

September 12, 2013

VIA Electronic Submission

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

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

Dear Ms. Murphy:

OTC Markets Group Inc.¹ (“OTC Markets Group”), on behalf of its wholly owned subsidiary OTC Link LLC (“OTC Link ATS”) respectfully submits to the Securities and Exchange Commission (the “SEC”) the following comments on proposed Regulation Systems Compliance and Integrity (“Reg. SCI”). OTC Link[®] ATS is a FINRA member broker-dealer and SEC registered ATS that provides a network facilitating broker-dealer trading in OTCQX[®], OTCQB[®], OTC Pink[®] and other securities. The SEC intends to include OTC Link ATS under Reg. SCI as proposed.

INTRODUCTION

OTC Markets Group agrees with the SEC that the capacity, integrity, resiliency, availability and security of significant automated market systems are vital to the operation and maintenance of fair and orderly markets. SRO and broker-dealer technology platforms need to operate in a robust and compliant manner with adequate capacity, testing and disaster recovery. Recent events clearly demonstrate that some technology systems have not met these standards. The issues that arise from systems breakdowns, however, are better solved by proactively planning for procedures around technology problems or natural disasters to ensure orderly trading rather than

¹[OTC Markets Group Inc.](#) (OTCQX: OTCM) operates Open, Transparent and Connected financial marketplaces for 10,000 U.S. and global securities. Through our OTC Link[®] ATS, we directly link a diverse network of broker-dealers that provide liquidity and execution services for a wide spectrum of securities. We organize these securities into marketplaces to better inform investors of opportunities and risks – OTCQX[®], The Best Marketplace with Qualified Companies; OTCQB[®], The Venture Stage Marketplace with U.S. Reporting Companies; and OTC Pink[®], The Open Marketplace with Variable Reporting Companies. Our data-driven platform enables investors to easily trade through the broker of their choice at the best possible price and empowers a broad range of companies to improve the quality and availability of information for their investors.

implementing a broad, overly prescriptive regulation such as Reg. SCI. Complex problems require communication and coordination, and the systems issues impacting trading markets are no different. Regulatory energy and resources should be focused on developing thoughtful, industry-wide protocols and procedures for mitigating investor risk and promoting coordinated trading across market centers to deal with systems failures and errors.

The Federal Aviation Administration (FAA), for example, imposes a host of mechanical and technical requirements on airline industry participants as a means to eliminate technical malfunction, and danger to human life, as much as possible. Even in that life and death context, however, the FAA recognizes that despite its best efforts sometimes systems will fail, and accordingly the FAA institutes procedures for dealing with total systems failure when it occurs.² We should have an industry protocol outlining how technology failures are handled, when trading should be halted and how common rules should be applied across market centers to cancel trades in a manner that is clear to investors. In the financial context, instead of preparing our markets to handle adversity, proposed Reg. SCI intends to create a regulatory regime that would impose substantial new regulations on all market participants, stifle innovations and overburden the industry and SEC staff, all without meaningfully increasing the likelihood of preventing, or even better identifying, the very problems it intends to solve. Our industry would be better served by consistent SEC and SRO regulations that establish clear protocols and procedures for stopping trading and later re-starting the markets when a material disruption occurs, such as what happened last month when an exclusive securities information processor (“SIP”) experienced a failure.

A revised Reg. SCI that thoughtfully addresses the regulation of material systems changes and the development of technology used to distribute reliable data under the National Market System would achieve the regulation’s stated benefits without imposing unintended burdens. To achieve a more efficient, effective regulation of systems compliance and integrity, OTC Markets Group makes five primary proposals:

² See Lisa Stark, Devin Dwyer and Scott Mayerowitz, *FAA Computer Glitch Knocked Out Electronic Flight Information*, ABC News, November 19, 2009, available at: <http://abcnews.go.com/Travel/BusinessTraveler/faa-computer-glitch-delays-flights-nationwide/story?id=9124958>; J. Nicholas Hoover, *Problems Plague FAA’s NextGen Air Traffic Control Upgrade*, Information Week, October 5, 2011, available at: <http://www.informationweek.com/government/information-management/problems-plague-faas-nextgen-air-traffic/231900067>; John Hughes, *Lockheed Air-Traffic Upgrade Now on Track, FAA Chief Says*, Bloomberg, August 31, 2012, available at: <http://www.bloomberg.com/news/2012-08-31/lockheed-air-traffic-upgrade-now-on-track-faa-chief-says.html>.

- 1) Reg. SCI should not apply to trading in non-NMS securities. Non-NMS trading is not susceptible to the issues the SEC intends to address through Reg. SCI. Trading of NMS securities involves a high degree of linkage and inter-dependency that can lead to rapid, widespread issues. Non-NMS equity trading is distributed across numerous connected broker-dealers that are not inter-dependent, using OTC Link ATS, NYSE's ArcaEdge, and the FINRA OTC Bulletin Board. The SEC has not provided any examples of widespread issues in non-NMS equity or debt trading. Absent a reasonable basis to believe widespread issues can occur outside of the NMS context, Reg. SCI should be limited to NMS trading.
- 2) Remove ATSs from Reg. SCI and regulate them through Reg. ATS and FINRA regulation. If the SEC determines to include ATSs with exchanges under the Reg. SCI umbrella, the ATSs should be given all of the options available to the exchanges, including access to the exclusive SIP, access to clearing, and SRO immunity.
- 3) Do not apply Reg. SCI to FINRA member broker-dealers. Allow FINRA to regulate broker-dealer systems through broker-dealer rulemaking and the written supervisory procedure process.
- 4) Increase industry-wide, consistent procedures for handling technology failures, trading errors and natural disasters. In short, give market centers the tools to fail gracefully, restart quickly and rollback easily in an orderly and coordinated manner. Efforts to ensure the integrity of systems are noble, but practical plans for recover and restart in the event of a systems issue are significantly more useful.
- 5) Focus a revised Reg. SCI on the exclusive SIPs responsible for transmitting NMS market data and on establishing procedures for the systems responsible for primary NMS market auctions that set the daily opening and closing prices, as these systems have been identified in the SCI proposing release as having the greatest potential impact on overall market risk. Development, testing and all other non-production systems should not be considered "SCI systems".

In addition to the proposals outlined above, Reg. SCI should be revised to:

- a. Enhance the safe harbor to encourage SCI entities to remain vigilant in their compliance and reporting to regulators.
- b. Alter the definition of an "SCI event" to capture only material systems outages and significant systems changes, as currently prescribed by Rule 301(b)(6)(ii)(G) of Reg. ATS. The SEC should issue guidance on what

constitutes “material” outages and “significant” changes, focusing on widespread outages and major changes.

- c. Delete the concept of “responsible SCI personnel,” and limit the scope of individuals responsible for taking action in the wake of an SCI event.
- d. Require notification to the SEC only when a widespread systems issue arises that prompts the entity to provide notification to its subscribers or participants.
- e. Focus more on recordkeeping than continuous reporting. Require SCI entities to retain all relevant information relating to systems changes and technical issues, making it available to the SEC upon request, but limit reporting to the SEC only to major systems and functionality changes, using periodic reports rather than individual reports prior to each change.
- f. Incorporate a phase-in period of two years for systems currently covered by the SEC’s Automated Review Program (“ARP”), and four years for all other applicable systems.
- g. Indicate that Reg. SCI filings do not need to be made in a tagged data format such as XBRL. The cost of XBRL conversion for SEC reporting companies has been significantly greater than any attending benefit, and there is no reason to believe the cost-benefit calculation for Reg. SCI filings would be any different.

The staggering breadth of Reg. SCI, combined with the ambiguous language in the proposing release would immediately impose severe burdens on “SCI Entities,” as that term is defined in the regulation. The effect which would be felt by their members, subscribers and ultimately investors, who would be left to bear higher costs while receiving lower quality services. The organizations that should be focused on the consistent improvement required to keep the U.S. at the forefront of financial market structure would instead be stifled by monumental new reporting requirements. Raising the regulatory burden and resources required for systems change will reduce the industry’s capacity for technological innovation, causing the long term global leadership and efficiency of U.S. markets to suffer.

Reg. SCI goes awry due to a lack of focus on truly impactful systems issues and a failure to identify the systems that have the greatest impact on the functioning of fair and orderly markets in the National Market System. The work of determining which systems play the most vital role has largely already been done. In the official report on the May 2010 “Flash Crash”, the staffs of the SEC and the Commodity Futures Trading

Commission note that the event was primarily caused by the manner in which a “large fundamental trader” chose to execute a sell order.³ The Flash Crash report goes on to determine that regardless of the systems used to make trading decisions, “fair and orderly markets require that the standard for robust, accessible, and timely market data be set quite high,” and to advocate for regulation focused on the SIP data in NMS securities, in particular “the integrity and reliability of market centers’ data processes, especially those that involve the publication of trades and quotes to the consolidated market data feeds.”⁴

The Reg. SCI proposing release describes several recent events including the Flash Crash, Superstorm Sandy and the initial public offerings of BATS and Facebook. More recently, the Nasdaq stock market ceased trading for approximately three hours due to a SIP-related systems issue. While each of these constitutes a major market event, notably, none involve even a hint of fraud. In fact, none of the concerns cited by the SEC in the Reg. SCI proposal involve fraud. The level of required notification, reporting, and internal process change in proposed Reg. SCI, however, is akin to the requirements placed on issuers through The Sarbanes-Oxley Act of 2002, a regulation specifically targeted at fraud prevention. Framed in this context, Reg. SCI appears to be a gross overreaction to recent market events.

In the case of Superstorm Sandy, the financial markets made the proper decision in determining to remain closed for two days. In the Reg. SCI proposing release, the SEC cited concerns with business continuity planning in relation to the decision to stay closed. As the SEC itself noted, however, the markets remained closed due to concerns for the physical safety of stock exchange and market center employees and the thousands of people in the greater New York City area that are involved in the financial markets. Forcing those people to attempt to travel through the storm-ravaged areas would have been irresponsible at best. The exchanges and market centers had the technology available to operate the markets, but chose to forgo two days of potential profits in favor of putting people ahead of financial gain. The SEC and FINRA could have led an initiative prior to the storm to institute a defined, organized process for how the markets should decide when to close and when to reopen around natural disasters.

³ 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 (the “Flash Crash Report”) at page 2.

⁴ Id, at page 8.

Reg. SCI also appears to be an attempt by the SEC to gather information in anticipation of press inquiries following a systems-related event. Even if firms were able to comply with the immense notification burdens of proposed Reg. SCI, the SEC does not have the resources to review and adequately absorb all of that information. In any event the information gathered by the SEC under Reg. SCI would likely not be adequate to give relevant insight into a specific systems problem. The SEC's limited time and energy should be spent regulating SRO's and only disclosing information regarding regulated entities to the press after a complete and thorough investigation has been made, not preparing to act as an all-encompassing spokesman for the trading industry.

As a threshold matter, we note our concurrence with two points raised in the NYSE Euronext⁵ comment letter to Reg. SCI. First, we join in questioning the SEC's authority to adopt Reg. SCI. We see nothing in the National Market System provisions of the Securities Exchange Act of 1934 (the "Exchange Act") that gives the SEC the authority to adopt the wide-ranging notification and systems access requirements included in the Reg. SCI proposing release. Second, while OTC Link ATS has not been subject to ARP, we share NYSE's concern with basing Reg. SCI on the ARP program. We observe that the procedures set forth in the two ARP policy statements were voluntary and thus never strictly followed, making it nearly impossible to evaluate the effectiveness of ARP and the ways in which it could be improved on in Reg. SCI. For example, did the ARP program result in the design and development of more robust systems, and if not, where did it fail? Were the ARP failures that Reg. SCI attempts to address due to lack of adherence to the ARP policy statements, or problems with the policies themselves? When did SRO's choose not to follow certain parts of the voluntary ARP policy statement letters and what was the reason?

In addition to the points discussed in the NYSE Letter, we note that the SEC's cost/benefit analysis significantly underestimates reportable events, notifications and costs to SCI entities and their users. Proposed Reg. SCI does not adequately address the burden on SCI entities and their users in terms of internal and external resources, and work-hours. While none of the identified SCI entities are small businesses under the Regulatory Flexibility Act, many of the users of SCI entities are small businesses that will be negatively impacted. A recent trilogy of cases in the D.C. Circuit⁶ have made it abundantly clear that the SEC must display thoughtful reasoning in its analysis

⁵ Letter from Janet McGinness, EVP & Corporate Secretary, NYSE Euronext to Elizabeth M. Murphy, Secretary, SEC, dated July 9, 2013.

⁶ See *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005); *Am. Equity Inv. Life Ins. Co v. SEC*, 613 F.3d 166 (D.C. Cir. 2010); and *Bus. Roundtable & U.S. Chamber of Commerce v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

of a rule's impact on efficiency, competition and capital formation. Given the broad, sweeping imposition of regulatory burdens contained in Reg. SCI, the SEC's cost/benefit analysis appears on its face to be insufficient.

PRIMARY PROPOSALS FOR IMPROVING PROPOSED REG. SCI

I. REG. SCI SHOULD NOT APPLY TO TRADING IN NON-NMS SECURITIES

Reg. SCI should only apply to trading in NMS securities because non-NMS trading is not susceptible to the issues the SEC intends to address through Reg. SCI. Trading of NMS securities involves a high degree of linkage and inter-dependency that can lead to rapid, widespread issues. Non-NMS equity trading is distributed across connected broker-dealers that are not inter-dependent, using OTC Link ATS, NYSE's ArcaEdge, and the FINRA OTC Bulletin Board. If any of these markets should experience an issue, trading and data dissemination could continue through the others.

Throughout Reg. SCI the SEC distinguishes between the NMS and non-NMS markets, citing the different thresholds and requirements that should be applicable to each. Specifically, the SEC estimates that using a threshold of 5% of average daily dollar volume ("ADDV") of non-NMS securities two ATSs would fall within the definition of an SCI entity, one of which would be OTC Link ATS. In any event, any ATS meeting the SEC's proposed 5% ADDV threshold would also meet the 2.5% average daily volume ("ADV") threshold we propose below for required compliance with Rule 301(b)(6)(ii) – further allowing the SEC to regulate ATSs using Reg. ATS as opposed to Reg. SCI.

Non-NMS trading is dispersed among broker-dealers and does not create the single points of failure that expose the overall market to greater risk. From the time of the SEC's initial introduction of ARP in 1989,⁷ through the proposal of Reg. SCI in 2013, the SEC has focused on mitigating the risk of systems failures. Reg. SCI describes a litany of recent systems failures that "highlight why rulemaking in this area may be warranted."⁸ None of these recent events involved the non-NMS market. In fact, the SEC has never pointed to a systems failure in the non-NMS market that had a

⁷ SEC Policy Statement: Automated Systems of Self-Regulatory Organizations; Release No. 34-27445; File No. S7-29-89 (November 16, 1989) ("ARP I").

⁸ Regulations Systems Compliance and Integrity, Securities Exchange Act. Rel No. 69077 (March 8, 2013), 78 Fed. Reg. 18084 (March 25, 2013) (the "Reg. SCI Proposing Release") at 18089.

significant, or even slightly material, impact on overall market risk or investor confidence. This is due to two primary factors:

- First, non-NMS trading does not create a single point of failure with regard to the distribution of market data that would allow a systems error to bring down the entire market. NMS market data is fed into a single quote stream consolidated by an SEC mandated exclusive securities information processor (“SIP”). A systems issue at the SIP level corrupts the entire NMS quote stream⁹, leading to the type of market-wide event experienced on August 22 at Nasdaq and described more generally in Reg. SCI. In contrast, non-NMS market data is consolidated by the market, not by a feed mandated by regulation. Non-NMS market data is consolidated either by a trading system that collects direct feeds to provide a consolidated quote, or by third-party redistributors. In fact, OTC Link ATS takes the data from ArcaEdge and FINRA’s OTC Bulletin Board and consolidates it, and ArcaEdge consolidates OTC Link ATS and OTC Bulletin Board data to provide best execution. If the data from the OTC Bulletin Board, for example, experiences an issue, market participants can choose to ignore the stale prices or remove the data from consolidated feeds. The non-NMS market data reaches just as wide an audience, but there is no single point at which a systems failure would corrupt the entire stream. In the event of a systems issue at a third-party redistributor, the trading systems can continue to provide their data directly to the market. In the event of a systems issue at the trading system level, other trading systems can continue to provide their own quote streams.
- Second, non-NMS equity trading accounts for a small fraction of overall equity trading, further reason why the impact of any non-NMS systems disruption would not cause the kind of widespread problems Reg. SCI is intended to prevent.

By the SEC’s own estimation, the costs of compliance with proposed Reg. SCI would be high. In the NMS market, where the risk is higher, it may be reasonable to impose some of Reg. SCI’s provisions on a limited subset of critical NMS systems. In the non-NMS market, where the risks associated with system failure are much more limited, the cost of compliance with Reg. SCI far outweighs any potential benefit.

⁹ The SEC could reduce this risk by providing guidance allowing for the SIP data to be ignored in certain circumstances, and permitting market participants to use other competing, non-exclusive consolidators.

II. ATSS SHOULD BE REMOVED FROM THE SCOPE OF REG. SCI AND REGULATED SOLELY THROUGH REG. ATS

The SROs are directly regulated by the SEC with the expectation that the group at the SEC currently handling ARP-related issues will be responsible for Reg. SCI. In contrast, all ATSS are broker-dealer members of FINRA, and as such are regulated by the SEC in conjunction with FINRA. Reg. ATS and the FINRA rules co-exist efficiently. Reg. ATS relies on the baseline standards imposed on ATSS by the FINRA rules, and adds a specific set of secondary regulations. In particular, FINRA generally acts as the lead regulator in dealing with ARP-like functions.¹⁰ As a result, Reg. ATS and the FINRA rules work in tandem as part of the broker-dealer regulatory structure, and ATSS can comply with both rule sets in an efficient manner that avoids duplicative or contradictory requirements. The SEC's limited resources would be taxed with increased SCI related reporting by ATSS, and should instead be focused on responding to and properly regulating market events at SROs. ATSS currently play the role of market innovators, but the increased burdens on ATSS and the higher degree of uncertainty would reduce that innovation. The SEC has not provided any examples of ATS systems issues¹¹ that were unable to be dealt with appropriately under the current FINRA regulatory structure.

If the SEC ultimately includes ATSS in Reg. SCI, the ATSS must be treated as equal to the exchanges and other SRO's. To bear the burdens of Reg. SCI, the SRO's rely on a sizable income stream from their contributions to the SIP, access to clearing, and, of course, SRO immunity from lawsuits. If ATSS are subject to the same regulatory burdens as exchanges, they should rightfully be able to access the same benefits. Without equality of benefits, the competitive landscape would be tilted far too greatly in favor of the exchanges. In the wake of the August 22, 2013 Nasdaq shutdown, the SEC announced its plans to hold a meeting with the head of the exchanges and SROs to discuss the SIP as well as other imperative market systems and infrastructure concerns.

¹⁰ See FINRA's targeted examination letters relating to (i) ATSS operated as dark pools, available at: <http://www.finra.org/Industry/Regulation/Guidance/TargetedExaminationLetters/P268091>; (ii) business continuity plans, available at: <http://www.finra.org/Industry/Regulation/Guidance/TargetedExaminationLetters/P197274> and FINRA Notice to Members 13-25, available at: <http://www.finra.org/Industry/Regulation/Notices/2013/P308420>; and (iii) high-frequency trading, available at: <http://www.finra.org/Industry/Regulation/Guidance/TargetedExaminationLetters/P298161>.

¹¹ The Reg. SCI Proposing Release, at 18089, includes the statement "While these are illustrative high-profile examples, they are not the only instances of disruptions and other systems problems experienced by SROs and ATS," however the corresponding footnote 67 only references problems at the London and Tokyo Stock exchanges as well as problems with hurricane Sandy.

No representatives from ATSS are included in this meeting, which further highlights the vastly different role and regulation of ATSS compared to exchanges and SROs.¹²

Reg. SCI proposes to extract Rule 301(b)(6) from Reg. ATS, amend it, and incorporate it into Reg. SCI. This would initially shift the balance of ATS regulation, making the SEC the primary regulator. From the adoption of Reg. ATS, the SEC intended for ATSS to be regulated differently than exchanges. Reg. SCI would impose the same sweeping regulatory regime on ATSS and exchanges, effectively ending the ability of a marketplace operator to select the ATS business structure in order to introduce innovative ideas into the financial markets. This represents a complete reversal from the SEC's reasoning when it adopted Reg. ATS, at which time the SEC "[made] clear its view that these systems should not be treated as exchanges under the Exchange Act or in any other context."¹³

Entrants seeking to operate securities markets face a substantial barrier to entry from becoming a national securities exchange, and often use the ATS process to implement new market structures. This is especially true in the trading of non-NMS securities. Reg. ATS exists because the SEC determined that it was beneficial to the markets to give trading systems a choice between registering as exchanges or as broker-dealer ATSS.¹⁴ The SEC stated that it "believes that allowing alternative trading systems to make a business decision about how to register with the Commission will continue to encourage the development of new and innovative trading facilities."¹⁵ FINRA has already made great strides towards regulating issues relating to ATSS, as evidenced by the round of inquiry letters FINRA sent to dark pool operators earlier this year.¹⁶

The proposed definition of SCI ATS incorporates ADDV thresholds based on the type of security traded on the ATS. An ATS that exceeds the thresholds would be classified as an SCI ATS and thus subject to the requirements of Reg. SCI. The SEC notes that no current ATS meets the 20% volume thresholds that trigger Rule 301(b)(6)(ii) compliance. Instead of adopting the arbitrary thresholds proposed under Reg. SCI,

¹² See U.S. SEC to meet exchange heads September 12 over Nasdaq outage, available at:

<http://www.reuters.com/article/2013/08/27/us-nasdaq-halt-sec-idUSBRE9700NC20130827>

¹³ Regulation of Exchanges and Alternative Trading Systems, Securities Exchange Act. Rel No. 40760 (December 8, 1998), 63 Fed. Reg. 70921 (December 22, 1998) (the "Reg. ATS Adopting Release") at 70857.

¹⁴ Id, at 70902.

¹⁵ Id, at 70856.

¹⁶ See FINRA's targeted examination letter relating to dark pools, *supra*, note 9.

OTC Markets Group proposes a logical approach that would result in a significant influx in the number of ATSS complying with the Reg. ATS systems requirements.

The ADV threshold in Rule 301(b)(6)(i) should be lowered to 2.5%, which would require a significant number of ATSS to comply with the systems capacity, integrity and security requirements already built into Rule 301(b)(6)(ii) within Reg. ATS. ATSS trading NMS securities manage their volume thresholds primarily to prevent being subjected to the order display and execution access requirements under Rule 301(b)(3). Many ATSS operate a dark pool model that is antithetical to the order display requirements. As a result, the volume threshold most ATSS seek to avoid is the 5% average daily share volume that triggers the 301(b)(3) requirements. Rule 301(b)(6)'s 20% ADV threshold is merely an afterthought. By lowering to 2.5% the ADV threshold for Reg. ATS's systems compliance requirements, while leaving in place the 5% average daily share volume threshold for the order display requirements, the SEC could bring the majority of ATSS into the systems compliance regime without disturbing their business models. As discussed in the Reg. SCI proposing release, the systems requirements for ATSS under Reg. ATS and Reg. SCI are substantially similar.¹⁷ The changes proposed in Reg. SCI, such as the inclusion of "manmade disasters" in the list of vulnerabilities can easily be implemented into the existing Reg. ATS. Moving Rule 301(b)(6) into Reg. SCI is clearly unnecessary and would be counterproductive.

III. REG. SCI SHOULD NOT APPLY TO ANY BROKER-DEALERS

We do not believe any broker-dealers should be regulated under Reg. SCI and the SEC ARP group. Broker-dealer operational regulation has been overseen almost entirely by FINRA. As part of their regulatory requirements, FINRA member broker-dealers are required to create and implement written supervisory procedures ("WSPs") covering the operation of their business. The WSP process allows the true experts in broker-dealer operation, the firms themselves, to devise procedures that keep them in-line with FINRA and SEC regulations. The process works, and allows FINRA to focus much of its regulatory attention on bigger picture issues impacting the broker-dealer industry. As noted above, FINRA has had recent opportunity to focus on issues relating to (i) ATSS operating as dark pools, (ii) business continuity plan and (iii) high-frequency trading.¹⁸

¹⁷ Reg. SCI Proposing Release at page 88.

¹⁸ See FINRA's targeted examination letters, supra, note 9.

IV. THE SEC SHOULD DEVELOP PROTOCOLS AND PROCEDURES PROMOTING ORDERLY MARKETS IN THE EVENT OF TECHNOLOGY FAILURES, TRADING ERRORS AND NATURAL DISASTERS

Proposed Reg. SCI, focuses on preventing systems malfunctions that would have a widespread impact on U.S. trading markets, but does little to improve how such widespread problems are handled. Reg. SCI should focus on improving the way market participants react to eventual systems problems, thereby creating a stronger backbone for our financial markets. In other contexts, the SEC has taken a realistic view and helped markets prepare for setbacks. For example, the SEC's "circuit breaker" and limit up-limit down mechanisms pause trading when prices move outside of a specified range. Our markets function more efficiently because the SEC understood that these trading issues will occur and planned to mitigate the attending risk and re-open markets in an orderly fashion. The same logic should be applied to technology issues.

When trading is disrupted, whether through a technology problem or otherwise, the SEC should immediately turn its attention to ensuring trading can be halted and restored quickly with as little disruption as possible to investors. At the outset of this letter we support the SEC's goal of ensuring that SRO and broker-dealer technology platforms operate in a robust and compliant manner with adequate capacity, testing and disaster recovery. That should not be the only goal, however. The SEC could easily focus its attention on (i) creating consistent processes for halting and re-starting trading in an orderly manner following a disruption, and (ii) standardizing trade break/cancellation procedures across market centers under the authority of FINRA. These measures would raise investor confidence by producing markets that deliver fair, predictable results in the wake of participant errors, technology issues, natural disasters and other problems potentially impacting trading.

V. REG. SCI SHOULD FOCUS ON THE SYSTEMS WITH THE GREATEST POTENTIAL IMPACT ON OVERALL MARKET RISK

Reg. SCI's definition of "SCI systems"¹⁹ overreaches, and should be tailored to focus only on systems impacting the core functions of the overall market: (i) the exclusive SIPs that transmit market data and (ii) the operation of the system responsible for

¹⁹ The Reg. SCI Proposing Release, at 18901, defines "SCI systems" as "those systems of, or operated by or on behalf of, an SCI entity that directly support trading, clearance and settlement, order routing, market data, regulation or surveillance."

primary NMS auction markets that set daily opening and closing prices. The definition of SCI systems imposes unnecessary burdens on noncore NMS functions.

There is no debate over the importance of market data transmission to the continuing operation of our financial markets. There should be a debate over the SEC creating these single points of failure by mandating exclusive SIPs in NMS securities and requiring that exchanges and broker-dealers use SIP data. Because of the SEC's outdated regulation of market data through a mandatory SIP, there is no competition in the marketplace based on quality, speed and cost of the consolidated data normalization function that the SIP provides. Broker-dealers must display the SIP data to their customers that are making trading decisions, and those trading decisions are in turn based on SIP data. Use of the SIP is outdated, however, and creates a regulatory problem. If any entity contributing to the SIP experiences an issue with its data, it poisons the entire feed. When the SIP was created, regulators could not handle data from multiple contributors, thus, the SIP was a technical necessity. Now, however, even the SEC's MIDAS system can consume and analyze multiple feeds directly from market centers. This should give the SEC, and all market participants, the ability to weed out any data issues related to a single contributor and continue to provide a healthy, consolidated data stream.

As of now, NMS market data distribution through the SIP represents the vast majority of the data that drives our markets. The scope and risk profile of NMS data distribution systems has made them a core marketplace function that is appropriately categorized as an "SCI system." However, it is time for the SEC to remove the SIP single point of failure it has created in NMS trading. This can be better accomplished by allowing competition with the SIP monopoly in NMS securities by eliminating Rule 603(c)(1) of Regulation NMS²⁰ and supporting a model of competing consolidators and market

²⁰ 17 CFR 242.603. The relevant language in the rule reads as follows:

(c) *Display of information.*

(1) No securities information processor, broker, or dealer shall provide, in a context in which a trading or order-routing decision can be implemented, a display of any information with respect to quotations for or transactions in an NMS stock without also providing, in an equivalent manner, a consolidated display for such stock.

Regulation NMS Rule 600(b), 17 CFR 242.600, includes the following definitions:

Consolidated display means: (i) The prices, sizes, and market identifications of the national best bid and national best offer for a security; and (ii) Consolidated last sale information for a security.

Consolidated last sale information means: the price, volume, and market identification of the most recent transaction report for a security that is disseminated pursuant to an effective national market system plan.

centers directly consuming other market data feeds. An NMS market center can declare “self-help” for trade responses and determine to ignore a particular market center, and the “self-help” concept should also apply to direct data feeds when problems arise. The SEC staff should consider issuing guidance and proposing rule changes so trading in NMS securities can take place by broker-dealers and exchanges using direct feeds for Reg. NMS compliance, best execution, quote display and when the SIP feed has failed.

Similarly, significant disruptions to the systems directly supporting the primary NMS auction markets, identified as those that set daily opening and closing prices, have been identified as issues for Reg. SCI to address. These NMS trading-related systems set the prices used for valuation, best execution, and investor expectation – each a core trading function.

The goal of regulation in this area should be the development of protocols and procedures for how to deal with technical errors when they occur. Technology failures that cause price setting mechanisms to not work effectively can be rather simple to deal with if proper protocols and procedures are developed, because the trades are taking place on one exchange. An appropriate default position for the SEC to institute in this situation would be to cancel all trades and have a new auction. For example, when BATS experienced a technical issue during the IPO of its own stock, BATS smartly chose to stop the opening auction with no trades executed and withdraw its IPO while it addressed the technology problems. BATS reached the right decision on its own, but the industry would benefit from the SEC publicly announcing recommended procedures for similar events. The affected entities would know how to move forward, and investors and counterparties would know what to expect and how best to respond to such an incident. At the very least, the general chaos experienced by the market in the wake of failed opening auctions where all trades were not cancelled would be avoided.

Intraday problems are more complex when the trades take place across multiple SROs, venues and instruments. When technology failures lead to significantly disorderly markets, the SEC must create better communication and coordination so that trades can be effectively cancelled across SROs, venues and instrument types. When multiple SRO's, venues and instruments are involved, centralizing trade break decisions with FINRA under consistent rules will lead to more orderly markets and a better investor experience. While events caused by significant human or technology errors should be rare, in those volatile situations the public will be better served, and have more confidence in our markets, if all trades are cancelled.

Outside of the systems that directly operate the core functions noted above, however, there are no systems with the kind of real-time interaction with the market that can cause immediate, irreversible damage. The current definition of “SCI systems” includes systems responsible for development and testing that have not been identified as leading to any of the issues that proposed Reg. SCI seeks to address. These are important functions to be sure, but not vital to the real-time operation of the markets. “SCI systems” would also include regulatory and surveillance systems. These systems are also important to the overall structure of the financial markets, but, like development and testing systems, do not impact real-time market activity.

ADDITIONAL PROPOSALS TO IMPROVE PROPOSED REG. SCI

(a) ENHANCE THE SAFE HARBOR PROVISIONS OF REG. SCI TO PROMOTE FULL AND COMPLETE COMPLIANCE FROM SCI ENTITIES

The safe harbor proposed in Reg. SCI Rule 1000(b)(2)(ii) is unclear in its scope and application, and open to uncertain interpretation. Without further insight into the concept of “reasonable policies and procedures,” and what constitutes adequate testing, monitoring, assessments and reviews for each system, SCI entities will not know whether they have complied with the safe harbor provision. The safe harbor is also unclear on what it means to appropriately follow the procedures an SCI entity develops. As currently written, it would be reasonable to interpret the safe harbor as excluding any SCI entity that suffers a significant systems event. That would leave SCI entities unsure of their potential exposure after an SCI event, and potentially more fearful of disclosing the type of post-event information that would be most useful to the SEC.

The safe harbor provision adds to concerns about which entities should ultimately be included under Reg. SCI. Specifically, entities that do not have SRO immunity, such as ATSS, may be subject to liability based on information reported under Reg. SCI’s Rule 1000(b)(4)(iv). Under that Rule, SCI entities must provide “an analysis of the parties that may have experienced a loss, whether monetary or otherwise, due to the SCI event . . . and an estimate of the aggregate amount of such loss.” Without a safe harbor and a guarantee of immunity, this kind of disclosure provides a roadmap for litigation against non-SRO SCI entities. This flaw in the wording of Reg. SCI represents yet another reason why ATS systems are better regulated under Reg. ATS instead of being lumped in with the exchanges under Reg. SCI. To the extent that any non-SROs are ultimately included in the definition of an SCI entity, and are not otherwise granted SRO-type

immunity, the Reg. SCI safe harbor should be modified to mitigate this type of liability concern.

OTC Markets Group endorses the Objective Safe Harbor Alternative proposed by the NYSE Euronext. A safe harbor with objective standards that exclude only those who fail to take appropriate corrective action, engage in a continuing pattern of Reg. SCI violations, or engage in intentional violations, provides the proper incentives for compliance. Such a standard would also allow SCI entities to reasonably evaluate their potential exposure when an SCI event occurs, which in turn will allow them to act swiftly and decisively in the critical moments following an SCI event.

(b) REVISE THE DEFINITION OF “SCI EVENT” TO INCLUDE ONLY MATERIAL SYSTEMS OUTAGES AND SIGNIFICANT SYSTEMS CHANGES

As a general matter, OTC Markets Group proposes to completely revise the current definition of SCI event in favor of an approach akin to that already outlined in Reg. ATS Rule 301(b)(6)(ii)(G), which requires a qualifying ATS to notify the SEC staff of material systems outages and significant systems changes. The term “SCI event” in Rule 1000(a) acts as a catch-all to describe any “systems disruption,” “systems compliance issue” or “systems intrusion.” Reg. SCI includes extensive definitions of each of these terms, each of which present numerous interpretive problems for the SCI entities seeking to understand their compliance responsibilities. OTC Markets Group recognizes that the SEC intended the definitions under SCI event to clarify the meaning of “material” and “significant” under ARP, however the result of the SCI event definition is to further confuse the issue and create an enormous, and confusing, reporting and compliance burden on SCI entities.

For example, the definition of “systems compliance issue” is “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 or governing documents, as applicable.” This requires an SCI entity to first determine whether an event has violated a law, rule, regulation or provision of the governing documents, then report the issue. The legal conclusion required goes well beyond the reporting of a systems issue – it requires an SCI entity to make a legal determination and then incriminate itself with the SEC by reporting an act of non-compliance. The real-time technical and legal analysis required to comply with this provision of Reg. SCI would be crippling to an SCI entity. With the insufficient safe harbor built in to Reg. SCI, an entity that does the tremendous work required to comply may then be subjecting itself to significant SEC sanctions as a result. This provision

takes the focus entirely away from creating effective systems and focuses on liability and legal compliance, which cloud the issues that Reg. SCI proposes to address.

As another example of the ill-considered nature of the definition of SCI event, the first of seven elements in the definition of “systems disruption” make the failure to maintain service level agreements into a reportable SCI event.

This would turn a contract negotiated between two firms into a regulatory standard. Any party to an SLA can become a *de-facto* regulator that can set the standard for a reportable SCI event. There are no constraints placed on the terms of an SLA, a breach of which would result in a reportable regulatory event. This will negatively impact the business of each SCI entity by significantly increasing the cost and time involved in negotiating an SLA, with each party worried about its potential regulatory liability stemming from the agreement. The cost involved in complying with just this one provision of Reg. SCI would far outstrip any fathomable related benefit. Second, the terms of an SLA can be a formality, with, for example, promises of uptime that are not related to practical reality. The variety of terms that may be included in an SLA would result in a deluge of useless notifications to the SEC, focusing on breaches of privately negotiated SLAs that often will have no bearing on the SEC’s regulatory concerns. If incorporated into Reg. SCI, SLA terms will become watered down to the point of being meaningless, as firms seek to limit their potential SCI exposure.

The SEC’s own technical standards as described in the request for proposal (RFP) for MIDAS, the SEC’s newest real-time market regulatory surveillance system, provides valuable insight into what the SEC deems to be valuable criteria for ensuring the effective operation of a system.²¹ The MIDAS RFP required that the hosted solution is available with “99% uptime”. 99% uptime would mean that out of approximately 250 trading days in a given year, the system could be completely unavailable for 2.5 days. One can only imagine the mountain of SCI notifications that would be required if an SCI entity operated a system at 99% uptime. The MIDAS RFP also requires that the technology have “sufficient capacity to meet all functional and performance requirements” that are specified in the RFP. As to security, the MIDAS RFP requires that non-SEC personnel be prevented access to the system by “appropriate firewalls and protocols” developed in conjunction with the SEC.

²¹ SEC Request for Proposal for Market Information Data Analytics System (MIDAS), available at: <https://www.fbo.gov/index?tab=documents&tabmode=form&subtab=core&tabid=79f60b45a79408f64d060d6178832687>

While 99% uptime would be a non-starter for most financial market SLAs, terms like “sufficient” capacity and “appropriate” firewalls, as used in an SLA, could theoretically serve as the basis for the definition of an SCI event. Instead of allowing these lower standards, however, it would be more reasonable to implement standards based on the “material systems outages” and “significant systems changes” standards already contemplated in Reg. ATS Rule 301(b)(6)(ii)(G). Under these thresholds, the SEC would receive notice of any systems changes likely to have a substantial impact on functionality, and would of course receive notice of any widespread outages with a material impact.

If the SEC does not limit Reg. SCI to the core NMS trading systems, we recommend that the same standards that applied to the systems of SCI Entities be applied to SEC-operated systems such as MIDAS and EDGAR with outside oversight and reporting on the SEC’s compliance.²² It would provide Congress and the public with confidence that SEC systems are of an equal standard to SRO regulatory systems.

(c) DELETE THE CONCEPT OF “RESPONSIBLE SCI PERSONNEL,” AND LIMIT THE SCOPE OF INDIVIDUALS RESPONSIBLE FOR TAKING ACTION IN THE WAKE OF AN SCI EVENT

Reg. SCI describes “responsible SCI personnel” as any employee or agent of an SCI entity that has responsibility for an SCI system or SCI security system. The vague notion of “responsibility” is further interpreted as being applicable to junior level employees as well as those with management-level positions. This broad definition could cover anyone, no matter how junior, working in a SCI entity’s technology or infrastructure department. Two main problems result from this definition. First, a junior employee considered a responsible SCI person may not have the organizational or technical understanding necessary to i) immediately recognize the severity of a systems problem and whether they have “become aware” of a reportable event and ii) go through the required steps to actually deliver notification to the SEC where required by Reg. SCI. Second, with this imposition of liability on nearly every member of an SCI entity’s technology staff, SCI entities may lose current employees who are uncomfortable with the potential risk and will likely have a much harder time finding qualified people to join their technology teams in the future. This will work directly counter to the goals of Reg. SCI. Instead of leading to more robust, reliable and

²² See Miles Weiss, *SEC Confronts Filing Backlog as Investors Await Berkshire Report*, Bloomberg, August 14, 2013, available at: <http://www.bloomberg.com/news/2013-08-15/sec-confronts-filing-backlog-as-investors-await-berkshire-report.html>

compliant systems, systems quality will degrade over time as less qualified people build and maintain these systems.

For these reasons, we recommend that the SEC delete the definition of “responsible SCI personnel” and move to a system where a firm’s senior management, and certain technology employees designated by the firm’s senior management, take responsibility for notifying the SEC in the case of a reportable event. It is reasonable to expect senior management to have the necessary judgment to determine the severity of an issue and the manner in which it needs to be reported in compliance with Reg. SCI. Limiting the responsibility to senior management will also help ensure that a firm’s responsible decision-makers are kept informed of reportable events in a timely manner, and eliminate the unnecessary liability imposed on junior members of the technology staff. While reporting to the SEC may be slightly delayed by the amount of time it takes a junior staff member to discuss an issue with a senior manager, the report itself will be made by senior personnel with the ability to deliver more complete and well thought out disclosure that will ultimately be more useful in mitigating any problems and preventing them in the future.

(d) REQUIRE SEC NOTIFICATION ONLY FOR SYSTEMS ISSUES THAT PROMPT NOTIFICATION TO AN SCI ENTITY’S SUBSCRIBERS OR PARTICIPANTS

SCI entities by their nature perform trading related services for a group of subscribers or participants. Competitive market forces provide ample motivation for keeping open lines of communication with subscribers when systems issues occur. When systems issues arise that impact subscriber access, functionality or security, each potential SCI entity informs their subscribers of the problem and the expected resolution, and generally follows with a post-mortem. 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. Competition among trading venues requires prompt notification to subscribers and participants. An entity that fails to give that type of notification will cease to exist before too long.

Based on this common practice, we recommend that the SEC notification requirements in Reg. SCI be aligned with SCI entities subscriber notifications. The baseline for notification should be a compilation of best practices currently used by potential SCI entities to determine when to send notifications to subscribers. Developing these best practices would set a reasonable regulatory standard and promote the dissemination of information material to market participants. As part of Reg. SCI, the SEC should receive copies of all subscriber notifications relating to specific systems issues, and

then may have the opportunity to ask for additional information from the SCI entity as necessary. SCI entities and ATSS should also be required to share with the SEC and FINRA any general subscriber communications and sales materials that describe changes in systems functionality, and ATSS specifically should also be required to provide the SEC and FINRA any subscriber communications regarding long-term or general systems issues. In practice, this policy would keep a clear line of demarcation between the regulators that should be kept apprised of systems issues for the purpose of industry-wide monitoring, and firm management that should be leading the specific efforts to fix those issues and prevent them from recurring.

(e) REG. SCI SHOULD FOCUS MORE ON RECORDKEEPING THAN REPORTING

Aligning the SEC notification requirement with subscriber notifications will sensibly limit the potential events triggering a notification obligation while still ensuring that the SEC is notified of any relevant systems issues. The SEC should have access to a greater set of information, but this is more sensibly accomplished through recordkeeping than continuous notification requirements. SCI Entities should be required to keep records of all systems changes and technical issues, and make that information available to the SEC upon request. A focus on recordkeeping would provide additional information to the SEC without imposing substantial cost on SCI entities, which is an efficient way to help rectify the cost/benefit imbalance that many commenters have noted plagues much of Reg. SCI.

Where notification to the SEC is required, it should be done through periodic, ideally quarterly, reporting of material systems changes. Under Reg. SCI as proposed, the SEC must receive at least 30 days prior notice of any planned material systems changes. The 30-day notice requirement places a substantial additional burden on SCI entities, and will delay, and sometimes prevent, systems changes necessary to the efficient operation of our trading markets. The SEC has not indicated that it will take any specific action other than “monitoring” during the 30 days post-notice, so it remains unclear what specific benefit would be derived from instituting this notice requirement.

A focus on recordkeeping and periodic reporting would allow the SEC staff to focus on relevant issues instead of being bogged down with meaningless notifications. Under Reg. SCI as proposed, 30 days prior notice to the SEC would be required for “material” systems changes, which include any change impacting 5% or more of a firm’s memory or throughput. While this standard may have been relevant for mainframes when ARP was written, changes to memory or throughput are very common changes in today’s world of virtualized servers and variable bandwidth of network connections. Reg. SCI

would also require notice for *any change* that could impact a firm's system downtime, which can reasonably be interpreted to mean any change to an SCI system, hardware, network or user configuration. The overly broad definitions of what constitutes "material" changes, both in Reg. SCI as written and in current SEC guidance, clearly capture many non-material changes as well. These types of changes and updates are frequent, routine, and necessary to maintain healthy systems that should not require a separate notification to the SEC in each instance. In addition to the enormous burden this would place on SCI entities, notifications of this type would either completely paralyze the limited resources of the SEC ARP staff or would wind up unread in a file in the SEC's offices. Neither result constitutes effective, efficient regulation.

Using the notification standards proposed in Reg. SCI, OTC Link ATS analyzed the number of reportable change events it would have had from October 2012 through July 2013. OTC Link ATS would have had a minimum of 430 reportable changes to our production systems. This does not include non-production environments such as staging, testing, development and subscriber certification environments, changes to which can also be reasonably interpreted to require SEC notification under Reg. SCI. Requiring the reporting of 430 systems changes over a 10 month period underscores the overreaching nature of Reg. SCI and the burdens it would place on SCI entities and on the SEC.

Reporting of systems outages under Reg. SCI will also present significant issues. Under Reg. SCI Rule 1000(b)(4)(iv), SCI entities must provide "an analysis of the parties that may have experienced a loss, whether monetary or otherwise, due to the SCI event . . . and an estimate of the aggregate amount of such loss." Under the definition of "systems disruption" in Reg. SCI, firms will be required to report the most minor outages, without regard for materiality. As proposed, the definition of systems disruption would even encompass regular, planned outages outside of trading hours. As noted above, this overbroad rule combined with the lack of an adequate safe harbor and a guarantee of immunity will provide a roadmap for litigation against non-SRO SCI entities.

Periodic reporting would allow the SEC to monitor material systems changes without the detrimental impact on SCI entities and the SEC. An annual systems change report, followed by quarterly updates of anything that has changed since the annual update, would give the SEC access to the same information and allow entities to deliver it in a more organized, structured form. The periodic reports would also substitute for the Reg. SCI Rule 1000(b)(6)(ii) notice requirement for material inaccuracies in prior

notifications. Quarterly updates would disclose any material deviations from plans previously reported, whether stemming from inaccuracies in prior reports or new information that prompts beneficial deviations from a systems implementation plan.

The SEC may also want to consider (i) using periodic reporting in place of the Reg. ATS Rule 301(b)(6)(G) requirement that applicable ATSS promptly notify the SEC of material systems changes and (ii) clearly defining material changes as significant platform, software or functionality changes, rather than day to day operational events. While the “promptly notify” standard may be less burdensome than the 30 day notification standard in Reg. SCI, periodic reporting in this context will still result in more organized, analytical reporting.

(f) REG. SCI SHOULD BE PHASED IN OVER A PERIOD OF TWO YEARS FOR SYSTEMS CURRENTLY COVERED BY ARP, AND FOUR YEARS FOR ALL OTHER APPLICABLE SYSTEMS

This letter, in addition to the more than 50 other Reg. SCI comment letters already filed, highlights the need for the SEC to review Reg. SCI with a focus on clarity, specificity, and thoughtful consideration of the potential impact of this type of sweeping regulation. The SEC’s goal of creating a “regulatory framework for ensuring that the securities trading markets develop and maintain systems with adequate capacity, integrity, resiliency, availability and security”²³ cannot be met without substantial investments of time, energy, and financial and personnel resources. Any firm ultimately included within the definition of an SCI entity should be afforded sufficient time to develop appropriate compliance and notification procedures.

For Reg. SCI to be implemented in an impactful manner for entities currently operating under ARP, they must have the opportunity to design, vet, and implement appropriate enhancements to their systems, and to train current personnel or identify qualified outside personnel to ensure continued compliance. These firms have been built and grown with at least an eye towards the type of obligations Reg. SCI will impose, yet full compliance with Reg. SCI as proposed would still require at least a two-year phase in period. Non-ARP entities must develop adequate procedures to ensure initial and ongoing compliance. The immense complexity of the burdens included in Reg. SCI may require some firms to completely alter their business models to remain viable in the

²³ Reg. SCI Proposing Release at 18091.

face of the myriad of new requirements. This type of complete re-architecture and reorganization would necessitate a phase-in period of at least four years.

CONCLUSION

OTC Markets Group supports the overall goals of gaining greater understanding of the systems that drive trading, and promoting the capacity, integrity, resiliency, availability and security of those systems. While these are goals worth striving for, no financial markets in the world have discovered how to be free of technology created downtime and trading errors. The SEC should focus on having trading procedures and processes that allow our markets to fail gracefully, restart quickly and rollback easily when such events happen. Reg. SCI, however, is focused on trying to prevent technology failures through a heavy handed regulatory reporting that would impose substantial costs on market participants and the SEC without concomitant benefits. Despite the breadth of provisions included in Reg. SCI, the regulation still offers no solutions for the recent market events that spurred its creation. The recommendations in this letter are intended to form the basis for a complete re-evaluation of Reg. SCI, its potential participants, and its impact on our financial markets. We do not need regulations that only hinder the dynamic, technology driven innovations that have made the U.S. financial markets the largest and most liquid in the world.

We appreciate the opportunity to comment on this proposal. Please contact me at (212) 896-4413 or dan@otcmarkets.com with any questions.

Very truly yours,



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