and submitted ISOs without Wedbush's knowledge. As in April

2011, Wedbush had not taken any steps to ensure that the ISOs complied with Regulation NMS because Wedbush had not authorized the customer to submit ISOs. These incidents demonstrate that Wedbush did not have "direct and exclusive control" over these risk settings as required by Rule 15c3-5(d), and did not have controls reasonably designed to ensure compliance with all regulatory requirements that must be satisfied on a pre-order entry basis.

Other Regulatory Requirements

47. Subsection (c)(2) of the Market Access Rule required Wedbush to have risk management controls and supervisory procedures that were reasonably designed to ensure compliance with all existing regulatory requirements. Wedbush did not have controls and procedures in connection with its market access business that were reasonably designed to ensure that Wedbush complied with all AML reporting and recordkeeping requirements applicable to Wedbush.

48. Exchange Act Rule 17a-8 requires broker-dealers to comply with the reporting, recordkeeping, and record retention requirements of the regulations adopted by the Department of the Treasury pursuant to the Bank Secrecy Act. The Bank Secrecy Act requires financial institutions such as broker-dealers to establish AML programs that include, among other things, internal policies, procedures, and controls, and authorizes the Department of the Treasury to adopt regulations prescribing minimum standards for AML programs. 31 U.S.C. §§ 5318(h)(1) and (2). Treasury regulations require broker-dealers to file reports of any suspicious transactions relevant to a possible violation of law or regulation, 31 C.F.R. § 1023.320, and state that broker-dealers regulated by a self-regulatory organization ("SRO") are deemed to satisfy the Bank Secrecy Act's AML program requirements if they comply with the AML program requirements of their SRO. 31 C.F.R. § 1023.210.

49. Wedbush's SRO, FINRA, requires its members to establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of suspicious transactions as required by the Bank Secrecy Act and Treasury regulations thereunder. See FINRA Rule 3310. As described below, on numerous instances Fillhart became aware of potential wash trading and other forms of potential manipulation, but she did not cause Wedbush to file reports regarding the suspicious activity, and Wedbush's policies and procedures did not cause Wedbush to detect suspicious activity and file such reports.

50. Wedbush's WSPs asserted that it did not permit its customers to execute wash and pre-arranged trades. Wedbush's WSPs defined "wash trades" as "transactions which result in no beneficial change of ownership" and defined a "pre-arranged trade" as "an offer to sell coupled with an offer to buy back at the same or at an advanced price, or the reverse."

51. In most of the trading platforms used by Wedbush sponsored access customers, individual traders were identified by a unique trader ID. While most traders received a single trader ID, on some occasions a single trader had multiple trader IDs. Wedbush did not have any controls or filters to prevent a single trader from trading with himself or herself in a customer firm's account, or to prevent two different traders from trading with each other in a customer firm's account.

52. Most trading platforms used by Wedbush's customers had risk settings to prevent potential wash trades, but Wedbush often did not require customers or platform providers to activate the settings, and Wedbush had no controls or procedures to prevent customers or platform providers from deactivating the settings if they were activated. Some exchanges offered functionality to block wash trades, but Wedbush had no controls or procedures requiring customers to use this anti-wash trade functionality.

53. Wedbush personnel responsible for filing suspicious activity reports pursuant to the Bank Secrecy Act relied on Fillhart and other employees in the Correspondent Services Division, which Bell oversaw, to review trading activity by sponsored access customers to determine whether it was relevant to potential violations of securities laws or regulations. But Bell and Fillhart knew or should have known that Wedbush did not have policies or procedures describing how Correspondent Services employees were to review trading to determine whether it was suspicious and should be reported.

54. The WSPs stated that Wedbush would review reports of potential wash trades from vendors and exchanges, determine whether there were potential securities violations, and if so, obtain representations from sponsored access customers regarding their internal wash trade reviews and systems.

55. A Wedbush employee who reported to Fillhart received reports of potential wash or pre-arranged trades from exchanges on a daily basis during the relevant period. For most of the trades on the reports, which involved two trader IDs in a single customer account, Fillhart did not ask the Wedbush employee to follow up with the customer firm because Fillhart assumed the two traders were independent and did not consider the trading suspicious. No one from Wedbush ever attempted to contact traders to determine whether they were pre-arranging their trades.

56. For trades with a single trader ID on both sides, Fillhart relied on the customer firm to follow up with the trader. On many occasions, the customer simply responded that it was not wash trading or was an error. On some occasions, the customer did not respond at all. Fillhart generally did not ask the Wedbush employee to follow up with customers for further explanation and did not report the trading to the AML officer as suspicious.

57. In February and March 2012, Fillhart learned from exchanges that numerous traders in the account of one of Wedbush's largest sponsored access customers, which had recently become a customer of a Wedbush correspondent broker-dealer under common ownership with the customer, appeared to be engaged in wash or pre-arranged trading. The customer and correspondent broker-dealer had not enabled pre-trade controls in the trading platform used by the customer that would have prevented wash or pre-arranged trades, and Wedbush did not take steps to enable such controls. The customer and correspondent broker-dealer informed Wedbush that they would either enable the controls in the platform or send future orders through a route that blocked wash trades. Fillhart did not directly enable the risk controls and Wedbush did not take any steps to ensure that the customer or correspondent broker-dealer either enabled the controls or sent future orders through a route that blocked wash trades.

58. The correspondent broker-dealer informed Wedbush that it had disabled one of the traders involved in the incidents, but Wedbush did not directly disable any of the traders. Wedbush had no controls or procedures for preventing traders who had been disabled by a customer or correspondent broker-dealer from obtaining a new trader ID through the same or a different Wedbush customer account.

59. On multiple occasions, Fillhart learned from exchanges that traders in the same customer account appeared to be engaged in potentially manipulative trading referred to as “layering,” which involves submitting and cancelling large numbers of non-*bona fide* orders on one side of the market in order to obtain executions at more favorable prices for smaller *bona fide* orders on the other side. See, e.g., *In the Matter of Hold Brothers On-Line Investment Services, LLC, et al.*, Admin. Proc. File No. 3-15046 (Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 and Section 9(b) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and Cease-and-Desist Orders, dated Sept. 25, 2012), at 5-6.

60. As early as February 2011, Fillhart notified the customer of potential layering activity in its account and told the customer that layering “is a manipulative activity.” Until at least September 2012, Fillhart continued receiving reports from exchanges of potential layering activity through the same customer account, but she did not cause Wedbush to develop or acquire any tools to detect or cause the reporting of potential layering activity and did not warn the customer’s principals that the account would be disabled if the trading activity continued.

61. In late 2011, Bell and Fillhart met with another senior officer in the Correspondent Services Division to discuss the substantial compliance risks posed to Wedbush by sponsored access customers like the one that had been the subject of numerous reports of potential layering and wash trading and had been addressed in face-to-face meetings with Commission staff—the customer that had thousands of essentially anonymous foreign traders trading through a single Wedbush customer account. Bell, Fillhart, and the other officer decided not to terminate the customer’s relationship with Wedbush, but agreed that Wedbush should not take on new market access customers with similar business models because of the compliance risks to Wedbush. In October 2012, Bell, Fillhart, and the other officer met again and decided to terminate Wedbush’s relationship with the customer.

62. During the relevant period, Wedbush did not file any suspicious activity reports relating to potential layering and filed only two suspicious activity reports relating to potential wash or pre-arranged trading. More broadly, Fillhart knew that Wedbush did not review for a variety of manipulative trading practices, including fictitious orders, marking the open or marking the close, traders at a Wedbush customer trading a security between each other to manipulate the price of the security, manipulating securities prices through wash trades, or layering.

Authorization of Traders

63. Subsection (b) of the Market Access Rule requires a broker-dealer with market access, or that provides a customer or any other person with access to an exchange or ATS through the use of its MPID or otherwise, to “establish, document, and maintain a system of risk

management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks” of its market access business. Subsection (c)(2)(iii) of the Market Access Rule required Wedbush to have risk management controls and supervisory procedures that were reasonably designed to restrict access to trading systems and technology that provide market access to persons and accounts pre-approved and authorized by Wedbush, the broker-dealer with market access. As described below, for many of its largest sponsored access customers, Wedbush only pre-approved and authorized the principals for the account and relied on its customer to pre-approve and authorize the thousands of individual traders who received market access through the account without reasonably designed controls and supervisory procedures to restrict access to trading systems and technology that provide market access to persons and accounts pre-approved and authorized by the broker or dealer. Accordingly, Wedbush failed to have controls and procedures that complied with Subsection (c)(2)(iii) of the Market Access Rule. Wedbush also did not effectively allocate these obligations, to the extent permitted by Subsection (d)(1) of the Market Access Rule, to its registered broker-dealer customers.

64. Wedbush’s WSPs asserted that sponsored access customers were required to provide authorized trader information to Wedbush “upon commencement of sponsored access and when a change occurs.” The WSPs also asserted that Wedbush would verify authorized trader information annually. Wedbush did not have any controls or procedures requiring customers to obtain approval from Wedbush before authorizing new traders.

65. When Wedbush opened a sponsored access account, Wedbush employees obtained identifying information and performed background checks only on the principals of the entity opening the account, not on other individuals that the entity authorized to trade through the account. While customers sometimes copied a Wedbush employee on their emails instructing platform providers to authorize new traders to trade through the customer’s account, Wedbush did not have any written policies or procedures for pre-approving or authorizing new traders for existing sponsored access accounts.

66. Some customer firms and platform providers used a one-page “AccountID creation form” that called for certain information about each authorized trader, but Wedbush did not require use of the form and Wedbush rarely obtained copies of the forms from customers. There was a section on the form for approval of the trader’s access, but neither Wedbush nor the customers completed that section of the form.

67. For customer firms with hundreds or thousands of traders, Wedbush usually relied on the customer firm to maintain a list of authorized traders and their trader IDs. Beginning in September 2011, Wedbush employees who reported to Fillhart occasionally obtained lists of authorized traders from customer firms with large numbers of traders and ran searches by name to determine whether any traders were subject to sanctions or restrictions on business activity by the Office of Foreign Assets and Control (OFAC), an office with the Department of the Treasury that administers economic and trade sanctions based on U.S. foreign policy and national security goals. These searches were done after, not before, the customer firm extended market access to the traders. OFAC’s programs are separate and distinct from the AML requirements imposed on broker-dealers by Exchange Act Rule 17a-8 and underlying Treasury regulations.

68. For customer firms with hundreds or thousands of traders, neither Fillhart nor Bell asked Wedbush employees to take any steps to verify trader names or identities or to speak to any of the traders. Bell and Fillhart knew that Wedbush relied exclusively on the customer firms, some of which were not registered broker-dealers, to confirm trader identities and oversee their trading strategies. Fillhart herself had the experience of being unable to find a list of trader information for a particular Wedbush client. Because of these facts, particularly the component of Wedbush's business that provided sponsored access to hundreds or thousands of traders through Wedbush's customers, Wedbush's controls and procedures for the pre-approval and authorization of traders were not reasonable. As noted above, Wedbush also did not effectively allocate these obligations, to the extent permitted by Subsection (d)(1) of the Market Access Rule, to its registered broker-dealer customers.

Review of Effectiveness of Market Access Controls and Procedures

69. Section (e) of the Market Access Rule required Wedbush to establish, document, and maintain a system for regularly reviewing the effectiveness of its risk management controls and supervisory procedures relating to market access and to conduct a review of its market access business in accordance with written procedures at least annually. Wedbush did not have any written procedures for regularly reviewing the effectiveness of its market access controls and procedures, and Bell and Fillhart both acknowledged that they had primary responsibility for designing and implementing Wedbush's controls and procedures relating to its market access business. As described below, the only review relating in any way to the market access business that Wedbush conducted during the relevant period did not mention the Market Access Rule or any specific risk management controls or supervisory procedures relating to market access.

70. On Friday, March 23, 2012, in preparation for Wedbush's required certification of supervisory controls pursuant to SRO rules, one of Wedbush's Co-Chief Compliance Officers asked the two internal audit employees at Wedbush to review five areas of Wedbush's business, including one described as "High Frequency Trading." The memorandum containing this request did not mention the Market Access Rule, any other Commission rules, or sponsored access.

71. The internal audit employees prepared a written report dated Monday, March 26, 2012, describing their review, including one page relating to "High Frequency Trading/Exchange Traded Funds." The report did not mention the Market Access Rule, any other Commission rules, sponsored access, Wedbush's WSPs, or any specific risk management controls or supervisory procedures that Wedbush had adopted to comply with the Rule.

72. According to the report, the employees reviewed documents, observed procedures, and spoke with three employees in the Correspondent Services Division as part of the review. The report cited two specific steps—reviewing the checklist for onboarding new customers and observing software applications used for monitoring customer buying power and trading activities. The report noted that the software applications included risk management settings, but did not state that any specific settings were reviewed or tested.

73. The report concluded that, based on the internal audit employees' review, management's controls in the "High Frequency Trading/Exchange Traded Funds" area were adequate and functioning as intended.

74. The Co-Chief Compliance Officer incorporated this section of the report verbatim in a report that he sent to Wedbush's President and the rest of Wedbush's management team and Board on March 30, 2012. Like the internal audit report, this report did not mention the Market Access Rule, any other Commission rules, sponsored access, Wedbush's WSPs, or any specific risk management controls or supervisory procedures that Wedbush had adopted to comply with the Rule. No other reviews of the market access business were conducted by Wedbush employees during the relevant period.

75. Based on the report, as well as conversations with and information previously provided by Bell and others, Wedbush's President signed a certification dated March 30, 2012, citing SRO rules and Rule 15c3-5 (the Market Access Rule), and stating that the firm's risk management controls and supervisory procedures in connection with market access complied with Rule 15c3-5. For the reasons described above, that certification was inaccurate.

Preservation of Records

76. Section 17(a) of the Exchange Act and Rule 17a-4(b)(4) thereunder require broker-dealers to preserve for three years originals of all communications received and copies of all communications sent relating to its business as such. Wedbush did not preserve originals or copies of communications containing trading instructions relating to ISOs submitted by some of its customers under a Wedbush MPID through third-party trading platforms. As a result, Wedbush employees could not determine which orders submitted by those customers during the relevant period were ISOs.

Violations

77. Section 15(c)(3) of the Exchange Act requires broker-dealers to comply with the Commission's rules regarding safeguards, financial responsibility, and related practices of broker-dealers. Rule 15c3-5 thereunder requires broker-dealers with market access to establish, document, and maintain a system of risk management controls and supervisory procedures that is reasonably designed to manage the financial, regulatory, and other risks of its market access business; to maintain direct and exclusive control over the market access controls and procedures; and to establish, document, and maintain a system for regularly reviewing the effectiveness of its risk management controls and supervisory procedures relating to market access. As discussed above, Wedbush willfully violated Section 15(c)(3) of the Exchange Act and Rule 15c3-5 thereunder because it did not maintain exclusive control over risk management controls in sponsored access trading platforms; did not have a system of risk management controls and supervisory procedures that was reasonably designed to ensure compliance with all regulatory requirements, including those that must be satisfied on a pre-order entry basis; did not have controls and procedures reasonably designed to restrict access to market access trading systems to persons and accounts pre-approved and authorized by Wedbush; did not establish, document, and maintain a system for regularly reviewing the effectiveness of its risk management controls and supervisory procedures relating to

market access; and did not conduct an adequate review of its market access controls and procedures during the relevant period.

78. Under Section 21C(a) of the Exchange Act, a person is a cause of a securities violation if there is an underlying primary violation to which an act or omission of the person contributed and the person knew or should have known that his or her conduct would contribute to the violation. As discussed above, Fillhart was a cause of Wedbush's violation of Rule 15c3-5 because her acts and omissions contributed to Wedbush's violation and she knew or should have known that her conduct would contribute to the violation.

Civil Penalties

79. Respondent has submitted a sworn Statement of Financial Condition dated September 3, 2014 and other evidence and has asserted her inability to pay a civil penalty.

IV.

In view of the foregoing, the Commission deems it appropriate in the public interest to impose the sanctions agreed to in Respondent Fillhart's Offer.

Accordingly, pursuant to Section 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent Fillhart cease and desist from committing or causing any violations and any future violations of Section 15(c)(3) of the Exchange Act and Rule 15c3-5 promulgated thereunder.

B. Respondent Fillhart shall, within ten (10) days of the entry of this Order, pay disgorgement of \$25,000, which represents profits gained as a result of the conduct described herein, and prejudgment interest of \$1,478.31 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment must be made in one of the following ways: (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Christina Fillhart as a Respondent in these proceedings and the file number of these

proceedings; a copy of the cover letter and check or money order must be sent to Daniel M. Hawke, Chief, Market Abuse Unit, U.S. Securities and Exchange Commission, One Penn Center, 1617 JFK Boulevard, Suite 520, Philadelphia, PA 19103, with a copy to Steven D. Buchholz, Assistant Regional Director, U.S. Securities and Exchange Commission, 44 Montgomery Street, 28th Floor, San Francisco, CA 94104.

C. Respondent Fillhart shall pay a civil money penalty in the amount of \$25,000 to the Securities and Exchange Commission, but payment of \$15,000 of such amount and payment of post-judgment interest are waived based upon Respondent's sworn representations in her Statement of Financial Condition dated September 3, 2014 and other documents submitted to the Commission. Payment of the remaining \$10,000 shall be made in 36 monthly installments of \$277.78, with the first payment due within 10 days of the entry of this Order or on December 1, 2014, whichever is later, and each subsequent payment due on the 1st business day of the month, with the final payment due on November 1, 2017. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance, plus any interest accrued pursuant to SEC Rule of Practice 600 or 31 U.S.C. § 3717, shall be due and payable immediately, without further application.

Payment must be made in one of the following ways: (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Christina Fillhart as a Respondent in these proceedings and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Daniel M. Hawke, Chief, Market Abuse Unit, U.S. Securities and Exchange Commission, One Penn Center, 1617 JFK Boulevard, Suite 520, Philadelphia, PA 19103, with a copy to Steven D. Buchholz, Assistant Regional Director, U.S. Securities and Exchange Commission, 44 Montgomery Street, 28th Floor, San Francisco, CA 94104.

D. The Division of Enforcement may, at any time following the entry of this Order, petition the Commission to: (1) reopen this matter to consider whether Respondent provided accurate and complete financial information at the time such representations were made; and (2) seek an order directing payment of the maximum civil penalty allowable under the law. No other issue shall be considered in connection with this petition other than whether the financial information provided by Respondent was fraudulent, misleading, inaccurate, or incomplete in any material respect. Respondent may not, by way of defense to any such petition: (1) contest

the findings in this Order; (2) assert that payment of a penalty should not be ordered; (3) contest the imposition of the maximum penalty allowable under the law; or (4) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondent, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

A handwritten signature in cursive script, appearing to read "Brent J. Fields".

Brent J. Fields
Secretary

*Commissioner Aguilar
Commissioner Gallagher
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73653 / November 20, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-15913

In the Matter of

Wedbush Securities Inc.,
Jeffrey Bell, and Christina
Fillhart,

Respondents.

ORDER MAKING FINDINGS AND
IMPOSING REMEDIAL SANCTIONS
AND A CEASE-AND-DESIST ORDER
PURSUANT TO SECTION 21C OF THE
SECURITIES EXCHANGE ACT OF 1934
AS TO JEFFREY BELL

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest to enter this Order Making Findings and Imposing Remedial Sanctions and a Cease-And-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") as to Jeffrey Bell ("Respondent").¹

II.

Respondent has submitted an Offer of Settlement (the "Offer") that the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and over the subject matter of these proceedings, which are admitted, and except as provided herein in Section V, Respondent consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-And-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934 as to Jeffrey Bell ("Order"), as set forth below.

¹ On June 6, 2014, the Commission instituted public administrative and cease-and-desist proceedings pursuant to Sections 15(b) and 21C of the Exchange Act and Section 203(e) of the Advisers Act against Respondent Bell and co-respondents Wedbush Securities Inc. and Christina Fillhart.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds² that:

Summary

1. These proceedings involve the market access business of Wedbush, one of the largest volume market access providers in the United States. From July 2011 until at least January 2013 (the "relevant period"), Wedbush served as the gateway to U.S. markets for dozens of trading firms, including foreign, domestic, registered, and unregistered firms, as well as thousands of their traders. Most of these firms and their traders engaged in trading activity that did not flow through any Wedbush systems before reaching exchanges and other trading venues in the U.S.

2. During the relevant period, Wedbush failed to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the risks associated with its market access business, as required by Exchange Act Rule 15c3-5 (the "Market Access Rule" or "Rule").³ Violations of the Market Access Rule pose significant risks to the orderly functioning of the U.S. securities markets. Wedbush allowed thousands of essentially anonymous foreign traders to send orders directly to U.S. trading venues to trade billions of shares every month. Wedbush enjoyed increased trading commissions and fees generated by its high-volume market access customers from its risky market access business.

3. Wedbush failed to adopt and implement risk management controls that were reasonably designed to ensure compliance with applicable regulatory requirements—such as those for preventing naked short sales, wash trades, manipulative layering and money laundering. Wedbush's failure to adopt and implement such controls came after communications by the Commission's staff through an examination deficiency letter and in face-to-face meetings regarding Wedbush's compliance procedures whereby the staff informed Wedbush of compliance shortcomings and significant compliance concerns, particularly the access provided to unknown overseas traders. By nonetheless failing to adopt and implement the necessary risk management controls, Wedbush willfully violated the Market Access Rule, while Bell caused Wedbush's violation of the Rule by virtue of his responsibilities at the firm and his participation in communications with the Commission's staff.

4. Wedbush's lack of reasonably-designed market access controls and procedures resulted in Wedbush violating other regulatory requirements, including Regulations SHO and NMS. Wedbush also failed to preserve certain written communications with customers pertaining to its business as required by Exchange Act Rule 17a-4, including communications containing trading instructions relating to brokerage orders submitted directly by Wedbush's market access customers.

² The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

³ 17 C.F.R. § 240.15c3-5.

In connection with its market access business, Wedbush also failed to file suspicious activity reports pursuant to anti-money laundering ("AML") requirements in violation of Exchange Act Rule 17a-8.

Respondents

5. Wedbush Securities Inc. is a California corporation with its headquarters in Los Angeles, California. The firm was founded in 1955 and registered with the NASD as a broker-dealer in 1955, with the Commission as a broker-dealer in 1966 and as an investment adviser in 1970. Wedbush is a wholly-owned subsidiary of Wedbush, Inc., a privately-held company. As of December 31, 2012, Wedbush had 79 branch offices and 844 employees. During the relevant period, Wedbush was consistently ranked as one of the five largest firms by trading volume on NASDAQ.

6. During the relevant period, Jeffrey Bell was Executive Vice President of the Correspondent Services Division of Wedbush, reporting to the firm's President, and was an associated person of Wedbush. Bell also was President of Lime Brokerage LLC ("Lime"), another wholly-owned subsidiary of Wedbush, Inc. Bell, age 40, is a resident of Austin, Texas, and holds Series 7 and 24 licenses.

7. Christina Fillhart is a Senior Vice President in the Correspondent Services Division of Wedbush and is an associated person of Wedbush. Fillhart reported to Bell until late 2012, when she began reporting to one of Wedbush's Co-Chief Compliance Officers. Fillhart, age 56, is a resident of Covina, California, and holds Series 7, 24, 27, 53, and 63 licenses.

The Market Access Rule

8. The Commission adopted the Market Access Rule in November 2010 to require that broker-dealers with market access "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." *Risk Management Controls for Brokers or Dealers with Market Access*, 75 Fed. Reg. 69792, 69792 (Nov. 15, 2010) (Final Rule Release).

9. Section (b) of the Market Access Rule requires a broker-dealer with market access, or that provides a customer or any other person with access to an exchange through the use of its market participant identifier ("MPID") or otherwise, to "establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks" of its market access business.

10. Section (c) of the Market Access Rule identifies specific required elements of a broker-dealer's system of risk management controls and supervisory procedures relating to market access. Subsection (c)(1) addresses financial controls and procedures and subsection (c)(2) addresses regulatory controls and procedures. Under subsection (c)(2), a broker-dealer must have controls and procedures that are reasonably designed to ensure compliance with all regulatory requirements, including controls to prevent the entry of orders that do not comply with all regulatory requirements that must be satisfied on a pre-order entry basis and controls to restrict access to

trading systems and technology that provide market access to persons and accounts pre-approved and authorized by the broker-dealer with market access.

11. Section (d) of the Market Access Rule requires the risk management controls and supervisory procedures to be under the "direct and exclusive control" of the broker-dealer with market access. Subsection (d)(1) contains an exception to the direct and exclusive control requirement that applies when a broker-dealer with market access reasonably allocates, by written contract, after a thorough due diligence review, control over specific regulatory risk management controls and supervisory procedures to a broker-dealer customer who is registered with an exchange in the United States where the broker or dealer with market access has a reasonable basis for determining that such broker-dealer customer, based on its position in the transaction and relationship with an ultimate customer, has better access to the ultimate customer and its trading information such that it can more effectively implement the specified controls or procedures.

12. Section (e) of the Market Access Rule requires a broker-dealer with market access to establish, document, and maintain a system for regularly reviewing the effectiveness of its risk management controls and supervisory procedures relating to market access. Subsection (e)(1) requires the broker-dealer to conduct and document a review of its market access business at least annually in accordance with written procedures, and subsection (e)(2) requires the CEO to certify annually that the broker-dealer conducted the review and is in compliance with the Rule.

Wedbush's Market Access Business

13. Wedbush's primary market access business is part of the Correspondent Services Division, which originally handled only traditional clearing operations for introducing broker-dealers, otherwise known as "correspondent" firms. Wedbush began providing "sponsored" market access to customer firms in 2004, which allowed customer firms and their traders to send orders that bypassed Wedbush's trading systems and were routed directly to exchanges and other trading venues under a Wedbush MPID. Sponsored access customers were able to send orders that bypassed Wedbush's systems by using online trading platforms or software programs that the customer either owned directly or leased from a third-party platform provider, referred to as a service bureau.

14. During the relevant period, Wedbush had about 50 sponsored access customers that generated average monthly trading volume of 10 billion shares. Several of Wedbush's sponsored access customer firms had hundreds or thousands of authorized traders each. Wedbush's correspondent services business was the most profitable operation of Wedbush, Inc. Bell and Fillhart each received bonus compensation based in part on the profitability of the Correspondent Services Division, which depended largely on the trading volumes of Wedbush's market access customers. During the relevant period, Bell received salary of \$344,000 and bonus compensation of \$310,000 and Fillhart received salary of \$150,000 and bonus compensation of \$105,000.

15. In June 2011, Wedbush acquired Lime Brokerage LLC, a provider of trading technology platforms. After Wedbush acquired Lime, about 20% of Wedbush's sponsored access customers began using the Lime platform. The other 80% continued to use sponsored access either

through their own proprietary trading platform or through a third-party platform that the customer leased from a service bureau. As a result, during the relevant period, the vast majority of orders from Wedbush's sponsored access customers did not flow through Wedbush's own risk management systems.

16. Wedbush's primary risk management controls and supervisory procedures relating to market access were described in Chapter 31 of the firm's written supervisory procedures ("WSPs"), titled "Sponsored Access." On July 14, 2011, the day most provisions of the Market Access Rule took effect, Wedbush updated Chapter 31 to cite certain provisions of the Rule.

17. Bell and Fillhart, along with one other senior Wedbush employee in the Correspondent Services Division, had the primary responsibility for preparing and adopting Wedbush's controls and procedures relating to market access. Bell and Fillhart had authority to adopt and revise the firm's controls and procedures relating to market access, including the WSPs, without approval of Wedbush's President or Co-Chief Compliance Officers.

Wedbush Knew Of Compliance Issues For Its Sponsored Access Trading

18. Prior to the effective date of Rule 15c3-5, Wedbush received a number of indications that its sponsored access trading business posed particular regulatory and compliance risks. In 2009 and 2010, just before the relevant period, two of Wedbush's sponsored access customer firms extended their market access to a Latvian trader who used that access to conduct profitable trading as part of a widespread account intrusion and market manipulation scheme. The Commission obtained a judgment by default against the Latvian trader in connection with the scheme after learning the trader's identity from Fillhart in 2011. See *SEC v. Nagaicevs*, N.D. Cal. Case No. 12-CV-00413-JST (Order Granting Motion for Default Judgment, dated July 12, 2013; Order of Judgment and Equitable and Other Relief Against Defendant Igors Nagaicevs, dated July 18, 2013).

19. The Commission also imposed cease-and-desist orders, civil monetary penalties, and other relief against one of the Wedbush customer firms for acting as an unregistered broker in extending market access to the Latvian trader, and also obtained relief against the firm's principals. See *In the Matter of KM Capital Management, LLC, et al.*, Admin. Proc. File No. 3-14720 (Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 as to Yisroel M. Wachs, dated Sept. 19, 2012; Initial Decision as to KM Capital Management, LLC and Joshua A. Klein, dated Nov. 28, 2012; Notice that Initial Decision Has Become Final, dated Oct. 17, 2013).

20. Wedbush was well aware of the requirements, objectives, and importance of Rule 15c3-5. During the public comment period for the then-proposed Rule 15c3-5, Bell submitted a comment letter to the Commission on behalf of Wedbush on March 31, 2010. Bell also submitted a comment letter to the Commission on behalf of Wedbush on February 23, 2009 addressing a Nasdaq proposed rule change relating to sponsored market access, which was later approved by the Commission. Although proposing certain changes to the Nasdaq proposed rule, Bell and Wedbush stated in the 2009 comment letter that sponsoring non-broker-dealer customers "requires the highest

level of due diligence, oversight and controls. In this case, the sponsoring member is also the broker-dealer of record and would be accountable for all the responsibilities as such.” Despite this acknowledgement, one of Wedbush’s largest sponsored access customers was not a broker-dealer registered in the United States, and Wedbush failed to engage in the “highest level of due diligence, oversight and controls.”

21. On May 17, 2011, Commission staff from the Office of Compliance Inspections and Examinations (“OCIE”) sent an Examination Deficiency Letter to Wedbush, which was addressed to Bell. That letter advised Wedbush that the staff had identified deficient Wedbush controls relating to short sales, in violation of Regulation SHO, due in part to an excessive reliance upon a non-broker-dealer sponsored access client to locate shares before placing a short sale order. The Deficiency Letter also identified problems with internal controls over a third-party order management system. The Letter also stated that Wedbush had failed to respond promptly to compliance issues when they arose and there were weaknesses in its anti-money-laundering controls. This letter put Wedbush on notice that it was relying on inadequate regulatory controls that were outside of its direct and exclusive control.

22. On July 5, 2011, Wedbush representatives, including Bell and Fillhart, met with representatives of OCIE to discuss the impending effectiveness of the final Rule 15c3-5. During that meeting, the Commission’s staff expressed concerns about Wedbush’s largest sponsored non-broker-dealer client and the need to identify the ultimate traders. Wedbush’s presentation to the staff cited the Market Access Rule requirements relating to allocating compliance responsibilities to sponsored access broker-dealer clients and maintaining “direct and exclusive control” of risk settings in trading platforms.

Market Access Through Third-Party Trading Platforms

23. Section (d) of the Market Access Rule requires Wedbush to maintain exclusive control over the risk settings in the trading platforms that its customers use to access the markets, including both Wedbush’s own Lime platform and the non-Wedbush trading platforms that 80% of Wedbush’s customers used. As described below, for many customers that used non-Wedbush trading platforms, Wedbush’s control was not exclusive because it allowed customers to have access to determine and make changes to risk settings in the trading platforms.

24. Wedbush did not directly set or monitor regulatory risk settings in the third-party or client-proprietary trading platforms that 80% of Wedbush’s customers used. Customers had access to set and revise the risk settings, and could disable risk settings intended to prevent violations of specific regulatory requirements, such as illegal short sales, wash trades, and violations of Regulation NMS. In addition to Wedbush not having exclusive control over the settings, Wedbush’s customers, rather than Wedbush, leased the trading platforms from third parties and Wedbush had no contractual relationship with the platform providers.

25. Wedbush employees in the Correspondent Services Division received access from platform providers to view risk settings and trading activity in the platforms, but Bell and Fillhart knew that Wedbush did not have exclusive control over the settings.

26. Shortly before most provisions of the Market Access Rule took effect, Wedbush obtained email statements from many of the trading platform providers that the risk management settings in the platforms were under the direct and exclusive control of Wedbush. In reality, Wedbush did not have exclusive control of the risk management settings because Wedbush continued allowing sponsored access customers to determine and make changes to the risk settings in the platforms, and Wedbush had no contractual relationship with the platform providers. These statements also were not part of any legally enforceable contract; Wedbush had no contractual relationship with the platform providers.

27. Wedbush's WSPs stated that each new sponsored access customer would perform an initial "risk demonstration" to show Wedbush the customer's trading platform settings for certain financial and regulatory risk controls. Wedbush had a checklist for the risk demonstration that included settings to prevent clearly erroneous trades, wash trades, illegal short sales,⁴ and, unless authorized by Wedbush, intermarket sweep orders ("ISOs").⁵ That Wedbush needed the customer to show the settings to Wedbush demonstrates that Wedbush did not have "direct and exclusive control" over the risk settings in the platforms, as required by Rule 15c3-5(d).

28. In June 2012, platform providers, rather than sponsored access customers, provided Wedbush demonstrations of risk settings in their trading platforms. During a demonstration, the provider would submit test orders and confirm that certain risk settings were in place at the time of the demonstration.

29. Wedbush did not receive demonstrations of the actual risk settings in effect for particular sponsored access customers, and Wedbush did not have any physical ability to prevent customers from subsequently changing the settings shown during the platform provider's demonstration. Wedbush also did not maintain records of the risk settings in the platforms so that it could determine whether any settings had been changed without its consent.

30. Customers could, and sometimes did, change the risk settings without Wedbush's knowledge or consent. For example, as discussed below, Fillhart learned that on numerous occasions a risk setting to prevent illegal short sales failed to prevent violations of Regulation SHO because the wrong list of securities that were easy to borrow was loaded into the customer's third-party trading platform. Fillhart also learned that a customer repeatedly circumvented a risk setting

⁴ Rule 203(b)(1) of Regulation SHO prohibits broker-dealers from accepting or effecting a short sale order unless the broker-dealer has borrowed the security or entered into an arrangement to borrow the security, or has reasonable grounds to believe that the security can be timely borrowed, and has documented its compliance with Rule 203(b)(1).

⁵ Rule 611(c) of Regulation NMS requires the broker-dealer responsible for routing an ISO to take reasonable steps to establish that the order meets the requirements of Rule 600(b)(30) of Regulation NMS, which requires the broker-dealer routing the ISO to route simultaneously additional orders, as necessary, to execute against the full size of all better-priced protected quotations.

that was designed to prevent the use of ISOs. For other risk settings, such as controls to prevent wash trades, Wedbush often did not require customers or platform providers to activate the settings.

Attempts to Allocate Responsibility for Regulatory Controls and Procedures

31. The Final Rule Release for the Market Access Rule stated that Section 15c3-5(d) “is designed to eliminate the practice . . . whereby the broker-dealer providing market access relies on its customer, a third party service provider, or others, to establish and maintain the applicable risk controls.” *See* 75 Fed. Reg. at 69804. The Final Rule Release further cautioned that “the Commission continues to be concerned about circumstances where broker-dealers providing market access simply rely on assurances from their customers that appropriate risk controls are in place. . . . Accordingly, the Commission emphasizes that in any permitted allocation arrangement, the broker-dealer providing market access may not merely rely on another broker-dealer’s attestation that it has implemented appropriate controls or procedures.” *Id.* at 69808.

32. After the Market Access Rule took effect, Wedbush simply relied on attestations in the exact manner that the Final Rule Release said was improper. Wedbush attempted to assign to other broker-dealers the responsibility for regulatory risk management controls and supervisory procedures for many of its sponsored access customers. Wedbush employees documented purported agreements to assign responsibilities to other broker-dealers, but as described below, despite the plain language of Rule 15c3-5(d) and the staff’s statements on July 5, 2011, Wedbush failed to conduct the required “thorough due diligence review” when purporting to allocate responsibility to another broker-dealer and continued to simply rely on the other broker-dealer’s attestation that it had implemented appropriate controls and procedures.

33. For some customers, Wedbush entered into an allocation agreement with a registered introducing broker-dealer. For other customers, Wedbush entered into an allocation agreement directly with the sponsored access customer itself, if it was a registered broker-dealer trading its own capital on a proprietary basis. Some of these sponsored access customers used trading platforms that they themselves owned, either directly or through a corporate affiliate that they controlled. As a result, Wedbush often relied on a broker-dealer customer to monitor its own trading.

34. All of Wedbush’s purported allocation agreements were based on the same form, which Bell approved. The agreements did not specify any particular controls or procedures that Wedbush purported to be allocating. Even though Wedbush, as the party with market access, purportedly was attempting to allocate responsibility for controls or procedures to another broker-dealer, the agreements mistakenly stated that the other broker-dealer, rather than Wedbush, had “allocatable regulatory responsibilities as defined within SEC Rule 15c3-5.” As a result, it was not even clear from the documents themselves from and to which broker-dealer the controls or procedures purportedly were being allocated.

35. Bell knew or should have known that Wedbush did not conduct the required due diligence reviews of the other broker-dealers in connection with its attempts to allocate

responsibilities for market access controls and procedures, and that Wedbush also did not conduct later reviews to determine whether the other broker-dealers were adequately carrying out the responsibilities purportedly allocated. The agreements simply contained a statement by the introducing broker-dealer or registered customer firm that its regulatory risk management controls and supervisory procedures were reasonably designed to ensure compliance with all regulatory requirements.

36. Better access to the ultimate customer was discussed in the Final Rule Release as the reason why control over certain regulatory controls could be allocated after due diligence. Yet Wedbush did not have any policies or procedures for determining whether a broker-dealer to which it claimed to have assigned responsibilities had better access than Wedbush to ultimate customers such that the other broker-dealer could more effectively implement the risk management controls and supervisory procedures relating to market access.

Regulatory Requirements That Must Be Satisfied On a Pre-Order Entry Basis

37. Subsection (c)(2)(i) of the Market Access Rule required Wedbush to have risk management controls and supervisory procedures that were reasonably designed to prevent the entry of orders that do not comply with all regulatory requirements that must be satisfied on a pre-order entry basis. The Final Rule Release for the Market Access Rule specifically identified Regulations SHO and NMS as examples of regulatory requirements that must be satisfied on a pre-order entry basis, and with which a broker-dealer's controls and procedures must ensure compliance. *See* 75 Fed. Reg. at 69803. As described below, Wedbush's risk management controls and supervisory procedures were not reasonably designed to satisfy these pre-trade regulatory requirements and, in fact, did not prevent Wedbush customers from entering numerous orders that violated Regulations SHO and NMS.

38. Wedbush was responsible for ensuring that all short-sale orders submitted by its sponsored access customers complied with Regulation SHO. Among other things, Regulation SHO required Wedbush, prior to accepting or effecting a short sale order, to borrow the security or enter into an agreement to borrow the security, or have reasonable grounds to believe that the security could be timely borrowed (generally known as the "locate" requirement). Absent countervailing factors, "easy-to-borrow" lists may provide "reasonable grounds" for a broker-dealer to believe that the security sold short is available for borrowing without directly contacting the source of the borrowed securities (known as "easy-to-borrow securities"). Thus, for instance, if a broker-dealer seeking to rely on the list knows or should know that there are concerns regarding the list, it would not be reasonable for the broker-dealer to rely on the list. As an example, the Commission has stated that repeated failures to deliver in securities included on an "easy-to-borrow" list would indicate that the broker-dealer's reliance on such a list did not satisfy the "reasonable grounds" standard of Rule 203. *See Short Sales*, 69 Fed. Reg. 48008, 48014 (Aug. 6, 2004).

39. Wedbush's WSPs stated that the firm sometimes relied on sponsored access customers to meet the short-sale requirements of Regulation SHO. Wedbush maintained a list of easy-to-borrow securities, but Wedbush relied on sponsored access customers or their platform providers to load that list into third-party trading platforms rather than taking direct steps to make

sure that customers were using the correct list. Maintaining up-to-date lists in the trading platforms was a key step in the control process because the platforms relied on the lists to determine whether Regulation SHO had been satisfied before routing a short-sale order for execution.

40. Wedbush's procedures asserted that Wedbush allowed customers to submit short-sale orders for securities on the easy-to-borrow list and that it required customers to otherwise locate shares to borrow before submitting short-sale orders for securities not on the easy-to-borrow list. However, if a customer or platform provider failed to load the correct easy-to-borrow list, Wedbush had no controls or procedures to prevent the customer from submitting a short-sale order for a security that was not easy-to-borrow without first obtaining a locate.

41. On three occasions between July 2011 and November 2012, Fillhart learned that a customer or platform provider loaded the wrong easy-to-borrow list, which resulted in Wedbush customers submitting short-sale orders for securities that were not easy to borrow without first having located shares that it had reasonable grounds to believe could be timely borrowed as required by Regulation SHO. Bell and Fillhart knew that similar incidents had occurred numerous times before July 2011, based on the May 2011 OCIE Deficiency Letter and face-to-face meetings that Bell and Fillhart attended with Commission staff. The incidents demonstrated that Wedbush did not have "direct and exclusive control" over these risk settings in the trading platforms as required by Rule 15c3-5(d) and did not have controls reasonably designed to ensure compliance with all regulatory requirements that must be satisfied on a pre-order entry basis.

42. Wedbush was responsible for ensuring that all orders marked as ISOs by its sponsored access customers complied with Regulation NMS, which requires the broker-dealer responsible for routing an ISO to route simultaneously additional orders, as necessary, to execute against the full size of all better-priced protected quotations. Sending the simultaneous orders to sweep the market of better-priced protected quotations is essential to ensuring that the ISO order type is not misused and that other market participants willing to trade at more favorable prices do not have their orders bypassed.

43. Wedbush's WSPs asserted that in order to comply with Regulation NMS, Wedbush did not permit a customer to use ISOs unless the customer swept the market of all better-priced protected quotations. However, Wedbush did not have any controls or procedures reasonably designed to ensure that its customers complied with this regulatory requirement.

44. As a result of Wedbush's lack of "direct and exclusive control" over risk settings designed to ensure ISO compliance, and its failure to have controls and procedures reasonably designed to ensure compliance with the ISO requirements of Regulation NMS, at least one Wedbush customer submitted ISOs without Wedbush's prior knowledge and without a broker-dealer acting to ensure compliance with the relevant regulatory requirements. In April 2011, Fillhart learned from an exchange that one of Wedbush's largest sponsored access customers was submitting ISOs even though Wedbush did not authorize the customer to submit ISOs and even though Wedbush had not allocated responsibility to another registered broker-dealer to ensure that ISOs submitted by the customer complied with Regulation NMS. Without Wedbush's knowledge, the customer and its third-party platform provider had enabled an order route that was configured to

allow ISOs, even though the platform provider had previously informed Wedbush that the customer was not able to submit ISOs. This also demonstrated that it was unreasonable for Wedbush to rely on the written attestations that it received from the platform providers, as described above.

45. Because Wedbush had not authorized the customer to submit ISOs, Wedbush had not taken any steps to ensure that the ISOs complied with Regulation NMS. Fillhart instructed the platform provider to close the ISO route, but she did not directly close or disable the route and she knew that Wedbush did not have any controls or procedures to prevent a similar route from being enabled again in the future.

46. In November 2011, Fillhart learned that the same customer had again enabled an ISO route in its trading platform and submitted ISOs without Wedbush's knowledge. As in April 2011, Wedbush had not taken any steps to ensure that the ISOs complied with Regulation NMS because Wedbush had not authorized the customer to submit ISOs. These incidents demonstrate that Wedbush did not have "direct and exclusive control" over these risk settings as required by Rule 15c3-5(d), and did not have controls reasonably designed to ensure compliance with all regulatory requirements that must be satisfied on a pre-order entry basis.

Other Regulatory Requirements

47. Subsection (c)(2) of the Market Access Rule required Wedbush to have risk management controls and supervisory procedures that were reasonably designed to ensure compliance with all existing regulatory requirements. Wedbush did not have controls and procedures in connection with its market access business that were reasonably designed to ensure that Wedbush complied with all AML reporting and recordkeeping requirements applicable to Wedbush.

48. Exchange Act Rule 17a-8 requires broker-dealers to comply with the reporting, recordkeeping, and record retention requirements of the regulations adopted by the Department of the Treasury pursuant to the Bank Secrecy Act. The Bank Secrecy Act requires financial institutions such as broker-dealers to establish AML programs that include, among other things, internal policies, procedures, and controls, and authorizes the Department of the Treasury to adopt regulations prescribing minimum standards for AML programs. 31 U.S.C. §§ 5318(h)(1) and (2). Treasury regulations require broker-dealers to file reports of any suspicious transactions relevant to a possible violation of law or regulation, 31 C.F.R. § 1023.320, and state that broker-dealers regulated by a self-regulatory organization ("SRO") are deemed to satisfy the Bank Secrecy Act's AML program requirements if they comply with the AML program requirements of their SRO. 31 C.F.R. § 1023.210.

49. Wedbush's SRO, FINRA, requires its members to establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of suspicious transactions as required by the Bank Secrecy Act and Treasury regulations thereunder. See FINRA Rule 3310. As described below, on numerous instances Fillhart became aware of potential wash trading and other forms of potential manipulation, but she did not cause Wedbush to file reports

regarding the suspicious activity, and Wedbush's policies and procedures did not cause Wedbush to detect suspicious activity and file such reports.

50. Wedbush's WSPs asserted that it did not permit its customers to execute wash and pre-arranged trades. Wedbush's WSPs defined "wash trades" as "transactions which result in no beneficial change of ownership" and defined a "pre-arranged trade" as "an offer to sell coupled with an offer to buy back at the same or at an advanced price, or the reverse."

51. In most of the trading platforms used by Wedbush sponsored access customers, individual traders were identified by a unique trader ID. While most traders received a single trader ID, on some occasions a single trader had multiple trader IDs. Wedbush did not have any controls or filters to prevent a single trader from trading with himself or herself in a customer firm's account, or to prevent two different traders from trading with each other in a customer firm's account.

52. Most trading platforms used by Wedbush's customers had risk settings to prevent potential wash trades, but Wedbush often did not require customers or platform providers to activate the settings, and Wedbush had no controls or procedures to prevent customers or platform providers from deactivating the settings if they were activated. Some exchanges offered functionality to block wash trades, but Wedbush had no controls or procedures requiring customers to use this anti-wash trade functionality.

53. Wedbush personnel responsible for filing suspicious activity reports pursuant to the Bank Secrecy Act relied on Fillhart and other employees in the Correspondent Services Division, which Bell oversaw, to review trading activity by sponsored access customers to determine whether it was relevant to potential violations of securities laws or regulations. But Bell and Fillhart knew or should have known that Wedbush did not have policies or procedures describing how Correspondent Services employees were to review trading to determine whether it was suspicious and should be reported.

54. The WSPs stated that Wedbush would review reports of potential wash trades from vendors and exchanges, determine whether there were potential securities violations, and if so, obtain representations from sponsored access customers regarding their internal wash trade reviews and systems.

55. A Wedbush employee who reported to Fillhart received reports of potential wash or pre-arranged trades from exchanges on a daily basis during the relevant period. For most of the trades on the reports, which involved two trader IDs in a single customer account, Fillhart did not ask the Wedbush employee to follow up with the customer firm because Fillhart assumed the two traders were independent and did not consider the trading suspicious. No one from Wedbush ever attempted to contact traders to determine whether they were pre-arranging their trades.

56. For trades with a single trader ID on both sides, Fillhart relied on the customer firm to follow up with the trader. On many occasions, the customer simply responded that it was not wash trading or was an error. On some occasions, the customer did not respond at all. Fillhart

generally did not ask the Wedbush employee to follow up with customers for further explanation and did not report the trading to the AML officer as suspicious.

57. In February and March 2012, Fillhart learned from exchanges that numerous traders in the account of one of Wedbush's largest sponsored access customers, which had recently become a customer of a Wedbush correspondent broker-dealer under common ownership with the customer, appeared to be engaged in wash or pre-arranged trading. The customer and correspondent broker-dealer had not enabled pre-trade controls in the trading platform used by the customer that would have prevented wash or pre-arranged trades, and Wedbush did not take steps to enable such controls. The customer and correspondent broker-dealer informed Wedbush that they would either enable the controls in the platform or send future orders through a route that blocked wash trades. Fillhart did not directly enable the risk controls and Wedbush did not take any steps to ensure that the customer or correspondent broker-dealer either enabled the controls or sent future orders through a route that blocked wash trades.

58. The correspondent broker-dealer informed Wedbush that it had disabled one of the traders involved in the incidents, but Wedbush did not directly disable any of the traders. Wedbush had no controls or procedures for preventing traders who had been disabled by a customer or correspondent broker-dealer from obtaining a new trader ID through the same or a different Wedbush customer account.

59. On multiple occasions, Fillhart learned from exchanges that traders in the same customer account appeared to be engaged in potentially manipulative trading referred to as "layering," which involves submitting and cancelling large numbers of non-*bona fide* orders on one side of the market in order to obtain executions at more favorable prices for smaller *bona fide* orders on the other side. See, e.g., *In the Matter of Hold Brothers On-Line Investment Services, LLC, et al.*, Admin. Proc. File No. 3-15046 (Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 and Section 9(b) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and Cease-and-Desist Orders, dated Sept. 25, 2012), at 5-6.

60. As early as February 2011, Fillhart notified the customer of potential layering activity in its account and told the customer that layering "is a manipulative activity." Until at least September 2012, Fillhart continued receiving reports from exchanges of potential layering activity through the same customer account, but she did not cause Wedbush to develop or acquire any tools to detect or cause the reporting of potential layering activity and did not warn the customer's principals that the account would be disabled if the trading activity continued.

61. In late 2011, Bell and Fillhart met with another senior officer in the Correspondent Services Division to discuss the substantial compliance risks posed to Wedbush by sponsored access customers like the one that had been the subject of numerous reports of potential layering and wash trading and had been addressed in face-to-face meetings with Commission staff—the customer that had thousands of essentially anonymous foreign traders trading through a single Wedbush customer account. Bell, Fillhart, and the other officer decided not to terminate the customer's relationship with Wedbush, but agreed that Wedbush should not take on new market

access customers with similar business models because of the compliance risks to Wedbush. In October 2012, Bell, Fillhart, and the other officer met again and decided to terminate Wedbush's relationship with the customer.

62. During the relevant period, Wedbush did not file any suspicious activity reports relating to potential layering and filed only two suspicious activity reports relating to potential wash or pre-arranged trading. More broadly, Fillhart knew that Wedbush did not review for a variety of manipulative trading practices, including fictitious orders, marking the open or marking the close, traders at a Wedbush customer trading a security between each other to manipulate the price of the security, manipulating securities prices through wash trades, or layering.

Authorization of Traders

63. Subsection (b) of the Market Access Rule requires a broker-dealer with market access, or that provides a customer or any other person with access to an exchange or ATS through the use of its MPID or otherwise, to "establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks" of its market access business. Subsection (c)(2)(iii) of the Market Access Rule required Wedbush to have risk management controls and supervisory procedures that were reasonably designed to restrict access to trading systems and technology that provide market access to persons and accounts pre-approved and authorized by Wedbush, the broker-dealer with market access. As described below, for many of its largest sponsored access customers, Wedbush only pre-approved and authorized the principals for the account and relied on its customer to pre-approve and authorize the thousands of individual traders who received market access through the account without reasonably designed controls and supervisory procedures to restrict access to trading systems and technology that provide market access to persons and accounts pre-approved and authorized by the broker or dealer. Accordingly, Wedbush failed to have controls and procedures that complied with Subsection (c)(2)(iii) of the Market Access Rule. Wedbush also did not effectively allocate these obligations, to the extent permitted by Subsection (d)(1) of the Market Access Rule, to its registered broker-dealer customers.

64. Wedbush's WSPs asserted that sponsored access customers were required to provide authorized trader information to Wedbush "upon commencement of sponsored access and when a change occurs." The WSPs also asserted that Wedbush would verify authorized trader information annually. Wedbush did not have any controls or procedures requiring customers to obtain approval from Wedbush before authorizing new traders.

65. When Wedbush opened a sponsored access account, Wedbush employees obtained identifying information and performed background checks only on the principals of the entity opening the account, not on other individuals that the entity authorized to trade through the account. While customers sometimes copied a Wedbush employee on their emails instructing platform providers to authorize new traders to trade through the customer's account, Wedbush did not have any written policies or procedures for pre-approving or authorizing new traders for existing sponsored access accounts.

66. Some customer firms and platform providers used a one-page "AccountID creation form" that called for certain information about each authorized trader, but Wedbush did not require use of the form and Wedbush rarely obtained copies of the forms from customers. There was a section on the form for approval of the trader's access, but neither Wedbush nor the customers completed that section of the form.

67. For customer firms with hundreds or thousands of traders, Wedbush usually relied on the customer firm to maintain a list of authorized traders and their trader IDs. Beginning in September 2011, Wedbush employees who reported to Fillhart occasionally obtained lists of authorized traders from customer firms with large numbers of traders and ran searches by name to determine whether any traders were subject to sanctions or restrictions on business activity by the Office of Foreign Assets and Control (OFAC), an office with the Department of the Treasury that administers economic and trade sanctions based on U.S. foreign policy and national security goals. These searches were done after, not before, the customer firm extended market access to the traders. OFAC's programs are separate and distinct from the AML requirements imposed on broker-dealers by Exchange Act Rule 17a-8 and underlying Treasury regulations.

68. For customer firms with hundreds or thousands of traders, neither Fillhart nor Bell asked Wedbush employees to take any steps to verify trader names or identities or to speak to any of the traders. Bell and Fillhart knew that Wedbush relied exclusively on the customer firms, some of which were not registered broker-dealers, to confirm trader identities and oversee their trading strategies. Fillhart herself had the experience of being unable to find a list of trader information for a particular Wedbush client. Because of these facts, particularly the component of Wedbush's business that provided sponsored access to hundreds or thousands of traders through Wedbush's customers, Wedbush's controls and procedures for the pre-approval and authorization of traders were not reasonable. As noted above, Wedbush also did not effectively allocate these obligations, to the extent permitted by Subsection (d)(1) of the Market Access Rule, to its registered broker-dealer customers.

Review of Effectiveness of Market Access Controls and Procedures

69. Section (e) of the Market Access Rule required Wedbush to establish, document, and maintain a system for regularly reviewing the effectiveness of its risk management controls and supervisory procedures relating to market access and to conduct a review of its market access business in accordance with written procedures at least annually. Wedbush did not have any written procedures for regularly reviewing the effectiveness of its market access controls and procedures, and Bell and Fillhart both acknowledged that they had primary responsibility for designing and implementing Wedbush's controls and procedures relating to its market access business. As described below, the only review relating in any way to the market access business that Wedbush conducted during the relevant period did not mention the Market Access Rule or any specific risk management controls or supervisory procedures relating to market access.

70. On Friday, March 23, 2012, in preparation for Wedbush's required certification of supervisory controls pursuant to SRO rules, one of Wedbush's Co-Chief Compliance Officers asked the two internal audit employees at Wedbush to review five areas of Wedbush's business, including

one described as "High Frequency Trading." The memorandum containing this request did not mention the Market Access Rule, any other Commission rules, or sponsored access.

71. The internal audit employees prepared a written report dated Monday, March 26, 2012, describing their review, including one page relating to "High Frequency Trading/Exchange Traded Funds." The report did not mention the Market Access Rule, any other Commission rules, sponsored access, Wedbush's WSPs, or any specific risk management controls or supervisory procedures that Wedbush had adopted to comply with the Rule.

72. According to the report, the employees reviewed documents, observed procedures, and spoke with three employees in the Correspondent Services Division as part of the review. The report cited two specific steps—reviewing the checklist for onboarding new customers and observing software applications used for monitoring customer buying power and trading activities. The report noted that the software applications included risk management settings, but did not state that any specific settings were reviewed or tested.

73. The report concluded that, based on the internal audit employees' review, management's controls in the "High Frequency Trading/Exchange Traded Funds" area were adequate and functioning as intended.

74. The Co-Chief Compliance Officer incorporated this section of the report verbatim in a report that he sent to Wedbush's President and the rest of Wedbush's management team and Board on March 30, 2012. Like the internal audit report, this report did not mention the Market Access Rule, any other Commission rules, sponsored access, Wedbush's WSPs, or any specific risk management controls or supervisory procedures that Wedbush had adopted to comply with the Rule. No other reviews of the market access business were conducted by Wedbush employees during the relevant period.

75. Based on the report, as well as conversations with and information previously provided by Bell and others, Wedbush's President signed a certification dated March 30, 2012, citing SRO rules and Rule 15c3-5 (the Market Access Rule), and stating that the firm's risk management controls and supervisory procedures in connection with market access complied with Rule 15c3-5. For the reasons described above, that certification was inaccurate.

Preservation of Records

76. Section 17(a) of the Exchange Act and Rule 17a-4(b)(4) thereunder require broker-dealers to preserve for three years originals of all communications received and copies of all communications sent relating to its business as such. Wedbush did not preserve originals or copies of communications containing trading instructions relating to ISOs submitted by some of its customers under a Wedbush MPID through third-party trading platforms, in that Wedbush did not preserve records reflecting that such orders were ISOs. As a result, Wedbush employees could not determine which orders submitted by those customers during the relevant period were ISOs.

Violations

77. Section 15(c)(3) of the Exchange Act requires broker-dealers to comply with the Commission's rules regarding safeguards, financial responsibility, and related practices of broker-dealers. Rule 15c3-5 thereunder requires broker-dealers with market access to establish, document, and maintain a system of risk management controls and supervisory procedures that is reasonably designed to manage the financial, regulatory, and other risks of its market access business; to maintain direct and exclusive control over the market access controls and procedures; and to establish, document, and maintain a system for regularly reviewing the effectiveness of its risk management controls and supervisory procedures relating to market access. As discussed above, Wedbush willfully violated Section 15(c)(3) of the Exchange Act and Rule 15c3-5 thereunder because it did not maintain exclusive control over risk management controls in sponsored access trading platforms; did not have a system of risk management controls and supervisory procedures that was reasonably designed to ensure compliance with all regulatory requirements, including those that must be satisfied on a pre-order entry basis; did not have controls and procedures reasonably designed to restrict access to market access trading systems to persons and accounts pre-approved and authorized by Wedbush; did not establish, document, and maintain a system for regularly reviewing the effectiveness of its risk management controls and supervisory procedures relating to market access; and did not conduct an adequate review of its market access controls and procedures during the relevant period.

78. Under Section 21C(a) of the Exchange Act, a person is a cause of a securities violation if there is an underlying primary violation to which an act or omission of the person contributed and the person knew or should have known that his or her conduct would contribute to the violation. As discussed above, Bell was a cause of Wedbush's violation of Rule 15c3-5 because his acts and omissions contributed to Wedbush's violation and he knew or should have known that his conduct would contribute to the violation.

IV.

In view of the foregoing, the Commission deems it appropriate in the public interest to impose the sanctions agreed to in Respondent Bell's Offer.

Accordingly, pursuant to Section 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent Bell cease and desist from committing or causing any violations and any future violations of Section 15(c)(3) of the Exchange Act and Rule 15c3-5 promulgated thereunder.

B. Respondent Bell shall, within ten (10) days of the entry of this Order, pay disgorgement of \$25,000, which represents profits gained as a result of the conduct described herein, prejudgment interest of \$1,478.31, and a civil money penalty of \$25,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. Payment must be made in one of the following ways: (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) Respondent may make direct payment from a bank

account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or (3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Jeffrey Bell as a Respondent in these proceedings and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Daniel M. Hawke, Chief, Market Abuse Unit, U.S. Securities and Exchange Commission, One Penn Center, 1617 JFK Boulevard, Suite 520, Philadelphia, PA 19103, with a copy to Steven D. Buchholz, Assistant Regional Director, U.S. Securities and Exchange Commission, 44 Montgomery Street, 28th Floor, San Francisco, CA 94104.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondent, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.



Brent J. Fields
Secretary

*Commissioner Aguilar
Commissioner Gallagher
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73652 / November 20, 2014

INVESTMENT ADVISERS ACT OF 1940
Release No. 3971 / November 20, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-15913

In the Matter of

Wedbush Securities Inc.,
Jeffrey Bell, and Christina
Fillhart,

Respondents.

ORDER MAKING FINDINGS AND
IMPOSING REMEDIAL SANCTIONS
AND A CEASE-AND-DESIST ORDER
PURSUANT TO SECTIONS 15(b) AND
21C OF THE SECURITIES EXCHANGE
ACT OF 1934 AND SECTION 203(e) OF
THE INVESTMENT ADVISERS ACT OF
1940 AS TO WEDBUSH SECURITIES
INC.

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest to enter this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(e) of the Investment Advisers Act of 1940 ("Advisers Act") as to Wedbush Securities Inc. ("Wedbush").¹

II.

Respondent Wedbush has submitted an Offer of Settlement (the "Offer") that the Commission has determined to accept. Respondent admits the facts set forth in Annex A attached hereto and acknowledges that its conduct as set forth in Annex A violated the federal securities laws, admits the Commission's jurisdiction over it and the subject matter of these proceedings, and consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 and Section 203(e) of the Investment Advisers Act of 1940 as to Wedbush Securities Inc. ("Order"), as set forth below.

¹ On June 6, 2014, the Commission instituted public administrative and cease-and-desist proceedings pursuant to Sections 15(b) and 21C of the Exchange Act and Section 203(e) of the Advisers Act against Wedbush and co-respondents Jeffrey Bell and Christina Fillhart.

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III.

On the basis of this Order and Wedbush's Offer, the Commission finds² that:

Summary

1. These proceedings involve the market access business of Wedbush, one of the largest volume market access providers in the United States. From July 2011 until at least January 2013 (the "relevant period"), Wedbush served as the gateway to U.S. markets for dozens of trading firms, including foreign, domestic, registered, and unregistered firms, as well as thousands of their traders. Most of these firms and their traders engaged in trading activity that did not flow through any Wedbush systems before reaching exchanges and other trading venues in the U.S.

2. During the relevant period, Wedbush failed to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the risks associated with its market access business, as required by Exchange Act Rule 15c3-5 (the "Market Access Rule" or "Rule").³ Violations of the Market Access Rule pose significant risks to the orderly functioning of the U.S. securities markets. Wedbush allowed thousands of essentially anonymous foreign traders to send orders directly to U.S. trading venues to trade billions of shares every month. Wedbush enjoyed increased trading commissions and fees generated by its high-volume market access customers from its risky market access business.

3. Wedbush failed to adopt and implement risk management controls that were reasonably designed to ensure compliance with applicable regulatory requirements—such as those for preventing naked short sales, wash trades, manipulative layering and money laundering. Wedbush's failure to adopt and implement such controls came after communications by the Commission's staff through an examination deficiency letter and in face-to-face meetings regarding Wedbush's compliance procedures whereby the staff informed Wedbush of compliance shortcomings and significant compliance concerns, particularly the access provided to unknown overseas traders. By nonetheless failing to adopt and implement the necessary risk management controls, Wedbush willfully violated the Market Access Rule.

4. Wedbush's lack of reasonably-designed market access controls and procedures resulted in Wedbush violating other regulatory requirements, including Regulations SHO and NMS. Wedbush also failed to preserve certain written communications with customers pertaining to its business as required by Exchange Act Rule 17a-4, including communications containing trading instructions relating to brokerage orders submitted directly by Wedbush's market access customers. In connection with its market access business, Wedbush also failed to file suspicious activity reports pursuant to anti-money laundering ("AML") requirements in violation of Exchange Act Rule 17a-8.

² The findings herein are made pursuant to Wedbush's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

³ 17 C.F.R. § 240.15c3-5.

Respondents

5. Wedbush Securities Inc. is a California corporation with its headquarters in Los Angeles, California. The firm was founded in 1955 and registered with the NASD as a broker-dealer in 1955, with the Commission as a broker-dealer in 1966 and as an investment adviser in 1970. Wedbush is a wholly-owned subsidiary of Wedbush, Inc., a privately-held company. As of December 31, 2012, Wedbush had 79 branch offices and 844 employees. During the relevant period, Wedbush was consistently ranked as one of the five largest firms by trading volume on NASDAQ.

6. During the relevant period, Jeffrey Bell was Executive Vice President of the Correspondent Services Division of Wedbush, reporting to the firm's President, and was an associated person of Wedbush. Bell also was President of Lime Brokerage LLC ("Lime"), another wholly-owned subsidiary of Wedbush, Inc. Bell, age 40, is a resident of Austin, Texas, and holds Series 7 and 24 licenses.

7. Christina Fillhart is a Senior Vice President in the Correspondent Services Division of Wedbush and is an associated person of Wedbush. Fillhart reported to Bell until late 2012, when she began reporting to one of Wedbush's Co-Chief Compliance Officers. Fillhart, age 56, is a resident of Covina, California, and holds Series 7, 24, 27, 53, and 63 licenses.

The Market Access Rule

8. The Commission adopted the Market Access Rule in November 2010 to require that broker-dealers with market access "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." *Risk Management Controls for Brokers or Dealers with Market Access*, 75 Fed. Reg. 69792, 69792 (Nov. 15, 2010) (Final Rule Release).

9. Section (b) of the Market Access Rule requires a broker-dealer with market access, or that provides a customer or any other person with access to an exchange through the use of its market participant identifier ("MPID") or otherwise, to "establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks" of its market access business.

10. Section (c) of the Market Access Rule identifies specific required elements of a broker-dealer's system of risk management controls and supervisory procedures relating to market access. Subsection (c)(1) addresses financial controls and procedures and subsection (c)(2) addresses regulatory controls and procedures. Under subsection (c)(2), a broker-dealer must have controls and procedures that are reasonably designed to ensure compliance with all regulatory requirements, including controls to prevent the entry of orders that do not comply with all regulatory requirements that must be satisfied on a pre-order entry basis and controls to restrict access to trading systems and technology that provide market access to persons and accounts pre-approved and authorized by the broker-dealer with market access.

11. Section (d) of the Market Access Rule requires the risk management controls and supervisory procedures to be under the "direct and exclusive control" of the broker-dealer with market access. Subsection (d)(1) contains an exception to the direct and exclusive control

requirement that applies when a broker-dealer with market access reasonably allocates, by written contract, after a thorough due diligence review, control over specific regulatory risk management controls and supervisory procedures to a broker-dealer customer who is registered with an exchange in the United States where the broker or dealer with market access has a reasonable basis for determining that such broker-dealer customer, based on its position in the transaction and relationship with an ultimate customer, has better access to the ultimate customer and its trading information such that it can more effectively implement the specified controls or procedures.

12. Section (e) of the Market Access Rule requires a broker-dealer with market access to establish, document, and maintain a system for regularly reviewing the effectiveness of its risk management controls and supervisory procedures relating to market access. Subsection (e)(1) requires the broker-dealer to conduct and document a review of its market access business at least annually in accordance with written procedures, and subsection (e)(2) requires the CEO to certify annually that the broker-dealer conducted the review and is in compliance with the Rule.

Wedbush's Market Access Business

13. Wedbush's primary market access business is part of the Correspondent Services Division, which originally handled only traditional clearing operations for introducing broker-dealers, otherwise known as "correspondent" firms. Wedbush began providing "sponsored" market access to customer firms in 2004, which allowed customer firms and their traders to send orders that bypassed Wedbush's trading systems and were routed directly to exchanges and other trading venues under a Wedbush MPID. Sponsored access customers were able to send orders that bypassed Wedbush's systems by using online trading platforms or software programs that the customer either owned directly or leased from a third-party platform provider, referred to as a service bureau.

14. During the relevant period, Wedbush had about 50 sponsored access customers that generated average monthly trading volume of 10 billion shares. Several of Wedbush's sponsored access customer firms had hundreds or thousands of authorized traders each. Wedbush's correspondent services business was the most profitable operation of Wedbush, Inc. Bell and Fillhart each received bonus compensation based in part on the profitability of the Correspondent Services Division, which depended largely on the trading volumes of Wedbush's market access customers. During the relevant period, Bell received salary of \$344,000 and bonus compensation of \$310,000 and Fillhart received salary of \$150,000 and bonus compensation of \$105,000.

15. In June 2011, Wedbush acquired Lime Brokerage LLC, a provider of trading technology platforms. After Wedbush acquired Lime, about 20% of Wedbush's sponsored access customers began using the Lime platform. The other 80% continued to use sponsored access either through their own proprietary trading platform or through a third-party platform that the customer leased from a service bureau. As a result, during the relevant period, the vast majority of orders from Wedbush's sponsored access customers did not flow through Wedbush's own risk management systems.

16. Wedbush's primary risk management controls and supervisory procedures relating to market access were described in Chapter 31 of the firm's written supervisory procedures ("WSPs"), titled "Sponsored Access." On July 14, 2011, the day most provisions of the Market Access Rule took effect, Wedbush updated Chapter 31 to cite certain provisions of the Rule.

17. Bell and Fillhart, along with one other senior Wedbush employee in the Correspondent Services Division, had the primary responsibility for preparing and adopting Wedbush's controls and procedures relating to market access. Bell and Fillhart had authority to adopt and revise the firm's controls and procedures relating to market access, including the WSPs, without approval of Wedbush's President or Co-Chief Compliance Officers.

Wedbush Knew Of Compliance Issues For Its Sponsored Access Trading

18. Prior to the effective date of Rule 15c3-5, Wedbush received a number of indications that its sponsored access trading business posed particular regulatory and compliance risks. In 2009 and 2010, just before the relevant period, two of Wedbush's sponsored access customer firms extended their market access to a Latvian trader who used that access to conduct profitable trading as part of a widespread account intrusion and market manipulation scheme. The Commission obtained a judgment by default against the Latvian trader in connection with the scheme after learning the trader's identity from Fillhart in 2011. *See SEC v. Nagaicevs*, N.D. Cal. Case No. 12-CV-00413-JST (Order Granting Motion for Default Judgment, dated July 12, 2013; Order of Judgment and Equitable and Other Relief Against Defendant Igors Nagaicevs, dated July 18, 2013).

19. The Commission also imposed cease-and-desist orders, civil monetary penalties, and other relief against one of the Wedbush customer firms for acting as an unregistered broker in extending market access to the Latvian trader, and also obtained relief against the firm's principals. *See In the Matter of KM Capital Management, LLC, et al.*, Admin. Proc. File No. 3-14720 (Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 as to Yisroel M. Wachs, dated Sept. 19, 2012; Initial Decision as to KM Capital Management, LLC and Joshua A. Klein, dated Nov. 28, 2012; Notice that Initial Decision Has Become Final, dated Oct. 17, 2013).

20. Wedbush was well aware of the requirements, objectives, and importance of Rule 15c3-5. During the public comment period for the then-proposed Rule 15c3-5, Bell submitted a comment letter to the Commission on behalf of Wedbush on March 31, 2010. Bell also submitted a comment letter to the Commission on behalf of Wedbush on February 23, 2009 addressing a Nasdaq proposed rule change relating to sponsored market access, which was later approved by the Commission. Although proposing certain changes to the Nasdaq proposed rule, Bell and Wedbush stated in the 2009 comment letter that sponsoring non-broker-dealer customers "requires the highest level of due diligence, oversight and controls. In this case, the sponsoring member is also the broker-dealer of record and would be accountable for all the responsibilities as such." Despite this acknowledgement, one of Wedbush's largest sponsored access customers was not a broker-dealer registered in the United States, and Wedbush failed to engage in the "highest level of due diligence, oversight and controls."

21. On May 17, 2011, Commission staff from the Office of Compliance Inspections and Examinations ("OCIE") sent an Examination Deficiency Letter to Wedbush, which was addressed to Bell. That letter advised Wedbush that the staff had identified deficient Wedbush controls relating to short sales, in violation of Regulation SHO, due in part to an excessive reliance upon a non-broker-dealer sponsored access client to locate shares before placing a short sale order. The Deficiency Letter also identified problems with internal controls over a third-party order management system. The Letter also stated that Wedbush had failed to respond promptly to compliance issues when they arose and there were weaknesses in its anti-money-laundering

controls. This letter put Wedbush on notice that it was relying on inadequate regulatory controls that were outside of its direct and exclusive control.

22. On July 5, 2011, Wedbush representatives, including Bell and Fillhart, met with representatives of OCIE to discuss the impending effectiveness of the final Rule 15c3-5. During that meeting, the Commission's staff expressed concerns about Wedbush's largest sponsored non-broker-dealer client and the need to identify the ultimate traders. Wedbush's presentation to the staff cited the Market Access Rule requirements relating to allocating compliance responsibilities to sponsored access broker-dealer clients and maintaining "direct and exclusive control" of risk settings in trading platforms.

Market Access Through Third-Party Trading Platforms

23. Section (d) of the Market Access Rule requires Wedbush to maintain exclusive control over the risk settings in the trading platforms that its customers use to access the markets, including both Wedbush's own Lime platform and the non-Wedbush trading platforms that 80% of Wedbush's customers used. As described below, for many customers that used non-Wedbush trading platforms, Wedbush's control was not exclusive because it allowed customers to have access to determine and make changes to risk settings in the trading platforms.

24. Wedbush did not directly set or monitor regulatory risk settings in the third-party or client-proprietary trading platforms that 80% of Wedbush's customers used. Customers had access to set and revise the risk settings, and could disable risk settings intended to prevent violations of specific regulatory requirements, such as illegal short sales, wash trades, and violations of Regulation NMS. In addition to Wedbush not having exclusive control over the settings, Wedbush's customers, rather than Wedbush, leased the trading platforms from third parties and Wedbush had no contractual relationship with the platform providers.

25. Wedbush employees in the Correspondent Services Division received access from platform providers to view risk settings and trading activity in the platforms, but Bell and Fillhart knew that Wedbush did not have exclusive control over the settings.

26. Shortly before most provisions of the Market Access Rule took effect, Wedbush obtained email statements from many of the trading platform providers that the risk management settings in the platforms were under the direct and exclusive control of Wedbush. In reality, Wedbush did not have exclusive control of the risk management settings because Wedbush continued allowing sponsored access customers to determine and make changes to the risk settings in the platforms, and Wedbush had no contractual relationship with the platform providers. These statements also were not part of any legally enforceable contract; Wedbush had no contractual relationship with the platform providers.

27. Wedbush's WSPs stated that each new sponsored access customer would perform an initial "risk demonstration" to show Wedbush the customer's trading platform settings for certain financial and regulatory risk controls. Wedbush had a checklist for the risk demonstration that included settings to prevent clearly erroneous trades, wash trades, illegal short

sales,⁴ and, unless authorized by Wedbush, intermarket sweep orders (“ISOs”).⁵ That Wedbush needed the customer to show the settings to Wedbush demonstrates that Wedbush did not have “direct and exclusive control” over the risk settings in the platforms, as required by Rule 15c3-5(d).

28. In June 2012, platform providers, rather than sponsored access customers, provided Wedbush demonstrations of risk settings in their trading platforms. During a demonstration, the provider would submit test orders and confirm that certain risk settings were in place at the time of the demonstration.

29. Wedbush did not receive demonstrations of the actual risk settings in effect for particular sponsored access customers, and Wedbush did not have any physical ability to prevent customers from subsequently changing the settings shown during the platform provider’s demonstration. Wedbush also did not maintain records of the risk settings in the platforms so that it could determine whether any settings had been changed without its consent.

30. Customers could, and sometimes did, change the risk settings without Wedbush’s knowledge or consent. For example, as discussed below, Fillhart learned that on numerous occasions a risk setting to prevent illegal short sales failed to prevent violations of Regulation SHO because the wrong list of securities that were easy to borrow was loaded into the customer’s third-party trading platform. Fillhart also learned that a customer repeatedly circumvented a risk setting that was designed to prevent the use of ISOs. For other risk settings, such as controls to prevent wash trades, Wedbush often did not require customers or platform providers to activate the settings.

Attempts to Allocate Responsibility for Regulatory Controls and Procedures

31. The Final Rule Release for the Market Access Rule stated that Section 15c3-5(d) “is designed to eliminate the practice . . . whereby the broker-dealer providing market access relies on its customer, a third party service provider, or others, to establish and maintain the applicable risk controls.” See 75 Fed. Reg. at 69804. The Final Rule Release further cautioned that “the Commission continues to be concerned about circumstances where broker-dealers providing market access simply rely on assurances from their customers that appropriate risk controls are in place. . . . Accordingly, the Commission emphasizes that in any permitted allocation arrangement, the broker-dealer providing market access may not merely rely on another broker-dealer’s attestation that it has implemented appropriate controls or procedures.” *Id.* at 69808.

⁴ Rule 203(b)(1) of Regulation SHO prohibits broker-dealers from accepting or effecting a short sale order unless the broker-dealer has borrowed the security or entered into an arrangement to borrow the security, or has reasonable grounds to believe that the security can be timely borrowed, and has documented its compliance with Rule 203(b)(1).

⁵ Rule 611(c) of Regulation NMS requires the broker-dealer responsible for routing an ISO to take reasonable steps to establish that the order meets the requirements of Rule 600(b)(30) of Regulation NMS, which requires the broker-dealer routing the ISO to route simultaneously additional orders, as necessary, to execute against the full size of all better-priced protected quotations.

32. After the Market Access Rule took effect, Wedbush simply relied on attestations in the exact manner that the Final Rule Release said was improper. Wedbush attempted to assign to other broker-dealers the responsibility for regulatory risk management controls and supervisory procedures for many of its sponsored access customers. Wedbush employees documented purported agreements to assign responsibilities to other broker-dealers, but as described below, despite the plain language of Rule 15c3-5(d) and the staff's statements on July 5, 2011, Wedbush failed to conduct the required "thorough due diligence review" when purporting to allocate responsibility to another broker-dealer and continued to simply rely on the other broker-dealer's attestation that it had implemented appropriate controls and procedures.

33. For some customers, Wedbush entered into an allocation agreement with a registered introducing broker-dealer. For other customers, Wedbush entered into an allocation agreement directly with the sponsored access customer itself, if it was a registered broker-dealer trading its own capital on a proprietary basis. Some of these sponsored access customers used trading platforms that they themselves owned, either directly or through a corporate affiliate that they controlled. As a result, Wedbush often relied on a broker-dealer customer to monitor its own trading.

34. All of Wedbush's purported allocation agreements were based on the same form, which Bell approved. The agreements did not specify any particular controls or procedures that Wedbush purported to be allocating. Even though Wedbush, as the party with market access, purportedly was attempting to allocate responsibility for controls or procedures to another broker-dealer, the agreements mistakenly stated that the other broker-dealer, rather than Wedbush, had "allocatable regulatory responsibilities as defined within SEC Rule 15c3-5." As a result, it was not even clear from the documents themselves from and to which broker-dealer the controls or procedures purportedly were being allocated.

35. Bell knew or should have known that Wedbush did not conduct the required due diligence reviews of the other broker-dealers in connection with its attempts to allocate responsibilities for market access controls and procedures, and that Wedbush also did not conduct later reviews to determine whether the other broker-dealers were adequately carrying out the responsibilities purportedly allocated. The agreements simply contained a statement by the introducing broker-dealer or registered customer firm that its regulatory risk management controls and supervisory procedures were reasonably designed to ensure compliance with all regulatory requirements.

36. Better access to the ultimate customer was discussed in the Final Rule Release as the reason why control over certain regulatory controls could be allocated after due diligence. Yet Wedbush did not have any policies or procedures for determining whether a broker-dealer to which it claimed to have assigned responsibilities had better access than Wedbush to ultimate customers such that the other broker-dealer could more effectively implement the risk management controls and supervisory procedures relating to market access.

Regulatory Requirements That Must Be Satisfied On a Pre-Order Entry Basis

37. Subsection (c)(2)(i) of the Market Access Rule required Wedbush to have risk management controls and supervisory procedures that were reasonably designed to prevent the entry of orders that do not comply with all regulatory requirements that must be satisfied on a pre-order entry basis. The Final Rule Release for the Market Access Rule specifically identified Regulations

SHO and NMS as examples of regulatory requirements that must be satisfied on a pre-order entry basis, and with which a broker-dealer's controls and procedures must ensure compliance. *See* 75 Fed. Reg. at 69803. As described below, Wedbush's risk management controls and supervisory procedures were not reasonably designed to satisfy these pre-trade regulatory requirements and, in fact, did not prevent Wedbush customers from entering numerous orders that violated Regulations SHO and NMS.

38. Wedbush was responsible for ensuring that all short-sale orders submitted by its sponsored access customers complied with Regulation SHO. Among other things, Regulation SHO required Wedbush, prior to accepting or effecting a short sale order, to borrow the security or enter into an agreement to borrow the security, or have reasonable grounds to believe that the security could be timely borrowed (generally known as the "locate" requirement). Absent countervailing factors, "easy-to-borrow" lists may provide "reasonable grounds" for a broker-dealer to believe that the security sold short is available for borrowing without directly contacting the source of the borrowed securities (known as "easy-to-borrow securities"). Thus, for instance, if a broker-dealer seeking to rely on the list knows or should know that there are concerns regarding the list, it would not be reasonable for the broker-dealer to rely on the list. As an example, the Commission has stated that repeated failures to deliver in securities included on an "easy-to-borrow" list would indicate that the broker-dealer's reliance on such a list did not satisfy the "reasonable grounds" standard of Rule 203. *See Short Sales*, 69 Fed. Reg. 48008, 48014 (Aug. 6, 2004).

39. Wedbush's WSPs stated that the firm sometimes relied on sponsored access customers to meet the short-sale requirements of Regulation SHO. Wedbush maintained a list of easy-to-borrow securities, but Wedbush relied on sponsored access customers or their platform providers to load that list into third-party trading platforms rather than taking direct steps to make sure that customers were using the correct list. Maintaining up-to-date lists in the trading platforms was a key step in the control process because the platforms relied on the lists to determine whether Regulation SHO had been satisfied before routing a short-sale order for execution.

40. Wedbush's procedures asserted that Wedbush allowed customers to submit short-sale orders for securities on the easy-to-borrow list and that it required customers to otherwise locate shares to borrow before submitting short-sale orders for securities not on the easy-to-borrow list. However, if a customer or platform provider failed to load the correct easy-to-borrow list, Wedbush had no controls or procedures to prevent the customer from submitting a short-sale order for a security that was not easy-to-borrow without first obtaining a locate.

41. On three occasions between July 2011 and November 2012, Fillhart learned that a customer or platform provider loaded the wrong easy-to-borrow list, which resulted in Wedbush customers submitting short-sale orders for securities that were not easy to borrow without first having located shares that it had reasonable grounds to believe could be timely borrowed as required by Regulation SHO. Bell and Fillhart knew that similar incidents had occurred numerous times before July 2011, based on the May 2011 OCIE Deficiency Letter and face-to-face meetings that Bell and Fillhart attended with Commission staff. The incidents demonstrated that Wedbush did not have "direct and exclusive control" over these risk settings in the trading platforms as required by Rule 15c3-5(d) and did not have controls reasonably designed to ensure compliance with all regulatory requirements that must be satisfied on a pre-order entry basis.

42. Wedbush was responsible for ensuring that all orders marked as ISOs by its sponsored access customers complied with Regulation NMS, which requires the broker-dealer

responsible for routing an ISO to route simultaneously additional orders, as necessary, to execute against the full size of all better-priced protected quotations. Sending the simultaneous orders to sweep the market of better-priced protected quotations is essential to ensuring that the ISO order type is not misused and that other market participants willing to trade at more favorable prices do not have their orders bypassed.

43. Wedbush's WSPs asserted that in order to comply with Regulation NMS, Wedbush did not permit a customer to use ISOs unless the customer swept the market of all better-priced protected quotations. However, Wedbush did not have any controls or procedures reasonably designed to ensure that its customers complied with this regulatory requirement.

44. As a result of Wedbush's lack of "direct and exclusive control" over risk settings designed to ensure ISO compliance, and its failure to have controls and procedures reasonably designed to ensure compliance with the ISO requirements of Regulation NMS, at least one Wedbush customer submitted ISOs without Wedbush's prior knowledge and without a broker-dealer acting to ensure compliance with the relevant regulatory requirements. In April 2011, Fillhart learned from an exchange that one of Wedbush's largest sponsored access customers was submitting ISOs even though Wedbush did not authorize the customer to submit ISOs and even though Wedbush had not allocated responsibility to another registered broker-dealer to ensure that ISOs submitted by the customer complied with Regulation NMS. Without Wedbush's knowledge, the customer and its third-party platform provider had enabled an order route that was configured to allow ISOs, even though the platform provider had previously informed Wedbush that the customer was not able to submit ISOs. This also demonstrated that it was unreasonable for Wedbush to rely on the written attestations that it received from the platform providers, as described above.

45. Because Wedbush had not authorized the customer to submit ISOs, Wedbush had not taken any steps to ensure that the ISOs complied with Regulation NMS. Fillhart instructed the platform provider to close the ISO route, but she did not directly close or disable the route and she knew that Wedbush did not have any controls or procedures to prevent a similar route from being enabled again in the future.

46. In November 2011, Fillhart learned that the same customer had again enabled an ISO route in its trading platform and submitted ISOs without Wedbush's knowledge. As in April 2011, Wedbush had not taken any steps to ensure that the ISOs complied with Regulation NMS because Wedbush had not authorized the customer to submit ISOs. These incidents demonstrate that Wedbush did not have "direct and exclusive control" over these risk settings as required by Rule 15c3-5(d), and did not have controls reasonably designed to ensure compliance with all regulatory requirements that must be satisfied on a pre-order entry basis.

Other Regulatory Requirements

47. Subsection (c)(2) of the Market Access Rule required Wedbush to have risk management controls and supervisory procedures that were reasonably designed to ensure compliance with all existing regulatory requirements. Wedbush did not have controls and procedures in connection with its market access business that were reasonably designed to ensure that Wedbush complied with all AML reporting and recordkeeping requirements applicable to Wedbush.

48. Exchange Act Rule 17a-8 requires broker-dealers to comply with the reporting, recordkeeping, and record retention requirements of the regulations adopted by the Department of the Treasury pursuant to the Bank Secrecy Act. The Bank Secrecy Act requires financial institutions such as broker-dealers to establish AML programs that include, among other things, internal policies, procedures, and controls, and authorizes the Department of the Treasury to adopt regulations prescribing minimum standards for AML programs. 31 U.S.C. §§ 5318(h)(1) and (2). Treasury regulations require broker-dealers to file reports of any suspicious transactions relevant to a possible violation of law or regulation, 31 C.F.R. § 1023.320, and state that broker-dealers regulated by a self-regulatory organization (“SRO”) are deemed to satisfy the Bank Secrecy Act’s AML program requirements if they comply with the AML program requirements of their SRO. 31 C.F.R. § 1023.210.

49. Wedbush’s SRO, FINRA, requires its members to establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of suspicious transactions as required by the Bank Secrecy Act and Treasury regulations thereunder. See FINRA Rule 3310. As described below, on numerous instances Fillhart became aware of potential wash trading and other forms of potential manipulation, but she did not cause Wedbush to file reports regarding the suspicious activity, and Wedbush’s policies and procedures did not cause Wedbush to detect suspicious activity and file such reports.

50. Wedbush’s WSPs asserted that it did not permit its customers to execute wash and pre-arranged trades. Wedbush’s WSPs defined “wash trades” as “transactions which result in no beneficial change of ownership” and defined a “pre-arranged trade” as “an offer to sell coupled with an offer to buy back at the same or at an advanced price, or the reverse.”

51. In most of the trading platforms used by Wedbush sponsored access customers, individual traders were identified by a unique trader ID. While most traders received a single trader ID, on some occasions a single trader had multiple trader IDs. Wedbush did not have any controls or filters to prevent a single trader from trading with himself or herself in a customer firm’s account, or to prevent two different traders from trading with each other in a customer firm’s account.

52. Most trading platforms used by Wedbush’s customers had risk settings to prevent potential wash trades, but Wedbush often did not require customers or platform providers to activate the settings, and Wedbush had no controls or procedures to prevent customers or platform providers from deactivating the settings if they were activated. Some exchanges offered functionality to block wash trades, but Wedbush had no controls or procedures requiring customers to use this anti-wash trade functionality.

53. Wedbush personnel responsible for filing suspicious activity reports pursuant to the Bank Secrecy Act relied on Fillhart and other employees in the Correspondent Services Division, which Bell oversaw, to review trading activity by sponsored access customers to determine whether it was relevant to potential violations of securities laws or regulations. But Bell and Fillhart knew or should have known that Wedbush did not have policies or procedures describing how Correspondent Services employees were to review trading to determine whether it was suspicious and should be reported.

54. The WSPs stated that Wedbush would review reports of potential wash trades from vendors and exchanges, determine whether there were potential securities violations, and if so,

obtain representations from sponsored access customers regarding their internal wash trade reviews and systems.

55. A Wedbush employee who reported to Fillhart received reports of potential wash or pre-arranged trades from exchanges on a daily basis during the relevant period. For most of the trades on the reports, which involved two trader IDs in a single customer account, Fillhart did not ask the Wedbush employee to follow up with the customer firm because Fillhart assumed the two traders were independent and did not consider the trading suspicious. No one from Wedbush ever attempted to contact traders to determine whether they were pre-arranging their trades.

56. For trades with a single trader ID on both sides, Fillhart relied on the customer firm to follow up with the trader. On many occasions, the customer simply responded that it was not wash trading or was an error. On some occasions, the customer did not respond at all. Fillhart generally did not ask the Wedbush employee to follow up with customers for further explanation and did not report the trading to the AML officer as suspicious.

57. In February and March 2012, Fillhart learned from exchanges that numerous traders in the account of one of Wedbush's largest sponsored access customers, which had recently become a customer of a Wedbush correspondent broker-dealer under common ownership with the customer, appeared to be engaged in wash or pre-arranged trading. The customer and correspondent broker-dealer had not enabled pre-trade controls in the trading platform used by the customer that would have prevented wash or pre-arranged trades, and Wedbush did not take steps to enable such controls. The customer and correspondent broker-dealer informed Wedbush that they would either enable the controls in the platform or send future orders through a route that blocked wash trades. Fillhart did not directly enable the risk controls and Wedbush did not take any steps to ensure that the customer or correspondent broker-dealer either enabled the controls or sent future orders through a route that blocked wash trades.

58. The correspondent broker-dealer informed Wedbush that it had disabled one of the traders involved in the incidents, but Wedbush did not directly disable any of the traders. Wedbush had no controls or procedures for preventing traders who had been disabled by a customer or correspondent broker-dealer from obtaining a new trader ID through the same or a different Wedbush customer account.

59. On multiple occasions, Fillhart learned from exchanges that traders in the same customer account appeared to be engaged in potentially manipulative trading referred to as "layering," which involves submitting and cancelling large numbers of non-*bona fide* orders on one side of the market in order to obtain executions at more favorable prices for smaller *bona fide* orders on the other side. See, e.g., *In the Matter of Hold Brothers On-Line Investment Services, LLC, et al.*, Admin. Proc. File No. 3-15046 (Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 and Section 9(b) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and Cease-and-Desist Orders, dated Sept. 25, 2012), at 5-6.

60. As early as February 2011, Fillhart notified the customer of potential layering activity in its account and told the customer that layering "is a manipulative activity." Until at least September 2012, Fillhart continued receiving reports from exchanges of potential layering activity through the same customer account, but she did not cause Wedbush to develop or acquire any tools

to detect or cause the reporting of potential layering activity and did not warn the customer's principals that the account would be disabled if the trading activity continued.

61. In late 2011, Bell and Fillhart met with another senior officer in the Correspondent Services Division to discuss the substantial compliance risks posed to Wedbush by sponsored access customers like the one that had been the subject of numerous reports of potential layering and wash trading and had been addressed in face-to-face meetings with Commission staff—the customer that had thousands of essentially anonymous foreign traders trading through a single Wedbush customer account. Bell, Fillhart, and the other officer decided not to terminate the customer's relationship with Wedbush, but agreed that Wedbush should not take on new market access customers with similar business models because of the compliance risks to Wedbush. In October 2012, Bell, Fillhart, and the other officer met again and decided to terminate Wedbush's relationship with the customer.

62. During the relevant period, Wedbush did not file any suspicious activity reports relating to potential layering and filed only two suspicious activity reports relating to potential wash or pre-arranged trading. More broadly, Fillhart knew that Wedbush did not review for a variety of manipulative trading practices, including fictitious orders, marking the open or marking the close, traders at a Wedbush customer trading a security between each other to manipulate the price of the security, manipulating securities prices through wash trades, or layering.

Authorization of Traders

63. Subsection (b) of the Market Access Rule requires a broker-dealer with market access, or that provides a customer or any other person with access to an exchange or ATS through the use of its MPID or otherwise, to “establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks” of its market access business. Subsection (c)(2)(iii) of the Market Access Rule required Wedbush to have risk management controls and supervisory procedures that were reasonably designed to restrict access to trading systems and technology that provide market access to persons and accounts pre-approved and authorized by Wedbush, the broker-dealer with market access. As described below, for many of its largest sponsored access customers, Wedbush only pre-approved and authorized the principals for the account and relied on its customer to pre-approve and authorize the thousands of individual traders who received market access through the account without reasonably designed controls and supervisory procedures to restrict access to trading systems and technology that provide market access to persons and accounts pre-approved and authorized by the broker or dealer. Accordingly, Wedbush failed to have controls and procedures that complied with Subsection (c)(2)(iii) of the Market Access Rule. Wedbush also did not effectively allocate these obligations, to the extent permitted by Subsection (d)(1) of the Market Access Rule, to its registered broker-dealer customers.

64. Wedbush's WSPs asserted that sponsored access customers were required to provide authorized trader information to Wedbush “upon commencement of sponsored access and when a change occurs.” The WSPs also asserted that Wedbush would verify authorized trader information annually. Wedbush did not have any controls or procedures requiring customers to obtain approval from Wedbush before authorizing new traders.

65. When Wedbush opened a sponsored access account, Wedbush employees obtained identifying information and performed background checks only on the principals of the entity

opening the account, not on other individuals that the entity authorized to trade through the account. While customers sometimes copied a Wedbush employee on their emails instructing platform providers to authorize new traders to trade through the customer's account, Wedbush did not have any written policies or procedures for pre-approving or authorizing new traders for existing sponsored access accounts.

66. Some customer firms and platform providers used a one-page "AccountID creation form" that called for certain information about each authorized trader, but Wedbush did not require use of the form and Wedbush rarely obtained copies of the forms from customers. There was a section on the form for approval of the trader's access, but neither Wedbush nor the customers completed that section of the form.

67. For customer firms with hundreds or thousands of traders, Wedbush usually relied on the customer firm to maintain a list of authorized traders and their trader IDs. Beginning in September 2011, Wedbush employees who reported to Fillhart occasionally obtained lists of authorized traders from customer firms with large numbers of traders and ran searches by name to determine whether any traders were subject to sanctions or restrictions on business activity by the Office of Foreign Assets and Control (OFAC), an office with the Department of the Treasury that administers economic and trade sanctions based on U.S. foreign policy and national security goals. These searches were done after, not before, the customer firm extended market access to the traders. OFAC's programs are separate and distinct from the AML requirements imposed on broker-dealers by Exchange Act Rule 17a-8 and underlying Treasury regulations.

68. For customer firms with hundreds or thousands of traders, neither Fillhart nor Bell asked Wedbush employees to take any steps to verify trader names or identities or to speak to any of the traders. Bell and Fillhart knew that Wedbush relied exclusively on the customer firms, some of which were not registered broker-dealers, to confirm trader identities and oversee their trading strategies. Fillhart herself had the experience of being unable to find a list of trader information for a particular Wedbush client. Because of these facts, particularly the component of Wedbush's business that provided sponsored access to hundreds or thousands of traders through Wedbush's customers, Wedbush's controls and procedures for the pre-approval and authorization of traders were not reasonable. As noted above, Wedbush also did not effectively allocate these obligations, to the extent permitted by Subsection (d)(1) of the Market Access Rule, to its registered broker-dealer customers.

Review of Effectiveness of Market Access Controls and Procedures

69. Section (e) of the Market Access Rule required Wedbush to establish, document, and maintain a system for regularly reviewing the effectiveness of its risk management controls and supervisory procedures relating to market access and to conduct a review of its market access business in accordance with written procedures at least annually. Wedbush did not have any written procedures for regularly reviewing the effectiveness of its market access controls and procedures, and Bell and Fillhart both acknowledged that they had primary responsibility for designing and implementing Wedbush's controls and procedures relating to its market access business. As described below, the only review relating in any way to the market access business that Wedbush conducted during the relevant period did not mention the Market Access Rule or any specific risk management controls or supervisory procedures relating to market access.

70. On Friday, March 23, 2012, in preparation for Wedbush's required certification of supervisory controls pursuant to SRO rules, one of Wedbush's Co-Chief Compliance Officers asked the two internal audit employees at Wedbush to review five areas of Wedbush's business, including one described as "High Frequency Trading." The memorandum containing this request did not mention the Market Access Rule, any other Commission rules, or sponsored access.

71. The internal audit employees prepared a written report dated Monday, March 26, 2012, describing their review, including one page relating to "High Frequency Trading/Exchange Traded Funds." The report did not mention the Market Access Rule, any other Commission rules, sponsored access, Wedbush's WSPs, or any specific risk management controls or supervisory procedures that Wedbush had adopted to comply with the Rule.

72. According to the report, the employees reviewed documents, observed procedures, and spoke with three employees in the Correspondent Services Division as part of the review. The report cited two specific steps—reviewing the checklist for onboarding new customers and observing software applications used for monitoring customer buying power and trading activities. The report noted that the software applications included risk management settings, but did not state that any specific settings were reviewed or tested.

73. The report concluded that, based on the internal audit employees' review, management's controls in the "High Frequency Trading/Exchange Traded Funds" area were adequate and functioning as intended.

74. The Co-Chief Compliance Officer incorporated this section of the report verbatim in a report that he sent to Wedbush's President and the rest of Wedbush's management team and Board on March 30, 2012. Like the internal audit report, this report did not mention the Market Access Rule, any other Commission rules, sponsored access, Wedbush's WSPs, or any specific risk management controls or supervisory procedures that Wedbush had adopted to comply with the Rule. No other reviews of the market access business were conducted by Wedbush employees during the relevant period.

75. Based on the report, as well as conversations with and information previously provided by Bell and others, Wedbush's President signed a certification dated March 30, 2012, citing SRO rules and Rule 15c3-5 (the Market Access Rule), and stating that the firm's risk management controls and supervisory procedures in connection with market access complied with Rule 15c3-5. For the reasons described above, that certification was inaccurate.

Preservation of Records

76. Section 17(a) of the Exchange Act and Rule 17a-4(b)(4) thereunder require broker-dealers to preserve for three years originals of all communications received and copies of all communications sent relating to its business as such. Wedbush did not preserve originals or copies of communications containing trading instructions relating to ISOs submitted by some of its customers under a Wedbush MPID through third-party trading platforms. As a result, Wedbush employees could not determine which orders submitted by those customers during the relevant period were ISOs.

Violations

77. Section 15(c)(3) of the Exchange Act requires broker-dealers to comply with the Commission's rules regarding safeguards, financial responsibility, and related practices of broker-dealers. Rule 15c3-5 thereunder requires broker-dealers with market access to establish, document, and maintain a system of risk management controls and supervisory procedures that is reasonably designed to manage the financial, regulatory, and other risks of its market access business; to maintain direct and exclusive control over the market access controls and procedures; and to establish, document, and maintain a system for regularly reviewing the effectiveness of its risk management controls and supervisory procedures relating to market access. As discussed above, Wedbush willfully violated Section 15(c)(3) of the Exchange Act and Rule 15c3-5 thereunder because it did not maintain exclusive control over risk management controls in sponsored access trading platforms; did not have a system of risk management controls and supervisory procedures that was reasonably designed to ensure compliance with all regulatory requirements, including those that must be satisfied on a pre-order entry basis; did not have controls and procedures reasonably designed to restrict access to market access trading systems to persons and accounts pre-approved and authorized by Wedbush; did not establish, document, and maintain a system for regularly reviewing the effectiveness of its risk management controls and supervisory procedures relating to market access; and did not conduct an adequate review of its market access controls and procedures during the relevant period.

78. Section 17(a) of the Exchange Act and Rule 17a-8 thereunder require broker-dealers to comply with the reporting, recordkeeping, and record retention requirements of the regulations adopted by the Department of the Treasury pursuant to the Bank Secrecy Act. Treasury regulations require broker-dealers to file reports of any suspicious transactions relevant to a possible violation of law or regulation. As discussed above, Wedbush willfully violated Section 17(a) of the Exchange Act and Rule 17a-8 thereunder because it failed to file reports of suspicious trading activity in connection with its market access business.

79. Section 17(a) of the Exchange Act and Rule 17a-4(b)(4) thereunder require broker-dealers to preserve for three years originals of all communications received and copies of all communications sent relating to their business as such. As discussed above, Wedbush willfully violated Section 17(a) of the Exchange Act and Rule 17a-4(b)(4) thereunder because it failed to preserve originals or copies of communications containing trading instructions relating to ISOs submitted by its customers under a Wedbush MPID through third-party trading platforms.

80. Rule 203(b)(1) of Regulation SHO prohibits a broker-dealer from accepting or effecting a short sale order unless the broker-dealer has borrowed the security or entered into an arrangement to borrow the security, or has reasonable grounds to believe that the security can be timely borrowed, and has documented its compliance with Rule 203(b)(1). As discussed above, Wedbush willfully violated Rule 203(b)(1) of Regulation SHO because it allowed sponsored access customers to submit short-sale orders for securities that were not easy to borrow without first otherwise locating shares to borrow.

81. Rule 611(c) of Regulation NMS requires the broker-dealer responsible for routing an ISO to take reasonable steps to establish that the order meets the requirements of Rule 600(b)(30), which requires the broker-dealer routing the ISO to sweep the market by routing simultaneously additional orders, as necessary, to execute against the full size of all better-priced protected quotations. As discussed above, Wedbush willfully violated Rule 611(c) of Regulation NMS

because it allowed sponsored access customers to submit ISOs without Wedbush taking reasonable steps to ensure that it satisfied the requirements for sending ISOs.

Undertakings

Wedbush has undertaken to do the following:

82. Retain, at its own expense, one or more qualified independent consultants (the "Consultant") not unacceptable to the Commission staff to conduct a comprehensive review of Wedbush's current system of controls and procedures for compliance with all applicable regulatory requirements relating to its market access business, including but not limited to Exchange Act Rules 15c3-5 and 17a-8; to assess Wedbush's corporate governance and culture of compliance with respect to its market access business; and to provide recommendations for improvements as may be needed. The Consultant's review and analysis shall include:

a. Wedbush's documented system of risk management controls and supervisory procedures relating to market access as required by Exchange Act Rule 15c3-5, including both regulatory and financial risk management controls and supervisory procedures;

b. Wedbush's documented system for regularly reviewing the effectiveness of its risk management controls and supervisory procedures relating to market access;

c. Wedbush's policies and procedures to detect and cause the reporting of transactions by its market access customers that may be relevant to a possible violation of law or regulation as required by Exchange Act Rule 17a-8 and underlying Bank Secrecy Act regulations; and

d. Wedbush's corporate governance structure and culture of compliance relating to its market access business, including the structure and functioning of Wedbush's Business Conduct and Compliance departments relating to its market access business.

83. Provide, within thirty (30) days of the issuance of this Order, a copy of the engagement letter detailing the Consultant's responsibilities to Daniel M. Hawke, Chief, Market Abuse Unit, U.S. Securities and Exchange Commission, One Penn Center, 1617 JFK Boulevard, Suite 520, Philadelphia, PA 19103, with a copy to Steven D. Buchholz, Assistant Regional Director, U.S. Securities and Exchange Commission, 44 Montgomery Street, 28th Floor, San Francisco, CA 94104.

84. Cooperate fully with the Consultant, including providing the Consultant with access to its files, books, records, and personnel (and the files, books, records, and personnel of Wedbush's affiliated entities, to the extent they relate to Wedbush's market access business), as reasonably requested for the above-referenced review, and obtaining the cooperation of respective employees or other persons under Wedbush's control.

85. Require the Consultant to report to the Commission staff on its activities as the staff may request.

86. Permit the Consultant to engage such assistance, clerical, legal, or expert, as necessary and at a reasonable cost, to carry out its activities, and the cost, if any, of such assistance shall be borne exclusively by Wedbush.

87. Require the Consultant, within thirty (30) days of being retained (unless otherwise extended by the Commission staff for good cause), to provide Wedbush and the Commission staff with (i) an estimate of the time needed to complete the review and analysis, and (ii) a proposed deadline, subject to the approval of the Commission staff, for the preparation of a written report describing the review and analysis ("Report").

88. Require the Consultant to issue the Report by the approved deadline and provide the Report simultaneously to Wedbush and the Commission staff. The Report shall:

a. Evaluate the adequacy of Wedbush's documented system of risk management controls and supervisory procedures to manage the regulatory, financial, and other risks of its market access business and, as may be needed, make recommendations for strengthening Wedbush's system of market access controls and procedures;

b. Evaluate the adequacy of Wedbush's documented system for regularly reviewing the effectiveness of its risk management controls and supervisory procedures relating to market access and, as may be needed, make recommendations for strengthening Wedbush's system for regularly reviewing the effectiveness of its market access controls and procedures;

c. Evaluate the adequacy of Wedbush's policies and procedures relating to its market access business to detect and cause the reporting of transactions that may be relevant to a possible violation of law or regulation and, as may be needed, make recommendations for strengthening Wedbush's policies and procedures relating to suspicious activity reporting with respect to its market access business; and

d. Evaluate Wedbush's corporate governance structure and culture of compliance relating to its market access business and, as may be needed, make recommendations for improvements.

89. Submit to the Commission staff and the Consultant, within thirty (30) days of the Consultant's issuance of the Report, the date by which Wedbush will adopt and implement any recommendations in the Report, subject to Sections (a)-(c) below and subject to the approval of the Commission staff.

a. As to any recommendation that Wedbush considers to be, in whole or in part, unduly burdensome or impractical, Wedbush may submit in writing to the Consultant and the Commission staff a proposed alternative reasonably designed to accomplish the same objectives, within thirty (30) days of the Consultant's issuance of the Report. Wedbush shall then attempt in good faith to reach an agreement with the Consultant relating to each disputed recommendation and request that the Consultant reasonably evaluate any alternative proposed by Wedbush. If, upon evaluating Wedbush's proposal, the Consultant determines that the suggested alternative is reasonably designed to accomplish the same objectives as the recommendations in question, then the Consultant shall approve the suggested alternative and make the recommendations. If the Consultant determines that the suggested alternative is not reasonably designed to accomplish the same objectives, the Consultant shall reject Wedbush's proposal. The Consultant shall inform Wedbush and the Commission staff of the Consultant's final determination concerning any recommendation that Wedbush considers to be unduly burdensome or impractical within fourteen (14) days after the conclusion of the discussion and evaluation by Wedbush and the Consultant.

b. In the event that Wedbush and the Consultant are unable to agree on an alternative proposal, Wedbush and the Consultant shall jointly confer with the Commission staff regarding the disputed recommendation, and Wedbush shall accept the Commission staff's determination with respect to the disputed recommendation.

c. Within fourteen (14) days after the final determination of any disputed recommendation, Wedbush shall submit to the Consultant and the Commission staff the date by which Wedbush will adopt and implement the recommendation, subject to the approval of the Commission staff.

90. Adopt and implement, on the timetable set forth by Wedbush in accordance with paragraph 89, the recommendations in the Report. Wedbush shall notify the Consultant and the Commission staff in writing when the recommendations have been implemented.

91. Within thirty (30) days after Wedbush notifies the Consultant that the recommendations have been implemented, require the Consultant to certify, in writing, to Wedbush and the Commission staff, that Wedbush has implemented the Consultant's recommendations. The Consultant's certification shall also include an opinion of the Consultant as to whether Wedbush's risk management controls and supervisory procedures relating to market access are reasonably designed to manage the financial, regulatory, and other risks of its market access business, and whether Wedbush's policies and procedures relating to its market access business can be reasonably expected to detect and cause the reporting of transactions that may be relevant to a possible violation of law or regulation.

92. Within one hundred and eighty (180) days from the date of the Consultant's certification described in paragraph 91 above, require the Consultant to have completed a review of how Wedbush is implementing, enforcing, and auditing the effectiveness of its risk management controls and supervisory procedures relating to market access and its policies and procedures relating to suspicious activity reporting with respect to its market access business and submit a final written report ("Final Report") to Wedbush and the Commission staff. The Final Report shall include an opinion of the Consultant as to whether Wedbush is taking reasonable steps to implement, enforce, and audit the effectiveness of its risk management controls and supervisory procedures relating to market access and its policies and procedures relating to suspicious activity reporting with respect to its market access business.

93. Require the Consultant to enter into an agreement providing that, for the period of the engagement and for a period of two years after completion of the engagement, the Consultant shall not enter into any employment, consultant, attorney-client, auditing, or other professional relationship with Wedbush, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. The agreement will also provide that the Consultant will require that any firm with which it is affiliated or of which it is a member, and any person engaged to assist the Consultant in the performance of its duties under this Order, shall not, without prior written consent of the Commission staff, enter into any employment, consultant, attorney-client, auditing, or other professional relationship with Wedbush, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after completion of the engagement.

94. Certify, in writing, its compliance with the Undertakings set forth above. Wedbush's certification shall identify the Undertakings, provide written evidence of compliance in

the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Wedbush agrees to provide such evidence. The certification and supporting material shall be submitted no later than thirty (30) days after the completion of the Undertakings to Daniel M. Hawke, Chief, Market Abuse Unit, U.S. Securities and Exchange Commission, One Penn Center, 1617 JFK Boulevard, Suite 520, Philadelphia, PA 19103, with a copy to Steven D. Buchholz, Assistant Regional Director, U.S. Securities and Exchange Commission, 44 Montgomery Street, 28th Floor, San Francisco, CA 94104.

95. To ensure the independence of the Consultant, Wedbush shall not have the authority to terminate the Consultant without prior written approval of the Commission's staff and shall compensate the Consultant and persons engaged to assist the Consultant for services rendered pursuant to this Order at their reasonable and customary rates.

96. Wedbush may apply to the Commission staff for an extension of the deadlines described above before their expiration and, upon a showing of good cause by Wedbush, the Commission staff may, in its sole discretion, grant such extensions for whatever time period it deems appropriate.

97. The Commission's acceptance of Wedbush's offer of settlement and entry of this Order shall not be construed as its approval of any controls, policies, or procedures reviewed by the Consultant or implemented based on the Consultant's recommendations.

IV.

In view of the foregoing, the Commission deems it appropriate in the public interest to impose the sanctions agreed to in Respondent Wedbush's Offer.

Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act and Section 203(e) of the Advisers Act, it is hereby ORDERED that:

A. Respondent Wedbush cease and desist from committing or causing any violations and any future violations of Sections 15(c)(3) and 17(a) of the Exchange Act; Rules 15c3-5, 17a-4, and 17a-8 thereunder; Rule 203(b)(1) of Regulation SHO; and Rule 611(c) of Regulation NMS.

B. Respondent Wedbush is censured.

C. Respondent Wedbush shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of \$2,447,043.38 to the Securities and Exchange Commission. If timely payment is not made, interest shall accrue pursuant to 31 U.S.C. § 3717. Payment must be made in one of the following ways: (1) Wedbush may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) Wedbush may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or (3) Wedbush may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Wedbush as a Respondent in these proceedings and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Daniel M. Hawke, Chief, Market Abuse Unit, U.S. Securities and Exchange Commission, One Penn Center, 1617 JFK Boulevard, Suite 520, Philadelphia, PA 19103, with a copy to Steven D. Buchholz, Staff Attorney, U.S. Securities and Exchange Commission, 44 Montgomery Street, 28th Floor, San Francisco, CA 94104.

D. Respondent Wedbush shall comply with the Undertakings enumerated in paragraphs 82 through 97 above.

By the Commission.



Brent J. Fields
Secretary

ANNEX A

Respondent Wedbush Securities Inc. admits the facts set forth below (the "Admissions") and acknowledges that its conduct violated the federal securities laws:

Respondents

1. Wedbush Securities Inc. is a California corporation with its headquarters in Los Angeles, California. The firm was founded in 1955 and registered with the NASD as a broker-dealer in 1955, with the Commission as a broker-dealer in 1966 and as an investment adviser in 1970. Wedbush is a wholly-owned subsidiary of Wedbush, Inc., a privately-held company. As of December 31, 2012, Wedbush had 79 branch offices and 844 employees. From at least July 2011 until January 2013 (the "relevant period"), Wedbush was consistently ranked as one of the five largest firms by trading volume on NASDAQ.

2. During the relevant period, Jeffrey Bell was Executive Vice President of the Correspondent Services Division of Wedbush, reporting to the firm's President, and was an associated person of Wedbush. Bell also was President of Lime Brokerage LLC ("Lime"), another wholly-owned subsidiary of Wedbush, Inc.

3. Christina Fillhart is a Senior Vice President in the Correspondent Services Division of Wedbush and is an associated person of Wedbush. Fillhart reported to Bell until late 2012, when she began reporting to one of Wedbush's Co-Chief Compliance Officers.

Wedbush's Market Access Business

4. Wedbush's primary market access business is part of the Correspondent Services Division, which also handles traditional clearing operations for introducing broker-dealers, otherwise known as "correspondent" firms. Wedbush's sponsored market access customers send orders directly to exchanges and other trading venues by using online trading platforms or software programs that the customer either owns directly or leases from a third-party platform provider, referred to as a service bureau.

5. During the relevant period, Wedbush had about 50 sponsored access customers that generated average monthly trading volume of 10 billion shares. Several of Wedbush's sponsored access customer firms had hundreds or thousands of authorized traders each during the relevant period.

6. The Correspondent Services Division was Wedbush's most profitable division during the relevant period. Senior managers in the Correspondent Services Division, including Bell and Fillhart, received bonus compensation based in part on the profitability of the Division.

7. In June 2011, Wedbush acquired Lime Brokerage LLC, a provider of trading technology platforms. After Wedbush acquired Lime, about 20% of Wedbush's sponsored access customers began using the Lime platform. The other 80% continued to receive sponsored access either through their own proprietary trading platform or through a third-party platform that the customer leased from a service bureau.

8. Wedbush described some risk management controls and supervisory procedures relating to market access in Chapter 31 of the firm's written supervisory procedures ("WSPs"), titled "Sponsored Access."

9. Bell and Fillhart, along with one other senior Wedbush employee in the Correspondent Services Division, had primary responsibility for preparing and adopting Wedbush's controls and procedures relating to market access.

10. Wedbush was aware of the requirements set forth in Rule 15c3-5 when they became effective. During the public comment period for the then-proposed Rule 15c3-5, Wedbush submitted a comment letter to the Commission on March 31, 2010.

11. On May 17, 2011, Commission staff from the Office of Compliance Inspections and Examinations ("OCIE") sent an Examination Deficiency Letter to Wedbush, which was addressed to Bell. Among other things, the letter advised Wedbush that the staff had identified deficient Wedbush controls relating to short sales, identified problems with internal controls over a third-party order management system, identified weaknesses in the firm's anti-money-laundering controls, and that Wedbush had failed to respond promptly to compliance issues when they arose.

12. On July 5, 2011, Wedbush representatives, including Bell and Fillhart, met with representatives of OCIE to discuss the impending effectiveness of Rule 15c3-5. During that meeting, the Commission's staff expressed concerns about Wedbush's largest sponsored non-broker-dealer client and its thousands of traders. Wedbush's presentation to the staff cited the Market Access Rule requirements relating to allocating compliance responsibilities to sponsored access broker-dealer clients and maintaining "direct and exclusive control" of risk settings in trading platforms.

Market Access Through Third-Party Trading Platforms

13. Wedbush employees in the Correspondent Services Division received access from trading platform providers to view risk settings and trading activity in the platforms, but Wedbush did not have exclusive control over some of the regulatory risk settings in third-party or client-proprietary trading platforms because customers had access to set and revise the risk settings. On certain occasions, risk settings intended to prevent violations of rules relating to short sales¹ were not implemented in a trading platform according to Wedbush's instructions. On other occasions, a

¹ Rule 203(b)(1) of Regulation SHO prohibits broker-dealers from accepting or effecting a short sale order unless the broker-dealer has borrowed the security or entered into an arrangement to borrow the security, or has reasonable grounds to believe that the security can be timely borrowed, and has documented its compliance with Rule 203(b)(1).

customer or platform provider was able to disable or circumvent risk settings intended to prevent wash trades and violations of rules relating to intermarket sweep orders ("ISOs").²

14. Wedbush generally had no contractual relationship with third-party platform providers in that Wedbush's customers, rather than Wedbush, leased the trading platforms from third parties.

15. Shortly before most provisions of the Market Access Rule took effect, Wedbush obtained email statements from many of the trading platform providers that the risk management settings in the platforms were under the direct and exclusive control of Wedbush, but Wedbush did not have exclusive control of all risk management settings in the platforms because Wedbush allowed customers to change certain risk settings in the platforms.

16. Wedbush's WSPs stated that each new sponsored access customer would perform an initial "risk demonstration" to show Wedbush the customer's trading platform settings for certain financial and regulatory risk controls. Wedbush had a checklist for the risk demonstration that included, among other things, settings to prevent clearly erroneous trades, wash trades, improper short sales, and, unless authorized by Wedbush, ISOs.

17. In June 2012, Wedbush conducted demonstrations of risk settings in the trading platforms used by sponsored access customers. Wedbush conducted these demonstrations for each platform provider, rather than for each sponsored access customer. During a demonstration, the provider would submit test orders as instructed by Wedbush and confirm that certain risk settings specified by Wedbush were in place and functioning at the time of the demonstration.

18. In these demonstrations, Wedbush did not typically receive demonstrations of the actual risk settings in effect for particular sponsored access customers. As stated above, customers had access to set and revise some of the risk settings in the platforms that were shown during the platform provider's demonstration. Wedbush also did not maintain records of many of the actual risk settings in the platforms with respect to particular customers so that it could determine whether any settings had been changed without its consent.

19. In certain instances, customers or trading platform providers changed certain risk settings without Wedbush's knowledge or consent. For example, a risk setting to prevent improper short sales failed on numerous occasions because the wrong list of securities that were easy to borrow was loaded into the customer's third-party trading platform, and a customer repeatedly circumvented a risk setting that was designed to prevent the use of ISOs. For other risk settings, such as controls to prevent wash trades, Wedbush often did not require customers or platform providers to activate the settings.

² Rule 611(c) of Regulation NMS requires the broker-dealer responsible for routing an ISO to take reasonable steps to establish that the order meets the requirements of Rule 600(b)(30) of Regulation NMS, which requires the broker-dealer routing the ISO to route simultaneously additional orders, as necessary, to execute against the full size of all better-priced protected quotations.

Attempts to Allocate Responsibility for Regulatory Controls and Procedures

20. After the Market Access Rule took effect, Wedbush attempted to assign to other broker-dealers the responsibility for regulatory risk management controls and supervisory procedures for many of its sponsored access customers. In so doing, Wedbush did not conduct due diligence reviews specific to the other broker-dealer's market access controls and procedures and generally relied on the other broker-dealer's attestation that it had implemented appropriate controls and procedures.

21. Wedbush's agreements, which Bell approved, did not specify the particular controls or procedures that Wedbush purported to be allocating. The agreements instead referred generally to the categories of regulatory risk management controls and supervisory procedures required by subsection (c)(2) of the Market Access Rule. The agreements also did not specify the broker-dealer to which the controls or procedures purportedly were being allocated.

22. Wedbush did not conduct later reviews specific to market access controls and procedures to determine whether the other broker-dealers were adequately carrying out the responsibilities purportedly allocated.

23. For some registered broker-dealer customers trading their own capital on a proprietary basis, Wedbush entered into an allocation agreement directly with the customer to monitor its own trading. Wedbush did not have any written policies or procedures for determining whether a broker-dealer to which it claimed to have assigned responsibilities had better access than Wedbush to ultimate customers such that the other broker-dealer could more effectively implement the risk management controls and supervisory procedures relating to market access.

Regulatory Requirements That Must Be Satisfied On a Pre-Order Entry Basis

24. Wedbush was responsible for ensuring that all short-sale orders submitted under a Wedbush MPID by its sponsored access customers complied with Regulation SHO. Among other things, Regulation SHO required Wedbush, prior to accepting or effecting a short sale order, to borrow the security or enter into an agreement to borrow the security, or have reasonable grounds to believe that the security could be timely borrowed (generally known as the "locate" requirement). Absent countervailing factors, "easy-to-borrow" lists may provide "reasonable grounds" for a broker-dealer to believe that the security sold short is available for borrowing without directly contacting the source of the borrowed securities (known as "easy-to-borrow securities").

25. Wedbush's WSPs stated that the firm sometimes relied on sponsored access customers to meet the short-sale requirements of Regulation SHO. Wedbush maintained a list of easy-to-borrow securities, and Wedbush relied on sponsored access customers or their platform providers to load that list into third-party trading platforms. Maintaining up-to-date lists in the trading platforms was a key step in the control process because the platforms relied on the lists to determine whether Regulation SHO had been satisfied before routing a short-sale order for execution. If a customer or platform provider failed to load the correct easy-to-borrow list, Wedbush had no controls or procedures to prevent the customer from submitting a short-sale order for a security that was not easy to borrow without first obtaining a locate.

26. On three occasions between July 2011 and November 2012, a platform provider loaded the wrong day's easy-to-borrow list, which resulted in Wedbush customers submitting short-

sale orders for securities that were not easy to borrow without first having located shares that it had reasonable grounds to believe could be timely borrowed as required by Regulation SHO. Bell and Fillhart knew that similar incidents had occurred several times before July 2011.

27. Wedbush was responsible for ensuring that all orders submitted under a Wedbush MPID and marked as ISOs by its sponsored access customers complied with Regulation NMS, which requires the broker-dealer responsible for routing an ISO to route simultaneously additional orders, as necessary, to execute against the full size of all better-priced protected quotations.

28. Wedbush's WSPs asserted that in order to comply with Regulation NMS, Wedbush did not permit a customer to use ISOs unless the customer swept the market of all better-priced protected quotations. However, if a non-broker-dealer customer used ISOs, Wedbush did not have any controls or procedures designed to ensure that the ISOs complied with Regulation NMS.

29. At least one Wedbush customer submitted ISOs without Wedbush's prior knowledge and without a broker-dealer acting to ensure compliance with the relevant regulatory requirements. In April 2011, one of Wedbush's largest non-broker-dealer sponsored access customers was submitting ISOs even though Wedbush did not authorize the customer to submit ISOs. Without Wedbush's knowledge, the customer and its third-party platform provider had enabled an order route that was configured to allow ISOs, even though the platform provider had previously informed Wedbush that the customer was not able to submit ISOs.

30. Because Wedbush had not authorized the customer to submit ISOs, Wedbush had not taken any steps to ensure that the ISOs complied with Regulation NMS. Fillhart instructed the platform provider to close the ISO route, but Wedbush did not directly close or disable the route. Wedbush relied on the assurances of the customer and third-party platform provider that the ISO route had been closed and did not have any controls or procedures to prevent a similar ISO route from being enabled again in the future.

31. In November 2011, the same customer's third-party platform provider again enabled an ISO route in its trading platform at the request of the customer, and the customer submitted ISOs without Wedbush's knowledge. As in April 2011, Wedbush had not taken any steps to ensure that the ISOs complied with Regulation NMS because Wedbush had not authorized the customer to submit ISOs.

Other Regulatory Requirements

32. Exchange Act Rule 17a-8 requires broker-dealers to comply with the reporting, recordkeeping, and record retention requirements of the regulations adopted by the Department of the Treasury pursuant to the Bank Secrecy Act. Treasury regulations require, among other things, that broker-dealers file reports of any suspicious transactions relevant to a possible violation of law or regulation. 31 C.F.R. § 1023.320.

33. On numerous instances, Wedbush became aware of transactions or orders that were identified by exchanges as potentially representing wash or pre-arranged trading or other forms of potential market manipulation by Wedbush's sponsored access customers, but Wedbush did not file suspicious activity reports regarding the transactions or orders and Wedbush's controls and procedures did not cause Wedbush to file such reports.

34. Wedbush's WSPs asserted that Wedbush did not permit its customers to execute wash and pre-arranged trades. Wedbush's WSPs defined "wash trades" as "transactions which result in no beneficial change of ownership" and defined a "pre-arranged trade" as "an offer to sell coupled with an offer to buy back at the same or at an advanced price, or the reverse."

35. In most of the trading platforms used by Wedbush sponsored access customers, individual traders were identified by a unique trader ID. While most traders received a single trader ID, on some occasions a single trader had multiple trader IDs. Wedbush often did not implement controls or filters to prevent two different traders from trading with each other in a single customer firm's account, or to prevent a trader from trading with himself or herself by using different trader IDs.

36. Most trading platforms used by Wedbush's customers had risk settings to prevent potential wash trades, but for customers with hundreds or thousands of traders, Wedbush did not require the customers or their platform providers to activate the settings. Some exchanges offered functionality to block wash trades, but Wedbush did not require these customers to use the anti-wash trade functionality.

37. Wedbush's AML officer relied on employees in the Correspondent Services Division to review trading activity by sponsored access customers to determine whether it may be relevant to potential violations of securities laws or regulations. But Wedbush did not have written policies or procedures describing how Correspondent Services employees were to review trading to determine whether it was suspicious.

38. Wedbush requested and received from exchanges daily reports of potential wash or pre-arranged trades during the relevant period. For most of the trades on the reports identified as potential wash trades, which involved two trader IDs in a single customer account, Wedbush did not look into or report the trading as suspicious and typically assumed the two traders were independent. No one from Wedbush attempted to contact individual traders to determine whether they were pre-arranging their trades.

39. For trades with a single trader ID on both sides, Wedbush relied on the customer firm to follow up with the trader. On many occasions, the customer simply responded that it was not wash trading or was an error. On some occasions, the customer did not respond at all. Correspondent Services employees often did not report the trading to Wedbush's AML officer.

40. In February and March 2012, Wedbush learned of potential wash or pre-arranged trading in the account of one of its largest sponsored access customers, which had recently become a customer of a Wedbush correspondent broker-dealer. The customer and correspondent broker-dealer had not enabled pre-trade controls in the trading platform used by the customer to prevent potential wash trades, and Wedbush did not take steps to enable such controls. The customer and correspondent broker-dealer informed Wedbush that they would either enable the controls in the platform or send future orders through a route that blocked potential wash trades. Wedbush did not directly enable the controls and did not take any steps to ensure that the customer or correspondent broker-dealer either enabled the controls or sent future orders through a route that blocked potential wash trades.

41. The correspondent broker-dealer informed Wedbush that it had disabled one of the traders involved in the incidents, but Wedbush did not directly disable any of the traders. Wedbush

had no controls or procedures for preventing traders who had been disabled by a customer or correspondent broker-dealer from obtaining a new trader ID through the same or a different Wedbush customer account.

42. On multiple occasions between February 2011 and September 2012, Fillhart was informed by exchanges that traders in the same customer account appeared to be engaged in potentially manipulative trading referred to as "layering," which involves submitting and cancelling large numbers of non-*bona fide* orders on one side of the market in order to obtain executions at more favorable prices for smaller *bona fide* orders on the other side.

43. Wedbush notified the customer of the potential layering activity in its account and requested an explanation, but Wedbush did not develop or acquire any tools to detect potential layering activity during the relevant period, and Wedbush did not warn the customer's principals that the account would be disabled if the trading activity continued.

44. During the relevant period, Wedbush did not file any suspicious activity reports relating to potential layering and filed only two suspicious activity reports relating to potential wash or pre-arranged trading.

Authorization of Traders

45. When Wedbush opened a sponsored access account, Wedbush employees obtained identifying information and generally performed background checks only on the principals of the entity opening the account, not on other individuals that the entity authorized to trade through the account. While customers typically copied a Wedbush employee on their emails instructing platform providers to authorize new traders to trade through the customer's account, Wedbush did not have any written policies or procedures for pre-approving or authorizing new traders for existing sponsored access accounts.

46. Wedbush's WSPs asserted that sponsored access customers were required to provide authorized trader information to Wedbush "upon commencement of sponsored access and when a change occurs." The WSPs also asserted that Wedbush would verify authorized trader information annually. For customer firms with hundreds or thousands of traders, Wedbush usually relied on the customer firms to maintain a list of authorized traders and their trader IDs. Some of these customer firms were not registered broker-dealers. Wedbush employees did not typically speak to any of the traders or take any steps to verify trader names or identities.

47. Wedbush provided sponsored market access to customer firms with hundreds or thousands of traders, but Wedbush did not have controls and procedures to restrict access to trading systems and technology that provide market access to individual traders who had been pre-approved and authorized by Wedbush.

Review of Effectiveness of Market Access Controls and Procedures

48. Wedbush did not have any written procedures for regularly reviewing the effectiveness of its controls and procedures specific to its market access business.

49. On Friday, March 23, 2012, in preparation for Wedbush's required certification of supervisory controls, one of Wedbush's Co-Chief Compliance Officers asked the two internal audit

employees at Wedbush to review five areas of Wedbush's business, including one described as "High Frequency Trading." The memorandum containing this request did not mention the Market Access Rule, any other Commission rules, or sponsored access.

50. The internal audit employees prepared a written report dated Monday, March 26, 2012, describing their review, including one page relating to "High Frequency Trading/Exchange Traded Funds." The report did not mention the Market Access Rule, any other Commission rules, sponsored access, Wedbush's WSPs, or any specific risk management controls or supervisory procedures that Wedbush had adopted to comply with the Rule.

51. According to the report, the employees reviewed documents, observed procedures, and spoke with three employees in the Correspondent Services Division as part of the review. The report cited two specific steps—reviewing the checklist for onboarding new customers and observing software applications used for monitoring customer buying power and trading activities. The report noted that the software applications included risk management settings, but did not state that any specific settings were reviewed or tested.

52. The report concluded that, based on the internal audit employees' review, management's controls in the "High Frequency Trading/Exchange Traded Funds" area were adequate and functioning as intended.

53. The Co-Chief Compliance Officer incorporated this section of the report verbatim in a report that he sent to Wedbush's President and the rest of Wedbush's management team and Board on March 30, 2012. Like the internal audit report, this report did not mention the Market Access Rule, any other Commission rules, sponsored access, Wedbush's WSPs, or any specific risk management controls or supervisory procedures that Wedbush had adopted to comply with the Rule. No other reviews of risk management controls and supervisory procedures relating to market access were conducted by Wedbush employees as part of the annual review process.

54. Based on the report, as well as conversations with and information previously provided by Bell and others, Wedbush's President signed a certification dated March 30, 2012 stating that the firm's risk management controls and supervisory procedures in connection with market access complied with Rule 15c3-5. In light of all the facts described above in this Annex A, that certification was inaccurate.

Preservation of Records

55. Section 17(a) of the Exchange Act and Rule 17a-4(b)(4) thereunder require broker-dealers to preserve for three years originals of all communications received and copies of all communications sent relating to its business as such. Wedbush did not preserve originals or copies of communications containing trading instructions relating to orders designated as ISOs submitted by at least one of its sponsored access customers through a third-party trading platform. As a result, Wedbush employees could not determine from the firm's records which orders submitted by that customer during the relevant period were ISOs.

Conclusion

56. In connection with the conduct described in the foregoing Admissions, Wedbush acted willfully.³

³ A willful violation of the securities laws means merely “that the person charged with the duty knows what he is doing.” *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor “also be aware that he is violating one of the Rules or Acts.” *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 73663 / November 20, 2014

ADMINISTRATIVE PROCEEDING

File No. 3-16284

In the Matter of

**Blue Moon Investments,
Boulder Capital Opportunities II Ltd.,
Cabinet Acquisition Corp., and
eConnect, Inc.,**

Respondents.

**ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
AND NOTICE OF HEARING
PURSUANT TO SECTION 12(j) OF
THE SECURITIES EXCHANGE ACT
OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Blue Moon Investments, Boulder Capital Opportunities II Ltd., Cabinet Acquisition Corp., and eConnect, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Blue Moon Investments (CIK No. 1094376) is a dissolved Nevada corporation located in Kelowna, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Blue Moon is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended June 30, 2010, which reported a net loss of \$17,190 for the prior nine months.

2. Boulder Capital Opportunities II Ltd. (CIK No. 1026215) is a delinquent Colorado corporation located in Chandler, Arizona with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Boulder Capital is

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delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2007, which reported a net loss of \$17,857 for the prior nine months.

3. Cabinet Acquisition Corp. (CIK No. 817717) is a Delaware corporation located in Mesa, Arizona with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Cabinet Acquisition is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended March 31, 2010, which reported a net loss of \$10,651 from the company's March 24, 1999 inception to March 31, 2010.

4. eConnect, Inc. (CIK No. 1058985) is a Nevada corporation located in San Pedro, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). eConnect is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10 registration statement on May 14, 1998, which reported a net loss of \$500 for the year ended December 31, 1997.

B. DELINQUENT PERIODIC FILINGS

5. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

6. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

7. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and/or 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each

class of securities registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

November 20, 2014

In The Matter Of

**Bravo Enterprises Ltd.
Immunotech Laboratories, Inc.
Myriad Interactive Media, Inc.
Wholehealth Products, Inc.**

File No. 500-1

**ORDER OF SUSPENSION
OF TRADING**

It appears to the Securities and Exchange Commission that there is a lack of current and accurate information concerning the securities of the issuers listed below.

1. Bravo Enterprises Ltd. is a Nevada corporation with its principal place of business in Patchogue, New York. Questions have arisen concerning the accuracy and adequacy of publicly disseminated information, including information about the relationship between the company's business prospects and the current Ebola crisis. The company is quoted on OTC Link (previously "Pink Sheets") operated by OTC Markets Group Inc. ("OTC Link"), under the stock symbol OGNG.
2. Immunotech Laboratories, Inc. is a Nevada corporation with its principal place of business in Monrovia, California. Questions have arisen concerning the accuracy and adequacy of publicly disseminated information, including information about the relationship between the company's business prospects and the current Ebola crisis. The company is quoted on OTC Link under the stock symbol IMMB.

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3. Myriad Interactive Media, Inc. is a Delaware corporation with its principal place of business in Toronto, Canada. Questions have arisen concerning the accuracy and adequacy of publicly disseminated information, including information about the relationship between the company's business prospects and the current Ebola crisis. The company is quoted on OTC Link under the stock symbol MYRY.
 4. Wholehealth Products, Inc. is a Nevada corporation with its principal place of business in Anaheim, California. Questions have arisen concerning the accuracy and adequacy of publicly disseminated information, including information about the relationship between the company's business prospects and the current Ebola crisis. The company is quoted on OTC Link under the stock symbol GWPC.

The Commission is of the opinion that the public interest and the protection of investors require the suspension of trading in the securities of the above-listed companies.

THEREFORE, IT IS ORDERED, pursuant to Section 12(k) of the Securities Exchange Act of 1934, that trading in the securities of the above-listed companies is suspended for the period from 9:30 a.m. EST, on November 20, 2014, through 11:59 p.m. EST, on December 4, 2014.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

Commissioner Gallagher
Not participating

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Release No. 73664 / November 21, 2014

Admin. Proc. File No. 3-15794

In the Matter of the Application of

MITCHELL T. TOLAND
c/o Brad S. Maistrow, Esq.
17 Battery Place, Suite 711
New York, NY 10004

For Review of Action Taken by

FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION—REVIEW OF DENIAL OF
MEMBERSHIP CONTINUANCE APPLICATION

Registered securities association denied member's application to permit continued association of an individual who was subject to a statutory disqualification because of his willful failure to disclose his 2005 bankruptcy filing. *Held*, review proceeding is *dismissed*.

APPEARANCES:

Brad S. Maistrow for Mitchell T. Toland.

Alan Lawhead and *Andrew J. Love* for Financial Industry Regulatory Authority, Inc.

Appeal filed: March 12, 2014
Last brief received: June 19, 2014

Mitchell T. Toland, an individual subject to statutory disqualification from association with a member firm, appeals from the decision by the Financial Industry Regulatory Authority, Inc. ("FINRA") denying the application of his former employer, Hallmark Investments, Inc. ("Hallmark"), to remain a FINRA member notwithstanding its employment of Toland as a

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general securities representative.¹ Toland is subject to statutory disqualification because he willfully failed to disclose his 2005 bankruptcy filing on his Uniform Application for Securities Industry Registration or Transfer ("Form U4"). Toland asserts that FINRA abused its discretion in denying his request to postpone the hearing on Hallmark's application, which he subsequently declined to attend, and requests that we remand this matter for a hearing. For the reasons explained below, we dismiss Toland's application for review.² We base our findings on an independent review of the record.

I. Background

A. Toland became subject to statutory disqualification when FINRA found in a September 2009 settled order that he willfully failed to disclose his 2005 bankruptcy filing on his Form U4.

In a September 22, 2009 settled order, FINRA found that Toland willfully failed to disclose his 2005 bankruptcy filing on his Form U4.³ Persons associated with brokers are required to update their Forms U4 with certain information,⁴ including whether the person filed for bankruptcy within the last ten years or is subject to any unsatisfied liens or judgments.⁵ FINRA and other SROs use this important information in assessing the fitness of associated persons,⁶ and "[t]he duty to provide accurate information and to amend the Form U4 to provide current information assures" that interested parties "have all material, current information about

¹ *In the Matter of the Continued Ass'n of Mitchell T. Toland as a Gen. Sec. Rep. with Hallmarks Invs., Inc.*, SD-1812 (Feb. 19, 2014), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@adj/documents/nacdecisions/p448164.pdf>.

² Commission precedent allows Toland to appeal FINRA's decision denying Hallmark's application. *Timothy P. Pedregon, Jr.*, Securities Exchange Act Release No. 61791, 2010 WL 1143089 (Mar. 26, 2010) (considering associated individual's appeal of FINRA decision denying firm's membership continuance application); see also *Nicholas S. Savva*, Exchange Act Release No. 72485, 2014 WL 2887272, at *1 n.5 (June 26, 2014) (concluding that person subject to statutory disqualification was a "person[] aggrieved by FINRA's denial" of his employer's membership continuance application).

³ *Dep't of Enf. v. Mitchell T. Toland*, Discip. Proceeding No. 20070099785-02 (Sept. 22, 2009).

⁴ See FINRA By-Laws, Article V, Section 2(c) (requiring that every Form U4 be kept current at all times through supplementary amendments filed within thirty days of learning of the facts or circumstances giving rise to the amendment).

⁵ Form U4 question 14K(1) asks, among other things, whether the associated person has filed a bankruptcy petition in the past ten years. Question 14M asks whether the person has any unsatisfied liens or judgments against him.

⁶ See *Timothy H. Emerson, Jr.*, Exchange Act Release No. 60328, 2009 WL 2138439, at *5 (July 17, 2009) (citing *Thomas R. Alton*, Exchange Act Release No. 36058, 52 SEC 380, 1995 WL 464801, at *2 (Aug. 4, 1995), *aff'd*, 105 F.3d 664 (9th Cir. 1996) (Table)).

the securities professional with whom they are dealing."⁷ Toland's willful omission of his bankruptcy in the Form U4 made him subject to statutory disqualification under Section 3(a)(39) of the Securities Exchange Act of 1934,⁸ and, as a result, disqualification under FINRA's By-Laws.⁹ Pursuant to the parties' settlement, FINRA suspended Toland in all capacities for forty-five days and fined him \$5,000.¹⁰

B. Hallmark submitted a membership continuance application seeking to continue its association with Toland and then sought postponement of the first hearing date on the application.

On December 2, 2009, Hallmark submitted an MC-400 Membership Continuance Application to FINRA's Department of Registration and Disclosure seeking to permit Toland, who had been associated with Hallmark since 2005, to continue to associate with the firm as a general securities representative, although he was subject to statutory disqualification. "[A] person subject to statutory disqualification cannot become or remain associated with a FINRA member firm unless the person's member firm applies for, and is granted, in FINRA's discretion, relief from the statutory disqualification."¹¹ Nonetheless, FINRA permits certain individuals subject to statutory disqualification to continue to associate with their employers pending resolution of the employers' membership continuance applications.¹² Toland continued to work for Hallmark while its application was pending.

⁷ *Richard A. Neaton*, Exchange Act Release No. 65598, 2011 WL 5001956, at *6 (Oct. 20, 2011).

⁸ See 15 U.S.C. § 78c(a)(39) (providing that a person is subject to statutory disqualification if he willfully has made a false or misleading statement of material fact, or has omitted to state a material fact required to be disclosed, in any application or report filed with a self-regulatory organization).

⁹ FINRA By-Laws, Art. III, § 4 (stating that a person is subject to "disqualification" if such person is subject to "statutory disqualification" as defined in Exchange Act Section 3(a)(39)).

¹⁰ In an investigative interview preceding the settlement, Toland acknowledged his error and expressed remorse for his omission, which he characterized as inadvertent.

¹¹ *Savva*, 2014 WL 2887272, at *2 (citing FINRA By-Laws, Art. III, § 3(b), (d); *Joseph S. Amundsen*, Exchange Act Release No. 69406, 2013 WL 1683914, at *1 n.4 (Apr. 18, 2013), *petition for review pending* No. 13-1252 (D.C. Cir. filed Sept. 9, 2013)).

¹² Statutory Disqualification Process, <http://www.finra.org/Industry/Enforcement/Adjudication/NAC/StatutoryDisqualificationProcess/index.htm> (last visited Nov. 20, 2014) (stating that, notwithstanding the general rule that "a person who is subject to disqualification may not associate with a FINRA member in any capacity unless and until approved in an Eligibility Proceeding," "[i]f a person is currently associated with a FINRA member at the time the disqualifying event occurs, . . . the person may be permitted to continue to work in certain circumstances, provided the employer member promptly files a written application seeking permission to continue the employment in an Eligibility Proceeding" (emphasis omitted)).

FINRA initially scheduled a November 10, 2011 hearing on Hallmark's application before a subcommittee ("Hearing Panel") of FINRA's Statutory Disqualification Committee. But the individual the firm designated in its application to serve as a backup supervisor for Toland received a "Wells notice,"¹³ so Hallmark and Toland sought a postponement of the hearing to allow time to find a new backup supervisor. FINRA Member Regulation did not oppose the request and the hearing was adjourned without setting a new date for consideration of the application.¹⁴

C. FINRA set a new hearing date after learning that Toland had failed to disclose additional required information.

FINRA Member Regulation asserts that it became aware in February 2013 that Toland had failed to disclose additional required information in his Form U4 – eight outstanding judgments and liens totaling more than \$490,000.¹⁵ Two liens predated Toland's settlement with FINRA but Toland did not disclose them to FINRA at the time, and the settlement did not address them. The remainder of the liens and judgments arose after the settlement of Toland's willful failure to disclose his bankruptcy filing.

Member Regulation's discovery led to new urgency in the scheduling of the hearing on Hallmark's application. FINRA initially set a June 5, 2013 hearing, but Toland's counsel had a previously scheduled court appearance on that date. The parties agreed to hold the hearing on August 15, 2013, which FINRA memorialized in a May 15, 2013 scheduling order.

D. Toland requested two additional postponements of the hearing date.

On July 22, 2013, Toland moved to postpone the August 15 hearing date based on his counsel's unavailability. Member Regulation objected, expressing skepticism for the need to

¹³ A Wells notice is a communication from a regulator or self-regulatory organization, such as the Commission or FINRA, that it intends to recommend bringing an enforcement or disciplinary action against the recipient.

¹⁴ Toland asserts that FINRA failed to schedule a hearing for an agreed April 19, 2012 date. At that time, however, Toland's proposed backup supervisor had yet to qualify as a supervisor. The proposed backup qualified as a supervisor in January 2013.

¹⁵ These judgments and liens consisted of: (1) a \$28,004 New Jersey tax lien filed in January 2008; (2) a \$15,965 New York tax warrant filed in December 2008; (3) a \$10,140 New York tax warrant filed in September 2010; (4) a \$731 New York tax warrant filed in November 2010; (5) a \$22,951 judgment obtained by Columbia Grammar & Preparatory School in February 2011; (6) a \$614 judgment obtained by Midland Funding LLC in July 2011; (7) four federal tax liens totaling \$386,838 (addressing tax years 2003 through 2010) that were consolidated into a single lien filed in May 2012; and (8) a \$25,000 federal tax lien filed in June 2012 (for tax year 2011).

postpone the previously agreed date.¹⁶ Nonetheless, on August 5, 2013, FINRA granted Toland's motion and ordered that the hearing be held on October 17, 2013 at 12:30 p.m. at FINRA's Washington, D.C., headquarters. FINRA also directed the parties to complete their exchange of exhibits and witness lists by October 3, 2013.

On October 2, 2013, Toland sought an "emergency postponement" of the hearing date based on his mother's medical condition. Toland asserted that his mother recently had been diagnosed with an advanced stage of cancer, that he lived with her and was her sole caretaker, and that there were "no relatives or friends who [we]re able to take Mrs. Toland to and from her treatments and attend to her needs" after she received chemotherapy, which he expected would begin the following week. As such, Toland maintained that he could not attend the October 17 hearing. He did not propose an alternative hearing date.

On October 3, 2013, FINRA Member Regulation opposed Toland's postponement request but offered to change the location of the hearing to either FINRA's New York or New Jersey district office to accommodate Hallmark, Toland, and his counsel. Member Regulation also stated that it expected the hearing would run no more than two and a half hours, and FINRA later advised Toland that it anticipated he would need to be present for only approximately one hour of the hearing. On October 4, 2013, FINRA advised the parties that, although the Hearing Panel had denied Toland's postponement request, it would move the hearing to New York to accommodate him.

E. Neither Toland, his counsel, nor anyone representing Hallmark attended the telephonic hearing on Hallmark's application.

On October 15, 2013, Toland advised FINRA by letter that he would not attend the hearing on October 17 because his mother had a medical appointment scheduled for the same day. Toland asserted that, although the hearing had been moved to New York, this was insufficient to accommodate him because no one else "could bring his mother for treatment" and "attend to her while she suffered through the debilitating side effects thereof." FINRA thereafter informed the parties that the hearing would be held telephonically and provided them access information for the call.

On October 17, 2013, the Hearing Panel held a hearing on Hallmark's application. Neither Toland, his counsel, nor anyone representing or affiliated with Hallmark joined the teleconference, although only Toland asserted he was unavailable. Hallmark never submitted a witness list or any proposed exhibits in support of its application.

¹⁶ Member Regulation argued that, although Toland sought a postponement to allow his counsel to drive his daughter back to Ann Arbor, Michigan for her senior year of college, Toland's counsel represented that those travels would occur in the last week of August when he agreed to the August 15, 2013 hearing. In addition, Member Regulation asserted that it was "telling" that Toland sought the adjournment a little more than a week before final document exchange was due and "curious" that the extension was filed shortly after Member Regulation had outlined to Toland its argument for recommending denial of Hallmark's application.

F. FINRA's National Adjudicatory Council denied Hallmark's application.

After the hearing, the Hearing Panel submitted its written recommendation on Hallmark's application to FINRA's Statutory Disqualification Committee. On February 19, 2014, after the Committee presented a written recommendation to FINRA's National Adjudicatory Council, the NAC issued a seventeen-page decision denying Hallmark's application because "Toland's continued association with the Firm would create an unreasonable risk of harm to the market or investors."¹⁷

In so concluding, the NAC applied the framework set forth in *Paul Edward Van Dusen* and subsequent Commission opinions, applicable where the misconduct making an individual subject to statutory disqualification was previously the subject of a Commission or SRO sanction of specified duration.¹⁸ In such an instance, an SRO "ordinarily" may not deny relief "based solely on the underlying misconduct that led to the statutory disqualification" and completed sanction; rather, "something more is needed."¹⁹ In that respect, an SRO should "generally confine its analysis to new information,"²⁰ such as "[1] misconduct in which a statutorily disqualified person may have engaged since the misconduct that gave rise to the statutory disqualification, [2] the nature and disciplinary history of a prospective employer, and [3] the proposed supervisory structure to which the statutorily disqualified person would be subject."²¹ In rejecting Hallmark's application, the NAC relied on each of these three factors.

First, the NAC observed that "Toland engaged in serious intervening misconduct, which is identical to the misconduct underlying the disqualifying settlement order." The NAC was

¹⁷ Unlike a disciplinary hearing, the process for consideration of a membership continuance application does not involve the publication of a hearing panel decision appealable to the NAC. The NAC issued the sole written decision on Hallmark's application following the hearing.

¹⁸ Exchange Act Release 18284, 47 SEC 668, 1981 WL 315505, at *3 (Nov. 24, 1981) (setting forth framework in case where statutory disqualification arose from conduct addressed by Commission's eighteen-month conditional bar order); *Reuben D. Peters*, Exchange Act Release No. 49819, 57 SEC 657, 2004 WL 1351269, at *4-5 (June 7, 2004) (finding framework applicable where disqualification arose from permanent injunction entered for conduct also addressed by two-month Commission administrative suspension); *May Capital Group, LLC*, Exchange Act Release No. 53796, 2006 WL 1312955, at *5 (May 12, 2006) (clarifying that *Van Dusen* analysis applies where completed sanction was imposed by SRO).

¹⁹ *Harry M. Richardson*, Exchange Act Release No. 51236, 58 SEC 134, 2005 WL 424920, at *3 (Feb. 22, 2005); see also *Arouh*, 2010 WL 3554584, at *12 ("[W]here a statutorily disqualified person has applied for permission to associate after a sanction of specified duration has run its course, we have held that it would be inconsistent with the remedial purposes of the Exchange Act and unfair to deny the application solely on the basis of the misconduct that led to the original sanction." (citing *Van Dusen*, 1981 WL 315505, at *3)).

²⁰ *Arthur H. Ross*, Exchange Act Release No. 30956, 50 SEC 1082, 1992 WL 188932, at *2 (July 27, 1992).

²¹ *Richardson*, 2005 WL 424920, at *2 (citing *Van Dusen*, 1981 WL 315505, at *3).

"troubled and perplexed by Toland's repeated and continuing failures to disclose judgments and liens on his Form U4," particularly given the remorse he previously expressed for failing to disclose his 2005 bankruptcy filing. The NAC found that Toland's misconduct deprived customers and the investing public of material information concerning his financial difficulties and ability to manage his financial obligations. The NAC concluded that Toland's failures were inexcusable and raised serious doubts that he was able, or willing, to comply with securities rules and regulations.²² Thus, even without considering the circumstances that subjected Toland to statutory disqualification (the failure to disclose his 2005 bankruptcy), the NAC determined that Toland's recent failures to disclose judgments and liens were, on their own, sufficiently egregious to deny Hallmark's application.²³

Second, the NAC found that Hallmark "ha[d] a troubling disciplinary and regulatory history, particularly with respect to disclosure issues" and that the totality of that history was "disconcerting," supporting the conclusion that Hallmark was "not capable of assuming the additional heavy burden of supervising a statutorily disqualified individual such as Toland." The NAC concluded that, like Toland, Hallmark "has a troubling history of failing to comply with FINRA's reporting and disclosure obligations."²⁴ In addition, the NAC cited a number of additional events that cast substantial doubt on the quality of Hallmark's supervision.²⁵

²² In addition, the NAC noted that, when Toland eventually updated his Form U4 in July 2013, he failed to include three New York tax warrants that Member Regulation identified for him at the time it informed him of his disclosure failures.

²³ The NAC also found that Toland's disclosure failures, including his failure to disclose his 2005 bankruptcy, demonstrated a pattern of misconduct, but did not rely on it in denying the application.

²⁴ The NAC cited events including the following: (1) in February 2009, Hallmark and its owner settled a FINRA action related to a misleading and inaccurate application to change the firm's ownership; (2) in February 2010, FINRA issued a Cautionary Action that cited Hallmark for, among other things, failing to update the firm's Form BD to reflect that its owner had been suspended; and (3) a FINRA Cautionary Action cited Hallmark for failing to timely file Form U4 amendments, including with respect to Toland's disclosure of the 2009 settlement order relating to his failure to disclose his 2005 bankruptcy. In addition, the NAC noted that neither Hallmark's Form BD nor its principal's Form U4 disclosed a 2013 Indiana consent agreement. Although Toland does not dispute this, these documents do not appear in the record, and we accordingly do not rely on them in reaching our decision.

²⁵ Those events included: (1) in January 2013, Hallmark consented to findings that it failed to establish a reasonable supervisory system and procedures for retaining and reviewing email; (2) the Indiana consent agreement referenced above involved allegations that Hallmark and Toland's proposed supervisor failed to adequately supervise an individual at the firm; and (3) in 2009, FINRA cited Hallmark for failing to ensure that Toland and the firm's owner did not engage in activities requiring registration while they were suspended, and the explanations provided by the firm regarding the use of Toland's and Hallmark's owner's registered representative codes while they were suspended raised additional questions and concerns for FINRA. In addition, the NAC cited the Commission's "2012 examination report f[inding] that

(continued...)

Third, the NAC concluded that Hallmark "ha[d] not demonstrated that it could properly supervise a statutorily disqualified individual such as Toland," in that, among other things, Toland's proposed supervisors were "highly problematic." Because Toland's proposed supervisor already supervised fifteen individuals and served as chief compliance officer, the NAC was concerned that he lacked sufficient time to supervise Toland. In addition, the supervisor was named in an Indiana securities regulatory enforcement action for failure to supervise, which was resolved by consent agreement imposing restitution and a civil penalty, and the firm's regulatory and disclosure issues discussed above occurred under his watch.²⁶ The NAC also concluded that Toland's proposed backup supervisor was not qualified because he only recently became licensed as a principal, had re-entered the securities industry after a more than ten-year absence, and had no supervisory experience.²⁷

G. The NAC found that the Hearing Panel did not abuse its discretion by denying Toland's request to postpone the hearing.

In denying Hallmark's application, the NAC also found that the Hearing Panel did not abuse its discretion by denying Toland's request to postpone the hearing. The NAC relied on (1) the pendency of Hallmark's application since December 2009 (nearly four years before the October 2013 hearing), (2) the initial scheduling of the hearing for November 2011 (nearly two years before the eventual hearing), (3) the previous adjournments, (4) the postponement of the agreed August 15, 2013 hearing date at Toland's request over Member Regulation's objection, and (5) the Hearing Panel's willingness to move the hearing to New York to accommodate Toland and its subsequent decision to hold it telephonically. Given these facts, as well as the serious (undisputed) allegations of intervening and continuing misconduct by Toland and his continued employment in the securities industry pending resolution of Hallmark's application, the NAC found that the Hearing Panel properly denied Toland's request to postpone the October 17, 2013 hearing.²⁸

(...continued)

the Firm failed to establish [written supervisory procedures] related to reviewing customer accounts that receive penny stock and representatives['] use of email," and also finding "evidence of excessive trading and unsuitable recommendations in two of Toland's customer accounts."

²⁶ See *supra* notes 24 and 25 and accompanying text.

²⁷ The NAC also found Hallmark's proposed supervisory plan deficient for additional reasons. But because it found that there were serious issues with Toland's intervening misconduct, Hallmark's regulatory history, and Toland's proposed supervisors, the NAC determined it was unnecessary to allow Hallmark to amend the plan to cure its deficiencies, as the NAC would have done had it otherwise been inclined to approve the application.

²⁸ Toland later requested we stay the NAC's decision and allow him to continue to associate with Hallmark pending our consideration of his application for review. We denied his request. *Mitchell T. Toland*, Exchange Act Release No. 71875, 2014 WL 1338145, at *3 (Apr. 4, 2014).

II. Analysis

A. The standard of review for Toland's application is established by Exchange Act Section 19(f).

Toland challenges FINRA's denial of Hallmark's membership continuance application pursuant to Exchange Act Section 19(d).²⁹ Exchange Act Section 19(f) requires us to dismiss this proceeding if each of the following requirements is satisfied: (1) "the specific grounds on which [the] denial . . . is based exist in fact," (2) the denial "is in accordance with the rules of the self-regulatory organization," *i.e.*, FINRA, and (3) "such rules are, and were applied in a manner, consistent with the purposes of" the Exchange Act.³⁰ Because we find that each of these requirements is satisfied, we accordingly dismiss this proceeding.³¹

B. The specific grounds on which FINRA denied Hallmark's membership continuance application exist in fact.

We find that the specific grounds on which FINRA based its denial of Hallmark's membership continuance application, as summarized above, exist in fact. Indeed, Toland does not dispute that this element is satisfied. We conclude that the record supports the NAC's factual findings.³²

C. FINRA's denial of Hallmark's application was consistent with FINRA rules.

We also find that FINRA's denial of Hallmark's application was in accordance with FINRA rules.³³ "In a FINRA proceeding such as this, 'the burden rests on the applicant to show that, despite the disqualification, it is in the public interest to permit the requested

²⁹ 15 U.S.C. § 78s(d).

³⁰ *Id.* § 78s(f).

³¹ Toland does not argue, nor do we find, that FINRA's denial of Hallmark's application imposes any burden on competition of the sort prohibited by Exchange Act Section 19(f). *See Pedregon*, 2010 WL 1143089, at *8 n.35 (concluding that denial of membership continuance application "imposed no undue burden on competition").

³² In assessing the first element, we look to the record before the NAC. We address below Toland's assertion that he would have presented additional evidence had the hearing been postponed. *See* Section II.D.2.

³³ FINRA's By-Laws provide that it may grant a membership continuance application if, "in its discretion," FINRA determines that approval is "consistent with the public interest and the protection of investors." FINRA By-Laws, Art. III, § 3(d); *accord William J. Haberman*, Exchange Act Release No. 40673, 53 SEC 1024, 1998 WL 786945, at *2 n.7 (Nov. 12, 1998) ("NASD may, in its discretion, approve association with a statutorily disqualified person only if the NASD determines that such approval is consistent with the public interest and the protection of investors."), *aff'd*, 205 F.3d 1345 (8th Cir. 2000) (Table).

employment."³⁴ Toland does not assert that Hallmark met this burden, or even that his firm could have done so had Toland and Hallmark participated in the hearing, and he raises no procedural challenge under FINRA rules.³⁵ We find that FINRA complied with its substantive and procedural rules in denying Hallmark's application.

D. FINRA applied its rules in a manner consistent with the Exchange Act.

We also find that FINRA applied its rules in a manner consistent with the Exchange Act.³⁶ Toland does not dispute the validity of the NAC's substantive conclusions based on the record before it. Instead, he limits his argument to the single procedural claim that the Hearing Panel should have postponed the October 17, 2013 hearing.

1. The NAC's substantive findings are consistent with the Exchange Act.

We first address the NAC's substantive findings. The NAC appropriately concluded, and cogently explained the basis for its determination, that Toland's continued association with Hallmark would present an unreasonable risk of harm to the market and investors.³⁷ Among other things, we agree with the NAC's determination that "[r]egardless of the serious nature of Toland's original misconduct, his subsequent and repeated failures to disclose numerous outstanding liens and judgments during a four-year period are, on their own, sufficiently

³⁴ *Emerson*, 2009 WL 2138439, at *4 (quoting *Gershon Tannenbaum*, Exchange Act Release No. 31080, 50 SEC 1138, 1992 WL 213844, at *2 (Aug. 24, 1992)).

³⁵ Although Toland faults the Hearing Panel for declining to postpone the hearing, he asserts that FINRA's determination violated the Exchange Act, not its own procedure. See FINRA Rule 9524(a)(5) (providing that Hearing Panel "may postpone or adjourn any hearing" (emphasis added)). We reject Toland's argument for the reasons set forth in Section II.D.2.

³⁶ Toland does not assert that those rules, to the extent applied here, are inconsistent with the Exchange Act, nor do we so find.

³⁷ The Exchange Act provides that FINRA may "bar from becoming associated with a member any person, who is subject to a statutory disqualification." Exchange Act Section 15A(g)(2), 15 U.S.C. § 78o-3(g)(2). For FINRA's denial of a membership continuance application to be consistent with the Exchange Act, "FINRA must 'independently [evaluate the] application, based upon the totality of the circumstances, and . . . explain the bases for its conclusion.'" *Pedregon*, 2010 WL 1143089, at *5 (quoting *Frank Kufrovich*, Exchange Act Release No. 4543, 55 SEC 616, 2002 WL 215446, at *5 (Feb. 13, 2002)). We "have afforded FINRA discretion in determining whether persons subject to statutory disqualification should be permitted to associate with a member firm." *Leslie A. Arouh*, Exchange Act Release No. 62898, 2010 WL 3554584, at *13 (Sept. 13, 2010) (citations omitted).

egregious to warrant denial" of Hallmark's application.³⁸ The NAC's finding is consistent with our recognition of the critical importance of an associated person's accurate disclosure on his Form U4,³⁹ and the material risks that such inaccurate disclosure conceals.⁴⁰ We also agree that Hallmark "has a troubling history of failing to comply with FINRA's reporting and disclosure obligations," which supports the conclusion that the firm is "not capable of assuming the additional heavy burden of supervising a statutorily disqualified individual such as Toland." And we share the NAC's concern that Toland's proposed supervisors are "highly problematic"⁴¹ given, among other things, the primary supervisor's current supervision of fifteen other individuals and additional duties as chief compliance officer,⁴² the regulatory difficulties that Hallmark experienced during the proposed supervisor's tenure, and the proposed backup supervisor's inexperience.⁴³

³⁸ Toland's misconduct was all the more troubling given his previous failure to disclose his 2005 bankruptcy on his Form U4 and associated expressions of remorse. Although the NAC did not rely on the original misconduct as a part of a pattern, it would have been justified in doing so. See *Morton Kantrowitz*, Exchange Act Release No. 54278, 2006 WL 2252394, at *5 (Aug. 7, 2006) (concluding that two incidents "demonstrate[d] a sufficient pattern of misconduct to make consideration of the earlier statutorily disqualifying event appropriate").

³⁹ *Rosario R. Ruggiero*, Exchange Act Release No. 37070, 52 SEC 725, 1996 WL 164175, at *3 (Apr. 5, 1996) (emphasizing that "[t]he candor and forthrightness of [individuals making these filings] is critical to the effectiveness of [SRO] screening process" (quoting *Alton*, 1995 WL 464801, at *2 (alteration in original))).

⁴⁰ A representative's serious undisclosed financial problems raise concerns about whether he can "responsibly manage his own financial affairs, and ultimately cast doubt on his ability to provide trustworthy financial advice and services to investors relying on him to act on their behalf as a securities industry professional." *Robert D. Tucker*, Exchange Act Release No. 68210, 2012 WL 5462896, at *9 (Nov. 9, 2012), *appeal dismissed*, No. 13-31 (2d Cir. Sept. 24, 2013).

⁴¹ "[I]n determining whether to permit the employment of a statutorily disqualified person, the quality of the supervision to be accorded that person is of utmost importance." *Citadel Sec. Corp.*, Exchange Act Release No. 49666, 57 SEC 502, 2004 WL 1027581, at *4 (May 7, 2004) (internal quotation omitted). For this reason, "[w]e have made it clear that such persons must be subject to stringent oversight by supervisors who are fully qualified to implement the necessary controls." *Id.*; see also *Haberman*, 1998 WL 786945, at *4 (recognizing the necessity of "stringent supervision for a person subject to a statutory disqualification").

⁴² *Emerson*, 2009 WL 2138439, at *5 (finding that FINRA "reasonably questioned whether [proposed supervisor] ha[d] sufficient time to devote to the heightened supervision of a statutorily disqualified individual given that [he] supervised nine other people" (internal quotation and brackets omitted)).

⁴³ *Pedregon*, 2010 WL 1143089, at *6 (finding assignment of unqualified backup supervisor to be "troubling"); see also *Emerson*, 2009 WL 2138439, at *5 (stating that the Commission was "concerned" with adequacy of supervisory plan given, among other things, proposed supervisor's "lack of experience supervising statutorily disqualified persons").

2. Toland's procedural argument is meritless.

As noted above, Toland's sole argument is that the Hearing Panel abused the "broad discretion" afforded it "in determining whether to grant a request for a continuance,"⁴⁴ and thus violated the Exchange Act by denying Toland a sufficient "opportunity to defend against" FINRA's case pursuant to a "fair procedure."⁴⁵ In particular, Toland asserts that "[g]iven the extremely critical circumstances," regarding his mother's health, "it was impossible" for him to attend the October 17, 2013 hearing. Even assuming that the Exchange Act provisions on which Toland relies apply to non-disciplinary proceedings such as this one,⁴⁶ we find that Toland's argument is meritless.

Although we sympathize with Toland's personal situation, we find that FINRA acted within the scope of its discretion in denying his request to postpone the hearing. To alleviate the need for Toland to travel, FINRA moved what it expected would be a relatively brief afternoon hearing to New York from Washington, D.C.⁴⁷ When Toland asserted he could not appear in

⁴⁴ See *Robert J. Prager*, Exchange Act Release No. 51974, 58 SEC 634, 2005 WL 1584983, at *13 (Jul. 6, 2005) ("In NASD proceedings, the trier of fact has broad discretion in determining whether to grant a request for a continuance."); *Falcon Trading Grp., Ltd.*, Exchange Act Release No. 36619, 52 SEC 554, 1995 WL 757798, at *5 (Dec. 21, 1995) ("It is well settled that in NASD proceedings, as in judicial proceedings, the trier of fact has broad discretion in determining whether a request for continuance should be granted, based upon the particular facts and circumstances presented."), *petition denied*, 102 F.3d 579 (D.C. Cir. 1996). Toland's attempt to distinguish these cases on their facts is misguided. In exercising its broad discretion, FINRA need not establish that the circumstances relevant to its determination are identical to those in prior cases involving either itself or its predecessor, NASD.

⁴⁵ Toland cites Exchange Act provisions applying to SRO disciplinary proceedings. See Exchange Act Section 15A(h)(1), 15 U.S.C. § 78-o3(h)(1) (generally requiring that "[i]n any proceeding by a registered securities association," such as FINRA, "to determine whether a member or person associated with a member should be *disciplined* . . . the association shall bring specific charges, notify such member or person of, and give him an opportunity to defend against, such charges, and keep a record" (emphasis added)); Exchange Act Section 15A(b)(8), 15 U.S.C. § 78o-3(b)(8) (requiring that the rules of registered securities associations must, among other things, "provide a fair procedure for the *disciplining* of members and persons associated with members" (emphasis added)).

⁴⁶ The NAC's decision to deny Hallmark's application is not a decision to discipline Toland. *Halpert & Co.*, Exchange Act Release No. 28615, 50 SEC 420, 1990 WL 322213, at *2 (Nov. 14, 1990) (noting that NASD's denial of membership was not "imposing a penalty on applicants in this matter or even a remedial sanction"); see also *id.* at *2 n.8 ("Under the Commission's rules, the NASD's action [to deny a membership continuance application] is not treated as a disciplinary proceeding." (citations omitted)).

⁴⁷ FINRA expected the hearing to last approximately two and a half hours, of which Toland would have needed to be present for only one hour. Toland offers no basis to dispute this time estimate. Hallmark never submitted a witness or exhibit list or estimated the amount of time it might need to present its evidence.

person, FINRA scheduled a telephonic hearing. Toland makes no attempt to explain why he could not have appeared telephonically, and he also fails to explain why no Hallmark witnesses or representatives (including the attorney representing both Toland and the firm) attended the hearing, given that only Toland asserted he was unavailable. Further, despite the long pendency of the application, Toland never proposed an alternative date for the hearing, but rather simply asserted that he was unavailable for at least eight to ten weeks.⁴⁸ Under these circumstances, we find it was reasonable for FINRA to proceed with the hearing as scheduled.⁴⁹

We also reject Toland's assertion that because the requested adjournment of the hearing "would not have presented an imminent risk of unreasonable . . . harm to investors," FINRA's decision to deny that postponement was "patently unfair." Toland ignores the relevant standard. The question is not whether granting the requested postponement would have presented an "imminent risk," but rather whether FINRA's decision to deny Toland's request was within the broad scope of its discretion.⁵⁰ For the reasons set forth above, we conclude that FINRA acted within the scope of that discretion.

We also find no merit in the specific assertions underlying Toland's argument. First, Toland asserts that the amount of time the FINRA proceedings had already taken at the time of the hearing demonstrates that a postponement posed no undue risk and blames FINRA's "foot dragging" for the scheduling delay. But it was Hallmark that requested a postponement of the initial hearing date (albeit an unopposed request), and Toland obtained a second postponement over Member Regulation's objection. Even if we were to accept Toland's attempt to attribute the delay "predominantly" to FINRA, we would find it beside the point. Just because one party obtains a continuance does not mean that the opposing party is automatically entitled to one

⁴⁸ Toland asserts that the NAC erred by concluding that he was seeking an eighteen-week postponement, rather than asserting his unavailability for eight to ten weeks. Under either circumstance, the NAC was justified in denying Toland's motion.

⁴⁹ See *Whiteside & Co.*, Exchange Act Release No. 26187, 49 SEC 963, 1988 WL 901551, at *4 (Oct. 14, 1988) (rejecting argument that "NASD was required to grant a postponement because [firm's chairman] was seriously ill and Whiteside, the firm's only other principal, could not leave the firm unattended" because "[t]he law does not require unlimited postponements of judicial proceedings" and concluding that "the NASD was not required to postpone this matter for a third time until some indefinite date in the future"), *aff'd*, 883 F.2d 7 (5th Cir. 1989); *cf. Harold B. Hayes*, Exchange Act Release No. 34662, 51 SEC 1294, 1994 WL 512480, at *7 (Sept. 13, 1994) (finding it was appropriate for NASD to deny continuance in disciplinary proceeding notwithstanding applicant's claim that his "reactive depression" rendered him unable to assist in his defense and manifested itself in "lack of concentration, memory loss, and severe stress, and was complicated by the side effects of the drug treatment he was undergoing").

⁵⁰ See *supra* note 44; see also *Falcon Trading Group*, 1995 WL 757798, at *5 (holding that our "inquiry is limited to determining whether the denial constituted 'an unreasoning and arbitrary insistence upon expeditiousness in the face of a justifiable request for delay'" (quoting *Richard W. Suter*, 47 SEC 951, 963 (1983))).

later.⁵¹ Toland also benefitted from the scheduling delays, during which he continued to work, because they allowed Hallmark time to search for qualified supervisors for him. In any event, regardless of the origin of the delay, FINRA had good reason to insist on expedience after it learned in early 2013 that Toland had again failed to make proper disclosure on his Form U4.

Second, we also reject Toland's claim that his "disciplinary history with respect to customer complaints" shows that postponement would have posed no risk. Even accepting Toland's efforts to minimize the significance of five prior customer complaints based on their age,⁵² we remain troubled by Toland's uncontested failure to disclose numerous judgments and liens on his Form U4.⁵³

Finally, we reject Toland's argument that the NAC's decision was "unfairly skewed" because, given the scheduling of the hearing, he could not present evidence of various "substantive and potentially mitigating factors." Because we have concluded that FINRA acted within the scope of its discretion when it denied Toland's postponement request, we need not consider his argument. But even if Toland had offered the testimony he now proffers, it would not undermine the factual basis on which the NAC relied in denying his firm's application.

First, Toland asserts that he would have presented the following potentially mitigating factors at a hearing: (1) his father's death in 2011 after a lengthy battle with Alzheimer's and dementia and its emotional and financial effects, (2) his son's receipt of intensive therapy for the last ten years as a result of various disabilities, and (3) his separation and divorce from his spouse. Although these factors may explain why Toland was in financial distress, they do not justify his failure to disclose the liens and judgments, establish that Toland's misconduct will not recur, or demonstrate that he presents no risk of future harm to investors.⁵⁴ And none of them relates to the sufficiency of Hallmark's supervision of Toland or its regulatory history.

⁵¹ Cf. *Thomas J. Fittin, Jr.*, Exchange Act Release No. 29173, 50 SEC 544, 1991 WL 292516, at *5 (May 8, 1991) (declining to find abuse of discretion in law judge's denial of respondent's postponement request where "hearings had already been postponed due to deaths in the families of the law judge and staff counsel").

⁵² Cf. *Emerson*, 2009 WL 2138439, at *5 ("Even where prior misconduct is not recent, it still 'reflects poorly on [an applicant's] judgment and trustworthiness.'" (quoting *Kufrovich*, 2002 WL 215446, at *6)).

⁵³ See *supra* notes 39 and 40 and accompanying text.


⁵⁴ See *Bernard D. Gorniak*, Exchange Act Release No. 35996, 52 SEC 371, 1995 WL 442063, at *2 (July 20, 1995) (noting that the securities business "presents a great many opportunities for abuse and overreaching, and depends very heavily on the integrity of its participants" (quoting *Richard D. Earl*, Exchange Act Release No. 22535, 48 SEC 334, 1985 WL 548312, at *2 (Oct. 16, 1985), *aff'd*, 798 F.2d 472 (9th Cir. 1986))); *Mayer A. Amsel*, Exchange Act Release No. 37092, 52 SEC 761, 1996 WL 169430, at *6 (Apr. 10, 1996) (stating that the securities industry is "a business that is rife with opportunities for abuse").

Second, we reject Toland's assertion that FINRA "improperly described the Firm's disciplinary and regulatory conduct as 'disconcerting,'" because, at the time of the hearing, Hallmark had "recently gone through an exhaustive 8-month Cycle Examination," which, Toland asserts, it completed "with flying colors."⁵⁵ Purported evidence of Hallmark's current compliance with its obligations does not negate the prior disciplinary and regulatory history that the NAC found disconcerting,⁵⁶ or the serious issues regarding the firm's proposed supervision of Toland.⁵⁷ And the NAC also found that Toland's post-disqualification misconduct standing alone was a sufficient basis to deny his application. In sum, FINRA acted within its discretion when it denied the postponement request, but even if FINRA had granted the request, Toland does not offer a sufficient basis to conclude that FINRA reasonably would have come to an alternative conclusion on his application.

Accordingly, for all these reasons, we dismiss this review proceeding. An appropriate order will issue.⁵⁸

By the Commission (Chair WHITE and Commissioners AGUILAR, STEIN, and PIWOWAR); Commissioner GALLAGHER not participating.

Brent J. Fields
Secretary


By: **Lynn M. Powalaki**
Deputy Secretary

⁵⁵ This assertion appears inaccurate given that Toland concedes that Hallmark was "directed to take certain corrective actions" as a result of the examination.

⁵⁶ Cf. *Kent M. Houston*, Exchange Act Release No. 71589A, 2014 WL 936398, at *78 (Feb. 20, 2014) ("FINRA has repeatedly held that a lack of disciplinary history is not mitigating for purposes of sanctions because an associated person should not be rewarded for acting in accordance with his duties as a securities professional." (citing *Philippe N. Keyes*, Exchange Act Release No. 54723, 2006 WL 3313843, at *6 (Nov. 8, 2006)).

⁵⁷ See *supra* notes 41-43 and accompanying text.

⁵⁸ We have considered all the arguments advanced by the parties. We reject or sustain them to the extent that they are inconsistent or in accord with the views expressed herein.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73664 / November 21, 2014

Admin. Proc. File No. 3-15794

In the Matter of the Application of

MITCHELL T. TOLAND
c/o Brad S. Maistrow, Esq.
17 Battery Place, Suite 711
New York, NY 10004

For Review of Action Taken by

FINRA


ORDER DISMISSING REVIEW PROCEEDING

On the basis of the Commission's opinion issued this day, it is

ORDERED that the application for review filed by Mitchell T. Toland be, and it hereby is, dismissed.

By the Commission.

Brent J. Fields
Secretary


By: Lynn M. Powalski
Deputy Secretary

*Commissioner Gallagher
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73678 / November 24, 2014

INVESTMENT ADVISERS ACT OF 1940
Release No. 3972 / November 24, 2014

INVESTMENT COMPANY ACT OF 1940
Release No. 31357 / November 24, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16286

In the Matter of

Alan Gavornik,
Nicholas Mariniello and
Lee Argush,

Respondents.

ORDER INSTITUTING ADMINISTRATIVE
AND CEASE-AND-DESIST PROCEEDINGS,
PURSUANT TO SECTION 15(b) OF THE
SECURITIES EXCHANGE ACT OF 1934,
SECTIONS 203(f) AND 203(k) OF THE
INVESTMENT ADVISERS ACT OF 1940,
AND SECTION 9(b) OF THE INVESTMENT
COMPANY ACT OF 1940, MAKING
FINDINGS, AND IMPOSING REMEDIAL
SANCTIONS AND A CEASE-AND-DESIST
ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Alan Gavornik ("Gavornik"), Nicholas Mariniello ("Mariniello") and Lee Argush ("Argush") (collectively, "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings

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herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, and except as provided herein in Section V, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Sections 203(f) and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds¹ that:

Summary

Respondents Gavornik, Mariniello and Argush, as the principals of Concord Equity Group Advisors, LLC ("Concord"), a formerly registered investment adviser under their majority control, breached their fiduciary duty to advisory clients by failing to disclose a conflict of interest, and by failing to seek to obtain best execution for their clients. In November 2008, Respondents entered into an undisclosed arrangement with an unaffiliated broker-dealer (the "Executing Broker") to provide trade execution for Concord's clients at a commission rate of \$0.01 per share executed. However, under the arrangement, the Executing Broker actually charged Concord's clients between \$0.04 and \$0.06 per share executed, and then paid the amount exceeding \$0.01 per share commission to Concord's affiliated broker-dealer, Tore Services, LLC ("Tore"), in the form of a "referral fee."² Thus, Tore (and through it, Respondents) were paid between \$0.03 and \$0.05 per share on Concord client transactions executed through the Executing Broker. In total, between November 2008 and June 2011 (the "relevant period"), Tore collected \$1,005,000 in transaction-based fees generated by Concord's clients' trading.

This commission-sharing arrangement represented a conflict of interest because Concord and Respondents (who were fiduciaries) were incentivized to encourage Concord's clients to execute trades through the Executing Broker so that they could share in a portion of the execution commission. Yet, Respondents failed to adequately disclose the commission-sharing arrangement in Concord's Forms ADV Part II, or otherwise inform Concord's clients of the conflict. Gavornik, as the officer responsible for Concord's periodic filings with the Commission, including Concord's Forms ADV, failed to maintain a copy of Concord's Forms ADV Part II and each amendment

¹ The findings herein are made pursuant to Respondents' Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

² Certain of Concord's clients separately maintained a "soft-dollar" arrangement with the Executing Broker. Respondents did not share in the commissions clients paid in connection with any soft-dollar transactions.

thereto, or keep records of the dates that each Form ADV Part II was given to clients or prospective clients. In addition, by failing to advise clients of the \$0.01 execution rate negotiated with the Executing Broker, and instead arranging for clients to execute at higher commission rates – keeping the difference for themselves – Respondents also failed to seek to obtain best execution for their advisory clients.

Respondents

1. **Lee Argush**, age 54, resides in New Jersey. During the relevant period Argush was Concord's and Tore's chief executive officer and chief financial officer, and Concord's chief technology officer. Argush holds Series 3, 4, 7, 24, and 27 licenses. Following a June 2011 acquisition of Concord, Argush worked for Concord's successor entity until August 2013.

2. **Alan Gavornik**, age 53, resides in New Jersey. During the relevant period, Gavornik was Concord's executive managing director and chief compliance officer, and was primarily responsible for drafting and signing Concord's periodic filings with the Commission. He also served as Tore's CEO and chief compliance officer. Gavornik holds Series 7, 24, 63 and 65 licenses. Between June 2011 and December 2013, Gavornik worked for Concord's successor entity until December 2013.

3. **Nicholas Mariniello**, age 54, resides in New Jersey. During the relevant period Mariniello was Concord's and Tore's executive managing director and the president. Mariniello holds Series 4, 7, 24, 55, 63, and 65 licenses. Mariniello worked for Concord's successor entity from June 2011 to December 2013.

Other Relevant Entities

4. **Concord** is a limited liability company organized under the laws of New Jersey and, during the relevant period, it was located in Matawan, New Jersey. Concord was registered with the Commission as an investment adviser from 1994 through August 2012. Concord was wholly-owned by Concord Capital Partners, Inc. ("Concord Capital") until 2011, when it was acquired.

5. **Concord Capital** is a corporation organized under the laws of New Jersey and, during the relevant period, it shared Concord's Matawan, New Jersey address. Until its acquisition in 2011, Concord Capital was 62% owned by Respondents through a holding company named American Capital Acquisitions Partners ("American Capital"), and 38% owned by a private equity fund. The private equity fund played no role in Concord's management. Argush owned an approximately 46% interest in the holding company, while Gavornik and Mariniello each owned approximately 27% of the holding company.

6. **Tore** is a limited liability company organized under the laws of New Jersey and, during the relevant period, it was a broker-dealer registered with the Commission. Like Concord, Tore was a wholly-owned subsidiary of Concord Capital, with no employees or facilities that were independent from Concord, *i.e.*, Respondents held Tore titles but did little or no work for the

broker-dealer. Aside from collecting the fees from the commission-sharing arrangement described herein, Tore conducted no business. Tore was housed in Concord's Matawan, New Jersey office. Tore withdrew its broker-dealer registration effective June 20, 2011.

Facts

Concord's Formation and Organization

7. In 1999, Respondents began marketing what they referred to as an open architecture, web-based asset management and advisory platform (the "Concord Platform"). Argush built the Concord Platform, and served as Concord's chief technology officer, CEO and CFO. Gavornik and Mariniello were Concord's officers and managing directors. Mariniello was primarily responsible for sales and marketing. Gavornik was chiefly responsible for Concord's day-to-day operational and compliance functions, including Concord's filings with the Commission.

8. The Concord Platform was intended to guide Concord's clients – primarily small and medium-sized banks and trusts – through "customized" portfolio research, design and selection. The Concord Platform also enabled their clients' portfolio managers to monitor and rebalance investment portfolios and, beginning in 2008, to execute trades with the Executing Broker. For client trades executed by Executing Broker, the Concord Platform bundled orders from all clients into a single transaction, executed the transaction through the Executing Broker, then allocated the trades back to the appropriate client.

9. Concord also offered access to outside investment advisers ("sub-advisers") that were incorporated into its Concord Platform. Concord was responsible for vetting the sub-advisers, monitoring their performance, and advising Concord's clients on an ongoing basis as to the performance and continuing suitability of the sub-adviser to the clients' particular investment goals. Concord and Respondents also provided personalized advice to clients as to which service options and sub-advisers were best suited to the client's investment objectives, and performed related due-diligence services. Concord's clients paid for their services on a monthly basis at an agreed upon, fixed rate.

10. Respondents formed the broker-dealer Tore in early 2008, initially with the aspiration that it would execute trades for clients and the sub-advisers on the Concord Platform. In reality, as described herein, Tore had no client-facing role and no client or sub-adviser interactions. In fact, it performed no function, except to receive the undisclosed commission-sharing revenues paid to it by the Executing Broker for Concord client execution services.

The Commission-Sharing Arrangement

11. In early 2008, a sales representative for the Executing Broker contacted Concord to offer execution and related services. Negotiations ensued between the parties concerning how, mechanically, Concord could share in the commission-based revenue its clients would generate for

the Executing Broker, and on what terms, that is, how the parties could split the execution commissions.

12. By October 2008, Respondents reached an understanding with the Executing Broker that, through Tore, the Executing Broker would pay Respondents a “referral fee” that was equal to the amount that the Executing Broker charged Concord’s clients for execution in excess of \$0.01 per share executed. That is, from the amount the Executing Broker charged Concord’s clients for execution services – typically \$0.04 to \$0.06 per share executed – the Executing Broker kept \$0.01, and Respondents re-captured the balance in the form of a transaction-based “referral fee,” which the Executing Broker paid back to Respondents through Tore. In several instances, the specific rates charged by the Executing Broker were also negotiated and set by the Concord principals.

13. Respondents memorialized their understanding with the Executing Broker in an agreement dated May 27, 2009, which was signed by Mariniello in his capacity as president of Tore. Captioned *Commission Sharing Agreement for Referrals*, the agreement explicitly ratified the terms of the understanding reached in late 2008. The agreement, which was in part drafted by Gavornik, was also explicit that Tore was responsible for disclosing the arrangement to any clients “referred” to the Executing Broker.

14. Although Respondents called this transaction-based fee a “referral fee,” Tore did not actually “refer” any clients to the Executing Broker. Rather, for the most part, Mariniello, in his capacity as Concord’s chief salesperson, encouraged clients to execute trades through the Executing Broker. Indeed, Tore did not have any interaction with Concord’s clients, who were unaware of both Tore’s existence and that the Execution Broker was remitting a portion of their commissions to Tore.

15. When recommending the Executing Broker and discussing its commission rates with clients, Respondents did not disclose that they would financially benefit from the recommendation. More specifically, Respondents did not disclose that the Executing Broker had agreed to provide execution to Concord’s clients for significantly less than the clients were charged, with the difference going to Respondents, and that this represented a significant source of income to Respondents.

16. Consistent with the May 2009 agreement, and the understanding Respondents reached in October 2008, the vast majority of commissions paid by Concord’s clients to the Executing Broker were remitted to Tore. In total, during the relevant period, Tore collected commission-sharing revenues totaling \$1,005,000. Tore transferred the majority of that amount, approximately \$913,000 – or over 90% of the fees it collected from the Executing Broker – to its parent (and Concord’s parent) Concord Capital. Tore used the rest of the commission-sharing revenue, approximately \$92,000, to pay its very limited operating expenses.

Concord and the Respondents Failed to Disclose Accurately the Commission-Sharing Arrangement to Concord's Clients

17. The Respondents failed to disclose accurately to Concord's clients the nature or existence of the commission-sharing arrangement or the resulting conflict of interest. This failing rested principally on Gavornik, who (as described below) was responsible for Concord's day-to-day operations and compliance function, and also personally was responsible for Concord's materially deficient Form ADV disclosures. Argush, as Concord's CEO, failed to ensure that Concord fully disclosed to its clients any conflicts of interest, including by ensuring that Gavornik adequately disclosed the commission-sharing arrangement. For his part, Mariniello was the principal architect of the arrangement with the Executing Broker, and signed the *Commission Sharing Agreement for Referrals* in May 2009. At the same time, he was also the Concord employee most responsible for encouraging Concord clients to execute their trades with the Executing Broker, yet he also failed to ensure that Concord disclosed the conflict to its clients.

Concord's Forms ADV Part II Omitted Material Facts and were Misleading

18. As Concord's executive managing director, Tore's CEO, and the CCO for both entities, Gavornik was tasked with signing and filing Concord's Forms ADV with the Commission. He, thus, was responsible for ensuring that Concord disclosed any actual or potential conflicts of interest resulting from commission-sharing agreement. Instead, in the various iterations of Concord's Forms ADV Part II³ filed with the Commission during the relevant period, Gavornik failed to fully disclose the arrangement, despite knowing that when clients were advised to execute through the Executing Broker that the recommendation resulted in a substantial financial benefit to Respondents. The Forms ADV Part II were therefore materially misleading. In addition, Gavornik, and through him, Concord, failed to maintain a copy of the Concord's Forms ADV Part II and each amendment or revision thereto, or keep records of the dates that each Form was given to clients or prospective clients, as required by Rule 204-2(a)(14) under the Advisers Act.

Concord's Form ADV Part II Dated April 1, 2002

19. Concord is deemed to have filed a Form ADV Part II on April 1, 2002, but did not update it until November 2009.⁴ Thus, for the first 12 months the commission-sharing arrangement was in place (from October 2008 through November 2009), when Concord

³ Prior to amendments of Form ADV in 2010, Part 2 was designated as "Part II." See Rel. IA-3060 (July 28, 2010) at n.6.

⁴ Beginning with its annual update filed for the fiscal year ending on or after December 2010, existing registrants are required to file the Part 2 amendment electronically. Prior to that point, the Part II brochure was deemed to be filed with the Commission. See *Id.* at 118.

approached many of its existing clients and encouraged them to execute their trades through the Executing Broker, Concord's Form ADV Part II – which it also provided to clients – contained no discussion concerning Tore or the commission-sharing arrangement.

Concord's Forms ADV Part II Dated November 24, 2009 and March 29, 2010

20. Gavornik updated Concord's Form ADV Part II disclosures on November 24, 2009, and again on March 29, 2010 – 17 months after Concord had implemented the commission-sharing arrangement and 10 months after the agreement was memorialized. However, the updated Forms still failed to disclose the commission-sharing arrangement, and what information that was included was materially misleading. The disclosure stated:

TORE Services, LLC is a FINRA Member and registered broker dealer and affiliated entity to registrant. TORE may receive referral fees for referring prospective institutions to other broker dealers including customers of registrants (sic) related entities.⁵

[...]

An affiliate of Concord, TORE Services, LLC, a broker dealer, can process unsolicited transactions for institutional customers which may include a client of Concord. TORE has yet to commence or transact any such trading. (Emphasis added.)⁶

[...]

Registrants [*i.e.*, Concord] may suggest brokers to its financial institutional [sic] clients. Registrant receives no products, research or services in turn. An affiliated entity of Registrant, TORE Services, LLC may also suggest brokers to certain financial institutions in which TORE receives a referral fee. In such cases, all rates charged are determined by and between the broker and financial institution. (Emphasis added.)⁷

⁵ This disclosure was a response to Item 8 of Form ADV Part II, requiring registered advisers to state whether they have “arrangements that are material to its advisory business or its clients with a related person who is a ... broker-dealer.”

⁶ This disclosure responded to Item 9: “Participation or Interest in Client Transactions,” which asks whether Concord or a related person acting “[a]s broker or agent effects securities transactions for compensation for any client?”

⁷ This disclosure responded to Item 12.B and 13.A, asking, respectively: (1) “Does applicant or a related person suggest brokers to clients?”; and (2) “Does the applicant or a related

21. While these disclosures discussed Tore and the “referral fees,” they failed to convey completely and accurately the nature and existence of the conflict of interest presented by commission-sharing arrangement. Concord’s clients were not told that Tore played any role in their relationship with either Concord or the Executing Broker. Thus, these clients could not appreciate that they were subject to a commission-sharing arrangement. Indeed, Concord assured clients that if it suggested a broker-dealer to them, Concord would “receive[] no products, research or services in turn.” Conversely, Concord told clients that Tore would receive a “referral fee” only if Tore “suggest[ed] brokers” to them. However, as far as clients knew, they had no dealings with Tore and, thus, no reason to think that any referral or fee was being paid.

22. The information Concord provided in response to Item 9 – that Tore had had “yet to commence” any activity for which it would be compensated – was also false and misleading because Tore had been receiving between \$0.03 and \$0.05 per share on Concord client transactions with the Executing Broker since November 2008. In addition, the use of the prospective “may” in each of the passages quoted above is misleading because it suggested the mere possibility that Tore would make a referral and/or be paid “referral fees” at a later point, when in fact a commission-sharing arrangement was already in place and generating income to Tore and Respondents. Finally, the assertion that the commission rate charged for each client was to be negotiated between the client and the Executing Broker was also false. In reality, Respondents had an active role in negotiating and setting the execution fees clients paid to the Executing Broker, as well as in deciding how the fees would be divided up between Tore and The Executing Broker.

Concord’s Form ADV Part II Dated September 15, 2010

23. Following an examination of Concord by the Commission’s examination staff that concluded in August 2010, Concord included more expansive – yet still inadequate – language concerning its relationship with Tore in its Form ADV Part II, dated September 15, 2010. Specifically, Concord revised its responses to Item 9 and Items 12 and 13 to add that the fact that Tore “may” receive referral fees also meant that Concord, through Tore, “may have a conflict of interest regarding the recommendation of an executing broker dealer in that it may receive compensation.” But because the revised disclosure still failed to accurately describe Respondents’ arrangement with the Executing Broker, the modified disclosure still omitted material facts necessary to alert clients that cleared through the Executing Broker that they were in fact paying such fees. This is particularly true because Concord did not correct the false and misleading representations that it would not be compensated in connection with any broker recommendations and that Tore had “yet to commence” transactions.

24. Even with the expanded Form ADV Part II disclosure, Concord’s clients could not fully appreciate that by executing trades through the Executing Broker they would be brought

person have any arrangements, oral or in writing, where it: is paid cash by or receives some economic benefit [. . .] from a non-client in connection with giving advice to clients?”

within the scope of a commission-sharing arrangement such that the bulk of the commissions they paid to the Executing Broker were in fact passed back to the Concord principals via Tore.

25. In 2011, Concord was acquired and became an operating division of the acquiring company. The commission-sharing arrangement was terminated in connection with the acquisition.

Violations

26. As a result of the conduct described above, Respondents willfully⁸ violated Section 206(2) of the Advisers Act, which prohibits any investment adviser from engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. Proof of scienter is not required to establish a violation of Section 206(2) of the Advisers Act but, rather, may rest on a finding of simple negligence. *SEC v. Steadman*, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)). Specifically, the commission-sharing arrangement with the Executing Broker represented a clear conflict of interest that was not adequately disclosed to Concord clients; and, by arranging for certain of Concord's clients to pay amounts greater than the discounted commission rate Respondents negotiated with the Executing Broker without disclosing this fact, Respondents also failed to seek to obtain best execution for those clients.

27. As a result of the conduct described above, Respondent Gavornik willfully violated Section 207 of the Advisers Act, which makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission ... or willfully to omit to state in any such application or report any material fact which is required to be stated therein." Specifically, Concord's Forms ADV Part II filed with the Commission in 2009 and 2010 were false and misleading because they did not disclose that Concord's affiliated broker-dealer shared in the commission payments that Concord's clients paid to the Executing Broker or that the affiliated broker-dealer remitted those payments to Concord's affiliated broker-dealer.

28. As a result of the conduct described above, Respondent Gavornik willfully aided and abetted and caused Concord's violations of Section 204(a) of the Advisers Act, and Rule 204-2(a)(14) promulgated thereunder, which require that investment advisers registered with the Commission maintain and preserve certain books and records, including copies of each brochure

⁸ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)).

and each amendment or revision thereof, provided to any client or prospective client, and a record of the dates that each statement was given or offered to any client or prospective client.⁹

Undertakings

Respondent Gavornik has undertaken to provide to the Commission, within 14 days after the end of the twelve month suspension period described below, an affidavit that he has complied fully with the sanctions described in Section IV below.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondents' Offers.

Accordingly, pursuant to Section 15(b) of the Securities Act, Sections 203(f) and 203(k) of the Advisers Act, and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

A. Respondents Gavornik, Mariniello, and Argush each cease and desist from committing or causing any violations and any future violations of Section 206(2) of the Advisers Act.

B. Respondents Mariniello and Argush are censured.

C. Respondent Gavornik cease and desist from committing or causing any violations and any future violation of Sections 204(a) and 207 of the Advisers Act and Rule 204-2 thereunder.

D. Respondent Gavornik be, and hereby is, suspended from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization for a period of twelve months, effective on the second Monday following the entry of this Order;

E. Respondent Gavornik be, and hereby is, prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter for a period of twelve months, effective on the second Monday following the entry of this Order.

F. Respondent Gavornik be, and hereby is, suspended from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person

⁹ Rule 204-2(a)(14) was amended effective October 10, 2010, but the changes were not relevant to the requirements described herein. *See Amendments to Form ADV*, IA Rel. No. 3060 (Aug. 12, 2010).

who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock for a period of twelve months, effective on the second Monday following the entry of this Order.

G. Respondents shall, within ten days of the entry of this Order, pay disgorgement of \$1,005,000 and prejudgment interest of \$147,827, for a total of \$1,152,827, on a joint and several basis, to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600.

H. Respondents Gavornik, Mariniello and Argush each shall, within ten days of the entry of this order, pay a civil money penalty in the amount of \$150,000. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717.

I. Payment under this Order must be made in one of the following ways:

- (1) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Respondents may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (3) Respondents may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Lee Argush, Alan Gavornik and Nicholas Mariniello as Respondents in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Valerie A. Szczepanik, Assistant Director, Asset Management Unit, New York Regional Office, Securities and Exchange Commission, 200 Vesey Street, Suite 400, New York, New York, 10281, or such other person or address as the Commission staff may provide.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondents, and further, any debt for disgorgement, prejudgment interest, civil penalty or other

amounts due by Respondents under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondents of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By: Jill M. Peterson
Assistant Secretary

*Commissioner Gallagher
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73681 / November 25, 2014

INVESTMENT ADVISERS ACT OF 1940
Release No. 3973 / November 25, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16288

In the Matter of

HSBC Private Bank (Suisse),
SA

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS PURSUANT TO
SECTIONS 15(b)(6) AND 21C OF THE
SECURITIES EXCHANGE ACT OF 1934
AND SECTIONS 203(e) AND (k) OF THE
INVESTMENT ADVISERS ACT OF 1940,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-
AND-DESIST ORDER

I.

The Securities and Exchange Commission (the "Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b)(6) and 21C of the Securities Exchange Act of 1934 (the "Exchange Act") and Sections 203(e) and (k) of the Investment Advisers Act of 1940 (the "Advisers Act") against HSBC Private Bank (Suisse), SA ("HSBC Private Bank" or the "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Respondent admits the facts set forth in Section III.B. through H. below, acknowledges that its conduct violated the federal securities laws, admits the Commission's jurisdiction over it and the subject matter of these proceedings and consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b)(6) and 21C of the Exchange Act and Sections 203(e) and (k) of the Advisers Act, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (the "Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

A. Summary

1. From at least 2003 until its exit in 2011 from its business of providing broker-dealer and investment advisory services to U.S. clients (the "U.S. cross-border securities business"), HSBC Private Bank, through actions of certain relationship managers ("RMs") employed by it, its predecessor ("HSBC Private Bank (Legacy)"), and HSBC Guyerzeller Bank AG ("HSBC Guyerzeller Bank"), which became a part of HSBC Private Bank in 2009, violated certain provisions of the federal securities laws by providing cross-border brokerage and investment advisory services to U.S. clients without registering with the Commission as a broker-dealer and investment adviser.² During that time, the combined banks had approximately 368 client accounts that held securities and were beneficially owned by permanent U.S. residents ("U.S. clients"). Respondent was aware that, in certain instances, if its representatives were to provide such services in the United States or otherwise by use of the mails or other modes of interstate commerce, it would be required to register in the U.S. as a broker-dealer and investment adviser, absent an available exemption from registration. Neither HSBC Private Bank, HSBC Private Bank (Legacy), nor HSBC Guyerzeller Bank was registered with the Commission. Respondent's U.S. cross-border securities business activities realized approximately \$5.72 million in pre-tax income through its unlawful U.S. cross-border securities business activities.

2. With limited exceptions, not applicable here, Section 15(a)(1) of the Exchange Act requires anyone who makes use of the mails or any other means or instrumentality of interstate commerce, to engage in the business of effecting transactions in securities for the account of others, or to engage in a regular business of buying and selling securities for the person's own account, to register with the Commission as a broker-dealer.

3. Under Section 202(a)(11) of the Advisers Act, an investment adviser is a person who, for compensation, is in the business of providing investment advice to with respect to securities, unless the person falls within one of the exclusions from the definition of investment adviser. Per Section 203(a) of the Advisers Act, an investment adviser whose principal offices and places of business are outside the U.S. that make use of the mails or any means or instrumentality of interstate commerce in doing business with U.S. clients is required to register with the Commission unless an exemption from registration is available.

¹ The findings herein are made pursuant to Respondent's Offer and are not binding on any other person or entity in this or any other proceeding.

² Throughout this Order, the term "HSBC Private Bank" will be used to refer collectively to HSBC Private Bank (Suisse) SA (and its predecessors) and HSBC Guyerzeller Bank AB between 2003 and the merger in 2009, and to the merged entity from 2009 onward. The term "HSBC Private Bank (Legacy)" will refer to HSBC Private Bank (Suisse) SA (and its predecessors) alone between 2003 and the merger in 2009.

4. Certain HSBC Private Bank RMs, among other things, traveled to the United States to solicit new clients and/or service existing clients by providing investment advice and by soliciting or attempting to solicit securities transactions. These activities required HSBC Private Bank to register with the Commission, and it did not do so.

5. HSBC Private Bank understood that there was a risk of violating the federal securities laws by providing broker-dealer and investment advisory services to U.S. clients without being registered with the Commission, and took certain measures to manage and mitigate the risk that prohibited broker-dealer and investment advisory services might be provided to U.S. clients. However, HSBC Private Bank did not effectively implement these measures and did not sufficiently monitor the U.S. cross-border securities business. As a result, HSBC Private Bank violated its policies and the federal securities laws.

6. In 2010, HSBC Private Bank determined to end its U.S. cross-border securities business. In 2011, it developed a procedure for exiting the business, and put a team in place to implement the procedure. Respondent began to exit the business in May 2011. Nearly all of its U.S. client accounts were closed or transferred by the end of 2011.

7. Because certain of its RMs provided broker-dealer and investment advisory services in the United States at a time when neither HSBC Private Bank, HSBC Private Bank (Legacy), nor HSBC Guyerzeller Bank was registered with the Commission as a broker-dealer or investment adviser, Respondent willfully³ violated Exchange Act Section 15(a) and Advisers Act Section 203(a).

B. Respondent

8. HSBC Private Bank (Suisse) SA is a corporation incorporated and domiciled in Switzerland.⁴ HSBC Guyerzeller Bank merged with HSBC Private Bank in 2009. Both HSBC Private Bank and HSBC Guyerzeller Bank had operations in Lugano, Geneva, and Zurich, Switzerland. From 2003 through 2008, the private banks were operated independently, and each had its own executive committee ("ExCo"). The banks were part of "Group Private Banking" ("GPB"), and were governed by a parent-level entity, HSBC Holdings plc ("HSBC Group"), a U.K.-based multinational financial services holding company that provides a broad range of services to individual and corporate clients through its operating subsidiaries.⁵

³ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

⁴ Formerly HSBC Republic Bank (Suisse) SA.

⁵ All of HSBC Group's relevant policies and procedures govern employees of the private bank subsidiaries.

C. Respondent's U.S. Cross-Border Securities Business

9. During the period from at least 2003 through 2011, HSBC Private Bank, through actions of certain of its RMs, engaged in broker-dealer and investment adviser activities with U.S. clients. At various times during this period, among other things, HSBC Private Bank RMs solicited, established, and/or maintained brokerage and investment advisory accounts for U.S. clients; accepted and executed orders for securities transactions; solicited securities transactions; handled U.S. clients' funds and securities; provided account statements and other account information; and provided investment advice. These activities directly involved the use of the means or instrumentalities of interstate commerce, and consequently HSBC Private Bank was required to register under the federal securities laws. For these and other services provided to certain U.S. clients, HSBC Private Bank received transaction-based compensation or investment advisory fees.

10. Between 2003 and 2011, the combined banks maintained as many as 368 U.S. client accounts holding securities. The U.S. client accounts constituted as much as \$775 million in securities assets under management. These accounts were dispersed between HSBC Private Bank (Legacy) and HSBC Guyerzeller Bank. In 2003/2004, as many as 100 RMs serviced U.S. client accounts from desks in the banks' offices in Zurich, Geneva, and Lugano, Switzerland.

11. From at least 2003 to May 2011, Respondent continued to collect some broker-dealer commissions (or other remuneration based directly or indirectly on securities transactions) and investment advisory fees on U.S. client accounts. Altogether, between 2003 and 2011, the combined banks generated pre-tax income of approximately \$5.72 million through the use of U.S. jurisdiction means.

12. With respect to these accounts, RMs used a variety of the means or instrumentalities of interstate commerce to engage in the U.S. cross-border securities business without appropriate registration. For example, RMs traveled to the United States to meet with existing and/or prospective clients to provide investment advice and/or solicit securities transactions.

13. From 2003 through 2009, HSBC Private Bank RMs made more than 40 trips to the United States to meet with clients. These trips involved visits with approximately 20 U.S. clients, and the provision or solicitation of broker-dealer and/or investment advisory services.

14. In addition to traveling to the United States, RMs with U.S. clients also communicated securities-related information to their U.S. clients by means of interstate commerce while the clients were present in the United States, including through mails and e-mail. RMs provided investment advisory and broker-dealer services to these U.S. clients and made recommendations as to the merits of various types of investments.

D. Respondent Was Not Registered with the Commission to Provide Broker-Dealer or Investment Advisory Services to U.S. Clients

15. The above-referenced activities were engaged in at a time during which Respondent was not registered as a broker-dealer under Exchange Act Section 15(a) or as an investment adviser under Advisers Act Section 203(a), and was not exempted from registration as a broker-dealer or investment adviser.

E. Respondent Was Aware of the Broker-Dealer and Investment Adviser Registration Requirements

16. As described in Sections F and G below, throughout the period in question, Respondent was aware of the broker-dealer and investment adviser registration requirements related to the provision of cross-border broker-dealer and investment advisory services to U.S. clients.

F. Efforts to Address the U.S. Cross-Border Securities Business at HSBC Private Bank (Legacy)

17. Approximately 50 HSBC Private Bank (Legacy) RMs serviced U.S. clients with securities accounts on desks in Geneva, Zurich, and Lugano, Switzerland. Between 2003 and 2009 (when it merged with HSBC Guyerzeller Bank), HSBC Private Bank (Legacy) maintained as many as 193 U.S. client accounts holding securities. HSBC Private Bank (Legacy)'s U.S. client accounts held as much as \$366 million in securities assets.

18. In October 2003, in response to HSBC Private Bank (Legacy)'s request for advice, an outside law firm provided it with guidance regarding U.S. cross-border activities. In part as a result of this advice, the HSBC Private Bank (Legacy) ExCo decided to create a dedicated North American—or "NORAM" desk—to consolidate U.S. client accounts among a smaller number of RMs and service them in a compliant manner that would not violate the U.S. registration requirements. The establishment of NORAM, which operated from Switzerland, was announced internally on November 25, 2004. "This decision has been made so that the appropriate procedures, processes and controls can be put around these clients as they have unique. . . compliance requirements that need to be met." "All US resident clients are to be transferred to the NORAM Country Team by the end of 2004." This deadline was not met, in part because RMs did not want to lose clients by transferring them to NORAM.

19. In June 2005, Group Audit Private Banking, an internal audit group, announced an internal audit of HSBC Private Bank (Legacy). The audit was conducted between June 13 and July 15, 2005. The audit was completed, and a report circulated, in mid- to late July 2005. Although the report noted "good progress" in some areas since the previous audit in 2003, its general conclusion, as set forth in the Management Summary, was more negative, assessing levels of controls in HSBC Private Bank (Legacy)'s Front Office to be "below standard." Specifically, the portion of the report regarding NORAM concluded:

- GPB's cross-border marketing guidelines were not always respected. Investment instructions were being received from persons residing in the U.S. and executed.

- An HSBC Private Bank (Legacy) U.S. cross-border procedure was prepared in March 2004, and approved by its ExCo in March 2005; however, there is no evidence that this procedure was published to all RMs with U.S. clients.
- U.S. client accounts were required to be transferred to NORAM by April 1, 2005, however, “55 accounts in Geneva and 21 accounts in Zurich still have not been transferred, out of which 14 are physical persons.”

The report also identified deficiencies with travel reports and indicated that “hold mail controls are not being performed” for certain clients.

20. The head of HSBC Private Bank (Legacy) wrote a letter to the Audit Committee criticizing the audit, stating, among other things, that NORAM was new and could not be expected to complete the transfer of accounts in so short a timeframe. When the Audit Committee met, it affirmed its support for the internal audit results and process and directed management to do its utmost to ensure adherence with the rules.

21. HSBC Private Bank (Legacy) was slow to address the substantive deficiencies the internal audit identified. It took approximately eight months for HSBC Private Bank (Legacy) to finalize a cross-border policy. The policy was “broadcast” to all employees on March 29, 2006.

22. Nearly two years after the 2005 internal audit, and a year after the dissemination of the cross-border policy, HSBC Private Bank (Legacy)’s U.S. cross-border securities business was not fully compliant with the policy. An internal review undertaken by the Compliance department in April 2007 identified several deficiencies in HSBC Private Bank (Legacy)’s efforts to consolidate U.S. accounts in a compliant NORAM group. According to the report, “[w]ith respect to the U.S. policy, weaknesses were identified” in several areas, including:

- U.S. client accounts which had not been transferred to NORAM;
- Certain U.S. client accounts holding U.S. securities.
- Account opening forms had been signed inside the U.S.
- Mail was sent to clients in the U.S.

23. The internal audit report commented, “[s]ome of these weaknesses represent a major risk for HSBC Private Bank (Legacy) . . . [such as] when signing account opening forms in the US or when we provide Internet Banking Services to U.S. residents.”

24. In response to the 2007 audit, and continuing into 2008, HSBC Private Bank (Legacy) undertook additional efforts to encourage compliance with U.S. securities rules. HSBC Private Bank (Legacy) introduced enhanced training for RMs in August 2007. In January 2008, HSBC Private Bank (Legacy) put in place additional procedures to scrutinize more carefully RM travel plans. HSBC Private Bank (Legacy) also modified its information system to preclude the possibility of certain securities sales in the accounts of certain U.S. clients. In October 2008,

HSBC Private Bank (Legacy) issued and disseminated a revised U.S. policy referencing the SEC registration rules and stating that no new U.S. resident accounts would be opened and any exceptions would be limited to cash deposits.

25. Despite these efforts, progress in migrating these U.S. client accounts to NORAM and achieving full compliance remained slow through 2008. Ultimately, not all of the U.S. client accounts that were intended to be moved to the NORAM unit were, in fact, transferred. A reason for this was that RMs were reluctant to shift accounts to the NORAM business because they did not want to lose the accounts.

26. In 2008, HSBC Private Bank (Legacy) maintained 156 U.S. client accounts that held securities. These accounts contributed \$198 million to HSBC Private Bank (Legacy)'s securities assets under management.

G. Efforts to Address the U.S. Cross-Border Securities Business at HSBC Guyerzeller Bank

27. Between 2003 and 2009, when it merged with HSBC Private Bank (Legacy), HSBC Guyerzeller Bank maintained as many as 176 U.S. client accounts holding securities. HSBC Guyerzeller Bank's U.S. client accounts held as much as \$461 million in securities assets. These U.S. client accounts were serviced by as many as 44 HSBC Guyerzeller Bank RMs on desks physically located in Geneva, Zurich, and Lugano, Switzerland.

28. In 2001, HSBC Group, made the decision to merge two smaller and recently acquired private banks—Credit Commercial de France and Handelsfinanz—into HSBC Guyerzeller Bank. Although HSBC Guyerzeller Bank had a pre-existing base of U.S. clients at the time, the merger sharply increased the number of U.S. clients. As a result of the merger and the influx of U.S. clients, HSBC Guyerzeller Bank engaged outside counsel from a law firm based in the United States to provide advice regarding servicing U.S. clients. A legal memorandum was provided in response to this request for advice, but it does not appear to have been distributed to HSBC Guyerzeller Bank's RMs.

29. On May 2, 2003, in an attempt to provide advice to HSBC Guyerzeller Bank's RMs that was consistent with the advice he obtained from the outside law firm, HSBC Guyerzeller Bank's director of compliance sent a memorandum to all RMs in the Lugano and Geneva offices warning RMs: "No solicitation of clients and/or marketing activities in the US."

30. On January 14, 2004, the HSBC Guyerzeller Bank ExCo held a meeting that discussed proposed guidelines for servicing U.S. client accounts. The meeting minutes recite the ExCo's understanding of U.S. legal requirements: "US legislation forbids foreign entities from providing investment advice to U.S. residents over the phone, by mail, by fax, or by email if that foreign entity is not registered with the SEC." The ExCo decided (a) to stop opening accounts for U.S. clients, and (b) "in order [to] reduce the potential legal risk . . . to the bank," to close each U.S. client account with a balance of under \$750,000, unless it was related to a larger client group.

31. On January 30, 2004, a thorough summary of the ExCo's decisions (at the January 14, 2004 meeting and at a subsequent meeting) was circulated to all RMs. In addition to reflecting

the decisions above, it also provided more extensive guidance on how to service U.S. client accounts in a compliant manner, including restrictions on communications and travel.

32. On December 15, 2004, the HSBC Guyerzeller Bank's ExCo received an update regarding the "streamlining of the US client base," which referred to closing certain categories of U.S. client accounts. HSBC Guyerzeller Bank planned to preserve the 14 most valuable client relationships, while eliminating other U.S. accounts. The ExCo believed that this plan would enable them to service the "Group of 14" U.S. client accounts within the "private adviser" exemption from the Investment Advisers Act's registration requirements.⁶ The HSBC Guyerzeller Bank's ExCo set a target completion date for the plan of June 2005. The June 2005 deadline was not met, in part because RMs did not want to close their clients' accounts.

33. On January 29, 2007, a HSBC Guyerzeller Bank executive emailed the Compliance director regarding a number of U.S. client accounts that should have been closed. The email attached an updated list of "all relationships which were supposed to be closed 2 years ago but still remain at the bank." The executive continued, "we still see a fair number of relationships where there is a regular contact from and to the US, where regular mail is sent." The executive asked, "In order to reduce our exposure there may I ask you to remind these [RMs] to finally close these relationships and fast?"

34. Progress was slow. Nearly two years later, on December 10, 2008, the HSBC Guyerzeller Bank ExCo held a meeting that included a report "regarding the review of client relationships with US persons." This review revealed that U.S. accounts that were expected to be closed were still open.

H. Merger of HSBC Private Bank (Legacy) and HSBC Guyerzeller Bank and the Exit from the U.S. Cross-Border Business

35. In 2008, HSBC Group made plans to merge HSBC Private Bank (Legacy) and HSBC Guyerzeller Bank into a single entity, which would be referred to as HSBC Private Bank.

36. In July 2008, amidst a well-publicized civil and criminal investigation of UBS AG ("UBS"), a large Switzerland-based multinational financial services company, arising from UBS's provision of cross-border banking, broker-dealer and investment advisory services to U.S. clients, UBS formally announced that it would cease providing banking services to U.S. clients through its non-U.S. regulated entities. In 2008, as the UBS investigation became public, HSBC Private Bank and HSBC Guyerzeller Bank took steps to avoid accepting new U.S. clients from UBS. HSBC

⁶ Under the "private adviser" exemption, as previously set forth in Section 203(b)(3) of the Investment Advisers Act of 1940, advisers with a small number of clients were exempt from the registration requirements of the IAA. Section 203(b)(3) provided that "[registration is not required for] any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under title I of this Act." The Dodd-Frank Act eliminated this private adviser exemption. See 15 U.S.C. § 80b-3.

Private Bank and HSBC Guyerzeller Bank had policies restricting the opening of accounts for any new U.S. clients. In addition, on January 9, 2009, HSBC Private Bank management sent a broadly-distributed email stating, "UBS is closing approximately 19,000 accounts for US persons and residents as part of an agreement with US authorities. The accounts are described as undeclared for US tax purposes. Please advise your business that accounts should not be opened for US persons and residents that are closing accounts at UBS (source of funds). Moreover, RMs that handle accounts for US persons and residents should not accept funds from UBS into the existing accounts"

37. On February 10, 2009, the HSBC Private Bank ExCo determined to exit part of the U.S. market. Due to the "additional regulatory burden associated with the maintenance of U.S. clients, the HSBC Private Bank ExCo has taken strategic decisions designed to mitigate the risk of accidental breach of regulations and to reflect more accurately the cost of providing banking services to U.S. clients." HSBC Private Bank ExCo decided to close all accounts of US clients that (1) had not signed a W-9 form; or (2) had assets under management of under \$1 million. Accounts of U.S. clients with a W-9 and assets under management of over \$1 million were not required to be closed under this policy.

38. In December 2010, the GPB executive committee decided to exit the U.S. client business entirely. From then until the end of May 2011, GPB developed a revised U.S. clients policy, established a process for closing U.S. client accounts, and established an account closing team to implement the new process.

39. HSBC Private Bank began to exit the business in May 2011. Pursuant to the process that had been developed, RMs were not involved in closing their clients' accounts. HSBC Private Bank did not charge U.S. clients any brokerage or investment advisory fees associated with closing their accounts.

40. By the end of 2011, nearly all of HSBC Private Bank's U.S. client accounts were closed. As of July 2014, all known U.S. client accounts with securities that could be closed (consistent with Swiss legal obligations) had been closed.

I. Violations

41. As a result of the conduct described above, Respondent willfully violated Exchange Act Section 15(a) and Advisers Act Section 203(a).

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 15(b)(6) and 21C of the Exchange Act and Sections 203(e) and (k) of the Advisers Act, it is hereby ORDERED that:

A. Respondent is censured;

B. Respondent cease-and-desist from committing or causing any violations and any future violations of Section 15(a) of the Exchange Act or Section 203(a) of the Advisers Act; and

C. Respondent shall, within ninety (90) days of the entry of this Order, pay disgorgement of \$5,723,193, prejudgment interest of \$4,215,543, and a civil money penalty in the amount of \$2,600,000 to the Securities and Exchange Commission for remission to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. Payment must be made in one of the following ways:

(1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

(2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or

(3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying HSBC Private Bank (Suisse) SA as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Scott W. Friestad, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F Street, N.E., Washington, D.C. 20549-5010.

By the Commission.

Brent J. Fields
Secretary


By: Jill M. Peterson
Assistant Secretary

*Chair White
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9682 / November 25, 2014.

In the Matter of

BANK OF AMERICA, N.A. and

MERRILL LYNCH, PIERCE, FENNER &
SMITH, INC.

Respondents.

ORDER UNDER RULE 506(d) OF THE
SECURITIES ACT OF 1933 GRANTING
A WAIVER OF THE RULE 506(d)(1)(ii)
DISQUALIFICATION PROVISION

I.

Bank of America, N.A. and Merrill Lynch, Pierce, Fenner & Smith Inc. (the "Respondents"), submitted a letter dated November 18, 2014, requesting that the Securities and Exchange Commission (the "Commission") grant a waiver of disqualification under Rule 506(d)(1)(ii) of Regulation D under the Securities Act of 1933 (the "Securities Act") upon entry of the final judgment (the "Judgment") by the United States District Court for the Western District of North Carolina Charlotte Division (Civil Action No. 3:13-cv-447). The Judgment enjoins the Respondents from committing violations of Sections 17(a)(2) and (3), and Section 5(b)(1) of the Securities Act of 1933.

Rule 506(d)(2)(ii) of Regulation D provides that disqualification "shall not apply. . . upon a showing of good cause and without prejudice to any other action by the Commission, if the Commission determines that it is not necessary under the circumstances that an exemption be denied." The Commission has determined that as part of the Rule 506(d)(2)(ii) showing of good cause, the Respondents will comply with the following:

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- A. Retain, at Respondents' expense and within sixty (60) days of the issuance of this Order, a qualified independent consultant (the "Consultant") not unacceptable to the Staff. Respondents shall require the Consultant to conduct a comprehensive review of the policies and procedures relating to compliance with Rule 506 of Regulation D by Respondents and the subsidiaries of Respondents conducting any activities that would otherwise be disqualified pursuant to the Judgment (together with Respondents, the "Rule 506 Entities").
- B. Cooperate fully with the Consultant, including providing the Consultant with access to the Rule 506 Entities' files, books, records, and personnel as reasonably requested for the review, obtaining the cooperation of employees or other persons under Respondents' control, and permitting the Consultant to engage such assistance (whether clerical, legal, technological, or of any other expert nature) as necessary to achieve the purposes of the retention.
- C. Require the Consultant to complete its review and submit a written preliminary report ("Preliminary Report") to the Respondents and Commission staff within three hundred and sixty (360) days of the issuance of this Order. Respondents shall require that the Consultant test the Rule 506 Entities' policies and procedures relating to Rule 506 of Regulation D by conducting a statistically valid random sampling of transactions conducted in reliance on Rule 506 of Regulation D. Respondents also shall require the Preliminary Report to identify any instances of potential non-compliance with the policies and procedures relating to Rule 506 identified in the Preliminary Report, include a description of the review performed, the conclusions reached, recommendations for any changes in or improvements to the Rule 506 Entities' policies and procedures, and a procedure for implementing such recommended changes.
- D. Within one hundred and eighty (180) days of receipt of the Preliminary Report, adopt and implement all recommendations contained in the Preliminary Report; provided, however, that as to any recommendation that Respondents consider to be, in whole or in part, unduly burdensome or impractical, Respondents may submit in writing to the Consultant and Commission staff, within thirty (30) days of receiving the Preliminary Report, an alternative policy, practice, or procedure designed to achieve the same objective or purpose. Within forty-five (45) days of receiving the Preliminary Report, the Respondents and the Consultant shall attempt in good faith to reach an agreement relating to each recommendation that the Respondents consider to be unduly burdensome or impractical. Within fifteen (15) days after the discussion and evaluation by Respondents and the Consultant, Respondents shall require that the Consultant inform Respondents and Commission staff of the Consultant's final determination concerning any

recommendation that Respondents consider unduly burdensome or impractical, and Respondents shall abide by the determinations of the Consultant and adopt and implement all recommendations within the 180-day time period set forth in this paragraph. Respondents shall notify the Consultant and Commission staff, in a writing signed by the Respondents' principal executive officers or principal legal officers, when the recommendations have been implemented.

- E. Within one hundred and eighty (180) days from the date of the Respondents' implementation of the recommendations contained in the Preliminary Report, require the Consultant to submit a final written report ("Final Report") to the Respondents, including their principal executive officers and principal legal officers, and Commission staff. The Consultant shall certify in the Final Report that the Respondents have implemented the recommendations contained in the Preliminary Report and that the Respondent's policies and procedures designed to ensure compliance by the Rule 506 Entities with their obligations under Rule 506 of Regulation D are reasonably designed to achieve their stated purpose.
- F. On or after the date that the Respondents have adopted and implemented all recommendations referenced in paragraph D of this Order, and in no event earlier than the date when the Final Report is delivered pursuant to paragraph E of this Order, the Respondents may apply to the Commission for a waiver covering the remaining 30 months in the disqualification period that are not covered by this Order.
- G. Require the Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with the Rule 506 Entities, or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. The agreement will also provide that the Consultant will require that any firm with which the Consultant is affiliated or of which the Consultant is a member, and any person engaged to assist the Consultant in performance of the Consultant's duties under this Order shall not, without prior written consent of Commission staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with the Rule 506 Entities, or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.
- H. To ensure the independence of the Consultant, Respondents shall not have the authority to terminate the Consultant without prior written approval of Commission staff and shall compensate the Consultant and persons engaged

to assist the Consultant for services rendered pursuant to this Order at their reasonable and customary rates.

Based on the foregoing, Commission has determined that pursuant to Rule 506(d)(2)(ii) of Regulation D under the Securities Act a showing of good cause has been made that it is not necessary under the circumstances that the exemptions be denied.

Accordingly, **IT IS ORDERED**, pursuant to Rule 506(d) of Regulation D under the Securities Act, that a waiver from the application of the disqualification provision of Rule 506(d)(1)(ii) under the Securities Act for a period of 30 months resulting from the entry of the Judgment is hereby granted to the Respondents.

By the Commission.



Brent J. Fields
Secretary

*Commissioner Gallagher
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73694 / November 26, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16289

In the Matter of

NICKOLAS C. SKALTSIS,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 15(b) OF THE
SECURITIES EXCHANGE ACT OF 1934,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Nickolas C. Skaltsis ("Skaltsis" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") that the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, Respondent consents to the Commission's jurisdiction over him and the subject matter of these proceedings and to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

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1. Skaltsis was the co-trustee of Liberty Realty Trust ("Liberty"), a Dover, New Hampshire-based trust that was registered in 2009 as a trade name with the New Hampshire Secretary of State's Corporation Department with a purported purpose of purchasing and selling real estate. He was also president and a director of Phoenix Asset Group, Inc. ("Phoenix"), a Dover, New Hampshire-based entity that purported to be in the business of acquiring, rehabilitating and managing real estate properties. Skaltsis, age 62, was a resident of Dover, New Hampshire until he was incarcerated in 2013. Neither Skaltsis, Liberty, nor Phoenix has ever been registered with the Commission in any capacity.

2. On May 20, 2013, a final judgment was entered against Skaltsis by the Superior Court for the State of New Hampshire in William Gardner, New Hampshire Secretary of State v. Nickolas Skaltsis, et al., Docket No. 219-2013-CV-00031, permanently enjoining him from engaging in securities fraud in violation of New Hampshire Revised Statutes Annotated ("RSA") 421-B:3; issuing securities without being licensed to do so in violation of RSA 421-B:6; and selling unregistered securities in violation of RSA 421-B:11.

3. The New Hampshire Bureau of Securities Regulation's Petition for Injunctive Relief ("Petition") in the above-referenced action alleged, inter alia, that Skaltsis, individually and through Liberty and Phoenix, used a device, scheme, or artifice to defraud investors, including through the use of material and untrue statements to lure investors to invest money with him by claiming the monies would be used for the purchase, rehabilitation, and resale of distressed properties when the funds were actually misappropriated for personal use and no properties were ever purchased. The Petition further alleged that Skaltsis issued securities without being licensed to do so and that the securities were not registered or exempt from registration.

4. By soliciting investors, inducing at least 12 investors to effect transactions in securities, and receiving compensation in connection therewith, Skaltsis was engaged in the business of effecting transactions in securities for the accounts of others, and therefore acted as an unregistered broker-dealer.

5. On July 3, 2013, Skaltsis pled guilty to one count of theft by misapplication in violation of RSA 637:10 and three counts of theft by deception in violation of RSA 637:4 before the Strafford County Superior Court in New Hampshire in State v. Nickolas C. Skaltsis, SSC#219-2013-CR-48. He was also sentenced on July 3, 2013 to a prison term of 1½ to 5 years on the theft by misapplication count and a consecutive sentence of 3½ to 7 years for the three counts of theft by deception, the latter of which was suspended for a period of 10 years. Skaltsis was also ordered to make restitution in the amount of \$277,733.94.

6. The counts of the criminal information to which Skaltsis pled guilty alleged, inter alia, that Skaltsis obtained and exercised control over funds belonging to investors by deception and with the purpose of depriving investors of the money by representing that he would use the funds to acquire, rehabilitate and re-sell real estate properties and return the funds to investors with a fixed rate of interest, knowing that representation was false and, with regard to one investor, committed to purchasing specific real estate property on behalf of the investor and himself but instead withheld the money as his own.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Skaltsis' Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act Respondent Skaltsis be, and hereby is:

barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and

barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Brent J. Fields
Secretary


By: Jill M. Peterson
Assistant Secretary

*Commissioner Gallagher
Not participating*

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 73695 / November 26, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16290

In the Matter of

LIBERTY REALTY TRUST,

Respondent.

ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
PURSUANT TO SECTION 15(b) OF THE
SECURITIES EXCHANGE ACT OF 1934,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against Liberty Realty Trust ("Liberty" or "Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") that the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings and the findings contained in Section III.2 below, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

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III.

On the basis of this Order and Respondent's Offer, the Commission finds that:

1. Liberty Realty Trust ("Liberty") is a Dover, New Hampshire-based trust that was registered in 2009 as a trade name with the New Hampshire Secretary of State's Corporation Department with a purported purpose of purchasing and selling real estate. Nickolas C. Skaltsis ("Skaltsis") is the co-trustee of Liberty. Liberty has never been registered with the Commission in any capacity.

2. On May 20, 2013, a final judgment was entered against Liberty and Skaltsis by the Superior Court for the State of New Hampshire in William Gardner, New Hampshire Secretary of State v. Nickolas Skaltsis, et al., Docket No. 219-2013-CV-00031, permanently enjoining them from engaging in securities fraud in violation of New Hampshire Revised Statutes Annotated ("RSA") 421-B:3; issuing securities without being licensed to do so in violation of RSA 421-B:6; and selling unregistered securities in violation of RSA 421-B:11.

3. The New Hampshire Bureau of Securities Regulation's Petition for Injunctive Relief ("Petition") in the above-referenced action alleged, *inter alia*, that Liberty made use of a device, scheme, or artifice to defraud investors, including through the use of material and untrue statements to lure investors to invest money by claiming the monies would be used for the purchase, rehabilitation, and resale of distressed properties when the funds were actually misappropriated for personal use and no properties were ever purchased. The Petition further alleged that Liberty issued securities without being licensed to do so and that the securities were not registered or exempt from registration.

4. By soliciting investors and inducing at least 12 investors to effect transactions in securities, and receiving compensation in connection therewith, Liberty was engaged in the business of effecting transactions in securities for the accounts of others, and therefore acted as an unregistered broker-dealer.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondent Liberty's Offer.

Accordingly, it is hereby ORDERED pursuant to Section 15(b)(6) of the Exchange Act Respondent Liberty be, and hereby is:

barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; and

barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a

broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

Any reapplication for association by the Respondent will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against the Respondent, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Brent J. Fields
Secretary


By Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 73696 / November 26, 2014

ADMINISTRATIVE PROCEEDING

File No. 3-16291

In the Matter of

Bingo.com, Inc.,
Biocol, Inc.,
Biomass Processing Technology, Inc.,
Biomedtex, Inc., and
Carnegie International Corp.,

Respondents.

ORDER INSTITUTING
ADMINISTRATIVE PROCEEDINGS
AND NOTICE OF HEARING
PURSUANT TO SECTION 12(j) OF
THE SECURITIES EXCHANGE ACT
OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it necessary and appropriate for the protection of investors that public administrative proceedings be, and hereby are, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondents Bingo.com, Inc., Biocol, Inc., Biomass Processing Technology, Inc., Biomedtex, Inc., and Carnegie International Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Bingo.com, Inc. (CIK No. 1087853) is an Anguilla corporation located in Anguilla, British West Indies with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Bingo.com is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2005.

2. Biocol, Inc. (CIK No. 1101373) is a dissolved Wyoming corporation located in Irvin, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Biocol is delinquent in its periodic filings with the

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Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2005, which reported a net loss of \$300,800 for the prior nine months.

3. Biomass Processing Technology, Inc. (CIK No. 1230489) is a Delaware corporation located in West Palm Beach, Florida with classes of securities registered with the Commission pursuant to Exchange Act Section 12(g). Biomass Processing is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended June 30, 2007, which reported a net loss of over \$1.47 million for the prior six months.

4. Biomedtex, Inc. (CIK No. 1093816) is a dissolved Florida corporation located in Boca Raton, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Biomedtex is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 1999, which reported a net loss of over \$124,087 for the prior nine months.

5. Carnegie International Corp. (CIK No. 311172) is a Colorado corporation located in Hunt Valley, Maryland with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Carnegie is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended September 30, 2001, which reported a net loss of over \$1.49 million for the prior three months.

B. DELINQUENT PERIODIC FILINGS

6. As discussed in more detail above, all of the Respondents are delinquent in their periodic filings with the Commission, have repeatedly failed to meet their obligations to file timely periodic reports, and failed to heed delinquency letters sent to them by the Division of Corporation Finance requesting compliance with their periodic filing obligations or, through their failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

7. Exchange Act Section 13(a) and the rules promulgated thereunder require issuers of securities registered pursuant to Exchange Act Section 12 to file with the Commission current and accurate information in periodic reports, even if the registration is voluntary under Section 12(g). Specifically, Rule 13a-1 requires issuers to file annual reports, and Rule 13a-13 requires domestic issuers to file quarterly reports.

8. As a result of the foregoing, Respondents failed to comply with Exchange Act Section 13(a) and Rules 13a-1 and/or 13a-13 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate for the protection of investors that public administrative proceedings be instituted to determine:

A. Whether the allegations contained in Section II hereof are true and, in connection therewith, to afford the Respondents an opportunity to establish any defenses to such allegations; and,

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or revoke the registration of each class of securities registered pursuant to Section 12 of the Exchange Act of the Respondents identified in Section II hereof, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents.

IV.

IT IS HEREBY ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice [17 C.F.R. § 201.110].

IT IS HEREBY FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If Respondents fail to file the directed Answers, or fail to appear at a hearing after being duly notified, the Respondents, and any successor under Exchange Act Rules 12b-2 or 12g-3, and any new corporate names of any Respondents, may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f), and 310 of the Commission's Rules of Practice [17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f), and 201.310].

This Order shall be served forthwith upon Respondents personally or by certified, registered, or Express Mail, or by other means permitted by the Commission Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice [17 C.F.R. § 201.360(a)(2)].

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to

notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson
By **Jill M. Peterson**
Assistant Secretary

*Chair White
Not participating*

SECURITIES AND EXCHANGE COMMISSION

[Release No. IC – 31359; 812-14390

Banc of America Mortgage Securities, Inc, et al.; Notice of Application and Temporary Order

November 25, 2014

Agency: Securities and Exchange Commission (“Commission”).

Action: Temporary order and notice of application for a permanent order under section 9(c) of the Investment Company Act of 1940 (“Act”).

Summary: Applicants have received a temporary order (the “Temporary Order”) exempting them from section 9(a) of the Act, with respect to injunctions entered against Bank of America, N.A. (“BANA”), Merrill Lynch, Pierce, Fenner & Smith Incorporated (“Merrill Lynch”), and Banc of America Mortgage Securities, Inc. (“BOAMS,” and together with BANA and Merrill Lynch, the “Respondents”) on November 25, 2014 by the United States District Court for the Western District of North Carolina (the “District Court”) until the Commission takes final action on an application for a permanent order (the “Permanent Order,” and with the Temporary Order, the “Orders”). Applicants also have applied for a Permanent Order.

Applicants: BofA Advisors, LLC (“BoA Advisors”), BofA Distributors, Inc. (“BoA Distributors”), KECALP Inc. (“KECALP”), Merrill Lynch Ventures, LLC (“Ventures”), Merrill Lynch Global Private Equity, Inc. (“MLGPE”), and Merrill Lynch Alternative Investments LLC (“MLAI”) (each, an “Applicant” and collectively, the “Applicants”), and solely for purposes of agreeing to condition 3 of the application, the Respondents.

Filing Date: The application was filed on November 25, 2014.

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Hearing or Notification of Hearing: An order granting the application will be issued unless the Commission orders a hearing. Interested persons may request a hearing by writing to the Commission's Secretary and serving applicants with a copy of the request, personally or by mail. Hearing requests should be received by the Commission by 5:30 p.m. on December 22, 2014, and should be accompanied by proof of service on applicants, in the form of an affidavit or, for lawyers, a certificate of service. Pursuant to rule 0-5 under the Act, hearing requests should state the nature of the writer's interest, any facts bearing upon the desirability of a hearing on the matter, the reason for the request, and the issues contested. Persons who wish to be notified of a hearing may request notification by writing to the Commission's Secretary.

Addresses: Secretary, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090; Applicants: BOAMS, 21 North Tryon Street, Charlotte, NC 28255; BANA and Merrill Lynch, Bank of America Tower, One Bryant Park, New York, NY 10036; BoA Advisors and BoA Distributors, 100 Federal Street, Boston, MA 02110; KECALP and Ventures, 135 South LaSalle Street, Chicago, IL 60604; MLGPE, 135 South La Salle Street, Suite 811, Chicago, IL 60603; and MLAI, 4 World Financial Center, 250 Vesey Street, 11th Floor, New York, NY 10080.

For Further Information Contact: David J. Marcinkus, Senior Counsel, at 202-551-6882 or Mary Kay Frech, Branch Chief, at 202-551-6821 (Division of Investment Management, Chief Counsel's Office).

Supplementary Information: The following is a temporary order and summary of the application. The complete application may be obtained via the Commission's website by searching for the file number, or for an applicant using the Company name box, at <http://www.sec.gov/search/search.htm>, or by calling (202) 551-8090.

Applicants' Representations:

1. Bank of America Corporation ("BAC"), a corporation organized under the laws of Delaware, is a publicly traded company headquartered in Charlotte, North Carolina. As noted below, each of the Respondents and each of the Applicants is a direct or indirect wholly-owned subsidiary of BAC. BANA is a nationally chartered banking association headquartered in Charlotte, North Carolina that conducts retail, trust and commercial banking operations. BANA is an indirect wholly-owned subsidiary of BAC. BOAMS, a corporation organized under the laws of Delaware, is a direct wholly-owned subsidiary of BANA. Merrill Lynch, a corporation organized under the laws of Delaware, is an indirect wholly-owned subsidiary of BAC. Merrill Lynch, directly and through its subsidiaries and affiliates, provides investment, financing, advisory, insurance, banking and related products and services, and is registered as a broker-dealer under the Securities Exchange Act of 1934, and as an investment adviser under the Investment Advisers Act of 1940 (the "Advisers Act"). Merrill Lynch does not currently engage in Fund Service Activities (defined below), but it may do so in the future.

2. Each of the Applicants serves either as investment adviser (as defined in section 2(a)(20) of the Act) to investment companies registered under the Act or series of such companies ("Funds") or employees' securities companies ("ESCs"), or as principal underwriter (as defined in section 2(a)(29) of the Act) to open-end management investment companies registered under the Act ("Open-End Funds"). BoA Advisors, a limited liability company organized under the laws of Delaware, is registered as an investment adviser under the Advisers Act. BoA Advisors is a direct wholly-owned subsidiary of BofA Global Capital Management Group, LLC, which is in turn a direct wholly-owned subsidiary of BANA. BoA Distributors, a corporation organized under the

laws of Massachusetts, is an indirect wholly-owned subsidiary of BoA Advisors. BoA Distributors is a limited purpose broker-dealer registered with the Commission. KECALP, a corporation organized under the laws of Delaware, is an indirect wholly-owned subsidiary of BAC. Ventures, a limited liability company organized under the laws of Delaware, is an indirect wholly-owned subsidiary of BAC. MLGPE, a corporation organized under the laws of Delaware, is registered as an investment adviser under the Advisers Act. MLGPE is an indirect wholly-owned subsidiary of BAC. MLAI, a limited liability company organized under the laws of Delaware, is registered as an investment adviser under the Advisers Act. MLAI is an indirect wholly-owned subsidiary of BAC.

3. While no existing company of which the Respondents is an "affiliated person" within the meaning of section 2(a)(3) of the Act ("Affiliated Person"), other than the Applicants, currently serves as an investment adviser or depositor of any Fund or ESC or investment company that has elected to be treated as a business development company under the Act, or principal underwriter for any Open-End Fund, unit investment trust registered under the Act, or face-amount certificate company registered under the Act (such activities, collectively, ("Fund Service Activities")), Applicants request that any relief granted also apply to any existing company of which any of the Respondents is an Affiliated Person and to any other company of which any of the Respondents may become an Affiliated Person in the future (together with Applicants and Merrill Lynch, the "Covered Persons") with respect to any activity contemplated by section 9(a) of the Act.

4. On August 6, 2013, the Commission filed a complaint (the "Complaint") against the Respondents in the District Court in a civil action captioned *Securities and Exchange Commission v. Bank of America, N.A., et al.* (the "BOAMS Action").¹ The Complaint alleges violations of sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 (the "Securities Act") by Respondents arising out of an offering of prime residential mortgage-backed securities ("RMBS") in 2008 known as BOAMS 2008-A. The Complaint also alleges that Merrill Lynch and BOAMS violated section 5(b)(1) of the Securities Act by disclosing certain data regarding BOAMS 2008-A to some, but not all, investors, as well as by failing to file such data with the Commission.

5. In settlement of the BOAMS Action, Respondents submitted executed Consents of Defendants BANA, Merrill Lynch and BOAMS (the "Consents"). In the Consents, Respondents agreed to the entry of a final judgment, without admitting or denying the allegations contained in the Complaint (other than those relating to the jurisdiction of the District Court). On November 25, 2014 the District Court entered a judgment against Respondents (the "Judgment")² that enjoined Respondents from violating, directly or indirectly, sections 17(a)(2), 17(a)(3) and 5(b)(1)³ of the Securities Act (the "Injunctions").

¹ The conduct alleged in the Complaint is referred to herein as the "Conduct."

² *Securities and Exchange Commission v. Bank of America, N.A., et al.*, Civil Action No. 3:13-cv-447 (W.D.N.C. Nov. 25, 2014).

³ BANA was not named as a defendant in connection with the Commission's section 5(b)(1) claim and therefore did not consent to the entry of an injunction under that section.

Applicants' Legal Analysis:

1. Section 9(a)(2) of the Act, in relevant part, prohibits a person who has been enjoined from engaging in or continuing any conduct or practice in connection with the purchase or sale of a security, or in connection with activities as an underwriter, from performing Fund Service Activities. Section 9(a)(3) of the Act makes the prohibition in section 9(a)(2) applicable to a company, any Affiliated Person of which has been disqualified under the provisions of section 9(a)(2). Section 2(a)(3) of the Act defines "affiliated person" to include, among others: (a) any person directly or indirectly owning, controlling, or holding with power to vote, five per centum or more of the outstanding voting securities of such other person; (b) any person five per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; and (c) any person directly or indirectly controlling, controlled by, or under common control, with the other person. Applicants state that, taken together, sections 9(a)(2) and 9(a)(3) would have the effect of precluding Applicants and Covered Persons from engaging in Fund Service Activities upon the entry of the Injunctions because the Respondents are Affiliated Persons of each Applicant and Covered Person.

2. Section 9(c) of the Act provides that, upon application, the Commission shall by order grant an exemption from the disqualification provisions of section 9(a) of the Act, either unconditionally or on an appropriate temporary or other conditional basis, to any person if that person establishes that: (i) the prohibitions of section 9(a), as applied to the person, are unduly or disproportionately severe or (ii) the conduct of the person has been such as not to make it against the public interest or the protection of investors to grant the exemption. Applicants have filed an application pursuant to section 9(c)

seeking a Temporary Order and a Permanent Order exempting them and other Covered Persons from the disqualification provisions of section 9(a) of the Act. The Applicants and other Covered Persons may, if the relief is granted, in the future act in any of the capacities contemplated by section 9(a) of the Act subject to the conditions of the Temporary Order and the Permanent Order.

3. Applicants believe they meet the standard for exemption specified in section 9(c) of the Act. Applicants state that the prohibitions of section 9(a) as applied to them would be unduly and disproportionately severe and that the conduct of Applicants has been such as not to make it against the public interest or the protection of investors to grant the exemption from section 9(a).

4. Applicants state that the Conduct did not involve any of the Applicants engaging in Fund Service Activities.⁴ Applicants also state that the Conduct did not involve any Fund or ESC with respect to which Applicants engaged in Fund Service Activities. In addition, Applicants state that none of the Funds or ESCs with respect to which Applicants provide Fund Service Activities purchased or held BOAMS 2008-A.

5. Applicants and Respondents state that (a) none of the current directors, officers or employees of Applicants had any involvement in the Conduct; (b) none of the current directors, officers or employees of Respondents had any responsibility for the Conduct; (c) no current or former employee of Respondents who previously has been or who subsequently may be identified by Respondents or any U.S. regulatory or enforcement agencies as having been responsible for the Conduct will be an officer,

⁴ Applicants state that none of the Respondents currently serve in any of the capacities described in section 9(a) of the Act, and BANA and BOAMS will not do so in the future. Merrill Lynch has engaged in Fund Service Activities in the past (although it ceased doing so by the end of 2010), and it may do so in the future.

director or employee of any Covered Person; and (d) the employees of Respondents who were identified as having been responsible for the Conduct have had no, and will not have any involvement in the provision of Fund Service Activities on behalf of Applicants or other Covered Persons. Applicants assert that because the personnel of Applicants did not have any involvement in the Conduct, shareholders of the Funds and ESCs were not affected any differently than if those Funds and ESCs had received services from any investment adviser or principal underwriter that was not affiliated with Respondents.

6. Applicants submit that section 9(a) should not operate to bar them from serving the Funds or ESCs and their shareholders in the absence of improper activities relating to their Fund Service Activities. Applicants state that the section 9(a) disqualification would result in material economic losses for the Funds and ESCs to which Applicants provide Funds Service Activities, and such Funds' operations would be disrupted, as they sought to engage new advisers and distributors. Applicants assert that these effects would be unduly severe given the Applicants' lack of involvement in the Conduct. Moreover, Applicants state that the Respondents have taken remedial actions to address the Conduct, as outlined in the application. Thus, Applicants believe that granting the exemption from section 9(a), as requested, would be consistent with the public interest and the protection of investors.

7. Applicants state that (a) inability of the Adviser Applicants⁵ to continue providing investment advisory services to Funds would result in the Funds and their shareholders facing potential hardship and (b) the inability of BoA Distributors to continue to serve as principal underwriters to the Open-End Funds would similarly result

⁵ The "Adviser Applicants" are BoA Advisors, KECALP, Ventures, MLGPE, and MLAI.

in potential hardship to the Open-End Funds and their shareholders. Applicants state that they will distribute to the board of trustees/directors of the Funds (the "Boards") written materials describing the circumstances alleged in the BOAMS Action and any impact on the Funds, and the application. The written materials will include an offer to discuss the materials at an in-person meeting with each Board for which Applicants provide Fund Service Activities, including the directors who are not "interested persons" of the Fund as defined in section 2(a)(19) of the Act, and their independent legal counsel as defined in rule 0-1(a)(6) under the Act. Applicants state that they will provide the Boards with the information concerning the BOAMS Action and the application that is necessary for those Funds to fulfill their disclosure and other obligations under the federal securities laws and will provide them a copy of the Judgment as entered by the District Court.

8. Applicants state that if the Applicants were barred under section 9(a) of the Act from engaging in Fund Service Activities and were unable to obtain the requested exemption, the effect on their businesses and employees would be severe because they have committed substantial capital and other resources to establishing an expertise in the provision of Fund Service Activities. Applicants further state that prohibiting them from providing Fund Service Activities would not only adversely affect their business, but would also adversely affect their employees who are involved in those activities. Applicants state that many of these employees could experience significant difficulties in finding alternative fund-related employment.

9. Applicants state that Applicants and certain other affiliated persons of Applicants have previously received orders under section 9(c) of the Act, as the result of conduct that triggered section 9(a), as described in greater detail in the application.

Applicants' Conditions:

Applicants agree that any order granting the requested relief will be subject to the following conditions:

1. Any temporary exemption granted pursuant to the application will be without prejudice to, and will not limit the Commission's rights in any manner with respect to, any Commission investigation of, or administrative proceedings involving or against, Covered Persons, including, without limitation, the consideration by the Commission of a permanent exemption from section 9(a) of the Act requested pursuant to the application or the revocation or removal of any temporary exemptions granted under the Act in connection with the application.

2. Each Applicant and Covered Person will adopt and implement policies and procedures reasonably designed to ensure that it will comply with the terms and conditions of the Orders within 60 days of the date of the Permanent Order.

3. Respondents will comply in all material respects with the material terms and conditions of the Orders.

4. Applicants will provide written notification to the Chief Counsel of the Commission's Division of Investment Management with a copy to the Chief Counsel of the Commission's Division of Enforcement of a material violation of the terms and conditions of the Orders and the Judgment within 30 days of discovery of the material violation.

Temporary Order:

The Commission has considered the matter and finds that Applicants have made the necessary showing to justify granting a temporary exemption.

Accordingly,

IT IS HEREBY ORDERED, pursuant to section 9(c) of the Act, that Applicants and any other Covered Persons are granted a temporary exemption from the provisions of section 9(a), solely with respect to the Injunctions, subject to the representations and conditions in the application, from November 25, 2014, until the Commission takes final action on their application for a permanent order.

By the Commission.

Kevin M. O'Neill

Kevin M. O'Neill
Deputy Secretary